Report of the Independent Auditor

Independent Auditor's Report to the Governor and Company of the Bank of England

We have audited the financial statements of the Banking Department ('financial statements') which comprise the Income Statement, the Balance Sheet, the Cash Flow Statement, the Statement of Recognised Income and Expenses and the related notes, and the statements of account of the Issues Department ('statements of account') for the year ended 28 February 2007. These financial statements and statements of account have been prepared under the accounting policies set out therein.

This report is made solely to the Governor and the Company of the Bank of England and its Shareholder in accordance with Section 7 of the Bank of England Act 1998. Our audit work has been undertaken so that we might state to the Governor and the Company of the Bank of England and its Shareholder those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Governor and the Company of the Bank of England and its Shareholder, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of the Members of Court and auditors

The responsibilities of the Members of Court for preparing the *Annual Report*, including the financial statements and statement of account, in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the EU are set out in the Responsibilities of the Court of Directors in relation to the Financial Statements on pages 33 to 37. Our responsibility is to audit the financial statements and statement of account in accordance with relevant legal and regulatory requirements and International Standards on Auditing (United Kingdom and Ireland).

We report to you our opinion as to whether the financial statements of the Banking Department and statements of account of the Issue Department have been properly prepared in accordance with the basis of preparation set out in note 2 on pages 51 to 57 and page 92, respectively. We also report to you if the Bank has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if other transactions are not disclosed.

We read other information contained in the *Annual Report* and consider whether it is consistent with the audited financial statements and statements of account. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements or statements of account. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit having regard to International Standards on Auditing (United Kingdom and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and statements of account. It also includes an assessment of the significant estimates and judgements made by the Members of Court in the preparation of the financial statements and statements of account, and of whether the accounting policies are appropriate to the Bank's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and statements of account are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements, the basis of which is described in note 1 on page 51, and in the statements of account, the basis of which is described on page 92.

Report of the Independent Auditor continued

Opinion

In our opinion:

- The financial statements of the Banking Department on pages 47 to 90 for the year ended 28 February 2007 have been properly prepared in accordance with the basis of preparation set out in note 2 on pages 51 to 57.
- The statements of account of the Issue Department on pages 91 to 93 for the year ended 28 February 2007 have been properly prepared in accordance with the basis of preparation set out on page 92.
- The information given in the *Annual Report*, is consistent with the financial statements and statements of account.

KPMG Audit Plc
London
Chartered Accountants
Registered Auditor
17 May 2007

Note
The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Banking Department
Income Statement for the year to 28 February 2007

	Note	**2007 £m**	2006* £m
Profit before tax	4	191	99
Corporation tax net of tax relief on payment to HM Treasury	7	(25)	(5)
Profit for the year attributable to shareholder		**166**	**94**

* Tax relief on payments to HM Treasury is now credited to the Income Statement in accordance with paragraph 52 (b) of IAS 12. This is a change from the prior year which has been restated accordingly (see note 1 (s)).

The notes on pages 51 to 90 are an integral part of these financial statements.

Balance Sheet as at 28 February 2007

	Note	2007 £m	2006 £m
Assets			
Cash and balances with other central banks	9	99	185
Loans and advances to banks	10	31,552	14,506
Financial assets designated at fair value through profit or loss	11	3,298	5,663
Derivative financial instruments	12	121	291
Loans and advances to customers	13	5	6
Available for sale securities	14	3,755	3,705
Investments in group undertakings	15	13	18
Intangible assets	16	19	17
Property, plant and equipment	17	247	193
Investment properties	18	26	26
Current tax assets		31	–
Deferred tax assets	19	–	12
Other assets	20	197	131
Total assets		**39,363**	**24,753**
Liabilities			
Deposits from central banks	21	11,519	11,380
Deposits from banks and building societies	22	20,778	3,208
Other deposits	23	1,083	1,081
Derivative financial instruments	12	72	98
Financial liabilities designated at fair value through profit or loss	24	3,328	6,512
Other liabilities	25	450	354
Current tax liabilities		–	17
Deferred tax liabilities	19	30	–
Retirement benefits	26	243	371
Total liabilities		**37,503**	**23,021**
Equity			
Capital	27	15	15
Retained earnings	28	1,417	1,305
Other reserves	28	428	412
Total equity attributable to shareholder		**1,860**	**1,732**
Total equity and liabilities		**39,363**	**24,753**

On behalf of the Governor and Company of the Bank of England:

M A King Governor
J R Lomax Deputy Governor
T J Parker Chairman of NedCo
W R Jones Finance Director

The notes on pages 51 to 90 are an integral part of these financial statements.

Statement of Recognised Income and Expense
for the year to 28 February 2007

	Note	2007 £m	2006* £m
Profit for the year attributable to shareholder		166	94
Other recognised income and expense:			
Revaluation of available for sale securities		(93)	4
Revaluation of properties	17	55	–
Actuarial gains on retirement benefits	26	74	73
Tax credited/(charged) on items directly to equity	7	9	(23)
Net income recognised in equity	28	45	54
Total recognised income and expense for the period attributable to shareholder		**211**	**148**

* Tax relief on payments to HM Treasury is now credited to the Income Statement in accordance with paragraph 52 (b) of IAS 12. This is a change from the prior year which has been restated accordingly (see note 1 (s)).

The notes on pages 51 to 90 are an integral part of these financial statements.

Cash Flow Statement for the year to 28 February 2007

	Note	2007 £m	2006* £m
Cash flows from operating activities			
Profit before taxation		191	99
Adjustments between operating profit and net cash inflow/(outflow):			
Depreciation of property, plant and equipment	17	7	8
Amortisation of intangible assets	16	5	4
Loss on sale of available for sale securities		2	–
Decrease in deferred income accruals		169	507
Net (decrease)/increase from Euro Notes		(628)	690
Net decrease from Euro Bills		(2,467)	(53)
Net increase in other deposits		17,711	2,234
Net increase in foreign currency advances to banks		(1,170)	(2,345)
Net redemption/(purchase) of financial assets designated at fair value through profit or loss		2,176	(1,428)
Purchase of available for sale securities		(379)	(380)
Redemption of available for sale securities		246	119
Net increase in other accounts		(5)	(8)
Net cash inflow/(outflow) from operating activities before tax		**15,858**	**(553)**
Corporation tax paid		(22)	(20)
Net cash from operating activities		**15,836**	**(573)**
Cash flows from investing activities			
Dividends received		10	9
Proceeds from sale of property, plant and equipment		5	29
Purchase of property, plant and equipment		(14)	(10)
Net cash from investing activities		**1**	**28**
Cash flows from financing activities			
Payment to HM Treasury under Section 1 (4) of the Bank of England Act 1946		(47)	(38)
Net cash from financing activities		**(47)**	**(38)**
Net increase/(decrease) in cash and cash equivalents		**15,790**	**(583)**
Cash and cash equivalents at 1 March	32	5,805	6,388
Cash and cash equivalents at 28 February	32	**21,595**	**5,805**

* This statement has been restated to ensure that prior year numbers are presented on a consistent basis.

The notes on pages 51 to 90 are an integral part of these financial statements.

Notes to the Banking Department Financial Statements

1 General information

The Bank of England is the central bank of the United Kingdom and is incorporated under a Royal Charter of 1694. Legislation covering its operations includes the Bank Charter Act 1844 and the Bank of England Acts 1946 and 1998. The functions and core purposes of the Bank are set out on page 1.

The Bank Charter Act 1844 requires that the Bank's note issue function be separated from its other activities. Accordingly, for accounting purposes, the Bank is divided into Issue Department and Banking Department, which are accounting designations and reporting entities. Neither is an organisational unit of the Bank. The Issue Department is solely concerned with the note issue and the assets backing the issue. The statements of account of the Issue Department are given on pages 91 to 93, and show the note issue, the assets backing the issue, the income generated by those assets and the costs incurred in production, issue, custody and payment of notes. The entire profit of the Issue Department is paid over to HM Treasury. The Banking Department comprises all other activities of the Bank. The post-tax profits of Banking Department are effectively shared equally with HM Treasury unless the Bank and HM Treasury agree otherwise (see note 8).

2 Summary of significant accounting policies

The principal accounting policies applied in the preparation of the financial statements of the Banking Department are set out below. These policies have been consistently applied to all of the years presented, unless otherwise stated.

a Form of presentation of the financial statements

The financial statements of Banking Department comprise the Income Statement, the Balance Sheet, the Statement of Recognised Income and Expense, the Cash Flow Statement and related notes.

Under the Bank of England Act 1998, the Bank, in preparing the financial statements of the Banking Department, is subject to requirements corresponding to the Companies Act requirements relating to a banking company. The Bank may, however, disregard a requirement to the extent that it considers it appropriate to do so having regard to its functions.

The financial statements of the Banking Department have been prepared in accordance with the measurement and recognition requirements of the International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee (IFRIC) interpretations as adopted by the EU (together 'adopted IFRS').

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

In exceptional circumstances, as part of its central banking functions, the Bank may act as 'lender of last resort' to financial institutions in difficulty in order to prevent a loss of confidence spreading through the financial system as a whole. In some cases, confidence can best be sustained if the Bank's support is disclosed only when conditions giving rise to 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 disclosures in the Balance Sheet and Cash Flow Statement.
- Business segments.
- Contingent liabilities and guarantees.
- Information on credit risk.

Notes to the Banking Department Financial Statements continued

2 Summary of significant accounting policies continued

The financial statements have been prepared on the historical cost basis of accounting, modified to include the revaluation of land and buildings (excluding investment properties), financial assets that are available for sale, derivative contracts and all financial assets and financial liabilities that are held at fair value through profit or loss.

A number of new standards, amendments and interpretations to existing standards have been published. Whilst these are relevant to the Bank, they are only effective after 1 March 2007 and have not been adopted early. These include:

- IFRS 7 (Financial Instruments: Disclosures) which replaces IAS 30 (Disclosures in the Financial Statements of Banks and similar financial institutions) and certain of the disclosure provisions in IAS 32 (effective for annual periods beginning on or after 1 January 2007).
- Amendments to capital disclosures within IAS 1 (Presentation of Financial Statements) (effective for annual periods beginning on or after 1 January 2007).

The application of these standards in the 2006/07 accounts would not have had any financial impact because they are only concerned with disclosure.

The Bank will continue to review IFRS 7 and the above amendments to IAS 1 to determine the effect on its financial reporting going forward.

b Consolidation

The financial statements of the Bank's subsidiaries have not been consolidated with those of the Banking Department because, in the opinion of the Members of Court, the effect of including their assets, liabilities and results with those of the Banking Department would not be material. Investments in group undertakings are stated in the Balance Sheet at cost, less provision for impairment in value. Dividends from group undertakings are included as income when declared.

c Foreign currency translation

i Functional and presentational currency

The financial statements of the Banking Department are presented in sterling, which is the Bank's functional and presentational currency.

ii Transactions and balances

Foreign currency transactions are translated into sterling using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the Income Statement. Where a gain or loss on a non-monetary item is recognised directly in equity, such as equity investments classified as financial assets that are available for sale, the related exchange gain or loss is also recognised in equity.

d Derivative financial instruments

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently re-measured at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, or valuation techniques, such as discounted cash flow models. Generally the best evidence of the fair value of a derivative at initial recognition is the transaction price (ie the fair value of the consideration given or received). All derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative.

