Annual Report 2007

BANK OF ENGLAND

BANK OF ENGLAND

The Bank's core purposes are determined by Court as part of its role in setting the Bank's objectives and strategy. The statement opposite was reaffirmed by Court in May 2007.

Contents

The Bank's Financial Statements

The Bank's core purposes

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

It has been another significant year for the Bank on a number of fronts, both externally and internally: externally in terms of responding to the ever-changing economic environment and the rise in inflation, changes in the membership of the MPC, the implementation of Money Market Reforms to improve the way interest rate decisions are implemented, the launch of the new £20 banknote and a refocused *Financial Stability Report*; internally in terms of our ongoing journey to improve the management and efficiency of the Bank in delivering our core purposes and strategic priorities. The Bank's non-executive Directors continue to contribute to that effort in an effective way, utilising their differing perspectives and considerable range of expertise to shape the Bank's priorities and the way it is managed and goes about its work.

We continue to work to ensure that Court operates and is governed in line with the standards of a modern plc board. The changes to the governance of the Bank introduced in 2003 were fundamental and have changed the relationship between the executive and non-executive management of the Bank for the better. The role of non-executive Directors is now fully embedded and engaged in the management of the Bank — debating strategy and crystallising objectives, and monitoring the implementation and delivery of our priorities. Over the past year we have discussed how we can engage further with the Bank's financial stability work so that we are able to oversee the objectives and effectiveness of the Bank's work and the resources devoted to it. There has again been useful contact with HM Treasury over the past year, maintaining a link between the board and the shareholder. Views have been exchanged on a number of issues, including the MPC appointments process, and there has again been involvement in the appointment of new non-executive Directors.

So what have been the main highlights of the year from my perspective? The Bank has made further progress with the implementation of its strategy, notably Money Market Reforms and a refocused approach to financial stability work. Next year, as we enter the latter part of the period covered by the original strategy set out in 2003/04, we will be looking to make substantial progress with the plan to exit from retail customer banking and the efforts to

(1) The Committee of Non-executive Directors.

increase experience levels of staff across the Bank through our HR strategy. In terms of the management of the Bank, there has been significant progress in developing an integrated business planning framework. This is proving very fruitful. The Bank's strategy and objectives, financial and resource planning, project and risk management are increasingly joined together through a clear management and reporting framework, which is regularly reviewed by NedCo. Furthermore, good progress has been made this year to develop a system of management performance measures and indicators linked to the core purposes and strategic priorities. This is work in progress but should further strengthen the management of the Bank as it is developed further.

Cost management has inevitably remained an important part of NedCo discussions over the past year. The Bank, through Court, has set financial objectives to manage its costs and ensure resources support the strategic priorities. This year discussions have commenced with HM Treasury on the Bank's financial arrangements for the forthcoming five years. It is important that the Bank demonstrates effective management of its finances and costs across its functions. I believe the Bank has achieved this in an impressive way with total costs being held level for a number of years. The appointment of an Executive Finance Director in 2006 has been justified and sustains this improved approach to budgetary and financial control management. We have also considered the rising cost of pensions and options for change that we think will both contain the increase in costs and best equip the Bank in the recruitment market. I look forward to those options being taken forward in consultation with the Bank's staff this year.

The year also saw the Bank recover a very significant proportion of its costs relating to the BCCI litigation. This further justifies the Bank stance in response to the allegations of dishonesty, and I hope wider lessons will be drawn from the nature and outcome of this case.

Throughout the year the Audit, Risk Policy and Remuneration Committees have undertaken important work, which has been reported and discussed regularly at NedCo meetings. We have decided to merge later in 2007 the Audit and Risk Policy Committees now that the work envisaged for a separate Risk Policy Committee is largely completed. I am grateful to the Chair of each of these Committees for their work and leadership.

It has been a significant year for the MPC in terms of their decisions and the changing economic environment but also due to unexpected changes in the membership. We were all shocked by the untimely death of David Walton. This followed the unplanned early departure to the CBI of Richard Lambert. Non-executive Directors have a specific role in relation to the oversight of procedures that support the work of the MPC. Those processes continue to work well and are improved through continual review and refinement. My meetings with each member of the MPC to discuss processes continue to be productive and allow emerging themes and issues to be identified. Aside from the MPC's internal processes, there has been a good deal of external commentary about the MPC appointments process. This is only a matter for NedCo insofar as appointments impact on the effectiveness of MPC procedures. That has not been the case to date though clearly gaps in the MPC's membership are undesirable in terms of the wider reputation of the monetary policy process. Although the circumstances of 2006 could not have been foreseen, the process for identifying potential candidates for the MPC could be strengthened and we have made some practical suggestions to HM Treasury to assist the Chancellor in these significant appointments.

My thanks and appreciation go to Mary Francis and Sir Graham Hall for their service as Directors of the Bank over the past six years. I look forward to welcoming their successors. The Directors, along with all the staff of the Bank, remain focused on ensuring that the Bank carries out its role in a highly professional way in delivering its core purposes. I remain as impressed as ever by the dedication and professionalism of the leadership of the Bank and the commitment of the staff in delivering our priorities.

May 2007

Foreword by the Governor

Mervyn King Governor

In May the Bank celebrated ten years of independence. I hope there are few who would begrudge me one sentence to reflect on that decade before moving on to current challenges. The Monetary Policy Committee has helped to bring greater stability to the economy of this country and that achievement is a reflection on the careful institutional design of our new monetary policy regime.

During 2006 inflation rose, reflecting in part the impact of higher gas and electricity prices, and by the turn of the year was around 3%. In March 2007, the target measure of CPI inflation reached 3.1%. If the published rate varies by more than 1 percentage point from the 2% target, I am required under the Chancellor's remit to write an open letter explaining the reasons for the deviation and what action the MPC is taking to address it. So in April I wrote the first open letter since the MPC was set up. Since then inflation has fallen back to below 3%. A full discussion of past and prospective movements in inflation can be found in the May *Inflation Report*. But there should be no doubt that the Committee is determined to bring inflation back to the 2% target and is willing to take the action necessary to deliver that target in the medium term.

During the year the Bank has continued to make good progress towards implementing the strategy adopted in 2003. The first stage of the Money Market Reform programme was launched in May 2006 and has been successful both in reducing overnight interest rate volatility and in providing a safer and more efficient framework for the management of banking system liquidity. A second stage, involving longer-term financing of the banking system through bond purchases, is currently being implemented. A series of back-office projects are in train to improve the efficiency and controls around liquidity provision.

Another major event was the launch of the Adam Smith £20 note, the first in a new series of notes with additional security features. The number of counterfeit notes discovered declined in 2006, and continues to account for only a tiny fraction of notes taken out of circulation, but any risk to the integrity of the currency has to be taken extremely seriously, and the £20 note accounts for the largest share of the circulation and has been the most counterfeited.

Our Financial Stability activities were reorganised in 2005/06 to focus them more closely on the activities for which the Bank is accountable, and this greater focus is reflected in the much shorter *Financial Stability Report*, published in its new format for the first time in July. As that *Report* noted, much progress has been made by the Bank as well as the Tripartite Standing Committee and City firms in testing the financial system's resilience against shocks from all sources, and in developing plans for crisis management.

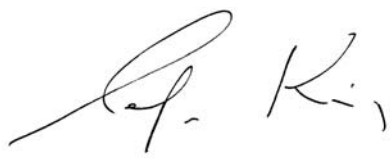
On domestic Bank issues we have made good progress in cutting our overhead costs, especially in central services, and on reinforcing the resilience of our central IT systems. Over the past four years the budget has been flat in money terms. In the field of HR, we have seen the launch of a new diversity strategy, with the strong support of Court, and of initiatives to improve career development and succession planning. I have been disappointed however at the length of time it has taken us to complete our review of pension provision in the Bank. A significant part of the delay has been attributable to complex legal issues arising from the new age discrimination regulations relating to pensions, issued at the end of 2006.

For all of us in the Bank, a great sadness was the sudden death in June 2006 of David Walton, who had served on the MPC for just under a year. He was a distinguished City economist and during his short tenure on the MPC he had gained the respect and affection of all who worked with him.

As a consequence of David's death, Steve Nickell's retirement and Richard Lambert's unexpected departure to become Director-General of the CBI, three of the four external members of the Committee were replaced last year: David Blanchflower joined in June, and Tim Besley and Andrew Sentance towards the end of the year. Kate Barker's reappointment to a third term, starting this June, provides some welcome continuity. All the external members have contributed hugely to the MPC's deliberations and activities in what has proved to be a challenging year.

In this connection and in many others I have been immensely grateful for the expertise and wise counsel of our non-executive directors, especially the chairman Sir John Parker. Their Report appears later in this document and gives some indication of the range and depth of their involvement in the Bank. Sir Graham Hall and Mary Francis left the Court at the end of May. Both made substantial contributions to the Bank, Nedco and its Committees. I look forward to welcoming their replacements although as I write, those announcements have not yet been made.

My thanks are due also to the Deputy Governors — Sir John Gieve and Rachel Lomax — and to the Executive Directors and all the staff whose experience, expertise and commitment continue to make a reality of our vision for the Bank, which is to strive to be the best in all that we do.



Governor of the Bank of England
May 2007

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 8–9.

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. Court's responsibilities include determining the Bank's objectives and strategy, and ensuring 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 38–44.

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 15. 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 2006/07 were Dr David Potter (Chairman), Sir Graham Hall, Peter Jay, Geoffrey Wilkinson, Arun Sarin, Sir William Morris (until May 2006) and David Rhind (from July 2006). The Chairman of NedCo attends meetings of the Remuneration Committee. The Committee's Report on Remuneration is on pages 29–32.

Audit Committee

The members of Audit Committee during 2006/07 were Amelia Fawcett (Chairman), Mary Francis, Sir Andrew Likierman, Paul Myners, Sir Brian Moffatt (until May 2006) and James Strachan (from July 2006). The Deputy Governors, the Executive Director for Central Services, the Finance Director, 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 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 2006/07 were Sir Andrew Likierman (Chairman), Amelia Fawcett, Dr David Potter, Paul Myners, Sir John Parker and Robert Wigley (from July 2006). A Deputy Governor, the Finance Director, 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 10.

The Court of Directors

Mervyn King Governor

Sir John Gieve Deputy Governor

Rachel Lomax Deputy Governor

Sir John Parker

Mary Francis, CBE LVO

Sir Graham Hall

Brendan Barber

Heather Rabbatts, CBE

Sir Callum McCarthy

Amelia Fawcett, CBE

Sir Andrew Likierman

Peter Jay

Dr David Potter, CBE

Geoffrey Wilkinson

Paul Myners

Arun Sarin

Professor David Rhind

James Strachan

Robert Wigley

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

- Chairman, National Grid plc
- Deputy Chairman, Port & Free World Zone, Dubai
- Non-executive Director, Carnival Corporation Inc. and Carnival plc
- Fellow, Royal Academy of Engineering
- Chancellor, University of Southampton

Heather Rabbatts, CBE
Appointed 1 June 2003.

