The Bank's core purposes

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

Core Purpose 1 **Monetary Stability**
Monetary stability means stable prices and confidence in the currency. Stable prices are defined by the Government's inflation target, which the Bank seeks to meet through the decisions on interest rates taken by the Monetary Policy Committee, explaining those decisions transparently and implementing them effectively in the money markets.

Core Purpose 2 **Financial Stability**
Financial stability entails detecting and reducing threats to the financial system as a whole. Such threats are detected through the Bank's surveillance and market intelligence functions. They are reduced by strengthening infrastructure, and by financial and other operations, at home and abroad, including, in exceptional circumstances, by acting as the lender of last resort.

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

- Other central banks and international organisations to improve the international monetary system.
- HM Treasury and the Financial Services Authority, under the terms of the Memorandum of Understanding, to pursue financial stability.

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

Foreword by the Chairman of NedCo[(1)]

Sir John Parker Chairman

By any benchmark the majority of the 2007/08 reporting year has been an extraordinary one for the financial markets, all who work in them and all who are affected, directly or indirectly, by their operations. There have been significant developments in relation to both the Bank's core purposes of monetary stability and financial stability. The Bank's role in pursuit of its two objectives and the process through which the Bank seeks to deliver has never been more closely examined, nor more publicly debated. Throughout this challenging period the Non-executive Directors have sought to provide informed support to the Executive. Of equal importance, NedCo as a body has been very conscious of its responsibility to provide challenge to the Governor and the Executive Team in relation to the Bank's response to the evolving situation.

We reported last year that the Non-executive Directors had discussed how we could engage further with the Bank's financial stability work in order to improve our oversight of the Bank's objectives and effectiveness in this area. In the absence of a legally defined role, that discussion continued through 2007 and resulted in a substantive programme of measures approved by Court in December to provide greater involvement and clarity of oversight for the Directors. That has included more formal reporting on financial stability risks and trends and observation of the process for producing the Bank's *Financial Stability Report* (*FSR*). Directors had been briefed early in the year on the Bank's growing concerns about risk pricing and inflated asset values in the markets dealing with complex financial instruments, as was reported in the *FSR*. As the liquidity crisis unfolded the Non-executive Directors and Court have received regular briefings on market conditions and the evolving policy responses.

The Bank, in consultation with the other Tripartite Authorities, was required to take action under its Financial Stability crisis management mandate in relation to Northern Rock. The Executive consulted and sought our approval, and provided us the opportunity to question various aspects of the arrangements. The Treasury Committee report on the Northern Rock crisis (*The Run on the Rock*) issued in January was a well-researched report. It provided Directors with a valuable pointer to lessons that could be learnt within the Bank on the Tripartite arrangements. A consultation paper by the Tripartite Authorities proposing banking reforms was also issued in January — this addressed the key deficiencies in the existing financial infrastructure that the Governor had articulated earlier. The Directors have subsequently been engaged in extensive debate on the Bank's response to this paper and they will be fully engaged in discussing the practical impact on the Bank's management and governance of Court with the Executive in the year ahead when the shape of the new legislation is clear.

Developments in relation to the Bank's monetary policy objectives have been significant too. As required by the MPC's mandate, the Governor wrote the first letter to the Chancellor when CPI inflation temporarily exceeded 3%. NedCo's mandate is, of course, focused on maintaining oversight of the MPC process. In this context, the Non-executive Directors followed the Treasury Committee's enquiries into '*The MPC of the Bank of England: ten years on*' with interest and contributed evidence directly to the Committee. NedCo considered the resulting report and its recommendations as helpful in the context of its oversight role of MPC processes.

(1) The Committee of Non-executive Directors.

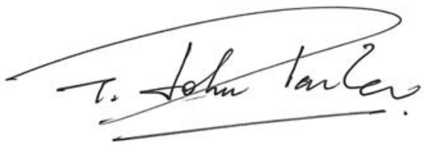
Some of the proposals contained within the Treasury Committee report and the Tripartite Consultation documents on banking reform are focused directly on the governance arrangements of the Bank. This includes the proposal to formalise the arrangements that Court has already put in place to ensure that we follow best practice in separating the chief executive and chairman roles. Court also supports the suggestion that the number of Non-executive Directors should be reduced. But we recognise that we will need to revisit the Bank's internal governance arrangements once the legislative impact on the Bank is finalised. The Non-executive Directors are also aware that they will need to play a role in agreeing the subsequent reshaping of the Memorandum of Understanding that establishes the role of the Tripartite Authorities in financial stability arrangements.

The Non-executive Directors have been carefully monitoring the Bank's response to the internal additional resource calls and balance sheet implications arising from the markets related work. In some cases diversion of personnel from other tasks has been necessary and the Executive have kept NedCo and Audit Committee informed about how any associated risks are being managed. However, despite the focus of attention having been on financial stability issues, key aspects of the Bank's enabling strategy have been taken forward. Cost management has again been prominent in NedCo's discussions and Directors were kept fully informed about the proposed changes in cash ratio deposits. Changes to the Bank staff pension arrangements have now been fully implemented and a new IT operating model has also been put in place. NedCo has also taken a keen interest in ongoing work to develop the Bank's business resilience. The Non-executive Directors have welcomed these developments which are aligned to the achievement of the established strategic priorities. The quality of regular reporting to NedCo on strategy, finance, performance, risk and project progress has been enhanced considerably. The Directors believe that we now have a well-established and comprehensive information flow on these critical operational matters.

The Audit and Remuneration Committees have continued to play a major role in our governance arrangements and have dealt with many important issues this year. There has been regular reporting back to NedCo on issues arising. I would like to thank the Chairs and members of these Committees and acknowledge their valuable work.

We have welcomed Roger Carr and Susan Rice as Directors during the past year whilst Heather Rabbatts left after a period of four years on Court. All of the Directors have made a substantial contribution over the past year, both in terms of time and expertise, and my sincere thanks go to them all.

Finally, during this exceptional year for the Bank I have stayed in close contact with the Governor and senior executives throughout the period of market turmoil. I have witnessed, at first hand, the extraordinary level of personal and professional commitment that has been maintained throughout this time. I think it is fair to say that as time has progressed the Bank's position has been increasingly understood as the true nature of the banking crisis has unfolded. The Governor was correct in saying recently that all parties have learnt lessons from the period of financial turmoil and the Non-executive Directors subscribe to that view. He has shown courage and dedicated leadership throughout this troubled period for which I thank him on behalf of NedCo. We were all delighted that he was appointed to, and accepted, a second term of office.



July 2008

Foreword by the Governor

Mervyn King Governor

I have made no secret over the past couple of years of my belief that the path of the economy would soon become much bumpier than during the first ten years of the Bank of England's independence. The events of the past twelve months have confirmed that view, as the Monetary Policy Committee (MPC) has confronted a series of decisions which have been among the most difficult and finely balanced it has ever had to take.

Last month, I wrote the second open letter to the Chancellor explaining why inflation had exceeded our 2% target by more than one percentage point. This means that we are now faced for the second time in less than two years with the prospect of a sharp, but temporary, rise in inflation, this time mainly from the impact of energy and food price rises. In fact, it is likely that inflation will remain above 3% until well into next year, prompting a series of such letters at three month intervals.

The MPC can have little impact on the path of inflation in the short term. It has not attempted to prevent inflation moving away from the target following the sharp rises in commodity prices. To do so would have required a large increase in interest rates with such a severe impact on output and employment that it would have risked inflation falling well below target further out. As we set out in the June open letter to the Chancellor and, earlier, in our May *Inflation Report*, the MPC continues to expect inflation to return to the 2% target during the forecast period, and is determined that it will do so. However, after two recent periods in which inflation has risen significantly, we cannot take for granted that inflation expectations for the medium term will remain firmly anchored on the target. The dilemma that has made our task so difficult since last summer is that we have had to balance this risk that inflation expectations might be dislodged against the possibility that inflation might fall below the target as a result of the very clear downside risks to activity and employment in the rest of the economy from the impact of the turmoil in financial markets. These are judgements the committee must continue to make month by month.

Northern Rock dominated the work of the Bank last summer and autumn. That bank's problems were an early symptom of a much more generalised malaise in the dollar, sterling, euro and other financial markets that has proved deep and long lasting. Northern Rock itself had too precarious a business model to last through more than the opening weeks of the crisis, and the Bank, with the authorisation of the Chancellor, acted as lender of last resort on 14 September, as described in the box on pages 21–22. The Bank of England responded in a proportionate manner, in several phases. From September, the Bank substantially increased the amount of liquidity in the short-term money markets, in response to requests from the banks. Later in the autumn, what began as a liquidity crisis caused by banks' hoarding of short-term funds transmuted into a credit crisis in which banks were increasingly reluctant to lend to each other because of fears about each others' solvency. So in December, in collaboration with other central banks, we launched the first of a series of longer-term money market auctions.

While joint action initially appeared to improve conditions in international markets, it was a false dawn and, by March, in the wake of the Bear Stearns rescue in the United States, we faced a deteriorating situation in which banks' fears about each other were compounded by the impact of wild market rumours about perfectly healthy institutions. That led to the Bank of England's decision, with the support of the Treasury, to launch a Special Liquidity Scheme, designed to contribute to a stabilisation of the markets.

While Northern Rock flagged the beginning of a very difficult period for the markets generally and for the United Kingdom in particular, in this country we now have a once-in-a-generation opportunity to create a new regime for dealing with financial crises. So I very strongly welcomed proposals for new legislation to strengthen the Bank's role in financial stability and to improve the framework for resolving the problems caused by failing banks, set out at the end of June in a new consultation document. This developed the ideas for reform published in the first Tripartite consultation document in January. Detail aside, the encouraging point from my public policy perspective is that the Government and the main opposition parties are committed to reforms that will put the UK ahead of the best current international standards. As we found last year, when too many of the options for dealing with Northern Rock were closed to us, we have lagged seriously behind. It is absolutely vital that we do not squander this opportunity by relaxing our efforts to make improvements once the market pressures around us start to diminish. This is an opportunity we cannot afford to miss, because it will help protect the British public from the effects of any future difficulties within the banking system. And the Bank itself is poised to adapt rapidly to meet the new roles and powers we are asked to take on in the pursuit of financial stability.

The Bank of England is well known by its peers to be among the leanest of central banks. So this year I am more than usually grateful to the staff of our relatively small organisation for the efforts they have made since last summer to resolve a succession of difficult issues. That applies to the front line operations in markets, financial stability and banking and also to the rest of the Bank, where almost every activity has been drawn into the credit crisis in one way or another, not least through the analytical work in Monetary Analysis on the impact on the economy.

I am extremely grateful to Rachel Lomax, for her contribution to the MPC, her tireless devotion to the work of the Bank and her personal support and wise counsel over the past five years. I wish her well in future. I would also like to pay tribute to Sir John Gieve for his hard work and loyalty. In particular since the events of last summer, John has played a major role in delivering the new framework for dealing with financial crises. The Government announced that it will make changes to the responsibilities of the Deputy Governor for Financial Stability, and John has decided he does not want to assume the new position. But I am very glad he is staying on to see us through until the bill is law next year.

I am extremely pleased that the Government has appointed Charlie Bean to succeed Rachel Lomax as Deputy Governor for Monetary Policy. I am equally delighted to welcome Spencer Dale, Charlie's successor as Executive Director for Monetary Analysis and Statistics, and Chief Economist. Spencer has been drawn from the Bank's pool of exceptionally talented younger economists. I was also very pleased that Andrew Sentance was reappointed to the Monetary Policy Committee. Among the Non-executive Directors, a belated welcome to Roger Carr and Susan Rice, who joined us during the year, after the last *Annual Report* went to press.

Finally, I am honoured to have been reappointed as Governor for a second term, and will try to the best of my abilities to rise to the varied challenges that will undoubtedly confront the Bank over the next five years.

July 2008

Governance and accountability

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

The Court of Directors

Court consists of the Governor, two Deputy Governors and 16 Directors.(1) The Directors are all non-executive. The Governors are appointed by the Crown for five years and the Directors for three years. Details of the current Court are set out on pages 8–9.

Under the Act, the responsibilities of Court are to manage the Bank's affairs, other than the formulation of monetary policy, which is the responsibility of the Monetary Policy Committee. Court's responsibilities include determining the Bank's objectives and strategy, and ensuring the effective discharge of the Bank's functions and the most efficient use of the Bank's resources.

Members of Court have been indemnified by the Bank against personal civil liability arising out of the carrying out or purported carrying out of their functions, provided they have acted honestly and in good faith and have not acted recklessly. These indemnities were granted in 2000 and approved by HM Treasury in accordance with the practice of the Government in relation to board members of Non-Departmental Public Bodies.

NedCo

The Act provides for a Committee of Court ('NedCo') consisting of all the Non-executive Directors, with a chairman designated by the Chancellor of the Exchequer. The chairman of NedCo is also Deputy Chairman of Court. NedCo has responsibilities for reviewing the Bank's performance in relation to its objectives and strategy, and monitoring the extent to which the Bank's financial management objectives are met. NedCo is also responsible for reviewing the procedures of the MPC, and in particular whether the Committee has collected the regional, sectoral and other information necessary for formulating monetary policy. Other functions of NedCo — in which it is supported by the Audit and Remuneration Committees — include reviewing the Bank's internal controls and determining the Governor's and Deputy Governors' remuneration and the terms and conditions of the service of the four members of the MPC appointed by the Chancellor. NedCo is required to make a report as part of the Bank's *Annual Report*. This is on pages 43–49.

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

The Monetary Policy Committee (MPC)

The Bank of England Act establishes the MPC as a Committee of the Bank, subject to the oversight of NedCo, and sets a framework for its operations. Under the Act, the Bank's objectives in relation to monetary policy are to maintain price stability and, subject to that, to support the Government's economic policies, including its objectives for growth and employment. At least once a year, the Government specifies the price stability target and its growth and employment objectives. The MPC must meet at least monthly; its members comprise the Governor and Deputy Governors, two of the Bank's Executive Directors and four members appointed by the Chancellor. In June 2008 the Chancellor of the Exchequer announced that the Government will advertise future vacancies for the Governor and Deputy Governors of the Bank of England and also for external members of the MPC. At the same time the Bank of England announced that it intends to advertise externally the executive appointments to the MPC that are its responsibility — Executive Director for Monetary Analysis and Statistics and Executive Director, Markets — when they become vacant in future. Membership of the MPC is given on page 15.

The MPC's decisions are announced after each monthly meeting and minutes of their meetings are published two weeks later. The quarterly *Inflation Report* includes the MPC's projections of inflation and output.

Remuneration Committee

The members of the Remuneration Committee during 2007/08 were Dr David Potter (Chairman), Sir Graham Hall (until May 2007), Peter Jay, Geoffrey Wilkinson, Arun Sarin, David Rhind and Roger Carr (from July 2007). The Chairman of NedCo attends meetings of the Remuneration Committee. The Committee's Report on Remuneration is on pages 34–36.

Audit Committee

The members of Audit Committee during 2007/08 were Amelia Fawcett (Chairman), Mary Francis (until May 2007), Sir Andrew Likierman, Paul Myners, James Strachan,

(1) At the time of publication of this report there were fifteen Non-executive Directors, with one post vacant.

Susan Rice (from July 2007) and Robert Wigley (from July 2007). The Deputy Governors, the Executive Director for Central Services, the Finance Director, the Head of Internal Audit and the external auditors normally attend the meetings of the Committee, and the Chairman of NedCo may also do so.

The functions of the Audit Committee are to:

- Assist Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management.
- Receive reports from, and review the work of, the internal and external auditors. The Committee also considers and makes recommendations on the appointment of the external auditors, their independence and their fees.
- Review the annual financial statements prior to their submission to Court, including consideration of the appropriateness of the accounting policies and procedures adopted. The Committee reports its conclusions to Court.

The Committee normally meets four times a year.

Risk Policy Committee

During 2004 a new committee of Court was formed to provide direction and assistance for Court in its responsibilities for the Bank's Risk Management Framework. In July 2007 the committee was discontinued. Court decided that sufficient progress had been made in the development of the risk framework such that risk information could be reported direct to Court, with Audit Committee accountable for providing assurance on the overall risk framework.