Derivatives are used for matching exposures on assets and liabilities, both individually and of portfolios. The Bank has not applied the hedge accounting rules of IAS 39 and accordingly has recognised all gains and losses on derivatives in the Income Statement.

e Interest income and expense

Interest income and expense are recognised in the Income Statement for all instruments measured at amortised cost and for interest-bearing assets held as available for sale, using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability on initial recognition. When calculating the effective interest rate, the Bank estimates cash flows considering all contractual terms of the financial instrument, and any revisions to these estimates are recognised in the Income Statement. The calculation includes all fees paid or received between parties, transaction costs and all other premiums or discounts.

f Fees and commission income

Fees and commissions other than those associated with financial instruments are recognised as the service is provided.

g Financial assets

The Bank classifies its financial assets in the following categories: financial assets at fair value through profit or loss; loans and advances; investments that are held to maturity; and, financial assets that are available for sale. The Bank determines the classification of its investments at initial recognition.

i Financial assets at fair value through profit or loss

A financial asset is classified in this category if it is acquired principally for the purpose of selling in the short term or if so designated by management. Derivatives are classified as held at fair value through profit or loss (see (d) above). The Bank does not currently hold financial assets for trading, but designates at inception assets matching the Bank's issued Euro Notes and Euro Bills as at fair value through profit or loss. This designation eliminates, or significantly reduces, inconsistencies that would otherwise arise from measuring assets and liabilities on a different basis. The relevant assets and liabilities together with the related derivatives are managed together and internal reporting is evaluated on a fair value basis.

ii Loans and advances

Loans and advances are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides money or services directly to a counterparty with no intention of trading the receivable.

iii Held to maturity

Investments classified as 'held to maturity' are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank's management has the intention and ability to hold to maturity. Were the Bank to sell other than an insignificant amount of such assets, the entire category would be reclassified as available for sale. The Bank does not currently have any assets classified as held to maturity.

iv Available for sale

All other financial assets are designated as 'available for sale'. These investments are those intended to be held for an indefinite period of time, which may be sold as part of the Bank's official operations or otherwise. They include sterling debt securities and unlisted equity investments.

Loans are recognised when cash is advanced to the borrowers. Purchases and sales of other financial assets are recognised on trade date, the date on which the Bank commits to purchase or sell the asset. Financial assets are initially recognised at fair value, plus directly attributable transaction costs for financial assets not carried at fair value through the Income Statement. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all of the risks and rewards of ownership. Financial assets that are available for sale and financial assets at fair value through profit or loss are subsequently carried at fair value.

Notes to the Banking Department Financial Statements continued

2 Summary of significant accounting policies continued

Loans and advances and investments that are held to maturity are carried at amortised cost using the effective interest method, less provision for impairment (see (j) below).

Gains and losses arising from changes in the fair value of assets classified as at fair value through profit or loss are included in the Income Statement in the period in which they arise. Gains and losses arising from changes in the fair value of financial assets that are available for sale are recognised directly in equity (net of related tax) until the financial asset is derecognised or impaired, at which time the cumulative gain or loss previously recognised in equity is recognised in the Income Statement. Interest on such assets, calculated using the effective interest method, is recognised in the Income Statement. Dividends on equity investments that are available for sale are recognised in the Income Statement when the Bank's right to receive payment is established.

The fair values of quoted investments in active markets are based on current bid prices. In other cases, the Bank establishes fair value by using appropriate valuation techniques.

h Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the Balance Sheet when there is a legally enforceable right to offset the amounts recognised and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

i Sale and repurchase agreements

Securities sold subject to repurchase agreements ('repos') are assets provided as collateral when the transferee has the right by contract or custom to sell or pledge the collateral; the counterpart liability is included in deposits from central banks, deposits from banks and building societies or other deposits, as appropriate, while the securities subject to repo remain on the Balance Sheet. Securities purchased under agreements to resell ('reverse repos') are recorded as loans and advances to banks or customers. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities lent to counterparties are also retained in the financial statements. Securities borrowed are not recognised in the financial statements, unless they are sold to third parties, in which case the obligation to return the securities is recorded at fair value as a liability.

The Bank may accept its own securities as collateral for reverse repos. Such reverse repo transactions are treated as collateralised and are treated in the same way as other reverse repo transactions.

j Impairment of financial assets

i Assets carried at amortised cost

At each Balance Sheet date the Bank assesses whether there is objective evidence that a financial asset or group of assets is impaired. If there is objective evidence that an impairment loss on loans and advances has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate adjusted for changes in benchmark rates for assets with variable rates. The carrying amount of the asset is reduced and the amount of the loss is recognised in the Income Statement.

ii Available for sale financial assets

At each Balance Sheet date the Bank assesses whether there is objective evidence that a financial asset or group of assets is impaired. If such evidence exists for financial assets that are available for sale, the cumulative loss measured as the difference between acquisition cost and the current fair value, less any impairment loss previously recognised, is removed from equity and recognised in the Income Statement. If, in a subsequent period, the fair value of a debt instrument designated as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed though the Income Statement. Impairment losses recognised in the Income Statement on equity instruments are not reversed through the Income Statement except on realisation.

k Intangible assets

Intangible assets consist of computer software and the costs associated with the development of software for internal use. Costs that are directly associated with the production of identifiable and unique software products, which are controlled by the Bank and which will probably generate economic benefits exceeding costs are recognised as intangible assets. These costs are amortised on the basis of the expected useful lives of the software, which range from three to five years. Costs associated with maintaining software programs are recognised as an expense when incurred.

l Property, plant and equipment

The Bank's properties were subject to a professional valuation as at 28 February 2007. Professional valuations are carried out every three years with subsequent additions included at cost, and provisions made for depreciation as explained below. In the intervening years, Members of Court consider whether there is any circumstance which would necessitate a significant change to the value at which these properties are carried in the Balance Sheet.

Subsequent costs are included in the asset's carrying amount or are recognised as a separate asset as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Bank and the cost of the item can be reliably measured. All other repairs and maintenance are charged to the Income Statement during the financial period in which they are incurred.

Any surplus arising on revaluation is recognised directly in a revaluation reserve within equity, except to the extent that the surplus reverses a previous revaluation deficit on the same asset recognised in the Income Statement, in which case the credit is to the Income Statement.

The depreciable amount of a revalued asset is based on its revalued amount. The revaluation surplus is not transferred to retained earnings until the asset's ultimate disposal.

Land is not depreciated. Depreciation, on other property, plant and equipment is charged on a straight-line basis:

Freehold buildings	over the estimated future lives which range from ten to twenty-five years
Plant within buildings	over periods ranging from five to twenty years
Computers	over periods ranging from three to five years
Other equipment	over periods ranging from three to twenty years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each Balance Sheet date. Assets that are subject to depreciation are reviewed at each reporting date to assess whether there is any indication that an asset may be impaired. An asset's carrying amount is written down immediately to its recoverable amount if the carrying amount is greater than its estimated recoverable amount. The recoverable amount is the higher of the asset's fair value (less costs to sell) and value in use.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the Income Statement.

m Investment properties

Investment properties are shown at cost. Where properties have subsequently been classified as investment properties, the book value at the date of reclassification as investment properties has been deemed to be cost. At present, investment properties mainly comprise freehold land and accordingly are not depreciated.

Notes to the Banking Department Financial Statements continued

2 Summary of significant accounting policies continued

n Leases

i As lessee

The leases entered into by the Bank are primarily operating leases. The total payments made under operating leases are charged to the Income Statement on a straight-line basis over the period of the lease. When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

Where property, plant and equipment have been financed by lease agreements under which substantially all the risks and rewards of ownership are transferred to the Bank, they are treated as if they have been purchased outright and classified as finance leases. Finance leases are capitalised at the commencement of the lease at the lower of the present value of the minimum lease payments or the fair value of the leased asset. Finance charges payable are recognised over the period of the lease based on the interest rate implicit in the lease to give a constant periodic rate of return.

ii As lessor

Where the Bank has granted long leases on property, the land element is treated as an operating lease. Operating lease income is recognised on a straight-line basis.

o Cash and cash equivalents

For the purposes of the Cash Flow Statement, cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, consisting of cash and balances with other central banks, loans and advances to banks, amounts due from banks and short-term government securities.

p Financial liabilities at fair value through profit or loss

During the year these liabilities included three-year notes denominated in euro (Euro Notes) and three-month and six-month bills denominated in euro (Euro Bills). Both Euro Notes and Euro Bills are stated at fair value. They are translated into sterling at the exchange rate ruling at the Balance Sheet date. All gains and losses arising from exchange rate movements and other fair value movements on the Euro Notes and Euro Bills are taken to the Income Statement. These liabilities are designated against certain bonds as detailed in note g (i) above to eliminate or significantly reduce recognition inconsistencies.

If the Bank buys any of its own securities as part of its operations, these are removed from the Balance Sheet.

q Provisions

Provisions are recognised in respect of restructuring, redundancy and legal claims arising from past events where it is probable that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated.

r Retirement benefits

The Bank operates non-contributory defined-benefit pension schemes providing defined benefits based on final pensionable pay. The assets of the schemes are held separately by the Bank in independent trustee-administered funds. The Bank also provides other post-retirement benefits, principally healthcare, for certain pensioners.

The liability recognised in the Balance Sheet in respect of defined-benefit pension schemes is the present value of the defined-benefit obligation at the Balance Sheet date less the fair value of the schemes' assets. The defined-benefit obligation is calculated annually by independent actuaries using the projected unit method. The present value of the defined-benefit obligation is determined by discounting the estimated cash outflows using interest rates of high-quality sterling corporate bonds that have terms to maturity approximating to the terms of the related pension liability. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised immediately in equity and reflected in the Statement of Recognised Income and Expense. Past service costs are recognised immediately in the Income Statement.

Other post-retirement benefits, principally healthcare for certain pensioners, are accounted for on a similar basis to that used to account for pension obligations.

s Current and deferred tax

Corporation tax payable on profits, based on the United Kingdom tax laws, is recognised as an expense in the period in which profits arise. Tax relief on payments to HM Treasury is now credited directly to Income Statement in accordance with paragraph 52 (b) of IAS 12. This is a change from the prior year which has been restated accordingly. The amount of tax relief in the current year is £25 million (2006: £14 million).

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax is determined using tax rates and laws that have been enacted or substantially enacted and which are expected to apply when the related deferred tax asset or liability is realised.

The principal temporary differences arise from depreciation of property, plant and equipment, revaluation of certain financial assets, revaluations of property, and provisions for pensions and other post-retirement benefits.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences and losses can be utilised.

Deferred tax related to fair value remeasurement of available for sale and actuarial gains and losses on retirement benefit obligations, which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the Income Statement together with the current or deferred gain or loss when and if realised.

t Bank capital

The entire equity capital comprising £14,553,000 of Bank Stock is held by the Treasury Solicitor on behalf of HM Treasury.