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

Peter Jay
Appointed 1 June 2003.

- Executive Professor of Political Economy, Henley Management College
- Chairman, Oxford Literary and Debating Union Trust

Arun Sarin
Appointed 1 June 2005.

- Chief Executive, Vodafone Group plc
- Director, Vodafone Group plc

Mary Francis, CBE LVO
Appointed 1 June 2001.

- Senior Independent Director, Centrica plc
- Non-executive Director, Alliance & Leicester plc
- Non-executive Director, St Modwen plc
- Non-executive Director, Aviva plc
- Trustee, Almeida Theatre

Sir Callum McCarthy
Appointed 20 September 2003.

- Chairman, The Financial Services Authority
- Member, University of Greenwich Court
- Trustee, Said Business School Foundation

Dr David Potter, CBE
Appointed 1 June 2003.

- Chairman and Founder, Psion plc
- Governor, London Business School
- Member, Higher Education Policy Institute, Advisory Board

Professor David Rhind
Appointed 1 June 2006.

- Vice-Chancellor and President, The City University
- Chairman, The Statistics Commission
- Chairman, Universities UK Employability, Business and Industry Policy Group

Sir Graham Hall
Appointed 1 June 2001.

- Chairman, Leeds Bradford International Airport

Amelia Fawcett, CBE
Appointed 1 June 2004.

- Chairman, GP Capital
- Non-executive Director, State Street Corporation
- Chairman, London International Festival of Theatre
- Deputy Chairman of the Board, National Portrait Gallery
- Director, Business in the Community

Geoffrey Wilkinson
Appointed 1 March 2005.

- Non-executive Director/Member, South West Strategic Health Authority
- Member, England Committee of the BIG Lottery Fund

James Strachan
Appointed 1 June 2006.

- Non-executive Director, Legal and General Group plc
- Non-executive Director, Care UK plc
- Non-executive Director, Welsh Water
- Chairman, RNID
- Trustee, Somerset House Trust
- Visiting Fellow, London School of Economics

Brendan Barber
Appointed 1 June 2003.

- General Secretary, Trades Union Congress
- Member, Executive Committee of International Trade Union Confederation
- Member, Executive Committee of European Trade Union Confederation
- Member, Council of Institute of Employment Studies

Sir Andrew Likierman
Appointed 1 June 2004.

- Professor, London Business School
- Non-executive Chairman, Applied Intellectual Capital plc
- Non-executive Director, The Tavistock and Portman NHS Trust
- Non-executive Director, Barclays Bank plc

Paul Myners
Appointed 1 June 2005.

- Chairman, Guardian Media Group
- Chairman, Land Securities Group plc
- Chairman of Trustees, Tate
- Chairman, Low Pay Commission

Robert Wigley
Appointed 1 June 2006.

- Chairman, EMEA, Merrill Lynch International
- Non-executive Director, Euroclear
- Deputy Chairman, Business in the Community
- Director, LCH.Clearnet Group Ltd
- Member, The Panel on Takeovers and Mergers

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

John Footman Executive Director Central Services

Nigel Jenkinson Executive Director Financial Stability

Warwick Jones Finance Director

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 form the Executive Team, the Bank's senior management group. The Executive Team meets weekly, and other senior officials (for example the 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 12–13.

Management structure

- **Mervyn King**
  Governor
  - **Rachel Lomax**
    Deputy Governor
    Monetary Policy
    - **Charlie Bean**
      Executive Director
      Monetary Analysis and Statistics
      - Monetary Analysis
      - Monetary and Financial Statistics
      - Centre for Central Banking Studies
    - **Paul Tucker**
      Executive Director
      Markets
      - Markets
  - **Peter Rodgers**
    Director of Communications
  - **John Footman**
    Executive Director
    Central Services
    - HR
      Louise Redmond
      Human Resources Director
    - IT
    - Property
    - Business Continuity
    - Security
  - **Warwick Jones**
    Finance Director
    - Finance
    - Risk Oversight
    - Projects
  - **Stephen Brown**
    Internal Audit
  - **Sir John Gieve**
    Deputy Governor
    Financial Stability
    - **Andrew Bailey**
      Executive Director
      Banking Services
      - Banking Services
    - **Nigel Jenkinson**
      Executive Director
      Financial Stability
      - Financial Stability

Advisers to the Governor:
Dame Juliet Wheldon (Legal)
Mario Blejer (Centre for Central Banking Studies)

Secretary of the Bank: Andrew Wardlow

Organisation overview

Monetary Analysis and Statistics

Charlie Bean
Alex Bowen – Senior Policy Adviser
Martin Brooke – Conjunctural Assessment & Projections
Mark Cornelius – International Economic Analysis
Neal Hatch – Structural Economic Analysis
Andrew Hauser – Inflation Report & Bulletin
Jo Paisley – Monetary & Financial Statistics
James Proudman – Monetary Assessment & Strategy
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 set 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
Sarah Breedon – Risk Management
Roger Clews – Special Adviser
Michael Cross – Sterling Markets
Paul Fisher – Foreign Exchange

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 and business continuity 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, including via practitioner committees.

The Risk Management Division is responsible for identifying, measuring and, with the front office divisions, managing risks from financial operations. Market Intelligence is co-ordinated by a Head and a dedicated team. Area-wide management is supported by a Chief Operating Officer and Unit.

Central Services

John Footman
Louise Redmond – HR Director
Stephen Collins – Business Continuity
Kevin Evans – HR Services
John Heath – Legal
Peter Higgs – Property Services & Security
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 IT, property, personnel, the Governors' private offices, press and public relations, 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.

Finance

Warwick Jones
David Collins – Finance
Michael Craig – Investment Unit

Finance is responsible for budgeting, financial accounting and monitoring the performance of the Bank in its attainment of its strategic priorities. In addition it provides project support, risk oversight and is responsible for the support of the Pension Fund trustees.

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 Resilience
Peter Brierley – Special Adviser
Phil Evans – International Finance
Andy Haldane – Systemic Risk Assessment

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 risks 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 Report*.

Review of 2006/07

The strategic priorities endorsed by Court for 2006/07 and published in last year's *Annual Report* were:

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

Strategic priority 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.

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

Strategic priority 4 The Bank should improve the design and production of banknotes in order to safeguard public confidence in the note issue.

Strategic priority 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.

Strategic priority 6 The Bank should be fully prepared in its management of financial crises and its business continuity planning.

Strategic priority 7 The Bank should promote safe and efficient payments and settlements system and be at the forefront of best practice in operational and policy areas.

Strategic priority 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 priorities for 2007/08 are shown on page 23.

The Governor has set out his vision for the Bank to 2008. The Bank should be focused on promoting monetary and financial stability in the United Kingdom. It should play an active role in the international monetary and financial community. But it should not take on additional responsibilities which are outside the remit of the 1998 Act and *Memorandum of Understanding*. Its work should be seen as a hallmark of excellence.

That vision for the Bank was turned into a strategy containing specific reforms to all the main line areas of the Bank. This section presents progress in 2006/07 in implementing that strategy, summarised around the eight strategic priorities.

Monetary policy

The Bank's first objective is to meet the inflation target set by the Government. The target was confirmed by the Chancellor in March 2006 as unchanged at 2% as measured by the twelve-month increase in the consumer prices index (CPI). CPI inflation rose over the course of 2006, from 1.8% in March to 3.0% in December, easing a little in January and February. In March 2007, after the period covered by this *Report*, CPI inflation rose further to 3.1%, triggering an open letter of explanation from the Governor to the Chancellor.

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 is estimated to have risen steadily in 2006, by 2.8%, close to the economy's recent historical average growth rate. The Labour Force Survey measure of the unemployment rate edged up through 2006, reaching 5.5% 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 and it conducts an annual survey of MPC members' general satisfaction with the various inputs to the policy process. The latest survey suggests that the MPC remains broadly happy with the

Members of the Monetary Policy Committee

Mervyn King Governor

Sir John Gieve Deputy Governor

Rachel Lomax Deputy Governor

Kate Barker

Charlie Bean

Tim Besley

David Blanchflower

Andrew Sentance

Paul Tucker

conjunctural and forecast material that it receives. The general level of satisfaction is similar to that found in previous years' surveys.

The Bank continues to improve support for the MPC. Plans to implement a quarterly Credit Conditions Survey of household and corporate lending were published in December. And the Bank's data uncertainty project, involving the development of a framework for coping with the uncertainty surrounding early releases of official economic data by combining it with surveys of business conditions and other economic indicators, is on track. A range of initiatives are in place to streamline processes, to allow the Monetary Analysis and Statistics area to run with smaller staff numbers overall. For example, the past year has seen the introduction of a new, simpler model for the international economy, and reviews of the Bank's collection of statistical data have identified savings for the Bank and its reporters. These changes are estimated to reduce the reporting burden for banks by around a third in the long run, with minimal adverse impact on the quality of the data. A cost-benefit analysis handbook, setting out how the needs of data users and the burden placed on suppliers can be balanced, was published in November 2006.

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

- The impact of energy prices on CPI inflation. Past rises in oil and wholesale gas prices directly raised the price of petrol and utility bills. Higher energy prices also raised businesses' costs and that will have fed through gradually to the price of other goods and services. Some unwinding of these price effects can be expected during the course of 2007, given that gas and oil prices have fallen back from earlier peaks. But it is always difficult to know how much of any change in inflation should be attributed to a change in the price of a particular good or service, because other prices may move to offset (or amplify) the effect on the overall price level. It is also possible that some of the pickup in inflation in 2006 reflected firm growth in output and the limited margin of spare capacity.

Review of 2006/07 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

Paul Fullerton
Yorkshire and the Humber

Wendy Hyde
London

Adrian Piper
Wales

Tony Strachan
Scotland

John Whitley
Central Southern England

John Young
North West

- The behaviour of inflation expectations. Inflation expectations affect the outlook for inflation in several ways. They influence: the nominal wage demands of employees, who care about their real purchasing power; the pricing decisions of businesses, which may seek higher price rises if they expect higher inflation in their costs and in competitors' prices; and the rate of return for borrowers and lenders. Survey measures of households' short-term expectations, and market-based breakeven inflation rates, have risen a little, perhaps reflecting the pickup in actual inflation over the past year. Measures of inflation expectations are still anchored to the target in the long run.
- The implications of the rise in unemployment. The rate of unemployment rose during much of 2006, while regular pay growth remained subdued. In part, these developments reflected a pickup in the supply of labour, driven by higher participation rates of older people and those previously classified as long-term sick, and by continued strong inward migration from Eastern Europe and elsewhere. Subdued labour demand also probably played a role, as employers first made more intensive use of existing staff retained during the mild slowdown in 2004–05. Both factors are likely to imply some downward pressure on wage growth. But employers may have chosen to scale back their hiring plans, to the extent that employees have successfully resisted the reduction in real take-home pay caused by the increase in energy and import prices since 2004. That would imply less downward pressure on wage growth.
- Asset prices and inflation. Over the past few years, the prices of a wide range of assets have risen substantially at home and abroad. That reflects a combination of optimism about future prospects, historically low long-term interest rates and a compression in risk premia, perhaps associated with rapid growth in global money and credit. The implications for CPI inflation of higher asset prices will depend on the reasons for the rise and the extent to which those factors persist.

