Annual Report 2010

BANK OF ENGLAND

BANK OF ENGLAND

The Bank's Core Purposes are determined by Court as part of its role in setting the Bank's objectives and strategy. The statement opposite was endorsed by Court in May 2010.

Contents

The Bank's Financial Statements

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 delegated to 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 and financial 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 United Kingdom 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 Court

Sir David Lees Chairman

Over the past year the governance of the Bank has undergone a radical change. Following the provisions of the 2009 Banking Act, the Court of Directors was last June reduced in size from 19 members to twelve, and the non-executive members from 16 to nine. Four non-executive members of the old Court continued and five were newly appointed — including myself, to assume the new role of Chairman.

One of our early tasks was to form the new Financial Stability Committee, whose task is to oversee and advise on the Bank's financial stability work. The Committee formulated for Court's approval a strategy (which is reproduced in this *Report*), and a framework for monitoring implementation. A first review of implementation of this strategy has been undertaken by the Financial Stability Committee and by Court and it remains the responsibility of Court to ensure that the current strategy remains fit for purpose. The Committee advised on aspects of the Dunfermline resolution and endorsed the policy messages in the Bank's *Financial Stability Report* ahead of publication.

In addition to the Financial Stability Committee, the exercise of good governance in the Bank is reinforced by the Remuneration Committee and the Audit and Risk Committee. Both are working well. A review of the effectiveness of Court was undertaken by myself during the year based on a series of interviews with individual members. A report was made to Court on the overall results of this review and some constructive suggestions are being effected.

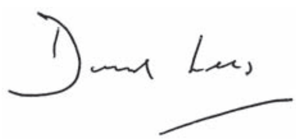
Whereas risk management in the commercial banking sector is more closely related to risk appetite, the focus in the central bank is more on risk tolerance and avoidance. Given the influx of new non-executive members of Court the Audit Committee, with the support of Court, set up a special working group to review risk governance in the Bank. The review continues with the aim of ensuring the Bank's processes are robust and reflect best practice. An early decision was to change the name and terms of reference of the Audit Committee to the Audit and Risk Committee to reflect both externally and internally the Committee's responsibilities for risk governance. On completion of the review a report will be made to Court.

Two other aspects of governance are worthy of comment both of which produced a satisfactory outcome. The first was a series of interviews carried out by myself with the external and internal members of the Monetary Policy Committee (MPC). This together with the completion of a questionnaire by all members of the MPC provided useful inputs for the Non-executive Directors Committee (NedCo) whose responsibility it is to ensure that the MPC's processes and the resources available to it are appropriate for its needs. The second was a formal review by NedCo of the Governor's proposed objectives for 2010/11 which were agreed.

As well as providing financial support, the Bank has made a substantial contribution to the policy debate over the past two years; developing approaches to operating monetary policy in a period of very low interest rates; and putting forward a clear line on the future structure and regulation of banking in this country. I and my non-executive colleagues on the Court have been impressed by the quality and rigour of the Bank's analysis and presentation of issues over the year. It is essential that we maintain the culture that fosters this, and build and develop the talent pool that will produce our future central bankers.

The new Court formed under the 2009 Banking Act has been in place for less than a year. Its reduced size has facilitated constructive discussion on many issues and I am grateful to all my colleagues, both executive and non-executive, for their committed and enthusiastic support in what has been another testing year for the Bank.

I write this foreword at a time for the country when firm and stable Government is necessary for the re-establishment of a strong economic and financial base. The Bank's contribution to this will be the continued pursuit of its monetary and financial stability core purposes.



May 2010

Foreword by the Governor

Mervyn King Governor

The past year has been one of great change at the Bank of England. We have established asset purchases as an important and effective monetary policy tool. We have continued to press the case for fundamental reform of the structure and regulation of the financial system. And we have a new Chairman of the Court and a new governance structure.

All this was done against a backdrop of enormous economic challenge. I am immensely proud of the way the Bank has proved adaptable and innovative, yet remained faithful to its history of intellectual rigour and public service.

The Bank's first strategic priority is to meet the inflation target set by the Government. That has been particularly challenging in the past year thanks to fluctuations in energy prices and the temporary cut in and subsequent restoration of the standard rate of VAT. As a result, CPI inflation started the year above its 2% target, fell back to 1.1% in September 2009, then rose sharply to 3.7% in April 2010. As a result, in May, I wrote an open letter to the Chancellor, the seventh since the Bank gained independence thirteen years ago.

Despite its volatility, inflation remains low by historic standards, and on track to meet the target in the medium term. As such, the framework has proved resilient to the stress of the financial crisis. It guided our monetary policy decisions going into the crisis, and it will guide them coming out of it.