Under Section 1 (4) of the Bank of England Act 1946, subsequent to the end of each year HM Treasury receives payments of half the post-tax profits unless the Bank and HM Treasury agree otherwise. The payments are deductible for corporation tax and charged to equity in the year to which they relate on the basis agreed as at the end of the relevant year.

u Commitments on behalf of HM Treasury

Commitments on behalf of HM Treasury in foreign currencies and gold arising in the course of operating the Exchange Equalisation Account are not included in these financial statements as the Bank is concerned in such transactions only as agent.

3 Significant accounting estimates and judgements in applying accounting policies

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

a Post-retirement benefits

Post-retirement benefits are long-term liabilities whose value can only be estimated using assumptions about developments over a long period. The Bank has employed actuarial advice in arriving at the figures in the financial statements (see note 26 (a), which includes relevant sensitivity analysis). Members of Court consider the assumptions used by the actuaries in their calculations to be appropriate for this purpose.

b Fair value of equity investments that are available for sale

Fair values of equity investments classified for accounting purposes as available for sale, which are held by the Bank for the long term as part of its central banking activities and which may not be readily saleable, have generally been established by discounting expected future dividends reflecting the benefit that the Bank derives from the investments (see note 14 (b), which includes relevant sensitivity analysis).

Notes to the Banking Department Financial Statements continued

4 Profit before tax

	Note	2007 £m	2006 £m
Income includes			
Charges for services to HM Government (including charges to the Issue Department in respect of the Note Issue)		64	60
Other operating income		48	47
Including: rental income from investment properties		2	2
Dividend income		10	9
Expenses includes			
Staff costs	5	123	115
Legal fees		2	13
Depreciation of property, plant and equipment	17	7	8
Software expenditure		6	4
Amortisation of intangible assets	16	5	4
Operating lease rentals — property		1	1
— equipment		1	1
Other administrative expenses		50	50
Repayment of BCCI legal fees(1)		(74)	–

(1) On 7 June 2006, a full and final settlement was agreed on costs in the proceedings brought by the liquidators of BCCI against the Governor and Company of the Bank of England. The Bank retained £73.6 million paid to it by the liquidators in November 2005.

5 Staff costs

	Note	2007 £m	2006 £m
Wages and salaries		77	77
Social security costs		8	8
Pension and other post-retirement costs:			
Funded pension schemes	26	19	19
Unfunded redundancy provisions	26	9	5
Other unfunded pension schemes	26	1	1
Other post-retirement benefits	26	9	5
		123	**115**

Average number of employees

The average number of persons employed by the Bank during the year was made up as follows:

	2007	2006*
Governors and other members of Executive Team	10	9
Managers and analysts	634	633
Other staff	1,145	1,245
	1,789	**1,887**

The number of persons employed by the Bank at the end of the year was 1,744; of which 1,555 were full-time and 189 were part-time (2006: 1,836 with 1,639 full-time and 197 part-time).

* Prior year figures have been adjusted for consistency.

6 Auditor's remuneration

	2007 £000	2006 £000
Audit fees		
Fees relating to current year	210	346
Fees payable to the auditor for other services provided to the Bank:		
Tax services	400	77
Services relating to IT	–	31
Internal audit services	–	7
All other services	30	195
	640	**656**

The auditor of the Bank in the current year is KPMG Audit Plc (2006: PricewaterhouseCoopers LLP).

7 Taxation

The tax charged within the Income Statement is made up as follows:

	2007 £m	2006* £m
Current United Kingdom corporation tax	19	25
Prior year corporation tax	(8)	(4)
Deferred tax — current year	13	(13)
— prior year	1	(3)
Tax charge on profit after provisions	**25**	**5**

The tax charge within the Income Statement differs from the amount calculated at the basic rate of tax on the profit for the year as follows:

	2007 £m	2006* £m
Profit before tax	191	99
Tax calculated at rate of 30% (2006: 30%)	57	30
Tax relief on payment to HM Treasury	(25)	(14)
Other	–	(4)
Prior year items	(7)	(7)
Total tax charge for the period	**25**	**5**

The tax (credited)/charged directly to equity comprises:

	2007 £m	2006* £m
Current United Kingdom corporation tax	(37)	1
Deferred tax	28	22
Tax (credited)/charged directly to equity	**(9)**	**23**

Notes to the Banking Department Financial Statements continued

7 Taxation continued

The tax (credited)/charged is attributable as follows:

	2007 £m	2006* £m
Revaluation of available for sale assets	(27)	1
Related to properties	(4)	–
Actuarial gain on retirement benefits	22	22
Tax (credited)/charged directly to equity	**(9)**	**23**

* Tax relief on payments to HM Treasury is now credited to the Income Statement in accordance with paragraph 52 (b) of IAS 12. This is a change from the prior year which has been restated accordingly (see note 1 (s)).

8 Payable to HM Treasury under Section 1 (4) of the Bank of England Act 1946

	2007 £m	2006 £m
Payable 5 April	41	23
Payable 5 October	42	24
	83	**47**

The Bank of England Act 1946, as amended by the Bank of England Act 1998, requires the Bank to pay HM Treasury, in lieu of dividend on the Bank's capital, on 5 April and 5 October, a sum equal to 25% of the Banking Department's post-tax profit for the previous financial year or such other sum as the Bank and HM Treasury may agree. The payments are deductible for corporation tax in the year to which the payments relate. The overall effect is that the Bank and HM Treasury will normally share Banking Department's post-tax profits equally. The sum paid on 5 April was based on provisional figures. The balance is payable on 5 October. When the due date falls on a non-business day, the payment is made on the last business day before the due date. These payments have been accrued and charged to equity at 28 February 2007.

9 Cash and balances with other central banks

	2007 £m	2006 £m
Cash	–	6
Due from the European Central Bank in respect of TARGET (a)	97	176
Other balances with central banks (b)	2	3
	99	**185**

a Due from the European Central Bank in respect of TARGET

This balance, denominated in euro, was €143 million at 28 February 2007 (2006: €258 million) and arises from the operation of the TARGET settlement system. This system, which links the real-time settlement systems in countries of the European Union (EU), enables payments to be made across borders within the EU. Such payments result in claims arising between the central banks in the member countries and with the European Central Bank. The individual positions that arise intraday between the central banks are netted into a single position with the European Central Bank at the close of business each day. The balance with the European Central Bank bears interest at rates related to the monetary conditions in the euro area.

b Other balances with central banks

These balances are correspondent accounts with other central banks used for Bank and customer business. The practice is that such accounts between central banks do not normally bear interest.

10 Loans and advances to banks

	2007 £m	2006* £m
Items in course of collection from banks	441	465
Loans and advances to banks	31,111	14,041
	31,552	**14,506**

* Prior year figures have been adjusted for consistency. Interest of £48 million on reverse repurchase contracts has been reclassified to other assets (note 20).

These balances include advances and reverse repurchase agreements, arising as part of the Bank's open market operations, as well as advances matching the deposits taken (notes 21–23). Amounts are stated after provisions for impairment, where appropriate. The level and composition of the Bank's open market operations, including the split between Banking and Issue Departments, depends on movements in the Bank's Balance Sheet described in the published 'Framework for the Bank of England's Operations in the Sterling Money Markets' (May 2006).

At 28 February 2007 loans and advances to banks included cash and cash equivalents of £21.5 billion (2006: £5.6 billion). The Bank held listed securities with a fair value at 28 February 2007 of £26.7 billion (2006: £6.8 billion) as collateral for loans and advances to banks, which are in the form of reverse repurchase contracts. The Bank is permitted to sell, repo or re-pledge these securities to third parties but had not done so at 28 February 2007 (2006: £nil).

The increase in loans and advances to banks for the year ending 28 February 2007 is due to the introduction of the Bank's Money Market Reform programme in May 2006 (as set out in the *Annual Report* on page 18).

11 Financial assets designated at fair value through profit or loss

	2007 £m	2006 £m
Listed foreign government securities	2,121	4,153
Other listed securities	1,177	1,510
	3,298	**5,663**

The holdings of foreign government and other foreign securities are funded by the Bank's issuance of medium-term securities (note 24) and held in two distinct portfolios. The first portfolio comprises the Bank's foreign exchange reserves. As at 28 February 2007 this portfolio was financed by the €2 billion Euro Note maturing on 28 January 2008 with assets mainly denominated in euro and Japanese yen; the latter coupled with currency swaps into euro. In future, the Bank's foreign currency reserves, which will total £3 billion equivalent in steady-state, will be financed by a new medium-term issuance programme. The second portfolio, denominated in euro, is held to enable the Bank to provide liquidity in the TARGET settlement system (note 9). These securities, amounting to £2,282 million at 28 February 2007 (2006: £2,820 million), and principally financed by the €3 billion Euro Note maturing on 27 January 2009, were used to generate this liquidity via intraday repurchase contracts.

At 28 February 2007 £57 million (2006: £nil) of securities were provided by the Bank as collateral under repurchase agreements.

Notes to the Banking Department Financial Statements continued

12 Derivative financial instruments

The Bank uses the derivative instruments described below. The purpose of these is to minimise the currency and interest rate exposures on the Bank's portfolio of financial assets and financial liabilities. They may also be used as an instrument in monetary policy transactions.

Interest rate and bond futures are exchange-traded contractual obligations to receive or pay a net amount based on changes in interest rates or to buy or sell a financial instrument on a future date at a specified price. The credit risk is limited because changes in the price of the contracts are settled daily with the exchange.

Cross currency interest rate swaps, forward exchange contracts, and interest rate swaps are commitments to exchange one set of cash flows for another. Swaps result in an economic exchange of currencies or interest rates (eg fixed rate for floating rate) or a combination of these. An exchange of principal occurs for cross currency interest rate swaps and forward exchange contracts, but no such exchange of principal usually occurs for interest rate swaps. The Bank's credit risk represents the potential cost to replace the swap contracts if counterparties fail to perform their obligations. This risk is monitored on an ongoing basis with reference to the current fair value, a proportion of the notional amount of the contracts and the liquidity of the market. To control the level of credit risk taken, the Bank assesses counterparties using the same techniques as for its lending activities and will take collateral if the replacement cost of all transactions with the counterparty breaches relevant thresholds.

The notional amounts of derivative financial instruments provide a basis for comparison with other instruments recognised in the Balance Sheet but do not necessarily indicate the amounts of future cash flows involved or the current fair value of the instruments and therefore do not indicate the Bank's exposure to credit or price risks. The derivative instruments move into profit (in which case they are treated as assets) or loss (in which case they are treated as liabilities) as a result of fluctuations in market prices relative to their terms. The aggregate contractual or notional amount of derivative financial instruments outstanding, the extent to which instruments have moved into profit or not, and thus the aggregate fair values of derivative financial instruments and liabilities, can fluctuate significantly from time to time. The fair values of derivative instruments are set out below.

a For the year to 28 February 2007

	Contract notional amount £m	Fair values Assets £m	Fair values Liabilities £m
Derivatives related to non-sterling investment securities and Euro Note liabilities			
Cross currency interest rate swaps — positive value	609	70	–
— negative value	–	–	–
	609	**70**	**–**
Other derivative instruments			
Forward exchange contracts — positive value	3,463	51	–
— negative value	3,672	–	(72)
	7,135	**51**	**(72)**
Total recognised derivative assets/(liabilities)		**121**	**(72)**

At 28 February 2007 the Bank accepted cash of £45 million as collateral for derivative financial instruments (note 22).

b For the year to 28 February 2006

	Contract notional amount £m	Fair values Assets £m	Liabilities £m
Derivatives related to non-sterling investment securities and Euro Note liabilities			
Interest rate swaps — positive value	483	7	–
— negative value	340	–	(1)
Cross currency interest rate swaps — positive value	758	63	–
— negative value	901	–	(67)
	2,482	**70**	**(68)**
Derivatives related to non-sterling securities and Euro Bill liabilities			
Interest rate swaps — positive value	1,953	60	–
— negative value	287	–	(3)
Cross currency interest rate swaps — positive value	354	45	–
— negative value	–	–	–
	2,594	**105**	**(3)**
Other derivative instruments			
Forward exchange contracts — positive value	4,438	116	–
— negative value	1,406	–	(27)
	5,844	**116**	**(27)**
Total recognised derivative assets/(liabilities)		**291**	**(98)**

At 28 February 2006 the Bank held cash of £63 million as collateral for derivative financial instruments (note 22).