Public understanding and education

The Bank promotes the case for low inflation and understanding of the current monetary policy framework through its publications, speeches, website and education programme. The *Inflation Report* and MPC minutes are the Bank's major regular publications on the operation of the policy framework. The *Quarterly Bulletin* carries articles outlining the Bank's analysis of a range of issues that are relevant to monetary policy, as well as articles describing developments in the markets and analysis relevant to other aspects of the Bank's work. The Bank's network of Agencies, located throughout the United Kingdom, also plays an important role in explaining monetary policy objectives and decisions to businesses and other organisations, in addition to gathering intelligence about business conditions for the MPC.

But a survey of members conducted by the Society of Business Economists in association with the Bank suggested there is room for improvement in the way the MPC communicates. There is an appetite for more information about the way policy actions are linked to economic data and for more forward-looking analysis of risks to the outlook. This would mean commenting more on what lies behind the *Inflation Report* fan chart and on how the MPC might change its thinking in response to developments in the data. The MPC is giving very serious consideration to these issues.

The MPC has continued to undertake a large number of public appearances to explain and build public understanding of monetary policy. Formal published speeches by MPC members are supplemented by a large number of talks and discussions with different audiences as part of the programme of visits to all parts of the United Kingdom, facilitated by the Bank's Agencies. During the past year, a total of 43 such visits were undertaken outside Greater London. The slight fall compared with the previous year largely reflected the number of new MPC appointments during the year. Alongside company visits and meetings with business groups, members of the MPC regularly undertake interviews with local and regional media. The programme is designed to build understanding of the case for low inflation, the objectives of monetary policy and the role of regional and sectoral information in MPC decisions. Year by year, it amounts to a considerable amount of contact with businesses, organisations and the wider public.

The Governor and other MPC members attended regular hearings with the Treasury Committee of the House of Commons, as well as other Parliamentary Committees. The MPC has participated in the Treasury Committee's inquiry into *The Monetary Policy Committee of the Bank of England: ten years on*. In February 2007, the Bank submitted a written paper to the Treasury Committee setting out developments in economic performance over recent years, the role of the United Kingdom's institutional framework and other factors that have affected policy making.

Opinion polls continue to be undertaken to inform the Bank about public opinion and understanding. In the February 2007 poll, carried out by NOP, 50% said they were 'very satisfied' or 'fairly satisfied' with the way the Bank is doing its job to set interest rates to control inflation. 13% were 'dissatisfied'. The net satisfaction rating of 37% compared with 49% in February 2006. Survey results are published quarterly and in the *Quarterly Bulletin* each year.

The Bank's education programme continues to contribute to building wider public understanding of its role and the importance of low inflation. Over the past year, there has been increased take-up of the Bank's general school resources: *Pounds & Pence* — a resource for 9–11 year olds on money and prices — and *Made of Money* — a resource for 14–16 year olds on the workings of the economy. In total, over 6,000 primary and secondary schools have received the Bank's educational packs and videos. The Bank's annual economics competition for schools and colleges, Target Two Point Zero, continues to be popular. Teams are tasked to take on the role of the MPC and set an interest rate to achieve the inflation target. The competition attracted 265 entries in 2006, its seventh year. The winning team was from Leeds Grammar School.

The Bank's museum attracted around 67,000 visitors in 2006/07 (2005/06: 55,000). Visitor numbers were affected by the museum's closure for redecoration from December 2005 to May 2006. The re-opening included new displays on inflation and the economy.

The Bank's website continues to be developed to increase public understanding. The education section of the website now includes a number of videos and resources designed for a non-specialist audience. The Bank also responds to enquiries and comments from the public on all

Review of 2006/07 continued

aspects of its work through a dedicated public information and enquiries team.

Money Market Reform

The first stage of the Money Market Reform (MMR) programme was launched successfully in May 2006. The Bank had four specific objectives:

- Overnight market interest rates to be in line with the Bank's official rate, so that there is a flat money market yield curve, consistent with the official policy rate, out to the next MPC decision date, with very limited day-to-day or intraday volatility in market interest rates at maturities out to that horizon.
- An efficient, safe and flexible framework for banking system liquidity management — both in competitive money markets and, where appropriate, using central bank money — in routine and stressed, or otherwise extraordinary, conditions.
- A simple, straightforward and transparent operational framework.
- Competitive and fair sterling money markets.

The new framework is based on combining a so-called reserves-averaging system with a narrow corridor for the overnight rate on the final day of a monthly maintenance period. Each month, reserves-scheme banks elect to maintain a target balance on average over a maintenance period running from one MPC meeting to the next. Those reserves 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 moved from daily to weekly, with a routine overnight fine-tuning operation on the final day of the maintenance period. Longer-term financing is provided at market rates via monthly long-term repo operations.

The programme was delivered on time and within budget. It has been successful in delivering its objective of reducing the volatility of overnight market interest rates. Over 60 banks and building societies are participating in the different elements of the new framework, a substantial increase on the previous framework, helping to make the system fairer and promoting stability. The Bank is grateful for the co-operation of the firms and individuals that enabled the new framework to launch successfully.

Preparation for the second stage of the Money Market Reform programme (MMR2) began in June 2006 and will continue into 2007/08 (see page 24). The Bank has issued a Market Notice setting out the framework for bond purchases that it is minded to adopt, and has consulted counterparties and other interested market participants about implementation issues.

A primary vehicle for consultation about the reforms has been the Money Market Liaison Group (MMLG), which brings together market intermediaries, market users, infrastructure providers and the authorities. During 2006/07, the MMLG established an Operations Sub-Group.

Banking operations

During 2006, the Bank continued to implement 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. The main focus of activity is currently on the migration of retail banking activities for major government users, notably HM Revenue and Customs (HMRC). Although there have been delays to the early stages of the HMRC Government Banking Programme, HMRC began in March 2007 the formal process for selecting new suppliers. The timetable continues to meet the Bank's target of achieving the migration to new suppliers by the end of 2009.

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 £135 billion (2005/06: £118 billion), of which £43 billion is accounted for by holdings of gold (2005/06: £36 billion).

Banknotes

The Bank is responsible for providing banknotes that the public can use with confidence. By value, the average in circulation during last year was £37.4 billion. Last year the Bank issued 770 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 over 60%.

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. The Bank incurred no loss in respect of these notes. In response to the robbery, John Gieve 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. The recommendations from that review have been implemented and, as a consequence, security has been improved in a number of areas.

A new £20 banknote was announced in October 2006 and introduced into circulation from 13 March 2007. The new note includes enhanced security features, and Adam Smith appears as the historical character on the reverse of the note. The change-over of £20 notes is expected to last for up to three years.

During calendar year 2006, some 384,000 counterfeit Bank of England notes were taken out of circulation. This represented 0.018% of the average stock of notes in circulation, and was 24% lower than the figure for 2005. More details on counterfeit statistics can be found on the Bank's website.(1)

Based on technical analysis of all counterfeits taken out of circulation, the Bank believes that serious organised criminals continue to be involved in banknote counterfeiting. The Bank works closely with law enforcement agencies to detect and stop counterfeiting.

Financial stability

The Bank's work on financial stability is overseen by the Financial Stability Board,(2) which is responsible both for assessing the key risks to the stability of the United Kingdom's financial system and for identifying how the Bank can contribute to reducing them. The discussions at the Financial Stability Board feed into meetings of the Standing Committee on Financial Stability held monthly with the Financial Services Authority (FSA) and HM Treasury.

The Bank published a new-style *Financial Stability Report* in July. It was shorter and more focused than the previous *Financial Stability Review* and outlined the Bank's high-level judgement of the major risks to the UK financial system and the main actions being taken to reduce them. The timetable for producing the *Report* was subsequently changed to an April/October timetable. In December, a speech(3) by John Gieve updated the Bank's assessment of the main risks discussed in the July *Report*. It explained that near-term risks to UK financial stability appeared to be low, reflecting robust profitability and capital levels in the major financial institutions and broadly benign macroeconomic conditions in the United Kingdom and globally. Nonetheless, it identified some significant downside risks over the medium to long term: the aggressive search for yield had continued, with a further relaxation of lending criteria and a rapid build-up of complex, potentially illiquid, financial instruments. There was a possibility that financial risk was being underpriced, and previous experience suggested that markets could move abruptly in the event of a change in sentiment that could dry up market liquidity and amplify the price adjustment.

In terms of initiatives to strengthen financial stability, the Bank and FSA initiated a series of stress-testing seminars with market participants to review ways of improving stress-test methodologies, and work progressed on reviewing the case for changes in supervisory liquidity standards, with Nigel Jenkinson appointed co-chair of a new Basel Committee sub-group on liquidity. Money Market Reform improved access to central bank liquidity under conditions of financial strain. Through its membership of the IMF Committee, G7 and G20, the Bank continued to press the case for IMF reform. The Governor's speech in December(4) set out the principles that should guide the design of international institutions and calling for further reform of the IMF to make it effective. Rachel Lomax also gave a speech(5) considering the role the IMF should be playing to promote international monetary stability and what needs to change to deliver that.

(1) www.bankofengland.co.uk/banknotes/about/counterfeit.htm.
(2) An internal committee comprising John Gieve (Chairman), Andrew Bailey, Charlie Bean, Alastair Clark, Nigel Jenkinson, Mervyn King, Rachel Lomax and Paul Tucker.
(3) 'Pricing for perfection' (www.bankofengland.co.uk/publications/speeches/2006/speech295.pdf).
(4) 'Through the looking glass: reform of the international institutions' (www.bankofengland.co.uk/publications/speeches/2006/speech296.pdf).
(5) 'International monetary stability: can the IMF make a difference?' (www.bankofengland.co.uk/publications/speeches/2006/speech289.pdf).

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Market intelligence

The Bank's objective is to generate, and make effective use of, first-class market intelligence relevant to UK monetary and financial stability. Leveraging off its operational relationships and expertise, such as that required in the management of the United Kingdom's foreign exchange reserves on behalf of HM Government, the Markets area of the Bank has for some years been establishing a global network of high-quality contacts in banking and capital markets. In addition to bilateral contacts, the Bank continues to meet regularly with market participants through the Foreign Exchange Joint Standing Committee, the Securities Lending and Repo Committee and other groupings.

Market intelligence is provided to the MPC and Financial Stability Board, and is used in the Bank's publications, such as the *Inflation Report*, the *Financial Stability Report* and the 'Markets and operations' article in the *Quarterly Bulletin*. To help co-ordinate and make the most effective use of the Bank's market intelligence, Michael Cross was appointed head of Market Intelligence in 2006, together with a small support team that has co-ordinated work within Markets and with other areas of the Bank, and with FSA counterparts.