Transactions Committee

Court is consulted about transactions outside the normal course of the Bank's business. In relation to Northern Rock (see pages 21–22) a number of special meetings and conference calls were held, and in November 2007 Court established a Transactions Committee to facilitate future consultation. The members are the Chairman of NedCo and two other Directors, normally his Deputy and the Chair of the Audit Committee.

Management structure

The executive management of the Bank lies with the Governors and Executive Directors. The responsibilities of Governors are set out below. The responsibilities of the Executive Directors are set out on pages 11–13.

Governor — Mervyn King

The Governor has overall executive responsibility for the management of the Bank in support of the Core Purposes. He defines the strategy for the Bank which, with the approval of Court, sets the direction for the organisation. This strategy is implemented via a detailed business plan and budget which are reviewed and agreed annually with Court. The Governor chairs the meetings of the Bank's Executive Team, which monitors delivery against plan and addresses key business issues. He provides leadership on both of the Bank's Core Purposes, chairing the Monetary Policy Committee and is a member of the Financial Stability Board. The Governor holds a press conference four times a year to launch the Bank's *Inflation Report* and regularly speaks publicly on issues covering the overall economy, monetary policy and financial stability.

Deputy Governor Monetary Policy — Rachel Lomax[1]

The Deputy Governor, Monetary Policy is a member and Deputy Chair of the Monetary Policy Committee and is a member of the Financial Stability Board. She provides oversight of the Markets, Monetary Analysis and Finance Directorates and, together with the Deputy Governor Financial Stability, oversees the Central Services functions. The Deputy Governor for Monetary Policy also chairs the Bank's Projects Group, which oversees the Bank's project portfolio and approves major projects, and the Business Risk Committee, which monitors the Bank's risk profile.

Deputy Governor Financial Stability — Sir John Gieve

The Deputy Governor, Financial Stability chairs the Bank's Financial Stability Board and is a member of the Monetary Policy Committee. He sits as a member of the Board of the Financial Services Authority and is the Bank's representative in the Tripartite Standing Committee Deputies. Within the Bank he oversees the Financial Stability and Banking Services Directorates and, together with the Deputy Governor Monetary Policy, oversees the Central Services functions. The Deputy Governor for Financial Stability also has specific responsibilities for the oversight of the Bank's business continuity preparations and its HR strategy.

All three Governors represent the Bank externally, including domestically through appearances in front of the Treasury Committee and internationally through membership of key international committees and groupings.

(1) From 1 July Charlie Bean succeeds Rachel Lomax as Deputy Governor — Monetary Policy.

The Court of Directors[1]

Mervyn King Governor

Sir John Gieve Deputy Governor

Rachel Lomax Deputy Governor

Sir John Parker

Brendan Barber

Sir Callum McCarthy

Amelia Fawcett, CBE

Sir Andrew Likierman

Peter Jay

Dr David Potter, CBE

Geoffrey Wilkinson

Paul Myners

Arun Sarin

Professor David Rhind, CBE

James Strachan

Robert Wigley

Roger Carr

Susan Rice, CBE

(1) As at June 2008: From 1 July Charlie Bean succeeds Rachel Lomax as Deputy Governor.

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

- Chairman, National Grid plc
- Deputy Chairman, DP World, Dubai
- Joint Chairman, Mondi plc
- Non-executive Director, Carnival Corporation Inc. and Carnival plc
- Non-executive Director, EADS
- Member of Prime Minister's Business Council
- Chancellor, University of Southampton

Sir Andrew Likierman
Appointed 1 June 2004.

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

Paul Myners
Appointed 1 June 2005.

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

Robert Wigley
Appointed 1 June 2006.

- Chairman, EMEA, Merrill Lynch International
- Chairman, Oxford University's Centre for Corporate Reputation Global Advisory Board
- Government Council for Education Excellence
- Member of Chancellor's High Level Group

Brendan Barber
Appointed 1 June 2003.

- General Secretary, Trades Union Congress
- Member, Executive Committee of International Trade Union Confederation
- Member, Executive Committee of European Trade Union Confederation
- Member, Council of Institute of Employment Studies
- Director, UK Commission for Employment and Skills

Peter Jay
Appointed 1 June 2003.

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

Arun Sarin
Appointed 1 June 2005.

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

Roger Carr
Appointed 1 June 2007.

- Chairman, Centrica plc
- Senior Adviser, Kohlberg, Kravis & Roberts & Co Ltd
- Deputy Chairman, Cadbury Schweppes plc
- Chairman, Mitchells and Butlers plc

Sir Callum McCarthy
Appointed 20 September 2003.

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

Dr David Potter, CBE
Appointed 1 June 2003.

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

Professor David Rhind, CBE
Appointed 1 June 2006.

- Non-executive Director, UK Statistical Authority
- Chairman, Socio-Economic Committee of the Nuclear Decommissioning Authority
- Chair, Government's Advisory Panel on Public Sector Information
- Trustee of the Nuffield Foundation

Susan Rice, CBE
Appointed 1 June 2007.

- Chairman & Chief Executive, Lloyds TSB Scotland plc
- Senior Independent Director of Scottish and Southern Energy plc
- Chair, Edinburgh International Book Festival
- Non-executive Director, Scottish Business in the Community
- Non-executive Director, Scotland's Futures Forum

Amelia Fawcett, CBE
Appointed 1 June 2004.

- Chairman, Pensions First
- Non-executive Director, Guardian Media Group
- Non-executive Director, State Street Corporation
- Chairman, London International Festival of Theatre
- Deputy Chairman of the Board, National Portrait Gallery
- Director, Business in the Community

Geoffrey Wilkinson
Appointed 1 March 2005.

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

James Strachan
Appointed 1 June 2006.

- Non-executive Director, Legal and General Group plc
- Non-executive Director, Care UK plc
- Non-executive Director, Welsh Water
- Non-executive Director, Sarasin and Partners LLP
- Non-executive Director, Social Finance
- Trustee, Somerset House Trust
- Visiting Fellow, London School of Economics

The Executive Team[1]

Mervyn King Governor

Sir John Gieve Deputy Governor

Rachel Lomax Deputy Governor Monetary Policy

Andrew Bailey Executive Director Banking Services and Chief Cashier

Charlie Bean Executive Director Monetary Analysis and Statistics

John Footman Executive Director Central Services

Nigel Jenkinson Executive Director Financial Stability

Warwick Jones Finance Director

Paul Tucker Executive Director Markets

The diagram on the next page shows how responsibility for individual functions is delegated within the Bank. Each major function is headed by an Executive Director reporting to one or more Governors. The Governors and Executive Directors form the Executive Team, the Bank's senior management group. The Executive Team meets fortnightly, and other senior officials (for example the Human Resources and Communications Directors) join the meetings when matters within their areas of responsibility are discussed.

A more detailed overview of the main operational areas, and other management, is given on pages 12–13.

(1) As at June 2008: From 1 July Charlie Bean succeeds Rachel Lomax as Deputy Governor — Monetary Policy, and Spencer Dale succeeds Charlie Bean as Executive Director Monetary Analysis and Statistics.

Management structure[1]

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

Advisers to the Governor:
Dame Juliet Wheldon (Legal)
Alastair Clark

Secretary of the Bank: Andrew Wardlow

(1) As at June 2008: From 1 July Charlie Bean succeeds Rachel Lomax as Deputy Governor — Monetary Policy, Spencer Dale succeeds Charlie Bean as Executive Director Monetary Analysis and Statistics, and Jenny Scott succeeds Peter Rodgers as Director of Communications.

Organisation overview

Monetary Analysis and Statistics

Charlie Bean(1)
Alex Bowen – Senior Policy Adviser
Martin Brooke – Conjunctural Assessment & Projections
Mark Cornelius – International Economic Analysis
Neal Hatch – Structural Economic Analysis
Andrew Hauser – Inflation Report & Bulletin
Jo Paisley – Monetary & Financial Statistics
James Proudman – Monetary Assessment & Strategy
Peter Westaway – Monetary Instruments & Markets

The Monetary Analysis (MA) divisions are responsible for providing the Bank with the economic analysis it needs to discharge its monetary policy responsibilities.

Its economists conduct research and analysis of current and prospective developments in the United Kingdom and international economies. The MA divisions produce the *Quarterly Bulletin* and the *Inflation Report*, which set out the Monetary Policy Committee's assessment of the current monetary and economic situation in the United Kingdom and of the outlook for inflation and growth.

The work of the MA divisions, including reports from the twelve regional Agencies, provides analytical information for the interest rate decisions taken each month by the Monetary Policy Committee to achieve the Government's inflation target. The Monetary and Financial Statistics Division compiles, publishes and briefs on financial statistics, in particular the monetary aggregates and banking statistics. Special studies directed at international harmonisation and improvements to the statistics are also a feature of the work.

Centre for Central Banking Studies

Gill Hammond

The CCBS acts as a forum where central banks and academic experts from all over the world can exchange views on the latest thinking in central bank policies and operations. The CCBS supports the Bank of England's core purposes by promoting monetary and financial stability in the international context. It does this by building capacity in central banks around the world and promoting the sharing of best practice and new ideas among all central bankers. Its goal is to be recognised internationally as a centre of intellectual excellence for the study of central banking.

CCBS provides an extensive programme of seminars, workshops and conferences both in London and abroad, attended by central bankers from more than 130 countries.

Markets

Paul Tucker
Sarah Breeden – Risk Management
Roger Clews – Special Adviser
Michael Cross – Sterling Markets & Market Intelligence
Paul Fisher – Foreign Exchange

The main functions of the Markets area include conducting operations in the sterling money markets to implement the Monetary Policy Committee's interest rate decisions, while meeting the day-to-day demand for reserves of the banking system as a whole; managing the Bank of England's balance sheet; managing the United Kingdom's foreign exchange reserves, as the agent of HM Treasury; delivering financial market analysis and intelligence in support of the Bank's monetary and financial stability missions; and contributing to the management of financial and business continuity crises.

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

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

(1) From 1 July Spencer Dale succeeds Charlie Bean as Executive Director Monetary Analysis and Statistics.

Central Services

John Footman
Louise Redmond – HR Director
Stephen Collins – Business Continuity
Kevin Evans – HR Services(1)
John Heath – Legal
Peter Higgs – Property Services & Security
Chris Piper – Information Systems & Technology
Andrew Wardlow – Secretary of the Bank

The Central Services divisions encompass a range of support functions that underpin the Bank's activities and help to ensure that the Bank's reputation is maintained. These include IT, property, personnel, the Governors' private offices, press and public relations, and legal services.

Internal Audit

Stephen Brown

Internal Audit assists the Court of Directors and Executive Management in protecting the Bank, and its reputation, by independently and objectively evaluating the effectiveness of internal controls, risk management and governance processes. As part of this assurance Internal Audit recommends cost effective improvements which are agreed with management and tracked until implementation.

Finance

Warwick Jones
Simon Politzer – Projects, Risk & Performance
Tim Porter – Financial & Management Accounting

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

Banking Services

Andrew Bailey
Lee Dobney – Notes
David Ingram – Special Adviser
Joanna Place – Customer Banking
Alastair Wilson – Market Services

Customer Banking Division provides banking services to the Government and other customers, principally central banks and other financial institutions.

Notes Division manages the note issue, including the relationship with De La Rue, the supplier of notes to the Bank.

Market Services Division operates the Real Time Gross Settlement (RTGS) system through which payments relating to the major UK payments and securities settlement systems are settled and, from this operational role, contributes analysis to the Bank's continuing work in developing safe and efficient payment and settlement systems. It also provides the back-office functions to support the Bank's sterling and foreign currency transactions including settling the Bank's Open Market (monetary policy) Operations.

Financial Stability

Nigel Jenkinson
Ian Bond – Financial Resilience
Peter Brierley – Special Adviser
Phil Evans – International Finance
Andy Haldane – Systemic Risk Assessment

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

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

The area seeks to detect risks to the structure and functioning of the UK financial system and to develop measures to strengthen the financial infrastructure at home and abroad to reduce those risks. In addition it undertakes work with HM Treasury and the FSA, to improve the arrangements for managing a financial crisis. The area also contributes to the monetary policy process, and promotes public understanding of issues relating to financial stability through, for instance, the regular *Financial Stability Report*.

(1) From 1 July Jonathan Curtiss succeeds Kevin Evans as Head of HR Services.

Review of 2007/08

The strategic priorities endorsed by Court for 2007/08 and published in last year's *Annual Report* were:

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

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

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

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

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

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

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

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

Enabling priorities for 2007/08 were:

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

The priorities for 2008/09 are shown on page 27.

Members of the Monetary Policy Committee(1)


Mervyn King Governor


Rachel Lomax Deputy Governor


Sir John Gieve Deputy Governor


Kate Barker


Charlie Bean


Tim Besley


David Blanchflower


Andrew Sentance


Paul Tucker

In 2003 the Governor set out a vision for the Bank. The Bank should be focused on promoting monetary and financial stability in the United Kingdom. It should play an active role in the international monetary and financial community. But it should not take on additional responsibilities which are outside the remit of the 1998 Act and Memorandum of Understanding. Its work should be seen as a hallmark of excellence.

That vision for the Bank was turned into a strategy containing specific reforms to all the main line areas of the Bank. This section presents progress during financial year 2007/08 in implementing that strategy, summarised around the eight strategic priorities.

Monetary policy

The Bank's first objective is to meet the inflation target set by the Government. The target was confirmed by the Chancellor in March 2007 as unchanged at 2% as measured by the twelve-month increase in the consumer prices index (CPI). CPI inflation fell back in 2007, from 3.1% in March — a rate that had triggered an open letter from the Governor to the Chancellor — to a rate below target in July 2007. Inflation then remained close to target for the remainder of 2007, although higher prices for energy, food and imports have raised inflation again during the first part of 2008.

Subject to meeting the inflation target, the Monetary Policy Committee (MPC) is also charged with supporting the Government's general economic policy objective of achieving high and stable levels of growth and employment. GDP is estimated to have risen steadily in 2007, by 3.0%, a little above the economy's recent historical average growth rate, though growth was then expected to slow markedly in 2008, in part reflecting the disruption to financial and credit markets. The Labour Force Survey measure of the unemployment rate edged down throughout 2007, reaching 5.2% of the workforce in the fourth quarter.

(1) As at June 2008: From 1 July Charlie Bean succeeds Rachel Lomax as Deputy Governor — Monetary Policy, and Deputy Chair of the Committee. Spencer Dale succeeds Charlie Bean as Executive Director Monetary Analysis and Statistics and Chief Economist.

Review of 2007/08 continued

The decisions of the MPC, together with its analysis and forecasts, are published in the minutes of their meetings and in the *Inflation Report*, and are not covered further here.

Support for the Monetary Policy Committee

The Bank's aim is to provide high-quality and comprehensive support to the MPC and it conducts an annual survey of MPC members' general satisfaction with the various inputs to the policy process. The latest survey suggests that the MPC remains broadly happy with the conjunctural and forecast material that it receives. The general level of satisfaction was a little higher than that found in the previous year's survey.

The Bank continues to improve support for the MPC. A new quarterly *Credit Conditions Survey* of household and corporate lending was launched, with the first surveys published in September 2007. Research on the causes and potential persistence of the 'Great Stability' of growth and inflation drew to a close, culminating in a conference attended by prominent outside researchers. 2007 also saw the completion of the Bank's data uncertainty project, involving the development of a framework for coping with the uncertainty surrounding early releases of official economic data by combining it with surveys of business conditions and other economic indicators. And the *Inflation Report* was recast to put more focus on the discussion of risks to the outlook, how the MPC monitors them, and how it would react to their crystallisation.

A range of initiatives is in place to streamline processes, to allow the Monetary Analysis and Statistics area to run with smaller staff numbers overall. For example, the past year has seen the introduction of a streamlined set of briefing products for the MPC, as well as changes to the management of research projects. A web-based system for the rapid retrieval and manipulation of time-series data has been developed. And the plan outlined in last year's *Annual Report* to relocate the Bank's regional offices to smaller premises, while maintaining existing intelligence gathering and representational activities, remains on track.