13 Loans and advances to customers

	2007 £m	2006 £m
Term loans	5	6
	5	**6**

Notes to the Banking Department Financial Statements continued

14 Available for sale securities

	2007 £m	2006 £m
Debt securities at fair value		
British Government securities listed on a recognised UK exchange	2,445	2,211
Other sterling securities listed on a recognised exchange	1,049	1,282
	3,494	3,493
Unlisted equity investments at fair value	261	212
	3,755	**3,705**

A loss of £2 million (2006: £nil) on the sale of available for sale securities was transferred to the Income Statement during the year.

a Debt securities

British Government securities and other sterling securities are held as investments and are one of the principal sources of income for the Bank. The Bank holds these securities for the long term, generally to maturity. However, as the Bank can envisage circumstances in which they might be sold before maturity they have been classified as assets that are available for sale.

All debt securities have fixed coupons.

b Unlisted equity investments

The unlisted equity investments held by the Bank are held as part of its functions as a central bank and are thus of a long-standing nature. The Bank's holdings in any particular institution may change from time to time as part of realignments of holdings among the shareholders and participants. Fair values of unlisted equity investments have been established using techniques reflecting the benefits that the Bank derives from the investments.

The Bank's investment in the Bank for International Settlements (incorporated in Switzerland) consists of shares of 5,000 Special Drawing Rights which are 25% paid. At 28 February 2007 the holding represents 8.7% (2006: 8.7%) of the issued share capital. The investment has been valued on a dividend yield basis providing a value of £257 million at the year end. A discount rate of 7% was used. Increasing the discount rate by 1% would deflate the valuation by £57 million, whilst decreasing the discount rate by 1% would inflate the valuation by £103 million.

The Bank's holding in the European Central Bank represents the Bank's contribution of €56 million to the capital of the European Central Bank. This represents 7% of the European Central Bank's capital (13.9% would have been payable had the United Kingdom participated in Economic and Monetary Union (2006: 14.4%)). This contribution is non-refundable and no dividends are expected. Its fair value has therefore been assessed as zero.

On the 28 March 2007 the Bank sold other unlisted equity shares for £3.3 million, which amount has been assessed as fair value at 28 February 2007.

15 Investments in group undertakings

	2007 £m	2006 £m
Cost of shares in group undertakings	**13**	**18**

The financial statements of the subsidiaries detailed below have not been consolidated with those of the Banking Department because, in the opinion of the Members of Court, the effect of including their assets, liabilities and results with those of the Banking Department would not be material.

a Minories Finance Ltd (in members' voluntary liquidation)

Minories Finance Ltd (MFL) a wholly-owned subsidiary which is incorporated in Great Britain has been in members' voluntary liquidation throughout the year ended 28 February 2007. The investment in this company is included in the Bank's Balance Sheet at 28 February 2007 at £12.5 million (2006: £12.5 million). The Bank expects to recover £2 million in excess of its investment and accordingly no provision for impairment has been made in these financial statements.

As a condition of reductions in capital in June 1987 and November 1996, the Bank gave indemnities whereby any future deficit in MFL's shareholders' funds would be made good by the Bank up to a maximum of £62.5 million in total. These indemnities were released in full during the year leaving a balance of £nil at 28 February 2007 (2006: £62.5 million).

b Other group undertakings

Two of the Bank's subsidiaries, BE Property Holdings Ltd and BE Services Ltd, were liquidated during the year. The remaining investments, all of which are wholly owned and incorporated in Great Britain, are stated in the Bank's Balance Sheet at an aggregate cost under £1 million. These subsidiaries, which are all non-trading, are as follows:

The Securities Management Trust Ltd	1,000 ordinary shares of £1
Houblon Nominees Ltd	2 ordinary shares of £1
BE Museum Ltd	10,000 ordinary shares of £1
BE Nominees Ltd	2 ordinary shares of £1

The aggregate net assets of these subsidiary companies are £1 million (2006: £6 million) which consist of balances held with the Bank.

Notes to the Banking Department Financial Statements continued

16 Intangible assets

Intangible assets comprise computer software costs capitalised.

	2007 £m	2006 £m
Cost		
At 1 March	26	20
Additions	7	6
Disposals	(1)	–
At 28 February	**32**	**26**
Accumulated amortisation		
At 1 March	9	5
Charge for the year	5	4
On disposals	(1)	–
At 28 February	**13**	**9**
Net book value at 28 February	**19**	**17**

17 Property, plant and equipment

	Freehold land and buildings £m	Equipment* £m	Total £m
Cost or valuation			
At 1 March 2006	193	38	231
Additions	1	10	11
Disposals	(5)	(1)	(6)
Revaluation of properties	45	–	45
At 28 February 2007	**234**	**47**	**281**
Accumulated depreciation			
At 1 March 2006	8	30	38
Charge for the year	2	5	7
On disposals	–	(1)	(1)
Written back on revaluation	(10)	–	(10)
At 28 February 2007	**–**	**34**	**34**
Net book value at 28 February 2007	**234**	**13**	**247**
Cost or valuation at 28 February 2007 comprised			
At 2007 valuation	234	–	234
At cost	–	47	47
	234	**47**	**281**

* Equipment includes £6 million held under finance leases (2006: £nil).

	Freehold land and buildings £m	Equipment £m	Total £m
Cost or valuation			
At 1 March 2005	209	35	244
Reclassification as investment property	(18)	–	(18)
Additions	2	3	5
At 28 February 2006	**193**	**38**	**231**
Accumulated depreciation			
At 1 March 2005	4	26	30
Charge for the year	4	4	8
At 28 February 2006	**8**	**30**	**38**
Net book value at 28 February 2006	**185**	**8**	**193**
Cost or valuation at 28 February 2006 comprised			
At 2005 valuation	191	–	191
At cost	2	38	40
	193	**38**	**231**

The figures for freehold land and buildings reflect professional valuations on a market value basis at 28 February 2007 by Nelson Bakewell, members of the Royal Institute of Chartered Surveyors (RICS). These valuations have been incorporated into the financial statements and were performed in accordance with the RICS Appraisal and Valuation manual.

18 Investment properties

Investment properties are held at cost. Where properties have been reclassified, the book value at the date of reclassification has been deemed cost. The investment properties substantially relate to freehold land on which the Bank has granted leases to third parties in excess of 100 years.

	2007 £m	2006 £m
Cost		
At 1 March	26	8
Reclassification from property, plant and equipment	–	18
At 28 February	**26**	**26**

The fair value of investment properties at 28 February 2007 was £43 million (2006: £42 million).

The Bank leases land and buildings to third parties. At the year end, minimum lease receivables under cancellable operating leases expiring in five or more years are £0.1 million per annum (2006: £nil), increasing to £0.3 million after five years (2006: £nil).

Notes to the Banking Department Financial Statements continued

19 Deferred tax assets and liabilities

Deferred tax is calculated on all temporary differences under the liability method using an effective tax rate of 30% (2006: 30%).

The movement on the deferred tax account is as follows:

	Note	2007 £m	2006 £m
Deferred tax			
Net asset at 1 March		12	18
Profit and loss charge	7	(14)	16
Other recognised income and expense	7	(28)	(22)
Net (liability)/asset at 28 February		**(30)**	**12**

	2007 £m	2006 £m
Deferred tax (liability)/asset relates to:		
Property revaluation	–	(5)
Available for sale securities	(106)	(100)
Pensions and other post-retirement benefits	62	119
Other provisions	14	(2)
	(30)	**12**

20 Other assets

	2007 £m	2006* £m
Short-term debtors and other assets	197	131
	197	**131**

* Prior year figures have been adjusted for consistency (see note 10).

21 Deposits from central banks

	2007 £m	2006 £m
Repayable on demand	938	1,337
Term deposits	10,581	10,043
	11,519	**11,380**

22 Deposits from banks and building societies

	Note	2007 £m	2006 £m
Items in course of settlement		3	2
Repayable on demand:			
Sterling		17,999	751
Euro		163	170
Collateral for derivatives	12	45	63
Cash ratio deposits		2,568	2,222
		20,778	**3,208**

The increase in repayable on demand balances for the year ending 28 February 2007 is due to the introduction of the Bank's Money Market Reform programme in May 2006 (as set out in the *Annual Report* — page 18).

Cash deposits in US dollars are taken from counterparties as collateral for certain derivatives (see note 12).

Cash ratio deposits are computed on the basis of banks' and building societies' eligible liabilities and are interest free. Any change in the amount due, as a result of either becoming or ceasing to be an eligible institution for the purpose of the Bank of England Act 1998, the twice-yearly recalculation of deposits or a change in the percentage used for calculation, is payable immediately. Under the Bank of England Act 1998, the percentage used in calculating the cash ratio deposits is set by HM Treasury, having regard to the financial needs of the Bank and subject to the approval of both Houses of Parliament.

Other deposits in both euro and sterling are held by banks for operational reasons connected to settlement systems.

23 Other deposits

	2007 £m	2006 £m
Deposit by Issue Department	49	53
Public deposits:		
Current accounts repayable on demand	900	875
Term deposits	5	25
Other deposits repayable on demand	129	128
	1,083	**1,081**

Public deposits are the balances on HM Government accounts, including Exchequer, National Loans Fund, Debt Management Office, National Debt Commissioners and dividend accounts.

Notes to the Banking Department Financial Statements continued

24 Financial liabilities designated at fair value through profit or loss

All changes in fair values since 1 March 2006 are considered attributable to changes in prevailing interest rates.