The Bank is very grateful to the many firms, asset managers 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 comprehension and resolution of crises should they occur.

Crisis management

The Bank must ensure that it is fully able, within the Standing Committee framework, to play its part in responding to financial crises or business disruption events, should they arise. The Bank carried out its first annual readiness assessment of financial crisis management plans in 2006. The Bank has also continued to run and participate in high-level crisis management exercises.

A number of discussions were held with international authorities about cross-border co-operation in the event of a financial crisis. In terms of other types of business disruption, the Bank, FSA and HM Treasury were involved in a successful market-wide exercise to improve contingency planning for a flu pandemic, and the Bank continues to run its own internal business continuity exercises. Split-site working practices continue for 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, the system operated by the Bank to enable the risk reduction that comes from real-time settlement. Average daily values settled in these three systems last year were £231 billion for the CHAPS sterling payment system, £197 billion for the CHAPS Euro system, and £346 billion for the CREST delivery-versus-payment system. RTGS is a key piece of the United Kingdom's financial infrastructure, and as such it must have high availability. During 2006, the system was available for 99.95% of the time, compared with 99.94% in 2005.

The Bank issued its third annual *Payment Systems Oversight Report* in February 2007. The overall message was that UK payment systems continue to exhibit a high level of robustness; in particular, the high-value payment systems come close to observing fully the internationally recognised standard of the Core Principles for Systemically Important Payment Systems. The Bank has developed a risk-based framework to guide its oversight activities — the 'Oversight Risk Framework' — which acts as a complementary tool to the Core Principles, helping the Bank to focus attention where the risks to financial stability are greatest.

Enabling strategy

People development

At the end of February 2007 the Bank employed 1,555 full-time staff and 189 part-time staff — this is approximately 5% fewer staff than at end February 2006.

Over the period, 269 staff left the organisation. 71 departures related to redundancies, of which many resulted from restructuring initiatives in Information Systems & Technology and in Property Services & Security. The Bank recruited 174 staff in 2006/07. These included 18 new graduates and post-graduates, 33 new entrants in analytical and management posts, 15 experienced IT specialists and 78 administrative staff.

The past year has seen the introduction of the Employment Equality (Age) Regulations 2006. The Bank undertook a review of its policies with a view to ensuring they were compliant with the new legislation, updated guidance for staff and managers on its intranet and is rolling out a new training package to complement existing diversity training. The Bank keeps under review its arrangements for consulting staff on matters affecting their interests and maintains a dialogue — both formal and informal — with representatives of the recognised trade union, Amicus.

Two objectives for 2006/07 were a review of the Bank's pension arrangements, and further steps to support the Bank's diversity strategy.

In 2006, the Bank launched a review of its current pension provision with the aim of identifying appropriate ways of reducing its ongoing contribution rate to a level that is both affordable in the long term and does not constrain the Bank's ability to make other elements of the total remuneration package more dynamic. A review of the impact of age discrimination legislation was also carried out. Consultation with the staff and Union over possible changes to pension provision will commence in the first half of 2007.

The Bank's redundancy scheme has also been reviewed in the light of age discrimination legislation. Many elements of the payments made to staff were age related and therefore, from 1 October 2006, a moratorium was placed on redundancies until such time as a new approach can be agreed with the staff and Union.

In April 2006, the Bank launched its new Diversity Strategy, an important part of the new overall HR strategy for the Bank. The Bank also appointed two diversity sponsors: Andrew Bailey and Heather Rabbatts, as executive and non-executive sponsors, respectively. The strategy highlighted four key areas for action: flexible working; recruitment; career development and communication.

Progress has been made in each of these areas. A Bank-wide Flexible Working project has been launched, and involves pilot teams around the Bank testing whether more flexible working patterns can be accommodated within working constraints. A review of the Bank's external recruitment has led to a number of new initiatives, chief among them the new Insight Week, which aims to give aspiring economists drawn from a broad range of universities and a wider range of backgrounds a unique insight into the Bank's activities. A number of career development initiatives were piloted, including a new induction programme for foreign nationals. The Bank also conducted its second Equal Pay audit, participated in Opportunity Now and Race for Opportunity benchmarking surveys, and joined Opportunity Now's Exemplar Employers project.

The Bank is committed to recruiting employees from as wide a range of backgrounds as possible. The Bank has a number of schemes for university students to gain work experience and receive funding for further economics or finance-related study to support the Bank's recruitment and diversity strategies. These schemes have received recognition by the National Council for Work Experience Awards. The Bank continues to recruit, train and develop disabled employees and makes reasonable adjustments where employees become disabled during their employment. Adjustments are made to assist employees in using the buildings, in performing jobs and attending training courses. A central register is maintained of all employees for whom various accommodations are made. The number of staff for whom specific accommodations are made is currently twelve.

The proportion of women managers stands at 29% of the total (2005/06: 28%), though women still occupy few of the most senior posts. The proportion of staff from ethnic minority backgrounds now stands at 7.2% (2005/06: 6.5%). Foreign nationals account for 6.3% of staff (2005/06: 6.5%). Thirty-three nationalities, other than British, are now working in the Bank.

The Bank continues to develop the training and support that allows staff to enhance their performance and career development options. This year saw new programmes for graduates, accountants, secretaries and Heads of Division.

Risk management

Building upon the previous year's activities, the Risk Oversight Unit (ROU) continued to develop and promote best practices of risk management across the Bank. In particular, there has been a focus on looking at risks in a more thematic way, relating them to the key processes

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supporting the core purposes, so that risk assessment is better integrated into how the Bank is run. For example, individual business area plans for the coming financial year now carry a detailed risk assessment, along with relevant mitigating actions. And to make risk oversight more operational, a new quarterly report has been developed, to enable changes in risks to be tracked through the year and the implications for future investment plans and projects to be considered. These steps support the Bank's annual Turnbull process, by ensuring that identified risks are controlled effectively by line management.

Developing risk awareness is crucial. A summary of the Bank-wide risk assessments and medium-term objectives for risk management has been published and distributed to all staff.

Information about the Bank's Risk Management Framework is given on pages 35–37.

Project management

The Bank's project portfolio is overseen by the Projects Group, chaired by Rachel Lomax. A total of 42 projects were completed across the Bank in 2006/07, including the successful conclusion of three major projects: Money Market Reform; the IT Infrastructure Transformation Programme; and the introduction of the new £20 banknote. A number of important new projects were also initiated during the year, including a major upgrade to the IT systems supporting banknote issuance and distribution, a programme of renewal of the Bank's custody settlement and liquidity management systems and processes, which should result in greater straight through processing and lower operating costs, and MMR2. The Bank also continued to invest in projects to maintain critical IT systems and building infrastructure. 2006/07 saw the start of a major programme to overhaul the electrical plant and machinery in Head Office, and an upgrade of the main banking platform.

The Bank's project review and management framework is maintained by the Project Support Unit (PSU) within the Finance area. PSU acts as a source of information for the project community in the Bank and has continued to develop the project framework. A new project management methodology was introduced in 2006/07, requiring projects to follow a phased approach to project delivery, from the proposal and initiation/planning phases through to post-implementation review. This methodology is derived from industry standard methods, tailored to fit within the Bank's project framework and to work with the Bank's IT development and procurement processes.

At a strategic level, clearer links have been established between the Bank's strategic priorities and individual projects. The investment planning process was enhanced to take account of strategy, performance measures and business risk before agreeing the project portfolio to include in the budget. Processes and tools to assess the business case for projects have also been strengthened in recent months, to provide greater assurance that the projects the Bank undertakes will deliver valuable business benefit.

Financial and budgetary processes

Finance built on the platform established by the successful general ledger project in 2005 and introduced a new costing system, together with some further process improvements, in advance of the budget round for 2007/08. Further improvements to processes, systems and controls are planned for the year ahead, to be overseen by Warwick Jones, the new Finance Director, appointed in October.

2006/07 also saw the development of a new quarterly performance measurement report, which has been provided to Court since July.

The Bank's priorities in 2007/08

The strategic priorities endorsed by Court for 2007/08 are:

Strategic priority 1 To maintain its track record of achieving the inflation target, the Bank should improve the quality and efficiency of the processes supporting the Monetary Policy Committee, advance its understanding of the changing nature of the inflation process and contribute to the development of inflation targeting.

Strategic priority 2 Money market operations should ensure stable overnight sterling interest rates and support improved banking system liquidity management, including by providing longer-term finance through, and adopting electronic bidding for, open market operations.

Strategic priority 3 Banking operations should be focused on ensuring monetary and financial stability, thus eliminating activities that do not contribute to those objectives, while also being efficient and resilient, in large part to be achieved by continuing to deliver the objectives of the Customer Banking Transition Programme.

Strategic priority 4 The Bank should ensure that its banknotes are designed and produced in order to maintain a high level of security against counterfeiting, and that the distribution of notes, including the new £20, ensures an efficient circulation that meets the Bank's objectives for quality.

Strategic priority 5 The Bank should draw on its upgraded analytical and market intelligence capabilities to deepen its understanding of the major risks to the UK financial system and work effectively with others to lower them.

Strategic priority 6 The Bank should be fully prepared in its management of financial crises and its business continuity planning, within the Standing Committee framework, and should work with others to strengthen international crisis management preparations.

Strategic priority 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.

Strategic priority 8 To deliver these strategic priorities, the Bank will aim for the highest business standards and will continuously improve the quality and training of its people and the integrity, controls and efficiency of its systems, processes and financial reporting.

Priorities for 2007/08 are:

- HR: to improve the Bank's recruitment, retention and development and to reform the Bank's pension scheme.
- Finance: to re-negotiate the Bank's long-term financial framework and to overhaul the Bank's financial systems.
- IT: to improve IT capability in the analytical areas and to develop a medium-term strategy for banking and market operations.

The Bank's priorities in 2007/08 continued

The strategic priorities for 2006/07 have been refreshed for 2007/08 to reflect progress to date and the key challenges ahead. This section provides an overview of the specific steps the Bank plans to take. Underlying themes remain streamlining processes — to improve quality and efficiency — and showing 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 remains to support the MPC with first-rate and creative analysis, so that the Committee can take interest rate decisions to meet the Government's target. One research priority in 2007/08 is to advance understanding of the changing nature of the inflation process, so that the Bank can continue to contribute to the intellectual development of monetary policy, and of inflation targeting in particular. For example, there are questions around the consequences of globalisation for UK inflation and output, what channels it works through (for example, via competitive pressures in product and labour markets), and how it affects the appropriate monetary policy response. How the UK transmission mechanism of monetary policy works may have changed over time. Some key strands of research will also be drawing to a close in 2007. In particular, the Bank will be holding a conference in September with prominent outside researchers about the causes and potential persistence of the 'Great Stability' of growth and inflation in recent years.