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

- Financial market turbulence and the implications for demand. The latter part of 2007 witnessed considerable turmoil in international financial markets. Growing losses on US sub-prime mortgage portfolios prompted a general loss of confidence in asset-backed securities and structured credit instruments. The consequent funding difficulties of some banks and their associated off balance sheet vehicles prompted the hoarding of liquidity and a sharp rise in term interbank interest rates.
  Although conditions in money markets subsequently improved somewhat, financial market conditions have remained febrile. These developments may affect demand through a number of channels, including the price and availability of credit, asset prices and heightened uncertainty. But it is difficult to judge the eventual impact, particularly since falling asset prices could interact with banks' capital requirements and borrowers' collateral limits to amplify the effect on spending.
- US slowdown and the world economy. US growth prospects worsened in late 2007 and early 2008. GDP growth fell sharply and the weakness in the housing market spread to other parts of the economy, although stimulatory macroeconomic policies and the weaker dollar should mitigate the slowdown. Tighter credit conditions and weaker US demand growth are likely to weigh on activity elsewhere in the world. So far, however, economic conditions in the euro area, the United Kingdom's largest trading partner, have remained consistent with steady, if subdued, growth. And prospects have remained robust in commodity-rich countries, China and other emerging markets.
- The impact of energy, food and import prices on CPI inflation. Since late 2007, a number of domestic gas and electricity suppliers have announced substantial tariff rises. Oil and food prices have continued to rise. And sterling has depreciated, putting upward pressure on import prices. These developments raised CPI inflation in the first part of 2008 and are expected to continue to push CPI inflation higher in the near term. But the extent of that rise will depend on what happens to other prices, and on the extent to which domestic producers and retailers absorb higher input costs in lower mark-ups.
- The behaviour of inflation expectations. The recent and prospective pickup in inflation comes soon after the previous period of above-target inflation in 2006/07. If households' and businesses' medium-term inflation expectations are heavily influenced by their recent experience, then repeated above-target

Regional Agents

Chris Bailey
South East & East Anglia

John Bartlett
West Midlands

Chris Brown
East Midlands

David Buffham
North East

Kevin Butler
South West

Phil Eckersley
Northern Ireland

Paul Fullerton
Yorkshire and the Humber

Peter Andrews
London

Adrian Piper
Wales

Tony Strachan
Scotland

John Whitley
Central Southern England

John Young
North West

outturns may cause them to place weight on the assumption that inflation will be persistently above 2%. If those expectations were built into higher wages and prices, that would raise medium-term inflationary pressures.

Public understanding and education

The Bank promotes the case for low inflation and understanding of the current monetary policy framework through publications and speeches, and its website, museum and schools' programme.

The *Inflation Report* and MPC minutes are the Bank's major regular publications on the operation of monetary policy. The *Quarterly Bulletin* carries articles relevant to monetary policy, as well as financial market developments and other aspects of the Bank's work. The Bank's network of twelve Agencies, located throughout the United Kingdom, also plays an important role in explaining monetary policy objectives and decisions to businesses and other organisations, in addition to gathering intelligence about business conditions for the MPC.

MPC members have continued to undertake a large number of public appearances to explain and build public understanding of monetary policy. Formal published speeches by MPC members totalled 31 in 2007/08. These were supplemented by a large number of talks and discussions with different audiences as part of the programme of visits to all parts of the United Kingdom, facilitated by the Bank's Agencies. During the past year, a total of 51 such visits were undertaken outside Greater London and involved individual companies and events with business groups, as well as regular interviews with local and regional media. The regional visits programme amounts to considerable ongoing contact with businesses and other organisations throughout the United Kingdom.

Review of 2007/08 continued

The Governor and other MPC members attended a number of parliamentary hearings with the Treasury Committee of the House of Commons, as well as other Parliamentary Committees. In 2007 this included hearings for the Treasury Committee's inquiry into the MPC after its first ten years.

The Treasury Committee's report, *The MPC of the Bank of England: ten years on*, emphasised the importance of public education regarding the case for low inflation and the Bank's role. In 2007/08, the Bank has continued to extend its public understanding work. In 2008, the Bank published a pamphlet, *What the Bank Does*, the first in a new series of publications aimed at the general public. An exhibition, *The Pound in Your Pocket*, on the topic of inflation and its control, opened in the Bank's museum in April 2008. The exhibition explains and demonstrates how interest rates are used to control inflation, and how inflation has often been higher in the past and elsewhere in the world. The Bank's museum attracted around 78,000 visitors in 2007/08, an increase of 18% from the previous year.

Development of the Bank's website also remains an important part of the Bank's efforts to inform the public of its role and work. The website now hosts a number of accessible films and interactive tools. In addition, through a dedicated public information and enquiries team, the Bank continues to respond to questions and enquiries from the public on all aspects of its work.

The Bank's schools' programme also contributes to building wider public understanding of its role and the importance of low inflation. Over the past year, there has been increased take-up of the Bank's school resources: *Pounds & Pence* — a resource for 9–11 year olds on money and prices, and *Made of Money* — a resource for 14–16 year olds on the workings of the economy. In total, well over 6,000 primary and secondary schools have requested the Bank's educational packs and films. The Bank's annual economics competition for schools and colleges, Target Two Point Zero, continues to be popular. Teams are tasked to take on the role of the MPC and set an interest rate to achieve the inflation target. In its eighth year the competition attracted 279 entries. The national final in March 2008 was won by Tiffin Girls' School from Kingston-upon-Thames.

To monitor public opinion and awareness of the Bank and its role, regular opinion polls are undertaken. In the February 2008 poll, carried out by NOP, 44% of respondents said they were 'very satisfied' or 'fairly satisfied' with the way the Bank is doing its job to set interest rates to control inflation; 14% were 'dissatisfied', with the remainder neutral or undecided. The net satisfaction rating of 30% compared with 37% in February 2007. Survey results are published quarterly and in the *Quarterly Bulletin* each year.

Money market operations

Money Market Reform

Preparation for the second stage of the Money Market Reform programme (MMR2) began in June 2006. That followed the successful implementation of the first stage, from May 2006.

The purpose of the MMR2 programme is to support the effective implementation of monetary policy by:

- Reducing unnecessary turnover of liquidity in the Bank's weekly short-term open market operations, by replacing a proportion of those short-term open market operations (OMOs) with longer-term financing through bond purchases.
- Introducing 'electronic bidding' in all the Bank's regular OMOs, replacing the existing telephone-based bidding. Electronic bidding should reduce some of the operational risk in telephone bidding — by cutting the need to re-key information and therefore reducing the time taken to process counterparties' bids.

Much of this programme is now implemented: the new electronic bidding system has been in use since November (for short-term OMOs) and the first gilt purchases via OMOs took place in January. The final phase of the MMR2 programme, the purchase of foreign-currency denominated bonds, to be swapped into sterling, is under way. The Bank has also sought comments from OMO counterparties on its preferred method for lending out part of the gilt portfolio that will be acquired through gilt purchase OMOs.

The Bank is grateful to the many banks who have helped in the implementation of further reforms to the sterling monetary framework at a time when there has been so much else going on in financial markets.

Money market operations

Strains in short-term money markets, which first appeared during August, led the Bank to adopt a number of the contingency provisions set out in the *Red Book* (which describes in detail the Bank's sterling monetary framework), in order to stabilise the overnight rate of interest. The steps the Bank took are explained in the Bank's 'Markets and operations' article in the *Quarterly Bulletin*. They included supplying additional reserves to the banking system in September 2007, and widening the range around banks' reserves targets within which reserves are remunerated. Those measures appeared to be effective in reducing the spread between Bank Rate and overnight interbank market rates, from September onwards. In December, as part of co-ordinated central bank action, the Bank announced three-month tenders (as part of its regular long-term repos) against a wider pool of high-quality collateral, to address elevated pressures in short-term funding markets.

Special Liquidity Scheme

On 21 April 2008, the Bank launched a Special Liquidity Scheme to allow banks and building societies to swap, for up to three years, high-quality temporarily illiquid assets for Treasury bills. The aim of the scheme is to improve the liquidity position of the banking system and contribute to confidence in financial markets.

Banking operations

During 2007, the Bank continued to implement its new customer banking strategy. This strategy will ensure it focuses on those banking activities required to enable the Bank to fulfil its responsibility as the central bank of the United Kingdom. A number of the current activities do not fit that description, and are closer in nature to retail banking. The main focus of activity is now on the migration of retail banking activities for major government users, notably Her Majesty's Revenue and Customs (HMRC). HMRC have selected the new suppliers and the Bank will work with them to support the migration plan. The timetable continues to meet the Bank's target of achieving the migration to new suppliers by the end of 2009.

The Bank will remain an important provider of banking services to government, but with the focus on high-value activities. The Bank will likewise continue to provide custodial services to a range of customers. Total assets held by the Bank as custodian are around £178 billion (2006/07: £135 billion), of which £72 billion are holdings of gold (2006/07: £43 billion).

Banknotes

The Bank is responsible for issuing banknotes that the public can use with confidence. The average value of notes in circulation over the past year was £39.4 billion. Last year, the Bank issued 1,231 million new notes and, at the year end, the number of Bank of England notes in circulation was 2,293 million. In terms of the value of notes in circulation, the £20 accounts for the largest share, at around 63%.

The new £20 note, bearing a portrait of Adam Smith, was launched on 13 March 2007. As at end-February 2008, the new design accounted for around 40% of the £26 billion of £20 notes in circulation. The changeover between the two designs is expected to take a further two years to complete and is the largest such replacement the Bank has undertaken as there are now twice as many £20 notes in circulation as there were when the Michael Faraday £20 was withdrawn in 2000/01. Ahead of the launch of the Adam Smith £20, there was extensive liaison with the cash industry to ensure that cash related technology would be compatible with the new note (for example, for ATM dispense and in cash accepting machines). Some 1.5 million leaflets and posters were distributed around the time of the launch to complement the extensive media coverage. These highlighted the design and enhanced security features of the new note.

In his Mansion House speech on 20 June 2007, the Governor highlighted problems with the condition and availability of £5 notes. Relatively few £5s are dispensed through ATMs. Moreover, those £5 notes in circulation tend to become soiled and scruffy as they are not regularly banked and then subject to sorting for fitness. The Bank will continue to work with the major players in the cash cycle to provide the public with greater access to the £5 notes needed to facilitate cash transactions in an efficient manner. Since the Governor's speech, the annual growth rate of £5 notes in circulation has risen from 5% in June 2007 to 11% in February 2008. Last year, the value of £5 notes in circulation increased by £142 million. There has also been a marked increase in the number of £50 notes in circulation over 2007/08: the annual growth rate has risen from 4% in March 2007 to 13% in February 2008, and the value of £50 notes in circulation by £822 million over this period.

Review of 2007/08 continued

In May 2007, Loomis Cash Management (LCM) — a subsidiary of Securitas AB — informed the Bank of non-compliant declarations under the rules of the Bank's Note Circulation Scheme. This resulted in a loss to the Bank of seigniorage income. The Bank used its power under the rules of the Note Circulation Scheme to appoint auditors, at Securitas AB's expense, to investigate. Additionally, Securitas AB was required to provide an indemnity to the Bank against non-payment of audit costs and the loss of seigniorage income. A final settlement between the Bank and Securitas was reached in June 2008. LCM transferred most of its operations to Vaultex UK Ltd (jointly owned by HSBC Bank and Barclays Bank) on 24 November 2007 and was replaced as a member of the Note Circulation Scheme by Vaultex from that date.

Counterfeits

During calendar year 2007, some 290,000 counterfeit Bank of England notes were taken out of circulation with a face value of £5.8 million. This represented 0.013% of the average stock of notes in circulation, and was 24% lower than the figure for 2006.(1)

Technical analysis reveals that organised criminal gangs are behind the vast majority of all counterfeits detected and the Bank continues to work closely with law enforcement agencies to detect and stop counterfeiting. In the past year, the police have made a number of significant arrests. The Bank is grateful for the support of the Serious and Organised Crime Agency and police forces around the country. The Bank also makes available to police, retailers and members of the public a range of banknote educational and training materials to help them identify genuine banknotes.(2)

Financial stability

The Bank's work on financial stability is overseen by the Financial Stability Board,(3) which is responsible both for assessing the key risks to the stability of the United Kingdom's financial system and for identifying how the Bank can contribute to reducing them. The discussions at the Financial Stability Board feed into meetings of the Tripartite Standing Committee on Financial Stability held monthly with the Financial Services Authority (FSA) and HM Treasury.

Financial markets have been under severe strain during much of the past year. The Bank published its *Financial Stability Report* (*FSR*) in April and in October 2007 which set out the Bank's assessment of the risks facing the financial system. In April 2007, the *FSR* warned that the financial system was vulnerable to an abrupt change in conditions as strong and stable macroeconomic and financial conditions had led firms to expand further their business activities and to extend risk-taking; with compensation for bearing risk at very low levels. During the summer the rise in arrears on US sub-prime mortgages, magnified by a gap between information available to originators and end-investors, and leveraged position-taking by some investors, led to severe global market turmoil with marked-to-market losses on assets linked to these mortgages leading to heightened uncertainty about all structured credit products. Liquidity evaporated in these markets and firms were left holding assets they had expected to transfer off balance sheet. Demand for leveraged loans fell sharply as risks were repriced adding to funding pressures. Hoarding of liquidity by banks as contingent (funding) risks crystallised, and uncertainties about counterparty risk, led to a sharp tightening in markets increasing pressures on banks reliant on wholesale funding. In the case of Northern Rock (see box on pages 21–22), these pressures became unsustainable and on 14 September the Chancellor of the Exchequer authorised the Bank of England to provide a liquidity support facility to Northern Rock. The October 2007 *FSR* highlighted these developments and the need for greater focus on liquidity management, more rigorous stress testing, greater transparency in the composition and valuation of structured products and improved disclosure of firms' risk exposures, including to off balance sheet vehicles.

Conditions in financial markets subsequently remained febrile as losses on structured products crystallised and a series of disclosures by firms, and opaque valuation assumptions, added to uncertainty about the size and incidence of losses. The Bank has undertaken heightened monitoring of conditions in the financial system during this period and provided regular assessments to the Tripartite Standing Committee on Financial Stability.

(1) More details on counterfeit statistics can be found at www.bankofengland.co.uk/banknotes/about/counterfeits.htm.
(2) Information on how to check banknotes can be found at www.bankofengland.co.uk/banknotes/security/index.htm.
(3) An internal committee comprising Sir John Gieve (Chairman), Martin Andersson, Andrew Bailey, Charlie Bean, Nigel Jenkinson, Mervyn King, Rachel Lomax and Paul Tucker. Non-executives are also invited to attend.

Northern Rock

Northern Rock had experienced rapid growth in its lending activity since converting from a mutual-form building society to a stock-form UK bank in 1997. At the time of conversion it was a retail-funded lender, but from the second half of 1999 it embarked on a growth strategy which was increasingly dependent on securitisation and other secured borrowing.(1) The bank roughly trebled its share of the UK mortgage market in eight years(2) but this was at the cost of a substantial compression in its lending spreads — in both absolute terms and relative to those of other lenders.

Following the onset of a widespread and severe deterioration in credit and money market conditions last year, the FSA told the Bank and the Treasury of their concerns about Northern Rock and its vulnerability in the current market circumstances. Intensive liquidity monitoring arrangements were put in place and consideration began of the merits, mechanics and legal aspects of a support facility were this to prove necessary. Northern Rock itself continued to explore all possible financing and sale options. An overall solution to Northern Rock's funding problem was needed and as the prospects of a successful securitisation or takeover faded, it became clear that, individually, potential wholesale lenders had little incentive to continue to provide funding. Northern Rock's position continued to deteriorate, and its board sought an assurance of liquidity support from the Bank.