But while that framework is necessary, it is not sufficient. Experience suggests there is a need for additional policy tools that could improve resilience in, and prevent excessive growth of, the financial sector. Last November, the Bank published a discussion paper on such macroprudential instruments and we will be discussing this area of policy with the new Government.

Other changes are also needed. The global financial system has been found wanting. The past year has seen three of our major banks continue in part or whole state ownership, the continuation of the Credit Guarantee Scheme, the Bank's Special Liquidity Scheme, extended market operations and the implicit 100% deposit guarantee. In November last year, the Bank disclosed the £61.6 billion of emergency liquidity assistance we provided to HBOS and RBS at the height of the crisis in Autumn 2008. Without that assistance, those institutions would not have survived. The system cannot be allowed to revert to its former ways as if nothing has happened. We must seize this opportunity for reform.

The Bank has sought to encourage debate around three aspects of reform: the structure of the system, regulation and resolution. At the heart of this debate is the paradox that in our market economy we have banks that are 'too important to fail'. We cannot allow that anomaly to continue.

Alongside the changes in the wider economy and financial system, we have reformed our own corporate governance. I was delighted to welcome Sir David Lees as Chairman of the Bank's new, smaller Court of Directors on 1 June 2009. I am grateful to Sir David for managing the transition so smoothly.

June 2009 also saw the inaugural meeting of the Financial Stability Committee as a sub-committee of Court. I chair the Committee, which is responsible for advising Court on the Bank's financial stability objective.

At the end of May, Kate Barker leaves the MPC after nine years on the Committee. It has been a pleasure to work with Kate and on behalf of everyone in the Bank, I would like to thank her for her dedicated public service.

Over the past year, the Bank has embraced significant change. With the support of a highly talented Executive Team, I look forward to new challenges.

May 2010

Governance and accountability

The framework for governance and accountability is set by the 1998 Bank of England Act. In some respects the framework was modified by the 2009 Banking Act, the relevant provisions of which came into force on 1 June 2009.

The Court of Directors

The Court of Directors is responsible for managing the affairs of the Bank, other than the formulation of monetary policy. Court's responsibilities under the Bank of England Act 1998 ('the 1998 Act') include determining the Bank's objectives and strategy, and ensuring the effective discharge of the Bank's functions and the most efficient use of its resources. Following the 2009 Banking Act ('the 2009 Act'), the Bank has a statutory objective to 'contribute to protecting and enhancing the stability of the financial systems of the United Kingdom' and the Court, consulting HM Treasury and on advice from the Financial Stability Committee (see below), determines the Bank's strategy in relation to that objective.

The members of Court are appointed by the Crown. Until June 2009, Court consisted of the Governor, the two Deputy Governors and 16 Directors. The 2009 Act reduced the number of Directors to nine. The nine Directors are all non-executive. One of them is designated by the Chancellor of the Exchequer to chair Court.

The Governors are appointed by the Crown for periods of five years, and the Directors for three years. In 2009/10, some were initially appointed for different durations so as to stagger end dates and help ensure continuity. Details of the current Court are set out on pages 6–7.

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 Chairman of Court is also chairman of a Committee of Court (NedCo) consisting of all the Non-executive Directors. NedCo has responsibilities for reviewing the Bank's performance in relation to its objectives and strategy, monitoring the extent to which its financial management objectives are met, reviewing the procedures of the Monetary Policy Committee (MPC, see below), reviewing the Bank's internal controls, and for determining the pay and terms of employment of the Governors, Executive Directors and external MPC members. The latter responsibility is delegated to the Remuneration Committee whose report is on pages 38–40. To a large extent NedCo's work is done through Court, though the Committee meets separately from Court to agree its Annual Report, which is on pages 41–43. NedCo also reviews the personal objectives agreed with the Governor by the Chairman of Court.

The Monetary Policy Committee (MPC)

The 1998 Act establishes the MPC as a Committee of the Bank and sets a framework for its operations. NedCo keeps the procedures followed by the MPC under review. Under the 1998 Act, the Bank's objectives in relation to monetary policy are to maintain price stability and, subject to that, to support the Government's economic policies, including its objectives for growth and employment. At least once a year, the Government specifies the price stability target and its growth and employment objectives. The MPC must meet at least monthly; its members comprise the Governor and Deputy Governors, two of the Bank's Executive Directors and four members appointed by the Chancellor. Membership of the MPC is given on page 14.

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.

Financial Stability Committee (FSC)

The FSC was created by the 2009 Act. It is chaired by the Governor and the other members are the two Deputy Governors, four members of Court nominated by the Chairman of Court (currently Sir David Lees, John Stewart, Mark Tucker and Harrison Young), and a Treasury observer (who may not vote). Until John Stewart's appointment to Court in December 2009, Roger Carr was a member of the Committee. The Committee may co-opt further members.