Apart from conducting longer-term research projects, the Bank will also take stock of existing research inside and outside the Bank where relevant to policymaking, and increase the amount of medium-term work undertaken. Business processes will be further improved to free up resources to support this shift in focus, for instance, in the forecast process and data management.

Advances in information technology and changes to working practices mean that the Bank's regional agents now have less need for substantial office accommodation because they can be on the road meeting contacts for a greater proportion of their time. The Bank's regional offices will therefore be moved to smaller premises over the next few years, reducing costs but allowing the agents to maintain their existing intelligence gathering and representational activities.

The priorities in the area of financial stability remain organised around three aims: risk assessment; risk reduction and the resolution of financial crises.

The Bank will continue to develop its toolkit for assessing systemic risk, such as new systemic risk models and stress-testing initiatives, and will seek to validate its risk assessment work through a new survey of market participants, to be trialled and launched in 2007/08. The Bank will aim to influence policy and behaviour in a number of areas to reduce systemic risk, such as: reform of the IMF, including its surveillance role and policy for lending into arrears; domestic reform of liquidity standards, following a review of international standards by the Basel Committee; and strengthening financial market infrastructure through the Bank's participation in the Committee for Payment and Settlement Systems at the Bank for International Settlements. The Bank's wider role in overseeing payment systems remains under review, and is under discussion with FSA and HM Treasury.

The Bank will continue to strengthen its readiness to manage a financial crisis, in the Standing Committee framework, and to contribute to wider initiatives to improve crisis management arrangements. There will be a particular focus on international co-operation in 2007/08, and on developing and testing arrangements for handling a cross-border financial crisis. The Bank's capacity to handle business disruption events will be strengthened further in 2007/08 through a number of exercises with other UK authorities and new initiatives with market participants, such as a live business continuity test in the sterling money markets, co-ordinated by the Bank's Money Markets Liaison Group, and a CHAPS business continuity test. The Bank will also make a start on plans to extend the scale of real-time split-site working in 2008 in its market and banking operations.

A number of major projects are under way in the Bank's Markets and Banking areas. The second stage of Money Market Reform (MMR2) began in June 2006 and will continue into 2007/08, building on the platform established by last year's successful first stage. MMR2 will provide longer-term financing to the banking system via bond purchases, thus reducing the size of repo operations. A new system of electronic bidding will be introduced for open market operations, which — in common with a number of other initiatives in the Markets area — is intended to reduce the Bank's operational risk. With the first stage of MMR in place, the Bank will strengthen its framework for managing counterparty relationships across the full range of its market operations. That will also support the Bank's market intelligence effort, as will plans to develop further staff expertise in this area.

In the area of the Bank's banking operations, the major project remains the Customer Banking Transition Programme, which will end the provision of customer banking services to the Government in late 2009. Intermediate steps for 2007/08 include the award by HMRC of contracts to banks. The exit of the Bank from these services has consequences for future resource levels. A staff redeployment programme will be tracked closely in 2007/08, and a strategy developed to meet IT requirements in this area in the long term. The upgrade of the software used in the Bank's main banking system is due for completion in 2007/08, while work will continue on a programme to streamline settlement processes, in part to support delivery of MMR2. The Bank will review possible replacement for RTGS, the high-value interbank payment system. RTGS was introduced in 1996 and this infrastructure is now ageing. Finally, work will continue on a major project to improve the IT and controls around the circulation of banknotes.

The delivery of the Bank's strategic priorities will continue to be supported by Central Services and Finance, particularly in the areas of HR, IT and financial control.

In 2007/08, the Bank will implement steps to improve staff recruitment, retention and development. Most important will be the start of a consultation process with staff about pensions — a critical part of ensuring that reward strategies remain up to date and affordable. Detailed planning will also be under way, supported by HR business partners, to introduce specific measures to improve retention and recruitment of experienced specialists in the analytical areas of the Bank. Other initiatives will include new guidelines on flexible working arrangements, in part to support the Bank's diversity strategy, and further additions to the Bank's suite of training programmes.

Changes to the way the Bank manages IT resources will be implemented in the year ahead. The current centralising approach towards shared services will continue: all first-line IT support and infrastructure support will soon be provided centrally. That will mean less duplication between business areas and the centre, more transparent costing and, across the Bank as a whole, a continuing move towards higher standards. Individual business areas in the Bank have very different IT requirements, and work is in train to identify the best ways of specifying and meeting these within a common framework.

Finance will continue to upgrade its systems, and work with Central Services to identify opportunities for systems consolidation and cost reduction where possible. Other Finance projects in the year ahead will include a review of the arrangements for managing the Bank's pension fund, and an upgrade to the existing risk reporting system. Additionally, the Bank is moving from incident logging at a local level to a new central system to track incidents Bank-wide. That will allow common themes to be identified and addressed. Finance will review all control and reconciliation procedures in 2007/08, including implementation of a number of recommendations by KPMG, appointed as the Bank's external auditor in 2006. The process for reviewing the Bank's financial framework will also commence in 2007/08, with the 2003 Cash Ratio Deposit settlement due to expire. Details about the Bank's finances are presented in the next section.

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 post-tax profit of Banking Department 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.

Spending in 2006/07

Spending on the Bank's policy functions (net of recoveries) has remained flat in nominal terms in 2006/07, and well within the spending projection contained in the 2003 CRD review. There has also been an accelerated growth in CRD income.

The 2006/07 outturn for net expenditure on policy functions was £104.1 million, compared to a 2005/06 outturn of £104.3 million.

The 2006/07 outturn was £2.4 million below the budget for policy functions. In the Monetary Analysis and Statistics and Financial Stability areas, there was a shortfall in direct expenditure and staff costs, in part reflecting efficiency savings and convergence to lower spending and staff numbers projected for 2007/08 on a quicker time path than expected. Risk to spending tends to be on the downside, as staff turnover generates vacancies that are not immediately filled, and some staff gaps remain.

The Bank received in 2006/07 a rebate relating to VAT payments in prior years and the introduction of a new partial exemption formula. These receipts have been recorded as an offset to the Bank's legacy costs in 2006/07.

The net spending position on remunerated functions was close to budget, with a surplus of £4.6 million.

In June 2006, a full and final settlement was agreed on costs in the proceedings brought by the Liquidators of BCCI against the Bank of England. The Bank's 2006/07 accounts reflect the retention of £73.6 million paid to it by the Liquidators in November 2005.

Bank expenditure by function

£ millions	2005/06 Actuals	2006/07 Budget	**2006/07 Actuals**	2007/08 Budget[(1)]
Policy functions				
Monetary policy[(2)]	60.9	63.9	64.2	65.8
Financial stability	44.2	43.8	41.8	42.2
Contingency reserve	–	–	–	1.2
Gross expenditure on policy functions	105.1	107.7	106.0	109.2
Recoveries	-0.8	-1.2	-1.9	-3.1
Net expenditure on policy functions	**104.3**	**106.5**	**104.1**	**106.1**
CRD income	119.7	122.1	129.1	143.7
Remunerated functions				
Note issue	46.1	58.1	54.0	60.4
Government agency services	9.9	9.7	9.4	9.7
Payment and settlement	13.6	12.3	12.2	12.4
Banking services	35.1	35.9	36.3	33.9
Other[(3)]	15.9	13.5	13.1	13.4
Gross expenditure on remunerated functions	120.6	129.5	125.0	129.8
Income from remunerated functions	123.2	135.0	129.6	128.5
Surplus (-) / deficit (+) on remunerated functions	**-2.6**	**-5.5**	**-4.6**	**+1.3**
BCCI legal fees	13.5	2.4	0.6	–
Legacy costs[(4)]	–	6.0	4.4	6.9
Total gross expenditure[(5)]	**239.2**	**245.6**	**236.0**	**245.9**
BCCI recoveries	–	–	-73.6	–

(1) From 2007/08, income offsets to the Bank's overheads are no longer netted. As a result, the levels of monetary policy, financial stability and related recoveries have all increased.
(2) From 2006/07, the costs of FX reserves have been included within monetary policy; previously published as part of 'Other'.
(3) 2005/06 restated to show gross costs of pension fund administration, the sports centre and tenants, and FX reserves.
(4) Pensioner benefits and interest on severance provisions (charged to policy functions and remunerated functions prior to 2006/07).
(5) From the Bank's management accounts; figures contain reporting differences to the statutory financial accounts, such as the inclusion of notional interest charges.

Financial review continued

Budget for 2007/08

The Bank's budget plans for policy functions in the year ahead reflect cuts in real spending and increased efficiency. Planned policy functions expenditure in 2007/08 — including a small contingency reserve — is broadly flat compared to the 2006/07 budget. Further streamlining and downwards pressure on the costs of the business processes are planned for each area of the Bank.

The Bank's spending on policy functions is projected to remain below the level of CRD income. The 2003 CRD settlement expires at the end of February 2008. The CRD scheme will be reviewed in 2007/08 by HM Treasury.

Budget plans for 2007/08 imply a deficit (£1.3 million) for remunerated functions. This follows a period of small annual surpluses. The Bank's aim remains to recover fully the costs of remunerated functions and to break even over the medium term.

These spending plans are underpinned by investment proposals of nearly £27 million in 2007/08. This figure is higher than in recent years, and reflects the large scale of planned investment in the banknote function and in the security of the Bank's premises. Annual investment spending is expected to fall back to its more typical range of £15–£20 million in subsequent years.

Proposals for major projects supporting the strategic priorities include:

Strategic priority	Project	Forecast total spend (£ millions)	Start date	Completion date
Monetary policy	Data uncertainty	1.0	2005/06 Q3	2007/08 Q3
Financial stability	Systemic risk assessment model (SRAM)	0.7	2006/07 Q4	2009/10 Q2
Money market operations	Money Market Reform 2	1.6	2006/07 Q2	2008/09 Q1
Banking operations	Upgrade software for the Bank's main banking system	1.9	2006/07 Q2	2007/08 Q2
	Custody, settlement and liquidity programme	4.3	2006/07 Q2	2008/09 Q4
	Customer business transition — phase 2	–(1)	2006/07 Q2	2010/11 Q2
Banknotes	Notes Division processes and IT infrastructure	7.0	2006/07 Q1	2008/09 Q2

(1) Funded from recurrent budget.

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 6.

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 insofar 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.

Court announced in the 2006 *Annual Report* a decision not to grant unfunded pension benefits in future to new appointees as Governors and Executive Directors. It will instead give the option to opt out of the pension scheme and receive an equivalent salary supplement.

Given the range of issues the Committee must examine, including pensions, and the fact that in June 2008 the Bank's new statutory framework will have been in place formally for ten years without a broad-based remuneration review, the Committee decided that in future it will carry out quinquennial reviews of senior Bank executive remuneration. The reviews will set the rate for each job irrespective of who was in post at the time. Between the reviews, salaries would be increased annually by an agreed automatic amount.

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 were set on appointment in consultation with the HM 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 2006 his salary was increased by $2^1/_2$% from £276,647 to £283,564.