The provision of such support is governed by the Memorandum of Understanding for Financial Stability between the Treasury, Bank and FSA, first signed in 1997:(3) such support should be undertaken where there is a genuine threat to the stability of the financial system and in order to avoid a serious disturbance in the UK economy. Under these arrangements, both the FSA and the Bank are required to make separate assessments of the seriousness of threats to the stability of the financial system and the wider economy and both judged that the position of Northern Rock and the risks of contagion were sufficiently serious to warrant the Bank's support. The FSA also judged that Northern Rock was solvent, exceeded its minimum regulatory capital requirements and had a good quality loan book. On this basis, the Chancellor authorised the Bank to provide liquidity support.

On 14 September, following market rumours, Northern Rock brought forward its profit warning and announced that it had agreed standby liquidity arrangements with the Bank. On the same day, the Tripartite Authorities issued a statement confirming that the Chancellor of the Exchequer had authorised the Bank to provide a liquidity support facility to Northern Rock for the duration of the current period of market turbulence, and that the Bank, in its role as lender of last resort, stood ready to make available facilities in comparable circumstances to other institutions that might face short-term liquidity difficulties.(4)

While the company's announcement contained the positive news that Northern Rock had access to a new source of funding, it also confirmed the extent of its difficulties and that led to a retail deposit run. Ways of resolving the situation were discussed between 15–17 September. On the evening of 17 September, the Chancellor announced that if it proved necessary the Government, with the Bank, would put in place arrangements that would guarantee all existing deposits in Northern Rock during the current instability in financial markets.(5) That undertaking was extended on 20 and 21 September,(6) when it was confirmed that the guarantee would cover existing (and renewed) deposits, and existing (and renewed) unsecured wholesale funding. On 9 October, the scope of the Government's guarantee was extended to cover new retail deposits,(7) and on 18 December it was further extended to include a number of other unsubordinated wholesale obligations.(8)

On 9 October, Northern Rock requested, and was granted, an additional facility from the Bank to enable it to pursue a full range of strategic options, and committed to complete this process by February 2008. The additional facility was supplementary to the Lender of Last Resort Facility announced by the Bank on 14 September. No further borrowing under the 14 September facility was allowed after 9 October. The additional facility was not subject to any specific borrowing limit, was secured against all Northern Rock's assets, and was repayable on demand. In view of the nature of the new facility, the Treasury agreed to give the Bank an indemnity against any losses and other liabilities arising from this new facility.

Review of 2007/08 continued

The Board of Northern Rock began the review of its strategic options in early October. On 19 November, Northern Rock announced that it had received indicative expressions of interest covering a range of options for the business. On the same day, the Chancellor published the principles that would be used to assess proposals received by Northern Rock regarding its future.(9) The three principles were: to protect taxpayers; to promote financial stability; and to protect consumers. Any proposals for the future of Northern Rock and its business required approval by the Tripartite Authorities as financiers in order to safeguard the public interest, as set out in the three principles. On 21 January the Chancellor announced that the Government would provide additional support in order to make a private sector solution for the entire company possible provided the solution was consistent with the Authorities' stated objectives; if no such proposal were received the government would bring forward legislation to facilitate public ownership of Northern Rock.(10)

The review of strategic options by the Board of Northern Rock was completed by the middle of February. On 17 February, the Chancellor announced that the Government had completed its review of the two proposals for resolution involving private sector participation, but it had concluded that they did not meet the test of protecting the taxpayer's interest when compared with the alternative, and therefore that Northern Rock should be taken into public ownership.(11) Subsequently, an Act of Parliament was passed which enabled the Government to acquire the shares of Northern Rock and provided for compensation to be determined by an independent valuer.

The Board of Northern Rock has since agreed with the Government its plans for operating while under public ownership. These include the objective of repaying loans originally advanced by the Bank by the end of 2010 and enabling the Government to release its guarantee arrangements by the end of 2011, subject to the FSA being satisfied of the capital position of Northern Rock at that time. As of 30 April, no further borrowing is allowed under the 9 October facility, and the Bank and the Treasury have agreed to make a committed reserve facility available to the Company for contingency purposes. The Bank has agreed with the Treasury that the current loan facilities to Northern Rock will be replaced with direct Treasury funding by the end of the current calendar year.

(1) The funding crisis at Northern Rock (pages 10–12), www.bankofengland.co.uk/publications/fsr/2007/fsrfull0710.pdf.
(2) In 2007 H1 Northern Rock accounted for 9.7% (gross) and 18.9% (net) of UK mortgage lending. In 1999 H1 these shares had been only 3.6% and 6% respectively.
(3) Memorandum of Understanding for Financial Stability, www.bankofengland.co.uk/financialstability/mou.pdf.
(4) Liquidity support facility for Northern Rock plc, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_94_07.cfm.
(5) Statement by the Chancellor of the Exchequer on financial markets, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_95_07.cfm
(6) Northern Rock plc deposits, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_96_07.cfm, and Northern Rock plc RNS, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_northernrock_07.cfm.
(7) Northern Rock plc deposits, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_104_07.cfm.
(8) Northern Rock plc: Extension of wholesale guarantee arrangements, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_149_07.cfm.
(9) Principles for assessing Northern Rock proposals, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_128_07.cfm.
(10) Northern Rock, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2008/press_04_08.cfm.
(11) Northern Rock plc, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2008/press_16_08.cfm.

The market turmoil heightened the importance of the initiatives the Bank was already undertaking to strengthen financial stability. The Basel Committee Working Group on liquidity, co-chaired by Nigel Jenkinson, the Executive Director for Financial Stability, produced a paper in February 2008 reviewing national supervisory regimes and their components and lessons from the period of stress.(1) The group conducted a fundamental review of the Basel Committee's sound practices for managing liquidity risk in banking organisations and issued enhanced sound practices for public comment in June 2008.(2) The Bank also continued to co-host, with the FSA, a series of stress-testing workshops that began in February 2007. These are designed for market participants to share, and help improve, best practice in this area so that firms can better plan for periods of adverse financial and/or economic conditions.

Market intelligence

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

Market intelligence is provided to the MPC and Financial Stability Board, and is used in the Bank's publications, such as the *Inflation Report*, the *Financial Stability Report* and the 'Markets and operations' article in the *Quarterly Bulletin*.

Timely and informed market intelligence has been a critical part of the Bank's assessment and understanding of financial market conditions and risks since August. The Bank is very grateful to the many firms, asset managers and individuals, in London, New York and elsewhere, who commit to helping it with this work. This investment in market intelligence work has strengthened the Bank's capacity to contribute, alongside the FSA and HM Treasury and its overseas counterparts, to the comprehension and understanding of the recent financial turmoil.

Crisis management

The Tripartite Authorities' crisis management arrangements, and the regulatory and legal framework within which those arrangements operate, were put to the test during the market turmoil of 2007 which led to Northern Rock seeking liquidity support from the Authorities and subsequently being taken into a period of public ownership (see box on pages 21–22). The Tripartite Authorities issued a discussion paper(3) in October 2007 seeking views on a revised regulatory and legal framework. Following feedback — including that of the House of Commons Treasury Select Committee(4) — the Authorities issued a consultation paper in January 2008(5) setting out proposals to strengthen the framework for financial stability and depositor protection (see box on pages 29–30). The Bank continues to work with HMT and FSA to make preparations to implement the necessary changes outlined in the consultation document, taking on board the feedback received as part of the consultation.

Payment and settlement systems

Three main payment and settlement systems use the RTGS platform to enable the risk reduction that comes from real-time settlement. Average daily values settled in these three systems in 2007 were £268 billion for the CHAPS sterling payment system, £224 billion for the CHAPS Euro system, and £417 billion for the CREST delivery-versus-payment system. RTGS is a key piece of the United Kingdom's financial infrastructure, and as such it must have high availability. During 2007, the system was available for 99.7% of the time compared with 99.9% in 2006. All of the downtime last year was attributable to a single event in February 2007 when the RTGS network connections suffered an interruption.

Target2, the new centralised infrastructure for settlement of euro RTGS payments was successfully launched in November 2007 by the European Central Bank, all euro payments traffic then migrated to the new system, and on 16 May 2008 the CHAPS Euro system closed.

(1) www.bis.org/publ/bcbs136.htm.
(2) www.bis.org/publ/bcbs138.htm.
(3) 'Banking reform – protecting depositors: a discussion paper', www.hm-treasury.gov.uk/consultations_and_legislation/bankingreform/consult_banking_reform.cfm.
(4) Outlined in its *Report* 'The run on the Rock', www.publications.parliament.uk/pa/cm/cmtreasury.htm#reports.
(5) 'Financial stability and depositor protection: strengthening the framework', www.hm-treasury.gov.uk/documents/financial_services/financial_stability_framework.cfm.

Review of 2007/08 continued

The Bank issued its fourth annual *Payment Systems Oversight Report* in February 2008. The overall message was that in recent years considerable progress has been made by UK payment systems in meeting the internationally recognised Core Principles for Systemically Important Payment Systems, and those high standards are being maintained. The report also notes that the period of market turbulence since August 2007 provided a test of the payment systems infrastructure, with unprecedented volumes of transactions being processed. The report concludes that the UK payment systems generally coped well with these additional pressures, though the events have highlighted some areas where further attention could be warranted, including the need for systems, and their members, to stress test against more demanding targets in the future. The events have also shown the need for greater co-ordination in contingency planning between different parts of the infrastructure, something the Bank continues to support.

Enabling strategy

Human Resources and employment policies

At the end of February 2008 the Bank employed 1,542 full-time staff and 211 part-time staff, approximately 1% more staff in total than at end February 2007. Most of this rise reflects the increased employment of temporary staff. At end February 2008, 1,579 Bank staff were on permanent contracts, a 2.5% fall from 1,620 at end February 2007.

During the period to end February 2008 246 individuals joined the Bank and 237 left the organisation (including temporary staff). Of the staff recruited only 81 were recruited on permanent contracts. Of these, 23 were new graduates (up from 16 the year before), 32 were experienced hires appointed to analytical and management roles (similar to 2006/07) and 26 were appointed to clerical or non-technical roles.

The high proportion of staff appointed on temporary contracts is largely due to preparations by the Banking Services area for exit from retail banking services and managing the introduction of the new £20 note. A further 55 staff joined on temporary vacation schemes (Sixth Form, Undergraduate, Postgraduate and PhD students). 15 of these will be joining the Bank later this year as permanent entrants to the graduate and PhD programmes.

The Bank keeps under review its arrangements for consulting staff on matters affecting their interests and maintains a dialogue — both formal and informal — with representatives of the recognised trade union, Unite. A framework giving scope for increased flexible working was launched in January 2008 following successful pilots. Flexibility in both jobs and careers will pave the way for greater diversity in the Bank's senior management. The Bank has reviewed and enhanced its maternity package in line with leading benchmarks. The latest in the series of biennial staff opinion surveys took place at the end of 2007 when staff were again given an opportunity to express their views on a range of issues. There was a good response rate and the results have been compared to those from previous surveys to measure overall employee satisfaction and engagement.

Pensions and redundancy developments

Following a review of its pension provision the Bank launched a consultation with the staff and union over changes to its pension scheme which was satisfactorily concluded in September 2007. Following this consultation the Bank's Final Salary pension was closed to new members and, with effect from 1 October 2007, a new Career Average pension section was opened to new members of staff. The new pension section has a normal pension age of 65, although this is subject to change depending on longevity trends.

The Bank's redundancy scheme was also reviewed, in the light of age discrimination legislation. Many elements of the payments made to staff were age related and therefore could not be continued. A moratorium on redundancy was in place throughout 2007. Proposals for a new redundancy policy were put to staff and the union and consultation was satisfactorily concluded in April 2008.

Diversity and career development

During 2007, the Bank continued to implement its Diversity Strategy launched in early 2006. Andrew Bailey continues to be the executive sponsor and James Strachan took over from Heather Rabbatts during the year as the non-executive sponsor. Throughout 2007 progress was made in four key areas identified for action: flexible working; recruitment; career development and communication.

The Bank's Diversity Strategy is committed to recruiting employees from as wide a range of backgrounds as possible. The Bank has partnered with the Oxford Access Scheme, a student-led organisation which aims to encourage students from inner city areas, especially those from ethnic minority communities and less privileged backgrounds, to enter into higher education in general and Oxford University in particular. In March 2007, the Bank also ran a new Insight Week, to give aspiring students from all disciplines at a broad range of universities and from a wide range of backgrounds a unique insight into the Bank's activities. A new external recruitment website launched in the autumn highlighted the Bank's commitment to diversity. It provides up-to-date information about our initiatives in the areas of diversity, flexible working and community relations, together with a wide range of staff profiles. For the second year running, the Bank's Post-Graduate Sponsorship Scheme has been short-listed for recognition at the National Council for Work Experience Awards.

A number of career development initiatives were introduced including a career development framework for secretarial staff and the creation of an internal network for women. This network has an overall remit to support women with their career progression at the Bank.

The proportion of women in senior roles stands at just over 25% at the end of February 2008. The proportion of staff from ethnic minority backgrounds now stands at just under 9% and within our graduate intake in 2007 they represented 13%. Part-time staff now constitute 12% of all Bank staff and 7% of roles at analyst and managerial level. The Bank continues to recruit, train and develop disabled employees and makes reasonable adjustments where employees become disabled during their employment. Adjustments are made to assist employees in using the buildings, in performing jobs and attending courses. A recent staff survey revealed that 46 employees have a disability, 18 of whom believe it to affect their workplace activities in some way. A central register is maintained of all employees for whom various accommodations are made. The number of staff for whom specific accommodations are made is currently 12 (2006/07: 12).

The Bank continues to develop the training and support that allows staff to enhance their performance and career development options. A particular focus for the year was the development of the Heads of Division (HoD) group. Early in the year the Bank defined a set of capabilities which captured those behaviours and skills which HoDs are required to demonstrate. The capabilities are supported by a development framework which directs HoDs to available and relevant training. To ensure that the pipeline of talent feeding this group of leaders remains strong, a mentoring scheme has been launched that provides a way for those aspiring to HoD to work with a mentor on topics such as career planning, leadership and personal effectiveness.

Finance

The Bank's financial framework was reviewed in 2007/08. The Chief Secretary to the Treasury announced in May 2007 a review of the Cash Ratio Deposit (CRD) scheme, led by a steering group whose members were Tamara Finkelstein (Director of Government Treasury Management, HM Treasury), Amelia Fawcett (Non-executive Director) and Warwick Jones (Finance Director).

The conclusions of the review were set out in a consultation paper published by HM Treasury in August 2007. Under the CRD regime, banks and building societies are required to place a percentage of their deposit base, above a minimum threshold, at the Bank interest-free. The review proposed that the CRD ratio should be reduced from 0.15% to 0.11% of eligible liabilities. It was estimated that this would result in a one-off reduction of approximately £700 million in the amount of cash ratio deposits held at the Bank. In part, the proposed reduction was possible as a result of steps taken by the Bank, approved by Court, to hold spending on its policy functions broadly flat in nominal terms over the past five years. Further details on the operation of the Bank's financial framework in 2007/08 are presented in the Financial Review section (page 31).

Finance reorganised during the year into two Divisions. The Financial and Management Accounting Division improved its financial reporting to Court and continued the rationalisation of the organisation of finance activities across the Bank. The formation of the Projects, Risk and Performance Division will give additional focus to the development of an integrated performance measurement system for the Bank as a whole.

Finance is taking further measures to improve the Bank's financial systems. The objectives are to simplify processes, bring financial and management accounting closer

Review of 2007/08 continued

together, reduce time spent processing and reconciling, and provide more value to the Bank through better, more timely, financial reporting. This is a major focus for Finance in 2008/09.

Information technology

In July 2007, the Bank agreed a new IT Operating Model which would support and enable the delivery of medium-term business strategy. The design of the Operating Model provides for the development of IT strategies for the four main business lines of the Bank — financial operations, notes, analytical processes and statistics — while continuing to pursue the delivery of an efficient but effective central shared services IT infrastructure.