	2007 **£m**	2006 £m
Financial liabilities designated at fair value through profit or loss		
Euro Notes	3,328	4,073
Euro Bills	–	2,439
	3,328	**6,512**

a Euro Notes

The Bank announced on 15 December 2006 that its foreign exchange reserves would be financed by a new issuance programme. Under the new programme medium-term securities will be issued on an annual basis, with a regular timetable, a high degree of transparency and a group of banks to market and distribute each issue. At the same time the Bank announced that no further Euro Notes would be issued. As at 28 February 2007 two Euro Note issues remained outstanding; a €2 billion issue maturing on 28 January 2008 and a €3 billion issue maturing on 27 January 2009. An additional 10% of both of these issues, plus any residuals arising from rounding down the auction bids, is held by the Bank and may be made available for sale and repurchase transactions with market makers in the old Euro Note programme. The position at 28 February 2007 was as follows:

	2007		2006	
	£m Fair value	**€m Nominal**	£m Fair value	€m Nominal
Total amount issued	3,661	5,500	5,348	7,700
Held by the Bank	(333)	(500)	(1,275)	(1,700)
Liabilities to third parties	**3,328**	**5,000**	**4,073**	**6,000**

Of the above liabilities to third parties, £1,334 million (2006: £1,496 million) fall due within one year.

b Euro Bills

	2007		2006	
	£m Fair value	**€m Nominal**	£m Fair value	€m Nominal
Original maturity of Bills in issue				
3 months	–	–	1,222	1,795
6 months	–	–	1,217	1,788
Liabilities to third parties	**–**	**–**	**2,439**	**3,583**

On 24 April 2006 the Bank announced that it would cease issuing Euro Bills. Thus the final Euro Bill auction took place on 11 April 2006. The outstanding €3.6 billion of Euro Bills matured over the following six months with the final Bill repaying on 12 October 2006 and therefore no amounts were outstanding at 28 February 2007 (2006: £1,833 million).

25 Other liabilities

	2007 £m	2006 £m
Payable to HM Treasury	83	47
Due to subsidiaries	15	20
Items in course of settlement	38	–
Short-term creditors, other liabilities and deferred income	314	287
	450	**354**

26 Retirement benefits

The Bank operates non-contributory defined-benefit pension schemes providing benefits based on final pensionable pay. The assets of the schemes are held separately by the Bank in independent trustee-administered funds. The Bank also provides other post-retirement benefits, principally healthcare, for certain pensioners.

Valuation for funding purposes

The main pension scheme, the Bank of England Pension Fund, is valued for funding purposes at intervals of not more than three years by an independent qualified actuary, with interim reviews in the intervening years. The latest valuation for funding purposes was as at 28 February 2005; it used the current unit method, and thus the funding target was based on each active member's current earnings, with the effect of future earnings increases on the accrued liabilities being included in normal future service contribution.

The valuation as at 28 February 2005	£m
Value of Fund assets	
Actuarial value of scheme liabilities	1,580
Scheme (deficit)/surplus	(1,879)
	(299)
Funding level	84%
Future service contribution rate	41.3%

For the 2005 valuation, the liabilities were valued by the actuary on an index-linked gilts yield discount rate, and no credit was taken in advance for the possibility that returns on investments held by the Fund would exceed the long-term interest rate. Allowance was made for past and prospective mortality improvements. The rate of RPI inflation used in the valuation and the pension increase assumption was 2.8% (2002: 2.5%).

The Bank and the Pension Fund Trustees, with advice from the actuary, agreed that the deficit should be amortised over the period to March 2014, with four annual payments of £52.5 million followed by six annual payments of £26.7 million.

Excluded from the contribution rate is a 3% cost of administration and other services set out in note 29 (d).

Notes to the Banking Department Financial Statements continued

26 Retirement benefits continued

Summary of amounts recognised in the financial statements under IAS 19

The Bank accounts for pension costs, other post-retirement benefits and redundancy provisions in accordance with IAS 19 (Employee Benefits). Under the standard, the difference between the market values of scheme assets and the present value of scheme liabilities is reported as a surplus or deficit in the Balance Sheet. The Bank has adopted the option of recognising actuarial gains and losses in full through the Statement of Recognised Income and Expense.

In the preparation of their valuations under IAS 19 referred to in this note, the actuaries have used the assumptions indicated below, which Members of Court have accepted for the purposes of accounting and disclosure under the standard.

Amounts recognised as liabilities in the Balance Sheet		**2007 £m**	2006 £m	2005 £m
Funded pension schemes	(a)	(22)	(147)	(301)
Unfunded post-retirement benefits:				
Redundancy provisions	(b)	(70)	(68)	(64)
Pension schemes	(c)	(6)	(5)	(4)
Other post-retirement benefits	(d)	(145)	(151)	(137)
		(243)	**(371)**	**(506)**

Pension expense recognised in the Income Statement		**2007 £m**	2006 £m
Funded pension schemes	(a)	19	19
Unfunded post-retirement benefits:			
Redundancy provisions	(b)	9	5
Pension schemes	(c)	1	1
Other post-retirement benefits	(d)	9	5
Total pension expense		**38**	**30**

Gains/(losses) recognised in the Statement of Recognised Income and Expense		**2007 £m**	2006 £m
Funded pension schemes	(a)	60	89
Unfunded post-retirement benefits:			
Redundancy provisions	(b)	2	(4)
Other post-retirement benefits	(d)	12	(12)
		74	**73**

a Main and Court pension schemes

As described above, the Bank operates non-contributory defined-benefit pension schemes providing benefits based on final pensionable pay. The assets of the schemes are held separately by the Bank in independent trustee-administered funds. The main pension scheme is the Bank of England Pension Fund. Some members of the Executive Team participate in the Court Pension Scheme. Further details are given in the Remuneration Report on page 29 of the *Annual Report*.

Summary of assumptions

Under IAS 19 measurement of scheme liabilities must be calculated under the projected unit method, which requires certain demographic and financial assumptions, including an assumption about future salary growth. The assumptions used are applied for the purposes of IAS 19 only.

The financial assumptions used by the independent actuaries to calculate scheme liabilities on an IAS 19 basis were:

	2007 %	2006 %
Inflation rate (RPI)	2.8	2.8
Discount rate	4.9	4.6
Rate of increase in salaries	4.6	4.6
Rate of increase of pensions in payment	2.8	2.8
Rate of increase for deferred pensioners	2.8	2.8

The discount rate assumption reflects the investment return on a Grade AA corporate bond at the Balance Sheet date.

The assumption for life expectancy for the schemes assumes that a male member reaching 60 in 2007 will live for 27 years (2006: 27 years) and a female member 28 years (2006: 28 years), and a male member reaching 60 in 2017 will live for 28 years (2006: 28 years) and a female member 29 years (2006: 29 years).

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with both current industry experience and the actual experience of the relevant schemes.

The assets in the schemes and the expected rates of return were:

	2007			2006		
	Long-term rate of return expected %	**Value** £m	**Percentage of total value** %	Long-term rate of return expected %	Value £m	Long-term rate of return expected %
Equities	7.2	897	44.9	7.3	999	52.3
Bonds	4.6	922	46.1	4.4	749	39.3
Properties	6.0	121	6.0	5.8	105	5.5
Cash and other assets	4.6	60	3.0	3.8	55	2.9
Total market value of investments	**5.7**	**2,000**	**100.0**	**5.8**	**1,908**	**100.0**

For the purposes of IAS 19, the asset values stated are at the Balance Sheet date. Market values of schemes' assets, which are not intended to be realised in the short term, may be subject to significant change before they are realised. The long-term expected rates of return have been determined after applying due consideration to the arrangements of paragraph 106 of IAS 19. Expected rates of return are used for the purposes of calculating the annual charge to the Income Statement in the subsequent year, and have no impact on the deficit in the scheme as calculated on an IAS 19 basis. The assumptions used do not necessarily reflect the investment return that may be achieved.

Notes to the Banking Department Financial Statements continued

26 Retirement benefits continued

The expected return on assets has been derived as the weighted average of expected returns from each of the main asset classes.

	2007 £m	2006 £m	2005 £m
Present value of defined-benefit obligations	(2,022)	(2,055)	(1,905)
Assets at fair value	2,000	1,908	1,604
Defined-benefit liability	**(22)**	**(147)**	**(301)**

The deficit in the schemes before taxation, on an IAS 19 basis, has decreased by £125 million to £22 million at the year end. The decrease has arisen principally as a result of additional contributions made to the schemes and a higher discount rate being applied to the obligations.

A +/-0.1% change to the discount rate would change the deficit on the main pension scheme by +/-£31 million. The assumptions relating to future mortality rates were last revised in 2006 to reflect increased longevity. If mortality rates were adjusted such that individuals were assumed to live for an additional year, the main scheme liabilities at the year end would increase by approximately £58 million.

The Bank expects to pay contributions of £84 million in the forthcoming year (2006: £84 million).

Components of pension expense in the Income Statement	**2007 £m**	2006 £m
Current service cost	36	28
Past service cost	3	1
Interest cost	93	95
Expected returns on assets	(113)	(105)
Total pension expense	**19**	**19**

The increase in current service costs results primarily from a fall in the discount rate used in the calculation. Costs are calculated based on the discount rate used for the previous year end. Accordingly, the discount rate used for 2007 is 4.6% (2006: 5.1%).

Gains/(losses) recognised in the Statement of Recognised Income and Expense	**2007 £m**	2006 £m
Cumulative actuarial losses recognised at the beginning of the year	(140)	(229)
Actuarial gain/(loss) on schemes' liabilities	74	(106)
Actuarial (loss)/gain on schemes' assets	(14)	195
Cumulative actuarial losses recognised at 28 February	**(80)**	**(140)**

Reconciliation of return on assets	2007 £m	2006 £m
Expected return on schemes' assets (net of expense)	113	105
Actuarial (loss)/gain on schemes' assets	(14)	195
Actual return on schemes' assets (net of expense)	**99**	**300**

Reconciliation of present value of defined-benefit obligation	2007 £m	2006 £m
Present value of defined-benefit obligation at 1 March	2,055	1,905
Current service cost	36	28
Past service cost	3	1
Interest cost	93	95
Actuarial (gain)/loss relating to schemes' liabilities	(74)	106
Benefits paid from schemes	(91)	(80)
Present value of defined obligation at 28 February	**2,022**	**2,055**

Reconciliation of the fair value of assets	2007 £m	2006 £m
Fair value of schemes' assets at 1 March	1,908	1,604
Actual return on schemes' assets	99	300
Bank contributions	84	84
Benefits paid from schemes	(91)	(80)
Fair value of schemes' assets at 28 February	**2,000**	**1,908**

Experience gains and losses	2007 £m	2006 £m	2005 £m
Experience (loss)/gain on defined-benefit obligation	(16)	20	30
Experience (loss)/gain on schemes' assets	(14)	195	62

b Redundancy schemes

As part of redundancy arrangements with staff, the Bank may give enhanced pension entitlement in the form of added years service or early pension rights. The costs of such benefits cannot be charged to the Pension Fund. The costs are therefore borne in the Bank's accounts, and represent the future cost of decisions that have already been taken. Provision is made for the costs of these benefits at the time the redundancy offer is announced based on actuarial advice.

The valuation of these provisions has been performed using the relevant assumptions applied for the IAS 19 valuation of pension schemes (see (a)).