The Deputy Governors' salaries have been reviewed in line with the remuneration policy described above. From 1 March 2006, the salaries of both Deputy Governors, Rachel Lomax and Sir John Gieve, were each increased by $2^1/_2$% from £228,748 to £234,467.

Benefits

The Remuneration Committee also keeps under review other benefits available to the Governors. Medical insurances and pension entitlements were the principal non-salary benefits received during the year to 28 February 2007.

Pension benefits

Pension benefits are provided through the Court Pension Scheme, supplemented by an unfunded scheme. This is currently a separate scheme from the pension scheme for staff, and is described on page 31.

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

Remuneration of Governors, Directors and MPC members continued

of the MPC, the Governors have no termination provisions at the end of their appointments.

Under the Bank of England Act, Governors are required to provide remunerated services to the Bank only. With Court's approval other directorships relevant to the Bank's work may be accepted, but any fees must be paid to the Bank. The only such directorship held during the past year has been the appointment to the FSA Board held by Sir John Gieve.

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;

Remuneration of members of Court	Salary £	Benefits £	Total 2006/07 £	Total 2005/06 £
Governor				
Mr M A King				
Joined 1 March 1991	281,258	438	281,696	275,340
Deputy Governors				
Ms J R Lomax				
Joined 1 July 2003	234,467	713	235,180	229,475
Sir E J W Gieve				
Joined 1 January 2006 (Note i)	234,467	1,574	236,041	38,321
Sir A M B Large				
Retired 15 January 2006	0	0	0	200,404
Non-executive Directors				
(Note i)	106,500	0	106,500	103,500
Total	**856,692**	**2,725**	**859,417**	**847,040**

Note

i 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 — currently Sir John Gieve, similarly sits on the Board of the FSA. Both have agreed to waive the remuneration due from the other body. Accordingly, Sir Callum McCarthy waived remuneration of £6,000 due from the Bank and Sir John Gieve waived remuneration of £25,000 due from the FSA.

and the remuneration of the Chairman of the Committee of Non-executive Directors is £12,000 per annum. Non-executive Directors do not receive any post-retirement benefits from the Bank. Other than the Chairs of the Committees of Court and Trustee Boards, Directors receive no additional fees for serving on those Committees. The Bank does, however, meet appropriate travel and subsistence expenses.

Pensions of the Governor and Deputy Governors

The Court Pension Scheme, in which the Governors participate, is a non-contributory occupational pension scheme. Some 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 2007, unfunded entitlements were provided for Mr King 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 were 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 (to which they are contractually entitled). Sir John Gieve joined after Court had decided not to grant unfunded benefits to new Governors and Executive Directors.

Remuneration of Monetary Policy Committee members

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

The external members of the MPC were paid at an annual rate of £153,047 in 2006/07 (2005/06: £149,314), pro rated for the number of days worked per week. They are appointed for terms of three years. Professor Nickell's

Pension entitlements and accruals (including unfunded entitlements)

	Transfer value as at 28.2.06 (£)	**Transfer value as at 28.2.07 (£)**	**Increase in transfer value (£)**	Accrued pension as at 28.2.06 (£pa)	**Accrued pension as at 28.2.07 (£pa)**	**Increase in accrued pension (£pa)**	**Transfer value of additional pension earned during year ended 28.2.07[1] (£)**
Mr M A King	3,571,700	3,950,400	378,700	147,100	164,300	17,200	286,200
Ms J R Lomax	470,600	635,400	164,800	20,300	29,000	8,700	174,600
Sir E J W Gieve	6,400	204,200	197,800	293	9,100	8,807	197,400

(1) Net of statutory revaluation applying to deferred pensions.

Remuneration of Governors, Directors and MPC members continued

term finished in May 2006, Mr Lambert resigned in March 2006 and Mr Walton died in service on 21 June 2006. Professor Blanchflower started his term on 1 June 2006, Professor Besley on 1 September 2006 and Dr Sentance on 2 October 2006. Professor Nickell worked in the Bank four days a week; Ms Barker, Mr Lambert, Mr Walton, Professor Blanchflower, Professor Besley and Dr Sentance all worked in the Bank for three days a week. They were paid respectively four fifths and three fifths of the basic MPC rate. The external members of the MPC are entitled to cover under the Bank's group medical insurance scheme. On leaving the Bank, external members are paid their salary for a period of three months; during that period the Bank has the right to veto any employment that would represent a conflict with their former MPC responsibilities.

In 1997, the Bank decided that the external members should be paid a 15% salary supplement in lieu of membership of the Bank's pension fund. This was calculated to be the correct funding cost of pension at the time. The 2006 *Annual Report* reported that the actual funding cost of pension provision at the Bank had risen sharply and was now closer to 41% due to a number of factors including greater longevity and lower bond rates. Court set an objective of reducing this 41% funding cost towards 30% of salaries, and decided, on the recommendation of the Committee, that it should end the underpayment of pension contributions to external members of the MPC by raising the level of their salary supplement to 30%.

The salaries of Executive Directors are not disclosable under the Companies Act requirements, as they are not members of Court. However, the official salary range for Executive Directors is £160,000 to £185,000. The salaries of the two Executive Directors who are members of the MPC are also given here for consistency with other members. Paul Tucker's 2006/07 annual salary was £170,404; and Charlie Bean's was £178,001. Both benefit from the Bank's normal range of staff benefits and from membership of the Court Pension Scheme.

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 8–9.

Principal activities and review of operations

The Bank's core purposes are set out on page 1. The Governor's Foreword, the Review of 2006/07 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, the Bank is divided into the Issue Department and the Banking Department; these are accounting designations — neither is an organisational unit of the Bank.

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.

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 a potentially systemic disturbance have improved. Accordingly, although the financial effects of such operations will be included in the Banking 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 financial statements of the Banking Department disclose less detail of certain elements than would be required under either adopted IFRS or the Companies Act. Disclosure limitations include:

- Constituent elements of the Income Statement.
- Note disclosures for income and expenses, particularly relating to net interest income and provisions.
- Related note disclosures in the Balance Sheet and cash flow statement.
- Business segments.
- Contingent liabilities and guarantees.
- Information on credit risk.

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 for the Banking Department have been properly prepared on the basis set out therein. 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 directors who held office at the date of approval of this *Report* confirm that, so far as they are aware, there is no relevant audit information of which the Bank's auditors are unaware; and each director has taken all the steps that they ought to have taken as a director to make themselves aware of any relevant information and to establish that the Bank's auditors are aware of that information.

Governance, financial statements and risk continued

Financial results

The Banking Department's financial statements for the year ended 28 February 2007 are given on pages 47–90, and show a profit before tax of £191 million (2005/06: £99 million). After a tax charge of £25 million (2005/06: £5 million), and a payment in lieu of dividend of £83 million (2005/06: £47 million), the profit transferred to reserves amounts to £83 million (2005/06: £47 million).

The statements of account for the Issue Department (which are given on pages 91–93) show that the profits of the note issue were £1,653 million (2005/06: £1,698 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.

Banking Department balance sheet

The principal reason for the increase in the Banking Department balance sheet, £39.4 billion at 28 February 2007 (2005/06: £24.8 billion), was the introduction of Money Market Reform (MMR) in May 2006. The new framework is based on a reserves-averaging system, with reserves-scheme participants electing to maintain a target balance on average over a maintenance period running from one MPC meeting to the next. These balances are reflected in 'deposits from banks and building societies' on the Banking Department balance sheet and have been matched by an increase in the Bank's lending via short-term open market operations (OMOs), 'loans and advances to banks'. At 28 February 2007, around £20.3 billion of Banking Department's assets comprised sterling money market refinancing provided through the Bank's OMOs (2005/06: £3.2 billion). The size of the Issue Department's deposit with Banking Department has remained close to £50 million.

On 15 December 2006, the Bank of England announced that its foreign exchange reserves will be financed by issuing medium-term securities on an annual basis, with a regular timetable, a high degree of transparency and a group of banks to market and distribute each issue. Shortly after the end of the 2006/07 financial year, the Bank launched a $2 billion three-year RegS/144A Eurobond to finance the Bank of England's foreign currency reserves. Associated with that, during the financial year, the Bank announced that it would cease its Euro Bills and Notes issuance programmes. €3,583 million of Euro Bills in issue at 28 February 2006 matured during the year. On 29 January 2007, €2,200 million of the Bank's three-year euro-denominated Notes (originally issued in 2004) matured. Only the remaining (second) €1,100 million tranche of the Euro Notes issued on 27 January 2006 was auctioned during the year, on 28 March 2006. The level of foreign currency assets, and related swaps held to minimise exposure to interest rate and currency risks, moved in step with foreign currency liabilities in issue.

Sterling and foreign currency deposits taken from central banks have remained fairly stable, at £11.5 billion at 28 February 2007 (2005/06: £11.4 billion).

The Banking Department balance sheet also contains the Bank's capital and reserves and cash ratio deposits (CRDs). These are predominantly invested in gilts, supranational sterling bonds and short-term repos. At end-February, capital and reserves totalled £1,860 million (2005/06: £1,732 million); the increase on the year reflected mostly retained profit. CRDs grew to £2,568 million at 28 February 2007 (2005/06: £2,222 million). The annual growth rate of nearly 16% (2005/06: 11%) was the highest since the CRD framework was placed on a statutory framework in 1998. The Bank's holdings of gilts securities were £2,445 million at 28 February 2007 (2005/06: £2,211 million) and holdings of other supranational sterling bonds were £1,049 million (2005/06: £1,282 million).

Issue Department balance sheet

The assets matching the note issue include reverse repos of government securities, undertaken as part of the Bank's OMOs, and the Ways and Means advance to HM Treasury, which has been unchanged at £13.4 billion since April 2000. There has been an increase in the maturity of reverse repos, reflecting the introduction of long-term repos to the Bank's open market operations in January 2006 in preparation for Money Market Reform. Some £15 billion of long-term repos were outstanding on 28 February 2007.

A combined balance sheet

The separation of Banking from Issue in the Accounts is required by statute. A summary combined Bank balance

Summary combined balance sheet	2007 £m	2006 £m[a]
Assets		
Ways and Means advance	13,370	13,370
Loans and advances	56,686	38,188
Financial assets designated at fair value through profit or loss	3,298	5,663
Derivative financial instruments	121	291
Available for sale securities	3,755	3,705
Other assets	533	397
Total assets	**77,763**	**61,614**
Liabilities		
Notes in circulation	38,449	36,914
Deposits	33,331	15,616
Derivative financial instruments	72	98
Financial liabilities designated at fair value through profit or loss	3,328	6,512
Other liabilities	723	742
Capital and reserves	1,860	1,732
Total equity and liabilities	**77,763**	**61,614**

(a) Prior year figures have been adjusted for consistency.

sheet as at 28 February 2007 is set out above.[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 largely by MMR.