Early in 2008, Business IT Partners were recruited to lead the development of the strategies and to improve the delivery of IT services for the analytical business areas and the financial operations of the Bank. A new IT Team was established in January 2008 to bring a stronger and more innovative focus to the delivery of IT services that support the analytical work in the Monetary Analysis, Financial Stability and Markets areas of the Bank. Further development of the IT organisation is planned for 2008 to enable the delivery of the new IT strategy for the financial operations of the Bank.

A comprehensive benchmarking of the common shared IT services was completed in February 2008 as a means of pursuing value for money in our commodity IT services. A strategy and targets for delivering initial improvements were agreed in March for implementation during 2008.

The Bank's priorities in 2008/09

The strategic priorities endorsed by Court for 2008/09 are:

Strategic priority 1 The Bank should continue to improve the quality and efficiency of the processes supporting the Monetary Policy Committee, advance the analysis, practice and communication of inflation targeting, and enhance its understanding of the changing inflation process.

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

Strategic priority 3 Banking operations should be focused on ensuring monetary and financial stability, thus eliminating activities that do not contribute to those activities, while also being efficient and resilient, in large part to be achieved by continuing to deliver the Customer Banking Transition Programme and developing clear plans for future systems and processes required to run the remaining business.

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

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

Strategic priority 6 The Bank should continue to manage the consequences of the recent financial crisis within the Standing Committee framework, and continue to work with others to strengthen international crisis management preparations. The Bank will contribute to work towards a special resolution scheme for Banks and will contribute to a review of the Tripartite arrangements in the light of recent events in financial markets.

Strategic priority 7 The Bank should promote safe and efficient payments and settlements systems, clarifying and implementing a revised remit for its payment systems oversight work following the conclusion of the statutory consultation process, whilst remaining at the forefront of best practice in operational and policy areas.

Strategic priority 8 To deliver these strategic priorities, the Bank will aim for the highest professional standards and will continuously improve its internal business processes.

Enabling priorities for 2008/9 are:

- Delivering changes to HR services to focus on providing efficient, value-added support to business areas.
- Developing an improved system of performance measurement.
- Implementing a new business-led IT operating model.

The Bank's priorities in 2008/09 continued

The strategic priorities for 2007/08 have been refreshed for 2008/09 to reflect progress over the past year and the challenges that lie ahead. This section provides an overview of the specific steps the Bank plans to take. The underlying themes are: to focus the Bank's activities on the core purposes; improve overall quality and efficiency; and to adapt to changing economic and financial market conditions.

In the area of monetary policy, the priority remains to support the MPC with first-rate and creative analysis, so that the Committee can take interest rate decisions to meet the Government's target. Accordingly, a key strategic objective in 2008/09 is to increase the amount of resources dedicated to analysis and research by exploiting resources freed up by ongoing streamlining initiatives. Given recent developments in financial markets, one priority is to improve our understanding of how new financial institutions, instruments and markets are affecting monetary conditions. Further analysis and research is to be undertaken on the role of monetary policy in the transmission mechanism; this will include work on inflation expectations and how these are determined. Other strands of work are aimed at improving our understanding of asset market movements and their information content, as well as ensuring the efficacy of the modelling tools used in the forecast process.

There are also a number of activities planned to improve communication on monetary policy issues, an area highlighted in the recent Treasury Select Committee report on *The MPC of the Bank of England: ten years on*. An inaugural conference with academics and City economists on UK monetary policy is scheduled for the autumn of this year, and it is envisaged that this will become a twice-yearly event.

To support these workstreams, business processes will be further improved to free up resources, for example by streamlining data management and automating the production of material supplied regularly to the MPC. The process of relocating the Bank's regional offices to smaller premises will also continue; this is generating significant financial savings while allowing the regional Agents to maintain — and in some cases enhance — their existing intelligence gathering and representational activities.

The priorities in the area of financial stability remain organised around three aims: risk assessment; risk reduction and the effective resolution of financial crises. The Bank will continue to improve the comprehensiveness and rigour of its assessments of key risks to the UK financial system by enhancing the toolkit for assessing systemic risk. It will increase the influence of this assessment and its messages on external decision-makers, in particular private sector risk-managers and public sector authorities, by implementing a revised communications plan.

The Bank will also aim to influence policy and behaviour to reduce systemic risk (working with HMT and the FSA as appropriate) by identifying and delivering a targeted set of risk reduction campaigns, such as: reform of the IMF, including its surveillance role and policy for lending into arrears; domestic reform of liquidity standards, following completion of the review of international standards by the Basel Committee; and strengthening financial market infrastructure through the Bank's participation in the Committee for Payment and Settlement Systems at the Bank for International Settlements. The Bank will undertake oversight of the payment systems most important for ensuring financial stability, working with the system operators and with other authorities to assess and mitigate significant risks in the systems.

The Bank will continue to strengthen its internal capacity for managing a financial crisis, measuring and testing readiness for a crisis at regular intervals, and will work with the FSA and HMT to implement the proposals outlined in the consultation documents to strengthen the UK framework for financial stability and depositor protection (see box on pages 29–30). The Bank will contribute to wider initiatives to improve crisis management arrangements internationally such as those proposed by the Financial Stability Forum (FSF).[1]

The Bank will continue to make improvements in its money market operations processes. The final phase of the MMR2 programme, the purchase of foreign-currency denominated bonds, to be swapped into sterling, is scheduled for 2008.

(1) For more information about the FSF, see www.fsforum.org.

Strengthening the UK framework for financial stability and depositor protection

The disruption in global financial markets that started in the second half of 2007 revealed a number of areas in which the framework for financial stability and depositor protection could be improved. In October, the Tripartite Authorities issued a Discussion Paper (*Banking Reform — Protecting Depositors*)(1) which set out the current framework and asked for feedback on how the UK framework could be strengthened.

In light of feedback received — which included that of the Treasury Select Committee in its report (*The run on the Rock*)(2) — the Tripartite Authorities produced a consultation document in January, *Financial stability and depositor protection: strengthening the framework*(3) and a further consultation document in July, *Financial stability and depositor protection: further consultation*.(4) These documents set out a range of proposals for improving the framework for UK financial stability. The key proposals are outlined below:

Procedures for dealing with a troubled bank

- Require banks to hold additional information to demonstrate to the FSA that they are meeting the 'threshold conditions', on an ongoing and forward looking basis;
- remove barriers to the provision of covert liquidity assistance to banks; and
- introduce a special resolution regime (SRR) for banks and building societies, to give the Tripartite Authorities greater control over the resolution of a failing bank. In practice, any decision to trigger the SRR and to deploy one or more of the tools would only be taken following intensive discussion between the Tripartite Authorities. The lead responsibilities would be:
  - the FSA for supervisory decisions and regulatory actions;
  - the Bank of England for liquidity support and operation of the SRR; and
  - HMT for public finances and the overall public interest.
- As part of this regime it is proposed that new powers be introduced to allow the Tripartite Authorities to:
  - transfer part or all of a failing bank to a private sector third party or to a publicly controlled bridge bank with a view to a subsequent private sector solution;
  - should it be apparent that immediate closure of the bank is appropriate, put the bank into a modified insolvency process to facilitate fast and orderly payment of depositors' claims under the Financial Services Compensation Scheme (FSCS); and
  - continue to apply existing resolution tools, such as public sector liability guarantees and capital injections.
- In addition, proposed reforms will:
  - strengthen the arrangements underpinning banknote issuance; and
  - formalise the Bank of England's role in the oversight of payment systems to ensure their robustness.

Effective deposit insurance arrangements

A number of changes are proposed to make deposit insurance more effective including:

- requiring banks to have readily available information on eligibility of depositors and on their account balances to support rapid payout;
- enabling the FSA to collect information that the FSCS requires (and share this with the FSCS);
- ensuring there are no barriers to the Bank of England, once resolution is invoked, being able to collect and share relevant information on the firm in question with the FSCS;
- consulting on changes to the FSCS compensation limits;
- legislating to ensure the FSCS has access to immediate liquidity through borrowing from the public sector;
- introducing powers allowing the introduction of pre-funding of the FSCS if it is considered appropriate to do so; and
- allowing the Authorities to call on the FSCS to contribute to the costs arising from the use of resolution tools.

Strengthening the Bank of England

- Formalise the Bank's role in financial stability in statute and give Court a formal role in overseeing performance in this area; and
- implement new corporate governance structures within the Bank, including legislating for the creation of a Financial Stability Committee, drawing upon external expertise. This would be a sub-committee of Court and will comprise senior representatives from within the Bank of England as well as non-executives drawn from Court and be chaired by the Governor.

The Bank's priorities in 2008/09 continued

Strengthening Tripartite co-ordination procedures

- Clarify responsibilities within the Memorandum of Understanding for decisions around providing support to firms; and
- the Bank will be able to require the FSA to collect the data it needs to fulfil its financial stability functions.

International initiatives

The Tripartite Authorities support the suggested international response expressed in the FSF's April 2008 report[5], including:

- strengthening prudential oversight of capital, liquidity and risk management;
- enhancing transparency and valuation in securitisation markets;
- changes in the role and uses of credit ratings, including through improvements in the quality of the rating process; expanded information on structured products; and the enhanced assessment of the underlying data quality; and
- learning the lessons around improving the Authorities' responsiveness to risks, and arrangements for dealing with stress in the financial system.

(1) www.hm-treasury.gov.uk/consultations_and_legislation/bankingreform/consult_banking_reform.cfm.
(2) www.publications.parliament.uk.
(3) www.hm-treasury.gov.uk/documents/financial_services/financial_stability_framework.cfm.
(4) www.hm-treasury.gov.uk/documents/financial_services/financial_stability_framework.cfm.
(5) www.fsforum.org/home/home.html.

The Bank's strategy for its Banking operations is to focus on activities that support the core purposes of monetary and financial stability. Central to this strategy is the Customer Banking Transition Programme. The second phase of this work, which will end the provision of customer banking services to the Government, is now expected to complete in late 2010 (including account run off), with the start of the migration activities planned for the end of 2008/09. The exit from these services has consequences on future resource levels and IT requirements in this area of the Bank in the long term, and the future of the Bank's main banking system will form a key part of the IT strategy for financial operations.

2008/09 will also see the launch of a new system that supports all aspects of the Bank's banknote distribution business. The new system, implemented along with improved business processes through a series of releases through the year, is expected to enhance the control environment and provide improved management information.

The delivery of the Bank's strategic priorities will be supported by Central Services and Finance, particularly in the areas of HR, IT and in business planning and performance measurement.

In delivering its HR strategy, the Bank will take steps to improve the efficiency of transactional HR processes while working with business areas to improve staff recruitment, retention and development. New guidelines on flexible working arrangements, in part to support the Bank's diversity strategy, have been introduced and were effective from 1 April 2008.

The delivery of the Bank's new IT operating model is expected to complete during 2008/09, with the appointment of IT business partners who will develop IT strategies for each of the main businesses of the Bank. These strategies are expected to inform the Bank's IT investment programme for the next few years. The new operating model is also expected to deliver a more efficient service which is better aligned with the business need, with more transparency around costs and service levels.

The Bank intends to improve its performance measurement framework, building on work that has already been done to integrate strategic planning, risk management and performance reporting at Court level. A new performance measurement system should enable each business area to monitor its contribution to the delivery of the Bank's core purposes and ultimately to help to set objectives for individuals. Finance also plans to deliver the first phase of a project to improve its budgeting and management accounting systems and processes. This project is expected to deliver clearer and more consistent financial information to business areas while streamlining the budgeting and reporting processes within Finance.

Financial review

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

- First, that the Bank will set a budget for spending on policy functions — monetary policy and financial stability — consistent with the figure given in the five-yearly review of the Cash Ratio Deposit (CRD) scheme. Under the CRD regime, banks and building societies are required to place a percentage of their deposit base, above a minimum threshold, at the Bank interest-free. The Bank then invests those deposits in interest-yielding assets, generating income to fund its policy functions.
- Second, that the other, remunerated, activities of the Bank will be expected to break even over the medium term. In these areas the focus will be on net spending, although the Bank will remain committed to providing value for money, without running undue risks. Any losses or gains from these activities will not flow through to the CRD-payer, but instead affect the Bank's capital.
- Third, that if spending on policy functions is in line with CRD income and other functions break even, the profit of the Bank is equivalent to the return on the assets in which its capital and reserves are invested — largely gilts and other AAA-rated sterling-denominated bonds. The Bank's post-tax profit is shared 50:50 with HM Treasury, subject to any other agreement.

Court considers the operation of the Bank's financial framework in fulfilling its responsibilities under the 1998 Bank of England Act.

Spending in 2007/08

Spending on the Bank's policy functions in 2007/08 was 2% higher than the outturn for 2006/07. Income from the CRD scheme increased by 14%.

The 2007/08 outturn for net expenditure on policy functions was £106.2 million; compared to a budget of £106.1 million and a 2006/07 outturn of £104.1 million. The budget included a contingency of £1.2 million, which met additional operational costs in Markets and Banking Services and accelerated capital charges, in particular for the agency accommodation project, which will generate future budget savings.

Remunerated functions generated net income of £10.3 million, compared to a small budgeted deficit. That reflected higher income from banking services, relating to higher customer volumes.

Financial review continued

Bank expenditure by function

£ millions	2006/07 Actuals	2007/08 Budget	**2007/08 Actual**	2008/09 Budget
Policy functions				
Monetary policy	64.2	65.8	67.3	68.1
Financial stability	41.8	42.2	41.9	42.3
Contingency reserve	–	1.2	–	1.2
Gross expenditure on policy functions	106.0	109.2	109.2	111.6
Recoveries	-1.9	-3.1	-3.0	-3.4
Net expenditure on policy functions	**104.1**	**106.1**	**106.2**	**108.2**
CRD income	129.1	143.7	147.6	127.2
Remunerated functions				
Note issue	54.0	60.4	59.7	69.3
Government agency services	9.4	9.7	9.5	9.2
Payment and settlement	12.2	12.4	12.5	12.7
Banking services	36.3	33.9	31.8	32.4
Other	13.1	13.4	13.7	13.2
Gross expenditure on remunerated functions	125.0	129.8	127.2	136.8
Income from remunerated functions	129.6	128.5	137.5	136.8
Surplus (-) / deficit (+) on remunerated functions	**-4.6**	**1.3**	**-10.3**	**0.0**
BCCI legal fees	0.6	–	–	–
Legacy costs(1)	4.4	6.9	6.6	6.6
Total gross expenditure(2)	**236.0**	**245.9**	**243.1**	**255.0**
BCCI recoveries	-73.6	–	–	–

(1) Pensioner benefits and interest on severance provisions.
(2) From the Bank's management accounts; figures contain reporting differences to the statutory financial accounts, such as the inclusion of notional interest charges.

Budget for 2008/09

The budget for the year ahead is consistent with the strategic priorities for 2008/09, and the assumption contained in the 2008 CRD review that spending on the Bank's policy functions will increase by a nominal 2% per year for the next five years. That follows a period of a number of years during which the Bank's policy budget has been held broadly flat in cash terms. More formal reporting to Court around ongoing value-for-money initiatives is planned.

Spending restraint is one factor that allowed the 2008 CRD review to propose in its conclusions a reduction in the CRD ratio from 0.15% to 0.11%. The minimum paying threshold for the CRD ratio has been maintained at £500 million, such that the smallest eligible institutions remain exempt and wide access to the Bank's sterling monetary framework (for which a CRD account is a requirement) is maintained.

Budget plans for 2008/09 imply that remunerated functions break even (ie with zero surplus). The Bank's aim remains to fully recover the costs of remunerated functions and to break even over the medium term.

These spending plans include proposals for just under £21 million of project-related expenditure in 2008/09. This figure is in line with recent years, and a significant proportion relates to major projects already in progress. Annual investment spending is currently forecast to fall slightly in future years.

Proposals for major projects supporting the strategic priorities include:

Strategic priority	Project	Forecast total spend (£ millions)	Completion date
Monetary Policy	Chartpack automation	1.2	2009/10 Q3
Financial Stability	Risk Assessment Model for Systemic Institutions (RAMSI)	1.1	2009/10 Q4
Money market operations	Money Market Reform 2	1.9	2008/09 Q3
Banking Operations	Custody, settlement and liquidity programme Customer business transition — Phase 2	2.9 –(1)	2008/09 Q2 2010/11 Q4
Banknotes	Notes Division processes and IT infrastructure	8.5	2008/09 Q4

(1) Funded from recurrent budget.