The Committee has the following statutory functions:

- To make recommendations to the Court of Directors, which they shall consider, about the nature and

implementation of the Bank's strategy in relation to the financial stability objective.
- To give advice about whether and how the Bank should act in respect of an institution, where the issue appears to the Committee to be relevant to the financial stability objective.
- In particular, to give advice about whether and how the Bank should use stabilisation powers under Part 1 of the 2009 Act in particular cases.
- To monitor the Bank's use of the stabilisation powers.
- To monitor the Bank's exercise of its functions under Part 5 of the 2009 Act (interbank payment systems).

Court has delegated to the Committee the following additional functions:

- To review and approve the broad thrust and key messages in the Bank's *Financial Stability Report* prior to publication.
- To monitor the Bank's exercise of its functions under Part 6 of the 2009 Act (Scottish and Northern Ireland banknotes).
- To advise the Governor about any loan, commitment or other transaction which it is proposed that the Bank should make or enter into for the purpose of pursuing the financial stability objective.

The Committee has recommended and Court has agreed a strategy for financial stability: this is reproduced on pages 26–27 of this *Report*, and is incorporated into the Bank's wider strategic objectives.

Remuneration Committee

The Remuneration Committee advises NedCo on 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).

The members of the Remuneration Committee until June 2009 were David Potter (Chairman), Roger Carr, Peter Jay, David Rhind, Arun Sarin and Geoffrey Wilkinson. From 1 June 2009 the members were Roger Carr (Chairman), Brendan Barber, António Horta-Osório and Sir David Lees. The Committee's Report on Remuneration is on pages 38–40.

Audit and Risk Committee

The functions of the Audit and Risk Committee are to assist Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management; and to assist NedCo in discharging its responsibilities under the 1998 Act for 'keeping under review the internal financial controls of the Bank with a view to securing the proper conduct of its financial affairs'. The Committee is responsible for providing independent assurance to Court that the Bank's risk and control procedures are adequate. The Committee receives reports from, and reviews the work of, the internal and external auditors, and satisfies itself that the key areas of financial and operational risk are adequately identified and satisfactorily addressed. The Committee reviews the annual financial statements prior to their submission to Court, considering the appropriateness of the accounting policies and procedures adopted. The Committee also considers and makes recommendations on the appointment of the external auditors, their independence and their fees.

The members of the Committee until June 2009 were Amelia Fawcett (Chairman), Susan Rice, James Strachan and Robert Wigley and from 1 June 2009 were Susan Rice (Chairman), Roger Carr, António Horta-Osório and Mark Tucker. John Stewart replaced Roger Carr on 1 December 2009. The Chairman of Court, the Deputy Governors, the Finance Director, the Head of Internal Audit and the external auditors normally attend the meetings of the Committee.

Management structure

The executive management of the Bank lies with the Governors and Executive Team. The responsibilities of the Executive Directors are set out on pages 10–11.

The Court of Directors


Mervyn King Governor


Charlie Bean Deputy Governor


Paul Tucker Deputy Governor


Sir David Lees Chairman of Court


Brendan Barber


Roger Carr


Lady (Susan) Rice, CBE


Lord (Adair) Turner


António Horta-Osório


Mark Tucker


Harrison Young


John Stewart

Sir David Lees Chairman of Court
Appointed 1 June 2009.
Term expires on 31 May 2012.

- Deputy Chairman, QinetiQ Group plc
- Member of the Panel on Takeovers and Mergers
- Director, Opus Arte Limited
- Trustee, Royal Opera House Endowment Fund
- Governor, Royal Ballet School

Lord (Adair) Turner
Appointed 20 September 2008.
Term expires on 31 May 2012.

- Chairman, The Financial Services Authority
- Chairman, Climate Change Committee
- Member of the Council, Overseas Development Institute
- Fellow of the Royal Society of Edinburgh

John Stewart
Appointed 1 December 2009.
Term expires on 30 November 2012.

- Chairman, Legal and General Group plc
- Non-executive Director, Telstra Corporation, Australia

Brendan Barber
Appointed 1 June 2003.
Term expires on 31 May 2011.

- 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

António Horta-Osório
Appointed 1 June 2009.
Term expires on 31 May 2012.

- Chief Executive, Santander UK plc
- Executive Vice President and Member of the Management Committee, Banco Santander SA
- Chairman of the Board, Banco Santander Totta, SA
- Honorary Consul General of the Republic of Singapore in Portugal
- Member of the Forum, Saïd Business School, University of Oxford, Business Advisory Council
- Member of the Board, Cambridge Judge Business School Advisory Board

Roger Carr
Appointed 1 June 2007.
Term expires on 31 May 2011.