Notes to the Banking Department Financial Statements continued

26 Retirement benefits continued

	2007 £m	2006 £m	2005 £m
Unfunded defined-benefit liability	**(70)**	**(68)**	**(64)**

Components of pension expense in the Income Statement	2007 £m	2006 £m
Past service cost	6	2
Interest cost	3	3
Total pension expense	**9**	**5**

Gains/(losses) recognised in the Statement of Recognised Income and Expense	2007 £m	2006 £m
Cumulative actuarial losses recognised at beginning of year	(13)	(9)
Actuarial gain/(loss) on schemes' liabilities	2	(4)
Cumulative actuarial losses recognised at 28 February	**(11)**	**(13)**

Reconciliation of present value of defined-benefit obligation	2007 £m	2006 £m
Present value of defined-benefit obligation at 1 March	68	64
Past service cost	6	2
Interest cost	3	3
Actuarial (gain)/loss on schemes' liabilities	(2)	4
Defined-benefits paid	(5)	(5)
Present value of defined-benefit obligation at 28 February	**70**	**68**

Experience gains and losses	2007 £m	2006 £m	2005 £m
Experience loss on defined-benefit obligation	–	(1)	(1)

The Bank expects to make payments of £5 million in the forthcoming year (2006: £5 million).

c Other unfunded pension scheme

As explained in the Remuneration section of the *Annual Report* on page 29, for Governors subject to the pensions earnings cap introduced in the Finance Act 1989, the Bank offers additional unfunded pensions so that their total pensions broadly match what would have been provided by the Court scheme in the absence of a cap. Provision is made for these in the Bank's accounts. In addition certain former Governors and Directors and the widows of some former Governors and Directors were granted *ex-gratia* pensions. Provision for these was made in the Bank's accounts when the grants were made.

The valuation of this scheme has been performed using the relevant assumptions applied for the IAS 19 valuation of pension schemes (see (a)).

	2007 £m	2006 £m	2005 £m
Unfunded defined-benefit liability	**(6)**	**(5)**	**(4)**

Components of pension expense in the Income Statement	2007 £m	2006 £m
Service and interest cost	1	1
Total pension expense	**1**	**1**

Amounts recognised in the Statement of Recognised Income and Expense	2007 £m	2006 £m
Cumulative actuarial losses recognised at beginning of year	(1)	(1)
Cumulative actuarial losses recognised at end of year	**(1)**	**(1)**

Reconciliation of present value of defined-benefit obligation	2007 £m	2006 £m
Present value of defined-benefit obligation at 1 March	5	4
Service and interest cost	1	1
Present value of defined-benefit obligation at 28 February	**6**	**5**

Experience gains and losses

For the year ended 28 February 2007, experience losses on the defined-benefit obligation were less than £1 million (2006: less than £1 million).

d Other post-retirement benefits

Some staff are entitled to receive healthcare benefits in retirement. Separate provision is made for these in the Bank's accounts as these cannot be paid out of the Pension Fund.

Summary of assumptions

The inflation and discount rates used for the purposes of measuring post-retirement benefit liabilities are the same as those used in the IAS 19 valuation of pension scheme liabilities (see (a)). Additionally, for accounting purposes the following assumptions have been made in respect of medical expense inflation:

	2007 %	2006 %
Initial medical trend	13.0	11.0
Ultimate medical trend	5.0	5.0
Years to ultimate	6.0	6.0

Notes to the Banking Department Financial Statements continued

26 Retirement benefits continued

	2007 £m	2006 £m	2005 £m
Unfunded defined-benefit liability	**(145)**	**(151)**	**(137)**

Sensitivity analysis provided by the actuaries suggests that a 0.1% decrease to the discount rate would change the deficit on the other post-retirement benefits by £3 million, and a 0.1% increase in the rate of medical claims by £3 million. If mortality rates were adjusted such that individuals were assumed to live for an additional year, the other post-retirement liabilities at the year end would increase by approximately £7 million.

The Bank expects to pay premiums of £3 million in the forthcoming year (2006: £3 million).

Components of expense in the Income Statement	2007 £m	2006 £m
Service cost	2	2
Interest cost	7	3
Total pension cost	**9**	**5**

Gain/(losses) recognised in the Statement of Recognised Income and Expense	2007 £m	2006 £m
Cumulative actuarial losses recognised at beginning of year	(62)	(50)
Actuarial gain/(loss) on scheme liabilities	12	(12)
Cumulative actuarial losses recognised at end of year	**(50)**	**(62)**

Reconciliation of present value of defined-benefit obligation	2007 £m	2006 £m
Present value of defined-benefit obligation at 1 March	151	137
Service cost	2	2
Interest cost	7	3
Actuarial (gain)/loss on scheme liabilities	(12)	12
Premiums paid	(3)	(3)
Present value of defined-benefit obligation at 28 February	**145**	**151**

Experience gains and losses	2007 £m	2006 £m	2005 £m
Experience gain on defined-benefit obligation	7	–	2

27 Capital

The entire capital comprising £14,553,000 of Bank Stock is held by the Treasury Solicitor on behalf of HM Treasury.

28 Retained earnings and other reserves

As at 28 February 2007	Share capital £m	Available for sale reserve £m	Property revaluation reserve £m	Retained earnings £m	Total equity and reserves £m
Balances as at 1 March 2006	15	249	163	1,305	1,732
Profit after tax for the year	–	–	–	166	166
Payment to HM Treasury	–	–	–	(83)	(83)
Other items recognised through the Statement of Recognised Income and Expense	–	(66)	59	52	45
Transfer	–	23	–	(23)	–
As at 28 February 2007	**15**	**206**	**222**	**1,417**	**1,860**

As at 28 February 2006*	Share capital £m	Available for sale reserve £m	Property revaluation reserve £m	Retained earnings £m	Total equity and reserves £m
Adjusted balances as at 1 March 2005	15	246	163	1,207	1,631
Profit after tax for the year	–	–	–	94	94
Payment to HM Treasury	–	–	–	(47)	(47)
Other items recognised through the Statement of Recognised Income and Expense	–	3	–	51	54
As at 28 February 2006	**15**	**249**	**163**	**1,305**	**1,732**

* Tax relief on payments to HM Treasury is now credited to the Income Statement in accordance with paragraph 52 (b) of IAS 12. This is a change from the prior year which has been restated accordingly (see note 1 (s)).

29 Related parties

a HM Government

The Bank provides several services to its shareholder, HM Treasury, and to other Government departments and bodies.

The main services during the year to 28 February 2007 were:

- provision of banking services, including holding the principal accounts of the Government;
- management of the Exchange Equalisation Account;
- management of the Note Issue; and
- operation of sanctions against specific countries.

The aggregate balances on HM Treasury and other public sector accounts are disclosed in note 23 as public deposits. The total charges made to the Government are disclosed in note 4.

b Group undertakings

All material transactions and balances between the Bank and its subsidiaries are disclosed in note 15 and note 25.

c Key management personnel

The following information is presented only in respect of those employees of the Bank who would be considered as key management personnel, as defined under IAS 24 (Related Party Disclosures). This comprises of the Governors, members of the Executive Team and Non-executive Directors. At 28 February 2007, the number of key management personnel was 26 (2006: 24).

Notes to the Banking Department Financial Statements continued

29 Related parties continued

The following particulars relate to loans and deposits between the Bank and key management personnel and persons connected with them.

	2007 £000	2006 £000
Loans		
Loans outstanding 1 March	39	38
Loans made during the year	24	23
Loans repaid during the year	(25)	(22)
Loans outstanding 28 February	**38**	**39**
Number of loans outstanding 28 February	5	4
Interest income earned during the year	1	1

No provisions have been recognised in respect of loans given to related parties (2006: nil).

	2007 £000	2006 £000
Deposits		
Deposits outstanding 1 March	367	433
Deposits taken during the year	797	644
Deposits repaid during the year	(763)	(710)
Deposits outstanding 28 February	**401**	**367**
Number of deposits at 28 February	10	8
Interest expense on above deposits	15	13

There were no other transactions that would be required to be shown under the provisions of the Companies Act 1985. None of the key management personnel had a material interest, directly or indirectly, at any time during the year in any other significant transaction or arrangement with the Bank or any of its subsidiaries.

All employees, including key management personnel, are entitled to season ticket loans (repayable monthly over ten months) and may choose to take personal loans (for periods up to three years at an interest rate of 3%) as part of their remuneration package. Staff may also apply for a medium-term loan secured by collateral at a rate of base rate plus 1%. All staff, including Governors and Executive Directors are entitled to banking facilities, including current and interest-bearing deposit accounts, at the Bank of England. Current accounts pay interest at commercial rates dependent upon the level of the balance.

Key management remuneration	2007 £000	2006 £000
Salaries and short-term benefits	2,140	1,907
Post-employment benefits	1,256	1,248
	3,396	**3,155**

Full information on the remuneration (including pension arrangements) of the Members of Court is given in the Remuneration Report on pages 29 to 32.

d The Bank's pension schemes

The Bank provides the secretariat, investment management and some banking and custodial services to the Bank's pension schemes. In the year to 28 February 2007 a charge of £2 million (2006: £2 million) was made for these services. These activities are undertaken on behalf of, and under the supervision of, the trustees of the schemes. The contribution paid to the Fund during the year was £84 million (2006: £84 million). There were no other material transactions between the Bank and the pension schemes during the year to 28 February 2007. At 28 February 2007 the balances on accounts held with the Bank were £3 million (2006: £1 million).

e Other entities with links to the Bank

In the normal course of its activities as a central bank, the Bank has relationships, involving some representation at management level and participation in funding, with international and domestic institutions. The Bank does not consider these institutions to be related parties.

30 Contingent liabilities and commitments

a Contingent liabilities

Contingent liabilities and commitments, some of which are offset by corresponding obligations of third parties, arise in the normal course of business, including contingent liabilities in respect of guarantees and indemnities in connection with liquidity support operations.

As part of its normal business, the Bank acts as custodian of its customers' assets and fulfils an agency role. No significant irrecoverable liability arises from these transactions.

Since 1930 there has also been a contingent liability in respect of uncalled capital on the Bank's investment in the Bank for International Settlements, now denominated in Special Drawing Rights (SDR). The sterling equivalent of this liability based on the SDR price at the Balance Sheet date was £137 million (2006: £147 million).

b Capital commitments

Contracts for capital expenditure authorised by members of Court and outstanding at 28 February 2007 amounted to £8 million (2006: £15 million).

Notes to the Banking Department Financial Statements continued

30 Contingent liabilities and commitments continued

c Operating lease commitments — minimum lease payments

	2007		2006	
	Land and buildings £000	Computer and other equipment £000	Land and buildings £000	Computer and other equipment £000
At the year-end, minimum annual lease payments under non-cancellable operating leases were:				
Expiring within one year	314	847	–	793
Expiring between one and five years	117	189	152	187
Expiring in five or more years	329	–	517	–
	760	**1,036**	**669**	**980**

The Bank leases the premises occupied by its regional agencies.

31 Financial risk management

a Strategy in using financial instruments

By their nature, the Bank's activities involve the use of financial instruments, including derivatives.