Remuneration of Governors, Directors and MPC members

Court determines the remuneration of the Bank's most senior executives, including the Governors, Executive Directors (who are not members of Court), the Advisers to the Governors and the members of the Monetary Policy Committee appointed by the Chancellor of the Exchequer (the external MPC members). Court is advised by the Remuneration Committee, the composition of which is shown on page 6. Although no executive member of Court sits on the Remuneration Committee, the Governor may be invited to attend meetings that do not consider his own remuneration. The Chairman of NedCo may also attend meetings.

Remuneration policy

The Remuneration Committee's approach is to carry out reviews of senior Bank remuneration every five years in order to set appropriate pay, benefits and conditions of service. The Committee takes account of supply and demand, including external salary comparisons insofar as these might impact upon the availability of good candidates while bearing in mind the Bank's position within the public sector. Where relevant, the Committee makes use of external advice to support this. The five-yearly reviews set the rate for each job and, in the case of the Governors and the external MPC members, the scale according to which salaries are automatically increased each year. Executive Directors and Advisers are subject to annual performance reviews as are all members of Bank staff. These can result in both merit increases to pensionable salary and in non pensionable bonuses.

The last review of remuneration for the Governors and for the external MPC members was carried out in 2006 with the assistance of Towers Perrin. The conclusions regarding the external MPC members found that their salary was appropriate for the roles and skills required. However, the review for the Governor found that the salary was low for the size and responsibilities of the role although the pension contributions were generous. The Committee determined that in future a higher salary should be offered but lower pension benefits. Overall these changes would be approximately cash neutral. The new remuneration package for a Governor should be composed of a salary range starting between £375,000–£400,000 with automatic increases of 2.5% per annum and a pension contribution between 15% and 30% salary.

Executives of the Bank have previously been invited to join the Court Pension Scheme. The Court Pension is non contributory and has a normal pension age of 60. The accrual rate allows members to achieve a maximum pension of two thirds of their pensionable salary at normal pension age after 20 years' service. The pension also provides for early retirement in exceptional circumstances (including ill-health), payment of a lump sum of four times pensionable salary in the event of death in service, allowances for a spouse's or civil partner's pension of 60% of the member's base pension and discretionary allowances for other dependents. Pensions and deferred pensions are reviewed annually and are normally increased in line with the rise in the retail prices index. Annual contributions from the Bank to the Court Pension Scheme had been running at approximately 70% of salaries to support pension accrual of active members.

In the light of the 2006 review, the Court Pension section was closed to new members and merged with the Staff Pension Fund on 30 July 2007. Existing members continue to accrue benefits under the terms described above. However, new executive appointees are now offered either membership of the Bank's new Career Average pension section, which is available to all new staff and is described on page 24, or a salary supplement of between 15% and 30%.

Remuneration structure for the Governors

The remuneration arrangements for the Governor and Deputy Governors are set out below.

Service contracts

The Governor and Deputy Governors are each appointed by the Crown for five-year terms. The Governors have no termination provisions at the end of their appointments, other than a period of three months' continued employment by the Bank when they cease to be members of the MPC.

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

Base salaries

On 1 July 2007 the salary of the Governor, Mervyn King, was increased by 2.5% from £283,564 to £290,653. On 1 March 2007, the salaries of both Deputy Governors, Rachel Lomax and Sir John Gieve, were each increased by 2.5% from £234,467 to £240,330. These increases are the automatic steps in the salary scale for their jobs.

Pension benefits

Pensions benefits for the current Governors are provided through the Court Pension section, supplemented in some instances by an unfunded scheme as described below.

For Governors serving before 2005 who are subject to the pensions earnings cap introduced in the Finance Act 1989, the Bank is contracted to provide additional unfunded pensions so that their total pensions broadly match what would have been provided by the Court Pension in the absence of the cap. During the year ended 29 February 2008, unfunded entitlements were provided to Mr King and Ms Lomax. Provision for these unfunded benefits is made in the Bank's financial statements. Court decided not to grant unfunded benefits to new Governors after 2005 and Sir John Gieve joined the Bank after this time.

Mr King's pension is fully accrued at the end of his first term in June 2008. For his second term of office he will earn no annual pension contribution from the Bank.

Other benefits

The Remuneration Committee also keeps under review other benefits available to the Governors. Medical insurances were the principal non salary benefits received during the year to 29 February 2008.

Reappointment of Mervyn King

On 30 January 2008, Mervyn King was appointed to a second term as Governor (1 July 2008 to 30 June 2013). On his reappointment Mr King was eligible for the terms of the new remuneration package from the 2006 review. Mr King declined to accept the new remuneration package and retained the salary and annual increases which applied during his first term.

Remuneration of Non-executive Directors

The Bank of England Act 1998 provides for the remuneration of the Non-executive Directors to be determined by the Bank with the approval of the Chancellor of the Exchequer. The remuneration of the

Remuneration of members of Court	Salary £	Benefits £	Total 2007/08 £	Total 2006/07 £
Governor				
Mr M A King				
Joined 1 March 1991	288,290	1,261	289,551	281,696
Deputy Governors				
Ms J R Lomax				
Joined 1 July 2003	240,330	751	241,081	235,180
Sir E J W Gieve				
Joined 1 January 2006 (Note i)	240,330	1,531	241,861	236,041
Non-executive Directors				
(Note i)	98,458	–	98,458	106,500
Total	**867,408**	**3,543**	**870,951**	**859,417**

Note

i Sir Callum McCarthy has been a member of Court since 22 September 2003 in his capacity as Chairman of the FSA. The Deputy Governor, Financial Stability — currently Sir John Gieve similarly sits on the Board of the FSA. Both have agreed to waive the remuneration due from the other body. Accordingly, Sir Callum McCarthy waived remuneration of £6,000 due from the Bank and Sir John Gieve waived remuneration of £26,500 due from the FSA.

Remuneration of Governors, Directors and MPC members continued

Non-executive Directors is £6,000 per annum; the remuneration of Non-executive Directors who chair the Remuneration Committee, the Audit Committee, the Risk Policy Committee (which was merged with the Audit Committee in July 2007) and the Trustee Board of the Court Pension Scheme (until its merger with the Staff Pension Scheme in July 2007) is £9,000 per annum; and the remuneration of the Chairman of the Committee of Non-executive Directors is £12,000 per annum. Non-executive Directors do not receive any post retirement or medical benefits from the Bank. Other than the Chairs of the Committees of Court and the Trustee Board, Directors receive no additional fees for serving on those Committees. The Bank does, however, meet appropriate travel and subsistence expenses.

Remuneration of external Monetary Policy Committee members

The Bank of England Act 1998 requires Court to determine the terms and conditions of service of the four members of the MPC appointed by the Chancellor of the Exchequer. These members are appointed for terms of three years and work a three day week.

The external members of the MPC were paid £94,125 in 2007/08 (2006/07: £91,829). They were also paid a salary supplement of 30% of salary in lieu of membership of the Bank's pension fund. They are entitled to cover under the Bank's group medical insurance scheme. On leaving the Bank external members are paid their salary for a period of three months during which period the Bank has the right to veto any employment that would conflict with their former MPC responsibilities.

The salaries of Executive Directors of the Bank are not disclosable under the Companies Act requirements, as they are not members of Court. However, the salaries of the two Executive Directors who are members of the MPC are given here for consistency. Paul Tucker's 2007/08 annual salary was £173,815; and Charlie Bean's was £181,561. The official salary range for Executive Directors is £160,000 to £185,000. Both are eligible for bonus dependent on their achievements with regard to their executive responsibilities, as are other Bank staff. Both receive the Bank's normal range of staff benefits and are members of the Court Pension section.

Pension entitlements and accruals (including unfunded entitlements)

	Cash equivalent as at 28.2.07 (£)	**Cash equivalent as at 29.2.08 (£)**	**Increase in cash equivalent (£)**	Accrued pension as at 28.2.07 (£pa)	**Accrued pension as at 29.2.08 (£pa)**	**Increase in accrued pension (£pa)**	**Cash equivalent of additional pension earned during year ended 29.2.08(1) (£)**
Mr M A King	3,950,400	4,835,500	885,100	164,300	179,200	14,900	229,100
Ms J R Lomax	635,400	922,600	287,200	29,000	38,100	9,100	193,000
Sir E J W Gieve	204,200	450,800	246,600	9,100	17,600	8,500	208,600

(1) Net of statutory deferred pension revaluation that would apply to accrued pension at the start of the year.

Governance, financial statements and risk

Governance of the Bank

The role of the Court of Directors and its Committees, and the names of the members of the Court of Directors, together with the principal outside appointments of the Non-executive Directors are given on pages 8–9.

Statement of the responsibilities of the Court of Directors in relation to the financial statements

The Court of Directors is responsible for ensuring that the financial statements of the Banking Department are properly prepared on the basis set out therein, as at 29 February 2008 and for the year to that date. The statements of account of the Issue Department are prepared in accordance with provisions agreed between the Bank and HM Treasury to implement the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968. The Court of Directors is responsible for ensuring that the statements of account are prepared in accordance with these requirements.

The Court of Directors is responsible for ensuring proper accounting records are kept, which disclose at any time the financial position of the Bank and enable Court to ensure that the financial statements comply with the requirements set out in note 2 thereto. The Court of Directors is also responsible for safeguarding the assets of the Bank and its subsidiaries, and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Court of Directors confirms that suitable accounting policies, consistently applied and supported by reasonable and prudent judgement and estimates, have been used in the preparation of the financial statements of the Banking Department. The accounting framework adopted is set out on pages 56–63.

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

Principal activities and review of operations

The Bank's core purposes are set out on page 1. The Governor's Foreword, the Review of 2007/08 and the Financial Review give a detailed account of the Bank's activities and operations during the year.

Presentation of the financial statements

The Bank Charter Act 1844 requires that the Bank's note issue function be separated from its other activities. Accordingly, the Bank is divided into 'Issue' and 'Banking'. The Issue Department and the Banking Department are accounting designations — neither is an organisational unit of the Bank.

The Issue Department is solely concerned with the note issue, the assets backing the issue, the income generated by those assets and the costs incurred by the Bank in printing, issuing, sorting and destroying notes. The entire profit of the note issue is paid over to HM Treasury.

The Banking Department comprises all the other activities of the Bank. The post-tax profits of Banking Department are shared equally with HM Treasury unless the Bank and HM Treasury agree otherwise. In preparing the financial statements of the Banking Department, the Bank, under the Bank of England Act 1998, is subject to requirements corresponding to the Companies Act requirements relating to a banking company. The Bank may, however, disregard a requirement to the extent that it considers it appropriate to do so, having regard to its functions. The Companies Act permits UK incorporated companies to prepare their financial statements either in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union or in accordance with UK Generally Accepted Accounting Principles (UK GAAP). The Bank has chosen to adopt the recognition and measurement requirements of IFRS together with the presentation and disclosure framework explained below.

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

In exceptional circumstances, as part of its central banking functions, the Bank may act as 'lender of last resort' to financial institutions in difficulty, in order to prevent a loss of confidence spreading through the financial system as a whole. In some cases, confidence can best be sustained if the Bank's support is disclosed only when the conditions giving rise to potentially systemic disturbance have improved. Accordingly, although the financial effects of such operations will be included in the Department's

Governance, financial statements and risk continued

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.

Financial results

The Banking Department's financial statements for the year ended 29 February 2008 are given on pages 52–91, and show a profit before tax of £197 million (2006/07: £191 million). After a tax charge of £36 million (2006/07: £25 million) and a payment in lieu of dividend of £81 million (2006/07: £83 million), the profit transferred to reserves amounts to £80 million (2006/07: £83 million).

The statements of account for the Issue Department (which are given on pages 92–94) show that the profits of the note issue were £2,327 million (2006/07: £1,653 million). These profits are all payable to HM Treasury. In accordance with the Currency and Bank Notes Act 1928, the assets of the Issue Department are sufficient to cover the fiduciary note issue.

Banking Department balance sheet

The Banking Department balance sheet expanded during 2007/08, to £72.9 billion at 29 February 2008 (2006/07: £39.4 billion). 'Loans and advances to banks' increased to £63.7 billion at 29 February 2008 (2006/07: £31.6 billion). The Bank's lending via short-term open market operations (OMOs), with a maturity of one week, declined during the period. In December 2007 and January 2008, the Bank introduced lending via three-month reverse repo operations against an extended range of collateral, as part of measures announced jointly with other central banks designed to address elevated pressures in term funding markets; this was allocated to the Banking Department. The Bank made facilities available to Northern Rock; the balance outstanding at 29 February 2008 was £24.3 billion (2006/07: nil).

The allocation of the three-month reverse repos to the Banking Department balance sheet gave rise to a much larger balance between the Banking Department and Issue Department balance sheets. The Issue deposit with Banking Department stood at £19.2 billion at 29 February 2008 (2006/07: £49 million). There was also an increase in 'deposits from banks and building societies' on the Banking Department balance sheet, to £24.9 billion at 29 February 2008 (2006/07: £20.8 billion). The largest component of these deposits is reserve balances. As part of the Bank's sterling monetary framework, reserve-scheme participants elect to maintain a target balance on average over a maintenance period running from one MPC meeting to the next.

At 29 February 2008, the Banking Department balance sheet contained £3.7 billion of assets and liabilities associated with the management of the Bank's foreign exchange reserves (2006/07: £3.3 billion). In December 2006, the Bank announced that its foreign exchange reserves would be financed by medium-term securities on an annual basis. In March 2007, the Bank launched a $2 billion three-year RegS/144A Eurobond; a further $2 billion bond was issued shortly after the 2007/08 financial year end. In January 2008, €2.2 billion of the Bank's three-year denominated notes (originally issued in 2005) matured. The levels of foreign currency assets, and related swaps held to minimise exposure to interest rate, currency and liquidity risks, moved in step with the foreign currency liabilities in issue.

Sterling and foreign currency deposits taken from central banks increased during the course of the year, to £18.6 billion (2006/07: £11.5 billion).

The Banking Department balance sheet also contains the Bank's capital and reserves and Cash Ratio Deposits (CRDs). These are predominantly invested in gilts, supranational sterling bonds and short-term repos. At end February, capital and reserves totalled £2,293 million (2006/07: £1,860 million); the increase on the year mostly reflected retained profit, an increase in the marked-to-market value of available for sale securities and an actuarial gain relating to the pension scheme. CRDs grew to £2,936 million at 29 February 2008 (2006/07: £2,568 million). The Banking Department's holdings of gilts securities were £2,520 million at 29 February 2008 (2006/07: £2,445 million) and holdings of other supranational sterling bonds was £1,021 million (2006/07: £1,049 million).

Issue Department balance sheet

Banknote liabilities continued to increase year on year, and were £45 billion on 29 February 2008 (2006/07: £38.5 billion). £3.4 billion of the increase was in 'Other notes', reflecting the use of higher value notes as cover for the notes issues of banks in Scotland and Northern Ireland at weekends. The Government proposes legislation to require commercial issuing banks to maintain sufficient and appropriate banknote-covering assets at all times.

There has been a change in the composition of Issue Department assets. The Ways and Means advance to HM Treasury was £7.4 billion at 29 February 2008 (2006/07: £13.4 billion). The Ways and Means facility is the central government's overdraft facility at the Bank of England. Until 2000, when the Debt Management Office took responsibility for the government's cash management function from the Bank of England, the facility was used as the means of balancing the government's day-to-day cash needs. Since 2000 its size had effectively been unchanged. It has always been the government's intention to reduce the advance over time. There were two such repayments in 2007/08, of £4 billion on 24 January 2008 and of £2 billion on 31 January 2008. The timing of this action was in order to provide the Bank with additional flexibility in managing its balance sheet. There was a further part repayment of the Ways and Means facility of £7 billion after year end, on 17 April 2008.