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 the Treasury may agree. The overall effect is that the Bank and the Treasury will normally share post-tax profits equally. Accordingly, the Bank paid £23 million in April 2006 and £24 million in October 2006 in respect of the year to 28 February 2006. In April 2007, the Bank paid the first payment of £41 million in respect of the financial year ended 28 February 2007, based on provisional full-year figures. The balance will be paid on 5 October 2007.

Risk management

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

Operational and non-financial risk description

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. As a central bank, the Bank also faces specific non-financial risks that arise in the pursuit of its two core purposes.

For example, it is vital that the economic analysis and forecasts that underpin the decisions on interest rates

(1) Information has been combined 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.

Governance, financial statements and risk continued

taken at the monthly meetings of the Monetary Policy Committee are based on accurate data, sound analysis and market intelligence and robust economic 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. The Financial Stability core purpose also depends heavily upon reliable market intelligence, robust risk assessments and strong operational controls. To operate effectively in all of its areas, the Bank needs to maintain a high level of public confidence. Shortcomings in any of these areas could have reputational or financial consequences. Each business area is responsible for managing its operational and non-financial risks and monitoring the associated controls.

Financial risk is discussed in note 31 to the Financial Statements.

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 and 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 11, that is closely aligned to the Bank's Core Purposes.
2 A planning framework with objectives and financial targets set at each level so that they are specific to the various operational areas in the Bank.
3 The appointment of experienced and suitably-qualified staff. Annual objective setting and appraisal procedures for all staff enable standards of performance to be monitored by management. A Bank-wide programme of training and development enables continuing improvement in relevant skills and knowledge.
4 A system of financial reporting via the Executive to Court, including forecasts and budgets which allow the monitoring of the key activities and progress towards strategic, including financial, objectives.
5 Defined procedures governing approval of capital and other project expenditure. These include annual budgets, detailed project approval procedures, monitoring reports and post-implementation reviews.
6 Oversight of the management of the Bank's balance sheet as a whole, delivery of the policy purposes of the Bank's operations and monitoring of the financial performance is delegated to the Executive Director, Markets, who reports quarterly to Executive Team and Court. The financial risks and associated controls are separately reported on pages 82–90, as required under IAS 30 and IAS 32.
7 An overall tolerance for risk and a Bank-wide Risk Management Framework, estabilished by the Risk Policy Committee (a committee of Court). The Business Risk Committee, a committee reporting to the Executive chaired by Rachel Lomax, is responsible for ensuring the implementation of the Bank-wide risk framework covering all financial and non-financial risks. The Risk Oversight Unit supports these committees and is responsible for overseeing this work and developing the framework in line with the Bank's strategic objectives.
8 A process under which the Executive report to Court quarterly on risk management has been instituted during the year. 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 Executive report to Court once a year on the management of risk and the control environment in their areas of responsibility. 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.

Oversight of the risk and controls 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, liquidity and operational risk; and the controls applied parallel those applied in respect of Bank business. The management of the EEA is conducted within a framework agreed annually with the Treasury, which is described in the EEA Report and accounts published by the 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 20–21.

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 by increasing recycling. The Bank's Head Office building has recently been accredited under the Carbon Trust's Energy Efficient Accreditation Scheme, and some 70% of the Bank's waste is recycled in some form. 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 voluntary work undertaken by its staff. During 2006/07, the Bank contributed £680,000 in support of its community programme (2005/06: £617,000). Donations in cash totalled £410,000 (2005/06: £389,000). This included: £15,000 via Bank of England Court Awards, through which donations are made to community organisations in recognition of outstanding volunteering commitment by members of staff; £5,000 for the David Sharp School Governor Awards; £55,000 to community organisations via the Staff Volunteering Award Scheme; and £32,000 matched funding under the payroll Give-As-You-Earn Scheme. The cost of other community contributions, including time spent by staff on community involvement, was £270,000 (2005/06: £228,000), and donations to academic research amounted to £134,000 (2005/06: £155,000).

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. A new, more relevant measure of prompt payment was introduced in 2006/07; it shows that the Bank paid 85% of its bills within these timescales.

The Bank estimates that the average trade creditor payment days for 2006/07 were 16 (2005/06: 19). 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 Payment Practice Code.(1)

(1) For details about the Code, see www.payontime.co.uk.

Report by the non-executive Directors

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 2006 to 28 February 2007, referring where relevant to other sections of the *Annual Report* which cover non-executive Directors' responsibilities as members of Court.

Non-executive Directors of the Bank have specific responsibilities under the Bank of England Act in addition to those they have as members of Court. They are responsible for reviewing the performance of the Bank in relation to its objectives and strategy, monitoring its financial management, and reviewing the procedures of the MPC. The functions of Court and NedCo are described more fully on page 6.

NedCo

Non-executive Directors provide independent input to the Bank's decision-making and guidance and advice for the Bank's executive management. They contribute actively to the management of the Bank across a range of business issues, and particularly in relation to the formation and oversight of the Bank's strategic priorities and financial objectives. NedCo receives a range of regular reports to facilitate this work including updates on progress with the implementation of the Bank's strategy and major projects.

NedCo's oversight of the Bank's performance is continuously being refined and improved. Over the past year, this has been facilitated by the introduction of three new regular reports — a quarterly performance measurement report, a quarterly risk management report and a quarterly financial stability report. The performance measurement report provides an assessment of progress against four high-level outcomes relating to the inflation target, the integrity of the currency, the stability of the financial system and trust in the Bank to carry out its core purposes in a fair, efficient and professional manner. This is work-in-progress aimed at further developing performance measures across the Bank's work. Further work will be undertaken in 2007/08 to provide a systematic framework to link the delivery of the Bank's core purposes and strategy, its financial framework and the measurement of individual performance and, in turn, remuneration. The quarterly risk management report provides an assessment of the key risks faced by the Bank together with relevant risk indicators, incidents and work underway to mitigate risks. Regular reporting in this format is intended to ensure that risk management is a routine exercise and discipline across the Bank.

During 2006/07, NedCo considered how it could increase its engagement and familiarity with the Bank's financial stability work. Although the Bank has limited powers in this area it is continuously seeking to improve the way it undertakes its particular role. Greater engagement is desirable so that non-executive Directors can assess the approach, processes and resources employed more effectively, consistent with their responsibilities to review performance against objectives. At the beginning of 2007 NedCo started to receive a quarterly report on financial stability, which summarises the Bank's work over the latest three months on the assessment of key risks to financial stability. In addition, members of the Risk Policy Committee now regularly attend meetings of the Financial Stability Board as observers to gain greater first-hand experience of how the Bank undertakes its financial stability work. These initiatives provide for greater oversight by NedCo of the Bank's financial stability work. Overall effectiveness will be reviewed through 2007/08.

A third board evaluation exercise was undertaken in 2006 to assess the effectiveness of NedCo and Court. The survey and subsequent discussions resulted in a series of actions to improve the operation of NedCo and Court during 2007. These include greater engagement with the Bank's financial stability work, and consideration of proposals to merge the Audit and Risk Policy Committees, which are discussed further below.

Non-executive Directors have continued to have contact with HM Treasury as the Bank's shareholder on behalf of government. The chairman of NedCo has discussed NedCo's requirements with the Treasury as vacancies for new non-executive Directors have arisen. Non-executive Directors have also benefited from discussions with the Treasury about its expectations of the Bank and the role of non-executive Directors. NedCo will welcome two new non-executive Directors later in the year. They will undertake a wide-ranging modular induction to the Bank's business functions and its financial management.

The Bank's strategy and its implementation

The Bank's strategic priorities are centre stage at NedCo meetings. Implementation of the programme of work to deliver the Bank's strategy has been regularly reviewed via regular reporting and discussion of particular elements of the strategy at various times. The Bank has substantially progressed the implementation of its strategy since 2003, designed to improve its ability to deliver the two core purposes of monetary and financial stability. There has been further good progress over the past year though there remains significant further work to do. The strategic priorities have been reviewed in NedCo and updated to reflect progress to date and new areas of emphasis for 2007/08. The Bank's performance is reviewed on pages 14–22 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 2006/07.

Over the past year, the implementation of Money Market Reforms — to improve the Bank's market operations to implement monetary policy — was a significant milestone. Overall, the reforms have been very successful. Overnight interest rate volatility has reduced significantly. Non-executive Directors regularly monitored progress of the project, including the related changes to the Bank's balance sheet. The follow-up programme to allow outright purchase of bonds by the Bank is now under way.

The Bank's refocused approach to financial stability work has been progressed with the new *Financial Stability Report* and organisational changes in the Financial Stability area. It remains too early to judge the success of the objectives to use smaller, flexible teams of more senior staff to identify emerging sources of potential systemic risk and to increase experience in the financial stability area. Non-executive Directors note that progress has been affected by vacancies in some positions. A review of the Bank's role in relation to payment systems oversight is being undertaken. The results and recommendations will be considered by NedCo in 2007/08.

Preparing for major disruptions to work is an increasingly important part of organisation planning. There has been further testing and refinement of the Bank business continuity and financial crisis planning capabilities. Non-executive Directors are encouraged by the appetite in the Bank to test and practice contingency plans. The Bank and the other tripartite authorities (FSA and HM Treasury) continue to show leadership in this field. Regular testing and exercises are increasingly important as experience of managing previous crises inevitably fades over time. The market-wide pandemic flu exercise, undertaken in the Autumn of 2006, has been widely praised. NedCo remains actively engaged with the Bank's assessment of its business continuity needs and the appropriate level of resilience required across its business functions. Non-executive Directors have observed the standards detailed in the 2005 Resilience Benchmarking project undertaken by the FSA and are monitoring, through the Risk Policy Committee, the degree to which the Bank meets them. Further work is under way to consider the degree and nature of split-site working and the use of shared facilities with other organisations to improve further the Bank's resilience in a cost effective way. This will be discussed further in NedCo during 2007.

Implementation of the strategy for customer banking remains uncertain. It is dependent on the Government Banking Programme. Progress has been made in 2006/07 with HM Revenue & Customs to enable the eventual transition to alternative providers of retail banking services for Government customers. It is important to maintain this momentum. The present position whereby the Bank does not recover the full cost of its banking services from its customers is clearly unsatisfactory. Non-executive Directors support the Bank's objective of ensuring that its banking operations are consistent with achieving its core purposes and of a securing a breakeven financial position for remunerated services.

The Bank's project management framework continues to support the selection, resourcing and monitoring of projects, both projects directly linked to implementing the Bank's strategy — such as the Money Market Reform programme — and more standard investment projects such as property and plant refurbishments. It also enables cross-Bank working and the realisation of business benefits beyond individual areas. Major projects are brought to NedCo for discussion ahead of approval by Court and NedCo monitors the overall weight of project work across the Bank. Non-executive Directors have questioned the total number of projects that are in train or planned but

Report by the non-executive Directors continued

are satisfied that the workload is spread across areas, and that sufficient resources are available and the associated risks have been considered. Detailed monitoring and appraisal, through the project management framework, will manage this workload over the coming year.