With the exception of the Note Issue liabilities and the associated assets, all of the Bank's financial instruments are booked to the Banking Department. The activities involving, and the strategies employed in using, these instruments are as follows:

i The implementation of monetary policy and the management of sterling banking system liquidity, in normal and stressed conditions. As set out on in the *Annual Report* (page 18), the Bank's Money Market Reform programme was introduced in May 2006. The new framework is based on a reserves-averaging system and has increased the Bank Departments Balance Sheet to £39.4 billion. In its open market operations, the Bank adjusts its stock of sterling money market lending to offset the impact of flows on reserves balances held at the Bank.

ii As part of the monetary policy framework introduced by the Chancellor of the Exchequer in 1997, the Bank of England holds its own foreign exchange reserves in support of its monetary policy objective. These reserves are separate from the Government's own foreign exchange reserves, which the Bank manages as the Treasury's agent. To date the Bank's holdings of foreign exchange reserves have been financed by the Euro Note and Euro Bill issuance programmes. In future, and as announced on 15 December 2006, the Bank's foreign exchange reserves will be financed by a new issuance programme. Under the new programme medium-term securities will be issued on an annual basis, with a regular timetable, a high degree of transparency and a group of banks to market and distribute each issue. In steady state the Bank will hold £3 billion equivalent of foreign exchange reserves on a currency hedged basis. Any intervention operation would therefore open an exchange rate exposure on the Bank's Balance Sheet. No such operations were conducted during the financial year.

iii Supporting the Bank's provision of payment services in sterling and euros. Foreign currency assets, principally financed on a currency hedged basis by the Euro Note maturing on 27 January 2009, are used to generate liquidity to meet the Bank's obligations as a member of the current TARGET wholesale payment system.

iv Supporting the Bank's provision of banking services to central banks, HM Government and others. The Bank uses foreign exchange transactions to manage exchange rate exposures arising from these services.

v The maintenance of the value of the Bank's capital and reserves, and the generation of income to pay for policy-related functions, including reinvestment of cash ratio deposits. The Bank holds a portfolio of high-quality securities of maturities up to fifteen years, which currently notionally matches a proportion of its capital and reserves.

vi Maintaining the technical capability and know-how to conduct special operations to support financial stability.

b Credit risk

The Bank is exposed to credit risk, which is the risk of loss arising from the failure of a borrower, issuer, counterparty or customer to meet its financial obligations to the Bank. Credit risk arises when the Bank provides liquidity to financial institutions via open market operations as part of monetary policy implementation; intraday in the Bank's provision of liquidity to facilitate the operation of the sterling and euro high-value payment systems (CHAPS and CHAPS euro); and the securities settlement system, CREST; and elsewhere in the Bank's management of its Balance Sheet, for example in the investment of the Bank's own funds and in the course of the banking services it provides to its customers.

The Bank's Credit Ratings Advisory Committee (CRAC), chaired by the Head of the Markets Directorate's Risk Management Division, reviews regularly the creditworthiness of issuers, counterparties and customers to whom the Bank may take credit exposures. CRAC makes recommendations to the Executive Director for Markets, who is responsible for decisions on internal credit ratings. CRAC is supported by a credit risk analysis team.

In providing liquidity via open market operations and, intraday, via the Bank's operation of wholesale payment systems, credit risk is managed by dealing with counterparties that meet appropriate credit and functional criteria, and by ensuring that exposures are fully collateralised (with appropriate margin) by high-quality, marketable securities. These exposures are monitored on a regular basis, and additional margin is called as required.

Credit risk on the securities held by the Bank is managed by holding only high-quality securities, issued chiefly by governments, government agencies and supranational organisations.

Banking services are provided to the UK government and other public sector entities, overseas central banks, international institutions, infrastructure providers, Bank staff and pensioners and other customers. The Bank may incur credit exposures to its customers in the course of providing such services. The reinvestment of customer deposits may also give rise to credit exposures.

In addition the Bank may incur credit risk in connection with any support operations it may undertake.

Geographical concentration of assets and liabilities

The Bank undertakes its operations in the United Kingdom. It does, however, accept deposits from overseas central banks. An analysis of the Bank's assets and liabilities by geographical area is given below:

	2007 £m	2006 £m
Assets		
United Kingdom	31,249	13,865
Rest of Europe	7,536	9,845
Rest of the World	578	1,043
	39,363	**24,753**
Liabilities		
United Kingdom	26,998	13,148
Rest of Europe	1,159	554
Rest of the World	11,206	11,051
	39,363	**24,753**

Notes to the Banking Department Financial Statements continued

31 Financial risk management continued

c Market risk

The Bank is exposed to market risk, principally through changes in the relative interest rates received on its assets and paid on its liabilities. Limited exposure may also be incurred to changes in exchange rates (see section (d)) and to shifts in general market conditions, such as the liquidity of asset markets. The Bank manages its exposures to market risk in ways that are consistent with the underlying purposes for which its operations are conducted. The Bank is exposed to interest rate risk principally via the investment of the Bank's capital and cash ratio deposits in high quality securities of maturity up to fifteen years. This portfolio is designed to maintain the value of the Bank's capital and generate income to pay for policy-related functions and is brought and held in normal circumstances. The Bank measures and limits the Value at Risk (VaR) of mismatched positions. VaR estimates, to a confidence level of 99%, the potential loss that might arise if existing positions were unchanged for ten business days, given the historical volatility of the returns on different assets, and the historical correlation between those returns.

d Currency risk

As noted above the Bank may take currency risk in the context of foreign exchange intervention, though no such operations were conducted in the year. Additionally, limited other foreign currency exposures may arise in the course of Balance Sheet management. However, the majority of these potential exposures are matched, mainly through the use of forward exchange contracts and currency swaps, and residual foreign exchange exposures are hedged on a regular basis. Therefore the Bank has no significant net foreign currency exposure, other than the Bank's investment in the Bank for International Settlements which is denominated in Special Drawing Rights and fair valued at £257 million.

e Cash flow and fair value interest rate risk

Interest sensitivity of assets and liabilities

For accounting purposes, cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates, both in the United Kingdom and abroad. Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates. The exposures to both kinds of interest rate risk arise in the course of the Bank's activities.

The following table summarises the Bank's interest rate exposure in the form of an interest rate repricing table. This shows when the interest rate earned or charged on assets and liabilities can change. The table may therefore be used to assess broadly the sensitivity of the Bank's net income to interest rate movements. The assets and liabilities are included at carrying amounts, categorised by the earlier of contractual repricing or maturity dates.

A positive sensitivity gap means that more assets than liabilities reprice in this time band. Subject to the broad time bands below, the mix of currencies involved, and the impact of derivative repricing, a positive sensitivity gap implies that the Bank's net interest income would benefit in that time band as a result of an increase in interest rates. A negative sensitivity gap indicates the reverse.

As at 28 February 2007	Up to 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m	Cash ratio deposits £m	Non-interest bearing £m	Total £m
Assets								
Cash and balances with other central banks	99	–	–	–	–	–	–	99
Loans and advances to banks	22,678	2,168	6,705	–	1	–	–	31,552
Financial assets designated at fair value through profit or loss	–	25	806	2,467	–	–	–	3,298
Derivative financial instruments	14	3	83	21	–	–	–	121
Loans and advances to customers	–	–	1	3	1	–	–	5
Available for sale securities	–	–	225	1,319	1,950	–	261	3,755
Investments in group undertakings	–	–	–	–	–	–	13	13
Intangible assets	–	–	–	–	–	–	19	19
Property, plant and equipment	–	–	–	–	–	–	247	247
Investment properties	–	–	–	–	–	–	26	26
Current tax assets	–	–	–	–	–	–	31	31
Other assets	–	–	–	–	–	–	197	197
Total assets	**22,791**	**2,196**	**7,820**	**3,810**	**1,952**	**–**	**794**	**39,363**
Liabilities								
Deposits from central banks	2,699	2,303	6,517	–	–	–	–	11,519
Deposits from banks and building societies	18,153	57	–	–	–	2,568	–	20,778
Other deposits	1,082	–	–	–	1	–	–	1,083
Derivative financial instruments	6	19	47	–	–	–	–	72
Financial liabilities designated at fair value through profit or loss	–	–	1,334	1,994	–	–	–	3,328
Other liabilities	–	–	–	–	–	–	450	450
Current tax liabilities	–	–	–	–	–	–	–	–
Deferred tax liabilities	–	–	–	–	–	–	30	30
Retirement benefits	–	–	–	–	–	–	243	243
Capital and reserves	–	–	–	–	–	–	1,860	1,860
Total equity and liabilities	**21,940**	**2,379**	**7,898**	**1,994**	**1**	**2,568**	**2,583**	**39,363**
Interest rate repricing gap	**851**	**(183)**	**(78)**	**1,816**	**1,951**	**(2,568)**	**(1,789)**	**–**
Cumulative gap	**851**	**668**	**590**	**2,406**	**4,357**	**1,789**	**–**	

Notes to the Banking Department Financial Statements continued

31 Financial risk management continued

As at 28 February 2006*	Up to 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m	Cash ratio deposits £m	Non-interest bearing £m	Total £m
Assets								
Cash and balances with other central banks	185	–	–	–	–	–	–	185
Loans and advances to banks	6,784	1,747	5,975	–	–	–	–	14,506
Financial assets designated at fair value through profit or loss	13	–	1,323	4,327	–	–	–	5,663
Derivative financial instruments	110	91	86	4	–	–	–	291
Loans and advances to customers	1	–	1	2	2	–	–	6
Available for sale securities	–	–	176	1,317	2,212	–	–	3,705
Investments in group undertakings	–	–	–	–	–	–	18	18
Intangible assets	–	–	–	–	–	–	17	17
Property, plant and equipment	–	–	–	–	–	–	193	193
Investment properties	–	–	–	–	–	–	26	26
Deferred tax assets	–	–	–	–	–	–	12	12
Other assets	–	–	–	–	–	–	131	131
Total assets	**7,093**	**1,838**	**7,561**	**5,650**	**2,214**	**–**	**397**	**24,753**
Liabilities								
Deposits from central banks	3,650	2,050	5,680	–	–	–	–	11,380
Deposits from banks and building societies	986	–	–	–	–	2,222	–	3,208
Other deposits	1,070	10	–	–	1	–	–	1,081
Derivative financial instruments	75	3	16	4	–	–	–	98
Financial liabilities designated at fair value through profit or loss	614	1,220	1,967	2,711	–	–	–	6,512
Other liabilities	–	–	–	–	–	–	354	354
Current tax liabilities	–	–	–	–	–	–	17	17
Retirement benefits	–	–	–	–	–	–	371	371
Capital and reserves	–	–	–	–	–	–	1,732	1,732
Total equity and liabilities	**6,395**	**3,283**	**7,663**	**2,715**	**1**	**2,222**	**2,474**	**24,753**
Interest rate repricing gap	**698**	**(1,445)**	**(102)**	**2,935**	**2,213**	**(2,222)**	**(2,077)**	**–**
Cumulative gap	**698**	**(747)**	**(849)**	**2,086**	**4,299**	**2,077**	**–**	

* This table has been restated to ensure that this note is presented on a consistent basis.

The table below summarises the average effective interest rate for monetary financial instruments not carried at fair value through profit or loss for the year ended 28 February 2007:

	2007 %	2006 %
Assets		
Cash and balances with other central banks	–	–
Loans and advances to banks	4.8	3.5
Loans and advances to customers	4.0	4.5
Liabilities		
Deposits from central banks	5.2	4.0
Deposits from banks and building societies	5.1	3.6
Cash ratio deposits	–	–
Other deposits	2.7	1.9

f Liquidity risk

The Bank is exposed to daily calls from overnight deposits, current accounts, maturing deposits and from margin and other calls on cash-settled derivatives. In sterling, such movements are reflected in the provision of refinancing to the banking system via open market operations and in the interim by impacting the level of reserve balances held with the Bank as set out in the *Annual Report* (page 18). In foreign currency, in addition to holding appropriate cash balances, the Bank manages liquidity through cash flow matching and the use of forward exchange contracts and currency swaps; the Bank also holds a portfolio of liquid foreign exchange reserves.