Reverse repos outstanding at 29 February 2008 were £17.6 billion (2006/07: £25 billion), and remained predominantly long term, reflecting changes to the Bank's OMOs in January 2006 in preparation for Money Market Reform (MMR). In January 2008, as part of the second stage of MMR, the Bank introduced gilt purchases on Issue Department via OMOs. The value of gilt securities at 29 February 2008 was £798 million (2006/07: nil). As noted in the previous section, Issue Department assets included a deposit with Banking Department, netted out in the consolidated balance sheet.

A consolidated balance sheet

The separation of Banking from Issue in the Accounts is required by statute. A summary consolidated Bank balance sheet as at 29 February 2008 is set out on page 40. It is provided for information purposes only, to assist comparison with other central banks.(1)

In summary, the consolidated balance sheet increased by £21 billion. Banknote liabilities increased by £7 billion, and sterling and foreign currency deposits taken from central banks by £7 billion; all other liabilities increased by £7 billion. In terms of assets, the balance outstanding with Northern Rock at 29 February 2008 was £24 billion, OMOs and the Ways and Means advance declined by £7 billion and £6 billion, respectively, outright gilt holdings increased by £1 billion, and foreign currency deposits and the placement of central bank deposits by reverse repo increased by £8 billion. Other assets increased by £1 billion.

Payment in lieu of dividend to HM Treasury

The Bank of England Act 1946, as amended by the Bank of England Act 1998, requires the Bank to pay to HM Treasury, in lieu of dividend on the Bank's capital, on the fifth day of April and October (or prior working day), a sum equal to 25% of the Bank's post-tax profit for the previous financial year or such other sum as the Bank and HM Treasury may agree. The overall effect is that the Bank and HM Treasury will normally share post-tax profits equally. Accordingly, the Bank paid £41.5 million in April 2007 and £41.7 million in October 2007 in respect of the year to 28 February 2007. On 4 April 2008, the Bank paid the first payment of £39 million in respect of the financial year ended 29 February 2008, based on provisional full-year figures. The balance will be paid on 3 October 2008.

Risk management

The Bank's activities require it to identify, assess and manage a wide range of risks effectively. The Bank's risks are managed through a framework that relates the policy

(1) Consolidated is defined as combined Banking and Issue Departments. Information has been consolidated without adjustment for the existence of differences in accounting policies between Banking and Issue Departments. The principal accounting policy difference with an effect on net assets is that Banking Department follows accruals accounting and Issue Department does not. Subsidiaries of Banking Department have not been consolidated on the grounds of immateriality. Comparative information is provided in accordance with the accounting framework of Banking Department set out in note 2(a) 'Form of presentation of the financial statements' to the Annual Accounts.

Governance, financial statements and risk continued

Summary combined balance sheet	2008 £m	2007 £m
Assets		
Ways and Means advance	7,370	13,370
Loans and advances	81,574	56,686
Financial assets designated at fair value through profit or loss	3,742	3,298
Derivative financial instruments	122	121
Available for sale securities	4,650	3,755
Other assets	1,200	533
Total assets	**98,658**	**77,763**
Liabilities		
Notes in circulation	44,978	38,449
Deposits	45,552	33,331
Derivative financial instruments	727	72
Financial liabilities designated at fair value through profit or loss	3,377	3,328
Other liabilities	1,731	723
Capital and reserves	2,293	1,860
Total equity and liabilities	**98,658**	**77,763**

and structure of risk management to the Bank's strategy and objectives. The framework identifies the roles and responsibilities of key parties in the risk management process and applies to all categories of risk.

The Bank's risk framework

The function of the Bank's risk management framework is to facilitate the identification, mitigation and management of risks which may impede the Bank's achievement of its strategic objectives.

The Bank's risk management activities are overseen by the Business Risk Committee (BRC). The BRC terms of reference give the committee responsibility for oversight of risk tolerance and policy, and monitoring the practical implementation of the framework. The BRC is supported in these activities by the Risk Oversight Unit.

The risk framework has been designed and implemented in a manner to ensure that it is 'fit for purpose', in order to ensure that the Bank's unique risk profile is assessed using the most suitable methodology available. This includes ensuring that suitable processes are in place for the identification, assessment and management of the risks to which the Bank is exposed, and that management develop suitable mitigating actions for those exposures deemed unacceptable.

The framework provides for both top-down and bottom-up assessment of the risks. From a top-down perspective the risks are articulated in terms of their potential impact on achievement of the Bank's two core purposes. From the bottom-up perspective, risks are articulated in terms of their potential impact on the achievement of each Directorate's specific business aims, as set out in the budget process.

The Bank's process for identifying, evaluating and managing significant risks is in accord with the guidance contained in the Combined Code issued by the Financial Reporting Council. An annual review of the effectiveness of the Bank's system of internal control is undertaken by the Executive Directors, and its findings are reported to Court.

Risk policy

The Bank's risk policy and appetite is articulated in a set of eleven standards. The risk standards map to the top level of the Bank's risk categorisation model. Each risk standard describes how and where the risk may arise, the Bank's tolerance of the risk and guiding principles of governance of the risk, including controls and key risk indicators. Each risk standard is owned by a member of the Executive Team. The standards are reviewed on an annual basis, and updated accordingly.

Risk governance

The key elements of the risk framework governance structure are listed below:

The Court of Directors: Court's overall responsibilities include determining the Bank's objectives and strategy, and ensuring the effective discharge of the Bank's functions and the most efficient use of the Bank's resources. Within this Court takes responsibility for the overall governance framework of the Bank, including the Bank's risk framework and system of internal controls.

The Governors and Executive Team (ET): ET holds the primary executive responsibilities delegated to them from Court. The Executive Directors are responsible for managing the risks within their Directorates, and ET for managing overarching issues and risks faced by the whole institution.

The Business Risk Committee (BRC): BRC is chaired by the Deputy Governor Monetary Policy, with the Executive Directors as members. The primary responsibilities of the BRC are:

- Setting and reviewing the Bank's risk framework and appetite through the formulation and ongoing review of each risk standard.
- To maintain oversight of risk management activity throughout the Bank, and alert ET and Court to key risk issues. This is facilitated through the BRC review of regular risk reporting, action plan formulation and monitoring.
- The BRC are supported in these tasks by the Risk Oversight Unit.

Risk Oversight Unit (ROU): The ROU's responsibilities include reviewing the implementation of the Bank's risk framework, and ensuring its continued development in accordance with the Bank's strategic objectives. ROU co-ordinates and compiles the risk reporting to BRC, ET and Court, and provides consultancy services to business areas including facilitation of risk management activities where required.

The Audit Committee: The Audit Committee assists Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management. It has responsibility for reviewing the findings of internal and external auditors and monitoring outstanding actions for timely completion. Since the dissolution of the Risk Policy Committee in July 2007, the Audit Committee terms of reference were expanded to including accountability for providing assurance that the overall risk framework is fit for purpose.

Assets and Liabilities Advisory Committee (ALCO): ALCO supports and advises the Executive Director, Markets on the management of the Bank's balance sheet under the terms of the Remit from the Governor. In the context of the Remit and risk framework, it monitors the financial performance and risk profile of the Bank's main financial activities, and of the balance sheet as a whole.

Other Committees with risk management responsibilities: Additional executive committees are in place to provide assurance on the profile and management of specific risk types, including:

- Credit Rating Advisory Committee
- Markets Risk Committee
- Security Committee
- Projects Group

In July 2007 the Risk Policy Committee of Court was discontinued. Court decided that sufficient progress had been made in the development of the risk framework such that risk information could be reported direct to Court, with Audit Committee accountable for providing assurance on the overall risk framework.

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

Exchange Equalisation Account

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

Governance, financial statements and risk continued

The risks incurred in conducting this business are similar to those in relation to the Bank's own business, namely credit, market, liquidity and operational risk; and the controls applied parallel those applied in respect of Bank business. The management of the EEA is conducted within a framework agreed annually with HM Treasury, which is described in the *EEA Annual Report and Accounts* published by HM Treasury.

Employees

Details of the Bank's employees, their involvement in the Bank's affairs and the Bank's approach to equal opportunities are given on pages 24–25.

Health and safety

Effective health, safety and risk management is a priority throughout the Bank. The Bank maintains a proportionate safety management system that delivers a safe business by active measurement and assessment.

The environment

The Bank monitors the impact of its operations on the environment, which is mainly through the use of power and the generation of waste. The Bank tries to minimise its impact through better use of its premises, using increasingly power-efficient equipment and by improved waste management. 10% of the electricity used in the Bank's premises is from renewable (green) sources. The Bank's Head Office building is accredited under the Carbon Trust's Energy Efficiency Accreditation Scheme and was awarded The Corporation of London's Clean City Platinum award in 2007. Approximately 95% of waste produced by the Bank at its two main sites in London and Essex is recycled or re-used in some form. This *Report* is printed on paper which contains 50% recovered waste and 50% virgin fibre and is certified as a Forest Stewardship Council mixed sources product.

Political and charitable donations

No donation was made for any political purpose. The Bank allows staff to take part in local political and community activity and may grant time off for such activity. No such time was granted for political interests in 2007/08 (2006/07: nil).

The Bank continued to play an active role in community initiatives and supported voluntary work undertaken by its staff. During 2007/08 the Bank contributed £587,000 in support of its community programme (2006/07: £680,000). Donations in cash totalled £343,000 (2006/07: £410,000), this included £15,000 via the Bank of England Court Awards through which donations are made to community organisations in recognition of outstanding volunteering commitment by members of staff; £5,000 for the David Sharp School Governor Awards; £52,000 to community organisations via the Staff Volunteering Award Scheme, and £32,000 matched funding under the payroll Give-As-You-Earn Scheme. The cost of other community contributions, including time spent by staff on community involvement, was £244,000 (2006/07: £270,000), and donations to academic research amounted to £93,000 (2006/07: £134,000).

Policy on payment of suppliers

The Bank subscribes to the principles and practices of the Better Payment Practice Code.[1]

The Bank estimates that the average trade creditor payment days for 2007/08 were 10 (2006/07: 16). This is an arithmetical calculation and does not necessarily reflect our practice, described above, nor the experience of any individual creditor.

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

Report by the Non-executive Directors

This section contains the Report from Non-executive Directors required by Section 4(2)(a) of the Bank of England Act 1998. It describes the responsibilities under the Act of the Committee of Non-executive Directors — NedCo — and how it has discharged them. The Report relates to the period from 1 March 2007 to 29 February 2008, referring where relevant to other sections of the *Annual Report* which cover Non-executive Directors' responsibilities as members of Court.

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

The operation of NedCo

Although Non-executive Directors of the Bank operate in an environment which is in some ways different from a commercial organisation, they also have duties and responsibilities similar to those of a typical company board. They do not involve themselves in the normal day-to-day operations of the Bank. Their role is to provide oversight and challenge for the Bank's executive management, acting as a check on and balance for how the Bank is managed. In this way, NedCo helps to develop and guide decisions taken by the Bank, covering all aspects of the Bank's strategy and business plan, as well as its financial objectives, within the framework established and agreed by Court.

To support NedCo's oversight of the Bank's work, Non-executive Directors receive and discuss a series of regular quarterly reports — covering strategy implementation and milestones, finance, project management, risk management and performance measurement against the Bank's four high-level outcomes.(1) Further improvements have been made to these reports over the past year, including information about delivering value-for-money initiatives across the Bank.

The practice that has been in place since 2004 whereby NedCo discusses the main business issues facing the Bank ahead of decisions taken by Court will be modified if legislation proceeds — as proposed — to enable the senior Non-executive Director to chair Court. The current arrangement was designed, in effect, to enable the Bank's governance practice to accord with contemporary principles. Non-executive Directors welcome this legislative proposal and the proposal to reduce the size of Court. A smaller membership should help Court and NedCo to have a more effective dialogue than is achievable with a body as large as at present. Non-executive Directors have discussed the optimal size of Court, and the structure and nature of its membership in the future, although this will depend in part on the statutory financial stability role given to the Bank and on Court's oversight responsibilities for it. The operation of NedCo and Court under new legislation will need to be considered further in due course.

In view of the continuing developments from the board evaluation which we undertook in 2006 — notably efforts to enhance the effectiveness of NedCo's oversight of the Bank's financial stability work — a further evaluation was not needed in 2007. A board evaluation has been undertaken for 2008 to review the operations of NedCo and Court over the past year. The chairman of NedCo has had regular discussions with HM Treasury as the Bank's shareholder and Non-executive Directors have commented on senior appointments at the Bank, and the merits of internal candidates for senior positions.

Financial stability oversight

After initiating changes last year — notably the introduction of a quarterly financial stability report to NedCo and attendance by Non-executive Directors at Financial Stability Board meetings — Non-executive Directors have continued to monitor closely the Bank's financial stability work. It is recognised that the Bank's financial stability role does not lend itself to the same clear-cut separation of oversight of processes and operational decisions that characterises its monetary stability responsibilities; and the 1998 Act does not refer to Non-executive Directors' role in relation to financial stability. However, NedCo has a formal duty under Section 3(a) to see that the Bank's performance reflects its

(1) The inflation target, the integrity of the currency, the stability of the financial system and trust in the Bank to carry out its core purposes in a fair, efficient and professional manner.

Report by the Non-executive Directors continued

strategy and objectives. To do that, NedCo has to be satisfied that the Bank's work on financial stability — under the Tripartite Memorandum of Understanding — is effective, and that adequate systems and resources are in place. In order to enhance their oversight further, in 2007 Non-executive Directors discussed and agreed with the executive management of the Bank a series of practical measures. Accordingly, a framework of annual, quarterly and monthly reports has been established to facilitate discussions about the Bank's risk assessment and risk reduction work, as well as the organisation, skill requirements and processes of the Financial Stability area. Attendance at the Financial Stability Board during 2007 has been reviewed. Although it provided a valuable insight into the Bank's work, by itself it was not considered sufficient. So it has been agreed that all Non-executive Directors will attend meetings on a rotating basis, as participants rather than as observers so that they can contribute. They will not attend discussions where actual or perceived conflicts of interest arise.

The discussions about the oversight of financial stability preceded the turmoil in financial markets that started in August 2007. Clearly, the improvements made in 2007 will need to be reviewed in the light of whatever changes are made to the Bank's financial stability role as part of the legislative reforms now being considered. The Bank's role may be defined in statute and Court may be given a formal role similar to its existing statutory oversight for the MPC procedures. NedCo welcomes these developments and is actively contributing to the Bank's thinking on the reform proposals.

Non-executive Directors have discussed the principles behind a special resolution regime, its potential design and the possible role of the Bank. It is vital that enough time is taken to ensure that the legislation is well designed and that it takes proper account of all relevant elements and the circumstances in which such a regime might be used. An important component of the overall framework will be arrangements to resolve difficulties before an institution is placed into such a regime. To play its part effectively, the Bank will need access to information about individual financial institutions at an early stage and well in advance of any provision of lender of last resort funding. The arrangements for a special resolution regime, including so called trigger mechanisms, will need to be clearly defined. Crucially, the responsibilities and powers assigned to the Tripartite Authorities, including the Bank, will need to be unambiguous. Non-executive Directors believe that there are good arguments for the Bank to be the body that is charged with operating a special resolution regime. However the Bank's financial stability role is defined, it will be essential that the Bank's responsibilities are matched by equivalent authority.

Financial market developments and financial support for Northern Rock

The Bank's earlier warnings relating to the underpricing of risk and the search for yield across financial markets are well documented. The events in financial markets since the summer of 2007 and the financial support provided to Northern Rock have seen these risks crystallise. This has placed a significant load on the Bank. Its market operations, market intelligence, banking, financial stability and monetary policy functions have all been affected to varying degrees. Non-executive Directors have been regularly informed of developments and the Bank's response to them. Court held additional meetings about the Bank's financial support for Northern Rock. NedCo has received monthly reports on events in financial markets and on Northern Rock, as well as regular quarterly financial stability reports.