Non-executive Directors have continued to review and challenge the costs and management of the Bank's central services and overheads. There has been further progress over the past year through greater integration with the Bank's main business functions in support of its core purposes, as well as delivering better use of resources in areas such as procurement. Very good progress has been made to improve procurement standards and management in the Bank, with significant cost savings achieved to date. There is further work to be done in terms of the management of central overhead costs, notably in IT to identify as far as possible where IT costs are incurred and what value is derived. Non-executive Directors have encouraged the executive management to push further in this direction. The overall shape of IT provision in the Bank and the drivers of IT investment will be considered further in 2007.

Non-executive Directors have considered various elements of the Bank's HR management over the past year, including pay, pensions and diversity. There has been some concern that the implementation of changes to the staff mix in the Monetary Analysis and Financial Stability areas has been adversely affected by a higher rate of resignation and vacancies over the past year. Non-executive Directors have emphasised the need to ensure that the Bank's HR strategy is focused both on recruitment and the retention of its best staff. We support the executive management's desire to identify and promote the Bank's best talent early in their careers, given the inevitable pay differentials between the Bank and financial sector employers in the City. Non-executive Directors also support a continuing emphasis on linking remuneration to performance.

The rising cost of pension benefits has been a key issue for the Bank over the past year. Non-executive Directors reviewed and considered options for changes to staff pension benefits proposed by the Bank's executive management, to achieve the objective of containing the rising cost of future pension liabilities. However, new age discrimination regulations — which came into force in December 2006 — unexpectedly raised questions about the Bank's existing pension provisions for staff which delayed consultation with staff on the preferred options for changes. Progress needs to be made in 2007 order to achieve the Bank's financial objectives.

Non-executive Directors welcome the efforts to improve the link between the Bank's strategic priorities and the performance assessment of the Bank executive management. It is equally important that the Bank's Executive Directors have career development plans to build-up their skills and potential in order that they are well placed for further progression within the Bank. This is part of a wider effort to ensure that succession planning is actively considered across the Bank as an integral part of HR management.

Financial management

The Bank's financial reporting has become more professional and supportive of the management of the Bank over the past few years. As noted in last year's *Report*, a priority for 2006/07 was to link to a greater degree the financial management of the Bank with performance measurement and management. There has been further significant progress in aligning budgetary management with the strategy and business outcomes. The Bank has developed an integrated and coherent business plan linking its strategy and budget with objectives for the coming year. This crystallises the changes and improved clarity of the Bank's financial framework over recent years and its use as a tool to support the implementation of the Bank's strategy. This progress has been cemented by the appointment in 2006 of an executive finance director, Warwick Jones, which was encouraged and fully supported by non-executive Directors.

Alongside improvements to the Bank's approach to financial management, there have been further efforts to strengthen cost control to meet the Bank's financial objectives. The Bank's approach to the treatment of legacy costs — which are unrelated to its operations and objectives — has continued to be improved and professionalised. Increases in some budgeted costs — notably pensions — have been offset by efforts to prioritise resources and remove costs that do not contribute to or support the Bank's core purposes. Non-executive Directors note that spending on policy functions has been below budget in 2006/07. This partly reflects lower staff costs due to unfilled vacancies, which is expected to be rectified in 2007/08.

The budget agreed by Court for 2007/08 to 2009/10 is discussed on pages 27–28. 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. One of the main uncertainties for the Bank's financial position remains the degree of progress with its strategy for customer banking and the costs of its remunerated services. Non-executive Directors expect the deficit on remunerated services to be temporary. Overall, non-executive Directors consider that the Bank's financial performance over recent years and the budget Court has agreed demonstrate strong financial discipline. The forthcoming review of the Bank's finances with HM Treasury can be undertaken against this positive background.

Non-executive Directors welcome the settlement of the costs incurred by the Bank as a result of the BCCI litigation. Non-executive Directors were consulted about the Bank's approach to the cost settlement. The outcome fully justifies the Bank's stance and conduct in relation to the allegations. NedCo has discussed the high-level issues arising from the case and non-executive Directors would hope that the lessons are actively considered by the wider legal profession.

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 terms of reference of each of the committees has been reviewed during the year. Non-executive Directors consider that the Audit, Risk Policy and Remuneration Committees have operated effectively during the year.

The Audit Committee has undertaken a substantial body of work during the year, including monitoring the Bank's progress in addressing priorities outlined by the Committee in early 2006. 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 2006/07, as reported in the internal controls section of the *Annual Report* (pages 36–37) 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.

Non-executive Directors note that there has been further progress made during the year on the Bank's Risk Management Framework. The Bank's risk standards are increasingly embedded in the work of the Bank, supported by quarterly risk and incident reporting processes. We do, however, note that the risk that the introduction of the Bank's proposals for new pension arrangements would be hampered and delayed by new legislation on age discrimination was not identified or mitigated in advance.

In the year ahead, the Audit and Risk Policy Committees will draw up proposals to merge into a single committee. Since the Risk Policy Committee was established, it has overseen the formation of the Bank's new risk framework and a set of risk standards. The priority now is to embed further the new framework. This can be done more effectively through a single 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 6. The report on remuneration for 2006/07 is set out on pages 29–32 and, so far as appropriate, forms part of this report. Non-executive Directors support the closure of the Court Pension scheme to new members and the plan to undertake quinquennial reviews of the remuneration of Governors and External MPC members.

MPC procedures

Non-executive Directors have a responsibility to keep the procedures followed by the MPC under review, in particular determining whether the MPC has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy. The Monetary Policy Committee's procedures are described on pages 14–17. As required under Schedule 3 of the Act, non-executive Directors receive a monthly report from the MPC and all members of the MPC are invited to attend NedCo every three months following publication of the Bank's *Inflation Report*. This provides an opportunity for non-executive

Report by the non-executive Directors continued

Directors to raise questions on the *Inflation Report* and on matters relevant to MPC procedures.

To keep MPC's procedures under review, non-executive Directors undertake a range of work. They periodically attend pre-MPC meetings and receive the minutes of the monthly MPC meetings, the Bank's quarterly *Inflation Report* and summaries of other meetings. Non-executive Directors also undertake visits to the Bank's Agencies 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. To assess the procedures supporting monetary policy, NedCo consider the responses to questionnaires completed each year by MPC members. These responses form an input into the discussions undertaken with individual members of the MPC by the Chairman of NedCo.

Overall, MPC members continue to consider the support that they receive from the Bank very positively, including the support provided for external members of the MPC. MPC members, led by the Governor, are constantly looking to refine and improve their processes that support monetary policy. Over the past year there has been some further re-engineering of the information provided to support the pre-MPC meeting. The information gathered by the Bank's network of Agencies continues to be viewed positively, with greater co-ordination with the Bank's wider input to the MPC. The contribution of the intelligence from the Bank's business contacts was particularly highlighted over the past year in relation to the MPC's assessment of migration into the United Kingdom.

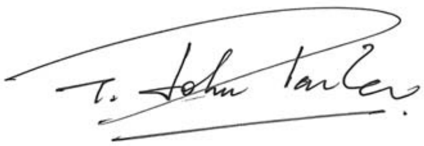
The quarterly forecasting process is judged to operate well. It continues to provide an appropriate framework for the MPC to consider the economic outlook and produce forecasts for growth and inflation. There has been some reduction in satisfaction compared with the previous year. To some extent, this might reflect the changes in MPC membership over the past year and the nature of the conjuncture over the period, particularly the shortcomings of existing models in analysing issues associated with the response of inflation to shocks such as the rise in energy prices. This highlights the important roles of uncertainty and judgement in the policymaking process. There is also a continued preference among MPC members to devote more time in forecast meetings to discussion relative to time spent on presentations, which has resulted in changes to bring that about. MPC members have also raised some concerns about staff turnover in the forecasting area of Monetary Analysis. The Bank has been addressing this issue through greater attention to the planning of staff moves within the Bank. This is consistent with the wider objective to increase experience levels in the Monetary Analysis area, which remains important to the overall effectiveness of MPC procedures.

Alongside the ongoing assessment of MPC procedures, non-executive Directors are aware that 2006/07 was a challenging year for the Committee given the unexpected turnover in membership. The circumstances of the past year were both exceptional and tragic in view of the sad and untimely death of David Walton following the unexpected departure of Richard Lambert to the CBI. At the same time, they highlight the contribution that a process for succession planning could make to assist with the identification and appointment of new MPC members. Non-executive Directors would support efforts to strengthen the process for MPC appointments in this way and to make them subject to normal public appointment procedures. This might also help to ensure that the balance of the MPC was maintained in terms of expertise and experience. The overriding purpose of any appointment is, of course, to recruit the best possible person for the job. Non-executive Directors are also conscious of the need to ensure that the terms and conditions of employment for external members of the MPC are competitive and do not limit the number of potential candidates.

Data from the Office for National Statistics remain a critical input into MPC processes. Progress has been made with the provision of improved data on the service sector, a priority set by the MPC for the ONS. At the same time, work within the Bank to develop a systematic approach to handling data uncertainty has progressed during the year. Unfortunately, the use of data on UK exports has been greatly undermined by the incidence of VAT-related fraud. This emphasises the importance of the MPC's use of a variety of data and information sources, including the Bank's Agencies, in its processes.

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 with appropriate actions identified to improve and adapt processes to address specific issues raises by MPC members. Constructive suggestions to improve MPC procedures further should be seen in the context of NedCo's recognition that the MPC in its first ten years has been very successful judged by its performance and reputation.

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



Report by the non-executive Directors continued

Attendance	Court (12)	NedCo (12)	Audit (4)	RemCo (5)	Risk Policy (3)
Sir John Parker – Attendance as an observer at Audit, Risk Policy Committees and Remco – Retired from Risk Policy Committee 31 May 2006	11	12	1	5	0
Sir William Morris – Retired from Court 31 May 2006	3/3	3/3		2/2	
Sir Brian Moffat – Retired from Court 31 May 2006	1/3	1/3	0/1		
Mrs Francis	9	10	3		
Sir Graham Hall	10	10		3	
Mr Barber	7	8			
The Hon Peter Jay	10	11		5	
Dr Potter	11	12		5	2
Ms Rabbatts	5	6			
Sir Callum McCarthy	10	10			
Ms Fawcett	9	10	4		2
Sir Andrew Likierman	9	9	2		3
Mr Wilkinson	11	12		5	
Mr Myners	11	12	3		3
Mr Sarin	7	7		0	
Professor Rhind – Appointed to Court 1 June 2006 – Appointed to RemCo 12 July 2006	8/9	9/9		1/2	
Mr Strachan – Appointed to Court 1 June 2006 – Appointed to Audit Committee 12 July 2006	7/9	8/9	3/3		
Mr Wigley – Appointed to Court 1 June 2006 – Appointed to Risk Policy Committee 12 July 2006	6/9	8/9			1/1

Mr King	11	12*
Ms Lomax	9	10*
Sir John Gieve	7	8*

* Attendance by invitation.