The table below analyses the Bank's assets and liabilities at the Balance Sheet date into relevant maturity groupings based on the remaining period to the contractual maturity date. This table, which is required under IAS 30 (Disclosures in the Financial Statements of Banks and Similar Institutions) is however not well suited to the Bank, which as the central bank is the ultimate source of sterling liquidity.

Notes to the Banking Department Financial Statements continued

31 Financial risk management continued

As at 28 February 2007	Up to 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m	Cash ratio deposits £m	Total £m
Assets							
Cash and balances with other central banks	99	–	–	–	–	–	99
Loans and advances to banks	22,678	2,168	6,705	–	1	–	31,552
Financial assets designated at fair value through profit or loss	–	25	806	2,467	–	–	3,298
Derivative financial instruments	14	3	83	21	–	–	121
Loans and advances to customers	–	–	1	3	1	–	5
Available for sale securities	–	–	225	1,319	2,211	–	3,755
Investments in group undertakings	13	–	–	–	–	–	13
Intangible assets	–	–	–	–	19	–	19
Property, plant and equipment	–	–	–	–	247	–	247
Investment properties	–	–	–	–	26	–	26
Current tax assets	–	–	31	–	–	–	31
Other assets	51	45	101	–	–	–	197
Total assets	**22,855**	**2,241**	**7,952**	**3,810**	**2,505**	**–**	**39,363**
Liabilities							
Deposits from central banks	2,699	2,303	6,517	–	–	–	11,519
Deposits from banks and building societies	18,153	57	–	–	–	2,568	20,778
Other deposits	1,082	–	–	–	1	–	1,083
Derivative financial instruments	6	19	47	–	–	–	72
Financial liabilities designated at fair value through profit or loss	–	–	1,334	1,994	–	–	3,328
Other liabilities	116	89	165	3	77	–	450
Deferred tax	25	–	3	–	2	–	30
Retirement benefits	83	–	9	–	151	–	243
Capital and reserves	–	–	–	–	1,860	–	1,860
Total equity and liabilities	**22,164**	**2,468**	**8,075**	**1,997**	**2,091**	**2,568**	**39,363**
Net liquidity gap	**691**	**(227)**	**(123)**	**1,813**	**414**	**(2,568)**	**–**
Cumulative gap	**691**	**464**	**341**	**2,154**	**2,568**	**–**	

As at 28 February 2006*	Up to 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m	Cash ratio deposits £m	Total £m
Assets							
Cash and balances with other central banks	185	–	–	–	–	–	185
Loans and advances to banks	6,784	1,747	5,975	–	–	–	14,506
Financial assets designated at fair value through profit or loss	13	–	1,323	4,327	–	–	5,663
Derivative financial instruments	94	45	87	65	–	–	291
Loans and advances to customers	1	–	1	2	2	–	6
Available for sale securities	–	–	176	1,317	2,212	–	3,705
Investments in group undertakings	–	–	–	–	18	–	18
Intangible assets	–	–	–	–	17	–	17
Property, plant and equipment	–	–	–	–	193	–	193
Investment properties	–	–	–	–	26	–	26
Deferred tax assets	–	–	–	–	12	–	12
Other assets	34	31	66	–	–	–	131
Total assets	**7,111**	**1,823**	**7,628**	**5,711**	**2,480**	**–**	**24,753**
Liabilities							
Deposits from central banks	3,650	2,050	5,680	–	–	–	11,380
Deposits from banks and building societies	986	–	–	–	–	2,222	3,208
Other deposits	1,070	10	–	–	1	–	1,081
Derivative financial instruments	79	1	15	3	–	–	98
Financial liabilities designated at fair value through profit or loss	614	1,220	1,967	2,711	–	–	6,512
Other liabilities	91	31	95	130	7	–	354
Current tax liabilities	–	–	17	–	–	–	17
Retirement benefits	–	–	–	–	371	–	371
Capital and reserves	–	–	–	–	1,732	–	1,732
Total equity and liabilities	**6,490**	**3,312**	**7,774**	**2,844**	**2,111**	**2,222**	**24,753**
Net liquidity gap	**621**	**(1,489)**	**(146)**	**2,867**	**369**	**(2,222)**	**–**
Cumulative gap	**621**	**(868)**	**(1,014)**	**1,853**	**2,222**	**–**	

* This table has been restated to ensure that this note is presented on a consistent basis.

Notes to the Banking Department Financial Statements continued

31 Financial risk management continued

g Fair values of financial assets and liabilities

The fair values of financial assets and liabilities classified as loans and receivables and deposits approximate carrying values due to their short-term nature.

32 Cash and cash equivalents

i Analysis of cash balances

	At 1 March 2006 £m	Cash flows £m	At 28 February 2007 £m
Cash and balances with other central banks (note 9)	185	(86)	99
Loans and advances to banks (note 10)	5,620	15,876	21,496
	5,805	**15,790**	**21,595**

ii Stock of liquidity

For the purposes of the cash flow statement, cash and cash equivalents comprise cash in hand and amounts due from banks within three months from the date of acquisition. This definition, which is required by IAS 7 (Cash Flow Statements), covers the Bank's stock of liquidity for operational purposes, but is not well suited to the Bank which as the central bank is the ultimate source of sterling liquidity. These include advances to the money market and banks, and reverse repurchase agreements which are regarded as a pool of assets for these purposes. The allocation of this liquidity between the components depends upon prevailing market conditions.

33 Date of approval

The Members of Court approved the financial statements on pages 47 to 90 on 17 May 2007.

Issue Department
Account for the period ended 28 February 2007

	Note	2007 £m	2006 £m
Income and profits			
Securities of, or guaranteed by, the British Government		628	619
Other securities and assets including those acquired under reverse repurchase agreements		1,082	1,124
		1,710	**1,743**
Expenses	2		
Cost of production of Bank notes		36	28
Cost of issue, custody and payment of Bank notes		17	14
Other expenses		4	3
		57	**45**
Payable to HM Treasury		**1,653**	**1,698**

Statement of balances: 28 February 2007

	Note	2007 £m	2006 £m
Assets			
Securities of, or guaranteed by, the British Government	3	13,370	13,370
Other securities and assets including those acquired under reverse repurchase agreements	4	25,079	23,550
Total assets		**38,449**	**36,920**
Liabilities			
Notes issued:			
In circulation	5	38,449	36,914
In Banking Department		–	6
Total liabilities		**38,449**	**36,920**

On behalf of the Governor and Company of the Bank of England:

M A King Governor
J R Lomax Deputy Governor
T J Parker Chairman of NedCo
W R Jones Finance Director

The notes on pages 92 to 93 are an integral part of these financial statements.

Notes to the Issue Department Statements of Account

1 Accounting policies

The statements of account are prepared in accordance with the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968. All profits of the note issue are payable to the National Loans Fund.

The statements of account are prepared on the basis of amounts received and paid.

2 Expenses

The expenses shown represent charges from the Banking Department for costs incurred in relation to the Note Issue.

3 Securities of, or guaranteed by, the British Government

	2007 £m	2006 £m
Ways and Means advance to the National Loans Fund	13,370	13,370
	13,370	**13,370**

The Ways and Means advance earns interest at the Bank's repo rate.

4 Other securities and assets including those acquired under reverse repurchase agreements

	2007 £m	2006 £m
Deposit with Banking Department	49	53
Short-term reverse repurchase agreements	10,030	17,497
Longer-term reverse repurchase agreements	15,000	6,000
	25,079	**23,550**

5 Notes in circulation

	2007 £m	2006 £m
£5	1,100	1,052
£10	5,886	5,591
£20	23,740	22,690
£50	6,705	6,510
Other notes[a]	1,018	1,071
	38,449	**36,914**

(a) Includes higher value notes used as cover for the note issues of banks in Scotland and Northern Ireland in excess of their fiduciary issues.

6 Assets and liabilities

a Interest rate exposure

As the liabilities of Issue Department are interest-free, the income of Issue Department is directly exposed to movements in interest rates. At the year end 28 February 2007, the assets of Issue Department had the following repricing period profile: repricing in up to one month £26 billion (2006: £31 billion); repricing in greater than one but less than three months £6 billion (2006: £4 billion); repricing in greater than three but less than six months £4 billion (2006: £2 billion); and, repricing in greater than six but less than twelve months £2 billion (2006: £1 billion).

b Currency exposure

All the assets and liabilities of Issue Department are denominated in sterling. The collateral provided under reverse repurchase operations may be in currencies other than sterling but this does not give rise to any direct currency exposure.

7 Accrued interest

At 28 February 2007 the unrecognised accrued interest on the assets held on the Issue Department Statement of Balances was £271 million (2006: £79 million).

8 Date of approval

The Members of Court approved the statements of account on pages 91 to 93 on 17 May 2007.

Contacts

Head Office

Threadneedle Street
London EC2R 8AH
020 7601 4444*

Regional Agencies

The South East and East Anglia

a London
London EC2R 8AH
020 7601 3954

b Cambridge
24 Newmarket Road
Cambridge CB5 8DT
01223 368256

Greater London

London EC2R 8AH
020 7601 5504

Central Southern England

PO Box 793
Notebeme House
84 High Street
Southampton SO14 2SU
02380 231060

South West

a Exeter
11/15 Dix's Field
Exeter EX1 1QA
01392 438302

b Bristol
Redcliff Quay
120 Redcliff Street
Bristol BS1 6HU
0117 927 7251

Wales

4 Village Way
Greenmeadow Springs
Tongwynlais
Cardiff CF15 7NE
02920 453600

West Midlands

Cornwall Court
19 Cornwall Street
Birmingham B3 2DT
0121 200 2599

East Midlands

3 College Street
Nottingham NG1 5AQ
0115 947 4577

Yorkshire and the Humber

Regent House
5 Queen Street
Leeds LS1 2TW
0113 242 0355

Northern Ireland

Harvester House
4/8 Adelaide Street
Belfast BT2 8GD
02890 241692

North East

Alderman Fenwick's House
PO Box 2BE
98-100 Pilgrim Street
Newcastle Upon Tyne
NE99 2BE
0191 261 1411

North West

a Manchester
82 King Street
Manchester M2 4WQ
0161 834 6199

b Liverpool
Lancaster House
Mercury Court
Tithebarn Street
Liverpool L2 2QP
0151 227 2553

Scotland

19 St Vincent Place
Glasgow G1 2DT
0141 221 7972

* General enquiries relating to the Bank may be made on 020 7601 4878 or by email to enquiries@bankofengland.co.uk. Information about the Bank and its publications and additional telephone numbers and email addresses are available on the Bank's website at www.bankofengland.co.uk.
Enquiries relating to the *Bank of England Quarterly Bulletin* and *Inflation Report* may be made on 020 7601 4030 and *Financial Stability Report* on 020 7601 3009.

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