The Bank's provision of additional liquidity since September and, since December, against a wider range of collateral has helped though not yet resolved the problems in financial markets. These intensified in 2008 both in the United Kingdom and elsewhere. The Bank's Special Liquidity Scheme, announced in April, is a substantial initiative to ensure that financial institutions can finance their activities more readily and have more confidence in each other. It will also be important for banks and other institutions to take action themselves to strengthen their financial positions and risk management in the light of these events.

The resulting additional work for the Bank, particularly for its senior and experienced staff, inevitably involved a redirection of effort and some delays to other work and projects. Non-executive Directors are satisfied that resources have been adequate for the additional work being undertaken and that the nature and risks associated with the work that has been delayed have been managed effectively.

The Bank's strategy and its implementation

The Bank's strategic priorities and the related work programmes have remained a core part of NedCo's agenda. Progress has been reviewed; and particular elements of the strategy have been regularly reported and discussed. Over the past year, some of these have progressed while others have been delayed. Clear milestones laid down in advance have helped NedCo to keep abreast of developments and discuss changes to plans with the executive management.

The strategic priorities have again been reviewed in NedCo and updated to reflect both progress to date and new developments. These have included extending strategic priority six — about financial crisis management — to include the Bank's work on the introduction of a special resolution regime for banks. The Bank's performance is reviewed on pages 14–26 of this *Annual Report*. In NedCo's opinion this evaluation is a fair statement of the Bank's performance against its objectives and strategy for 2007/08. Particular aspects of the Bank's strategy are discussed below.

Monetary policy

Monetary policy has been tested as economic conditions have become less benign and the inflation outlook has been more uncertain. Slowing growth with rising inflation is the stiffest challenge that the MPC has faced so far. This has made it more important than ever for the MPC to explain its thinking and policy decisions to financial markets, business and the public. NedCo's assessment of the processes and procedures of the MPC are discussed on page 47 below.

Market operations

After the introduction of the reforms to the Bank's money market framework in 2006/07, the Bank has in 2007/08 introduced systems and processes so that it can purchase and hold a portfolio of bonds. In common with other major central banks, the Bank has found its money market framework under strain during recent financial events. Elements of the framework were well designed to accommodate commercial banks' needs for additional reserves and ensure that the overnight money market rate of interest remains more closely in line with Bank Rate. Other elements need to be reviewed in the light of experience, notably the operation of the standing lending facilities. Liquidity provision by central banks becomes an important part of maintaining financial stability in stressed conditions; but the standing lending facility became stigmatised as a badge of illiquidity. This needs to be addressed.

Financial stability

The Bank's financial stability work has also been brought into sharp focus by the events in financial markets in 2007/08. The strategy of focussing on key risks and using an improved toolkit continues to be implemented. The Bank's *Financial Stability Report* and speeches by senior staff highlighted consistently the risks that have subsequently crystallised. However, the Bank is rightly thinking hard about how to get its messages across to markets so that they are more effective in shaping response and actions. As described earlier, the Bank is actively contributing to the work on reforms to financial stability, most notably a special resolution regime.

Payment systems

NedCo considered in 2007 the Bank's role in the oversight of payment systems and agreed with the Bank's executive management that a more formal statutory basis for oversight of payment systems was needed, with the Bank's role centred on its operational control of large value payment systems through RTGS.

Customer banking

The Bank's strategy for customer banking — namely to withdraw from retail banking services — has progressed over the past year; and some key milestones have been reached, including securing alternative banking services for HM Revenue & Customs. Non-executive Directors expect further progress in 2008/09 towards aligning the Bank's banking operations with its core purposes, and will expect customer banking to continue to recover the full cost of banking services from its customers.

Business resilience

More work has been undertaken to improve the Bank's business resilience in the event of major operational disruption, including extending further the scope of the Bank's split-site working across its banking and market operations. In last year's *Report*, Non-executive Directors drew attention to the need for further benchmarks. These have been set over the past year as part of the FSA's market-wide exercise. There have also been discussions with Non-executive Directors about the appropriate level of resilience for a central bank. In view of the risk, albeit small, of an event over a wide area affecting the Bank

Report by the Non-executive Directors continued

and its main contingency sites, Non-executive Directors asked whether critical operational functions should be replicated in another central bank. Work is under way to consider this.

Projects

Some major projects have been delayed during the past year — such as the replacement of IT systems for bank note distribution — because of changing priorities and strains on resources, particularly senior management time. Non-executive Directors have been kept informed of slippages and related risks and costs. The Bank's strong project management framework has helped during this period.

Services

Central Services have improved procurement management. Non-executive Directors have asked for key contracts to be benchmarked and considered by the Audit Committee. Improved procurement standards are part of a wider effort across the Bank to obtain value for money, which Non-executive Directors expect to see extended over the next year. Non-executive Directors have discussed the Bank's IT strategy and operations, which support the Bank's work. Improving IT support for analytical areas has been emphasised. Effective performance measurement criteria will tell us how well it is working.

Human resources

Non-executive Directors have again monitored the Bank's main HR work. These include: better hiring of experienced professionals; better managing the careers and talent of the Bank's best people; making individuals more accountable for their performance; and ensuring that rewards in the Bank match recruitment and retention needs. The Bank knows the HR challenges it faces; and good progress has been made over the year, notably on pensions, career development and diversity. The latest staff survey revealed good attitudes about working at the Bank. Non-executive Directors have asked for better performance criteria so that progress can be measured against HR goals.

Performance measurement needs to be a priority in the year ahead. The Bank needs an improved and integrated system so that management and staff can measure and improve their contribution to achieving the Bank's core purposes. Non-executive Directors expect to see further progress in this area in 2008/09.

Reforms to the Bank's pension benefits were delayed in 2006 by new age discrimination laws. But in 2007, after consultation with its staff and union representatives, the Bank introduced changes. These tackle the rising cost of pension benefits, increased longevity and the Bank's future pension liabilities. Non-executive Directors believe the new career average defined benefit scheme provides a better balance between pay and pensions for the staff of the Bank in the future, though some thought that a defined-contribution money-purchase scheme also had merits for staff and the Bank. An important feature of the reforms is that the retirement age will be reviewed regularly and adjusted to reflect greater longevity. Non-executive Directors support the shift towards a risk-free investment strategy for the pension fund, whereby assets are matched to the Bank's future liabilities, thus ensuring that the Bank does not in future have to make up investment shortfalls.

Financial management

The Bank's budgetary and financial reporting is providing a link between the Bank's financial management and its business operations and priorities. The Bank's business plan — linking its strategy with objectives for the year ahead — is fully integrated into the Bank's financial framework. Over recent years, quality, clarity and value of financial reporting has been transformed. This will be further improved in the coming year, by restructuring of the Finance area and by overhauling the Bank's financial processes and systems. The creation of a new Projects, Risk and Performance Division should lead to faster progress towards an integrated performance measurement system for the Bank.

The five-year review of the Bank's financial framework has been discussed regularly at NedCo; and the chair of the Audit Committee was a member of the steering group to review the Cash Ratio Deposit (CRD) scheme. Non-executive Directors agreed that the review's conclusions provided a sound basis for the Bank's finances over the next five years.

The budget agreed by Court for 2008/09 to 2010/11 is discussed on page 33. In the view of the Non-executive Directors, it successfully expresses the Bank's strategy in specific financial priorities. The Bank's control of its costs despite increasing burdens and recent pressures has benefited from sound budgetary management. The results of the Tripartite consultation on financial stability and depositor protection, particularly in relation to the

Bank's financial stability role, may require changes to the Bank's budget.

Audit and Remuneration Committees

Certain of the work required to fulfil NedCo's delegated functions is carried out by the Audit and Remuneration Committees of Court. The terms of reference of each of the committees have been reviewed during the year. Non-executive Directors consider that the Audit and Remuneration Committees have operated effectively during the year. Good progress has been made. The Bank's awareness of risk is deeper and risk reporting has improved, helped by a new incident reporting framework. We intend that improved risk and financial reporting will increasingly influence business operations and results.

The Audit Committee monitors the Bank's internal controls, on behalf of both Court and NedCo, and has reviewed the effectiveness of the system of internal financial controls which operated during 2007/08. This is reported in the internal controls section of the *Annual Report* (pages 40–41) which, so far as appropriate, forms part of NedCo's report.

The work of the Risk Policy Committee, which was wound up in July 2007 having completed its work to develop a risk framework for the Bank, has been effectively absorbed into the Audit Committee's oversight of the Bank's risk framework and through direct reporting to NedCo and Court.

The Remuneration Committee considers the remuneration of the executive members of Court and the terms and conditions of service of the members of the Monetary Policy Committee appointed by the Chancellor of the Exchequer. The report on remuneration for 2007/08 is set out on pages 34–36 and, so far as appropriate, forms part of this report.

MPC procedures

Non-executive Directors are responsible for keeping the procedures followed by the MPC under review and to ensure that it has adequate resources to do its work. This includes reviewing the regional, sectoral and other information used by the MPC for the purposes of formulating monetary policy.

As required under Schedule 3 of the Bank of England Act, Non-executive Directors receive a monthly report from the MPC. Every three months, following publication of the Bank's *Inflation Report*, MPC members are invited to attend NedCo to discuss both the *Inflation Report* and MPC procedures. As in previous years, Non-executive Directors have kept MPC procedures under review. As well as receiving the minutes of the monthly MPC meetings, the Bank's quarterly *Inflation Report* and summaries of other meetings, Non-executive Directors also periodically attend pre-MPC meetings and visit the Bank's Agencies round the country. They also see examples of the regional, sectoral and other information collected by the MPC during the year; and the Bank's Agents have attended NedCo meetings to explain the special surveys they undertake in response to questions raised by the MPC.

In order to assess formally the procedures for setting monetary policy, NedCo review and discuss the responses to questionnaires completed each year by MPC members. These responses inform the discussions undertaken with individual members of the MPC by the chairman of NedCo. Once again, MPC members are satisfied with the support provided by the Bank resources available. Processes have been improved over the past year as part of a wider programme across Monetary Analysis. Regular briefing on data releases has been streamlined to improve the focus of the material provided to the MPC and to shift resources away from routine reporting towards more analysis.

The intelligence gathered by the Bank's Agencies remains an important part of the information used by the MPC. This has been especially true at a time of increased uncertainty and divergent economic trends. MPC members also value the help of the Agencies in arranging their own visits around the United Kingdom to hear first hand about business and economic conditions and to explain their own views about the economy and interest rate decisions. The Agencies have tried to improve their intelligence gathering in several ways. These include a review of the coverage and representation of their contacts across the United Kingdom, an effort to standardise Agents' scores, and a project to process specific intelligence from the largest 500 companies in the economy. The relocation of a number of the Bank's Agencies over the past year has not impaired the intelligence provided to the MPC.

In 2006/07, MPC members were less satisfied than before with the quarterly forecasting process. Over the past year they think it has operated more effectively. In part, this is

Report by the Non-executive Directors continued

because familiarity has increased and the forecast team is more experienced. Nonetheless, the Bank is still working to improve further the quarterly forecasting process, to ensure discussions are more focussed on key economic issues and to target more precisely the material provided by staff. Non-executive Directors note the welcome the Bank has given to a survey of members of the Society of Business Economists, resulting in greater focus on the discussion in the *Inflation Report* of risks and how the Bank monitors them.

Longer-term research needs to be monitored alongside the demands of the monthly and quarterly MPC work cycles. Over recent years less time has been devoted to longer-term research partly because of efforts to streamline work and to control more tightly what research is undertaken. At the same time, the Bank must develop its ability to do research and needs to recruit and retain first-class economists, who tend to be attracted by the opportunity to undertake research alongside more immediate policy-related work. Increasing the efficiency of core briefing and forecasting work should free resources for longer-term analysis and research.

During the past year, Non-executive Directors contributed to the Treasury Committee's inquiry into the MPC's first ten years. They welcomed the report from the Committee; and Court and the MPC have published a written response to it. In particular, Non-executive Directors support the idea of having longer but non-renewable terms for external members of the MPC, though with variable duration. This is clearly a matter for Government and Parliament; and Non-executive Directors do not believe Court should play a role in the appointment or re-appointment of MPC members. Terms and conditions for external MPC members are, however, determined by Court. Non-executive Directors continue to believe that external membership of the MPC should normally be part-time to ensure the positions remain external in practice. They acknowledge the need for flexibility at the beginning of appointments to allow external members to secure additional roles outside the Bank.

Non-executive Directors welcome the changed process of appointing MPC members that were announced by HM Treasury in 2007. In last year's report Non-executive Directors said that succession planning and the process of appointments should be improved. Non-executive Directors support the Treasury Committee's proposal for a confidential pool of experts to be maintained to help fill vacancies in a timely fashion.

In NedCo's opinion, based on its review, the MPC's procedures, including those relating to the collection of regional, sectoral and other information, operated satisfactorily during the year. The Bank continues to improve and adapt processes to address specific issues raised by MPC members and NedCo.

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

Attendance	Court (15)	NedCo (11)	Audit (5)	RemCo (5)	Risk Policy (2)
Sir John Parker – Attendance as an observer at Audit, Risk Policy Committees and RemCo	13	10	2	2	0
Mrs Francis – Retired from Court 31 May 2007	2/3	2/3	2/2		
Sir Graham Hall – Retired from Court 31 May 2007	3/3	3/3		1/1	
Mr Barber	8	8			
The Hon Peter Jay	13	11		5	
Dr Potter	12	10		5	2
Ms Rabbatts – Resigned from Court 13 June 2007	0/4	0/4			
Sir Callum McCarthy	10	9			
Ms Fawcett	13	10	5		1
Sir Andrew Likierman	12	10	4		2
Mr Wilkinson	14	11		5	
Mr Myners – Stepped down from Court temporarily from 25 October 2007 to 1 February 2008 – Three meetings of NedCo and Court and 1 meeting of the Audit Committee took place during this period	10/12	8/8	4/4		2
Mr Sarin	7	5		0	
Professor Rhind	12	9		3	
Mr Wigley – Appointed to Audit Committee 11 July 2007	11	8	3/3		2
Mr Strachan	14	11	5		
Mr Carr – Appointed to Court on 6 July 2007, appointment effective from 1 June 2007 – Appointed to RemCo 11 July 2007	8/11	6/7		2/2	
Ms Rice – Appointed to Court on 6 July 2007, appointment effective from 1 June 2007 – Appointed to Audit Committee 11 July 2007	8/11	6/7	2/3		

Mr King	15	11*
Ms Lomax	12	10*
Sir John Gieve	13	11*

* Attendance by invitation.

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, Statement of Recognised Income and Expenses and the related notes, and the statements of account of the Issue Department ('statements of account') for the year ended 29 February 2008. 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 statements of account, in accordance with applicable law and International Financial Reporting Standards as adopted by the EU are set out in the Statement of the Responsibilities of the Court of Directors in relation to the Financial Statements on pages 37 to 42.

Our responsibility is to audit the Financial Statements and statements of account in accordance with relevant legal and regulatory requirements and having regard to 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 bases of preparation set out in note 2 on pages 56 to 62 and note 1 on page 93 respectively. We also report to you whether, in our opinion, the information given in the Remuneration report, the Governance, Financial Statements and Risk report and the Report by the Non-executive Directors on pages 34 to 49 is consistent with the financial statements and statements of account.

In addition we report to you if, in our opinion, 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 information specified by law regarding remuneration to Members of Court and other transactions are not disclosed.

We read the 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 56, and in the statements of account, the basis of which is described in note 1 on page 93.

Opinion

In our opinion:

- The financial statements of the Banking Department on pages 52 to 91 for the year ended 29 February 2008 have been properly prepared in accordance with the basis of preparation set out in note 2 on pages 56 to 62.
- The statements of account of the Issue Department on pages 92 to 94 for the year ended 29 February 2008 have been properly prepared in accordance with the basis of preparation set out in note 1 on page 93.
- The information given in the Remuneration report, the Governance, Financial Statements and Risk report and the Report by the Non-executive Directors is consistent with the financial statements and statements of account.

KPMG Audit Plc
London
Chartered Accountants
Registered Auditor
3 July 2008

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 United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.