- Chairman, Centrica plc
- Fellow of the Royal Society for the Encouragement of the Arts
- Companion of Institute of Management
- Visiting Fellow of the Saïd Business School

Mark Tucker
Appointed 1 June 2009.
Term expires on 31 May 2012.

- Board Member, Edinburgh Festival Centre Ltd
- Board Member, Edinburgh International Festival Society

Lady (Susan) Rice, CBE
Appointed 1 June 2007.
Term expires on 31 May 2011.

- Managing Director, Lloyds Banking Group Scotland
- Senior Independent Director, Scottish and Southern Energy plc
- Chairman, Edinburgh International Book Festival
- Non-executive Director, Scottish Business in the Community
- Non-executive Director, Scotland's Futures Forum
- Fellow of the Royal Society of Edinburgh

Harrison Young
Appointed 1 June 2009.
Term expires on 31 May 2011.

- Chairman, NBNCo Ltd
- Chairman, Better Place (Australia) Pty Ltd
- Non-executive Director, Commonwealth Bank of Australia
- Deputy Chairman and Board Member of the Asia Society Australia Asia Centre in Melbourne
- Deputy Chairman of advisory council of Asialink in Melbourne
- Board member of Financial Services Volunteer Corps

The Executive Team


Mervyn King Governor


Charlie Bean Deputy Governor
Monetary Policy


Paul Tucker Deputy Governor
Financial Stability


Andrew Bailey Executive Director
Banking Services and Chief Cashier


Spencer Dale Executive Director
Monetary Analysis and Statistics


Paul Fisher Executive Director
Markets


John Footman Executive Director
Central Services and
Secretary of the Bank


Andy Haldane Executive Director
Financial Stability


Warwick Jones Finance Director


Graham Nicholson Chief Legal
Adviser


Jenny Scott Executive Director
Communications

The diagram on the next page shows how responsibility for individual functions is delegated within the Bank. Each major function is headed by a member of the Executive Team. The Executive Team meets regularly, and other senior officials 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 10–11.

Management structure

- Internal Auditor — **Mervyn King**, Governor — **Graham Nicholson** Chief Legal Adviser
  - **Charlie Bean**
    Deputy Governor
    Monetary Policy
    - **Spencer Dale**
      Executive Director
      Monetary Analysis and Statistics
      - Monetary Analysis
      - Monetary and Financial Statistics
      - Centre for Central Banking Studies
    - **Paul Fisher**
      Executive Director
      Markets
      - Markets
  - **Vacancy**
    Executive Director
    HR
    - Human Resources
  - **Warwick Jones**
    Executive Director
    Finance
    - Finance
    - Projects
    - Risk Oversight
    - Property
  - **John Footman**
    Executive Director
    Central Services and Secretary of the Bank
    - IT
    - Business Continuity
    - Security
  - **Jenny Scott**
    Executive Director
    Communications
    - Public Communications & Information
  - **Paul Tucker**
    Deputy Governor
    Financial Stability
    - **Andy Haldane**
      Executive Director
      Financial Stability
      - Financial Stability
    - **Andrew Bailey**
      Executive Director
      Banking Services
      - Banking Services
      - Special Resolution Unit

Organisation overview

Monetary Analysis and Statistics

Spencer Dale
Mark Cornelius – International Economic Analysis
Phil Evans – Conjunctural Assessment & Projections
Gill Hammond – Centre for Central Banking Studies (CCBS)
Neal Hatch – Structural Economic Analysis
Jens Larsen – Macro Financial Analysis
Simon Price – Senior Adviser
James Proudman – Monetary Assessment & Strategy
Gareth Ramsay – Inflation Report & Bulletin
Mark Robson – Monetary & Financial Statistics
Tony Yates – Senior Adviser

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 UK and international economies. The MA divisions produce the *Quarterly Bulletin* and the *Inflation Report*, which sets out the Monetary Policy Committee's assessment of the current monetary and economic situation in the United Kingdom and of the outlook for inflation and growth.

The work of the 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 and the intelligence gathered through its close contacts with banks. Special studies directed at international harmonisation and improvements to the statistics are also a feature of the work.

The Centre for Central Banking Studies (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. CCBS provides an extensive programme of seminars, workshops and conferences both in London and abroad.

Markets

Paul Fisher
Sarah Breeden – Risk Management
Roger Clews – Special Adviser
Michael Cross – Foreign Exchange
Graeme Danton – Markets Strategy & Risk Operations
Chris Salmon – Sterling Markets

The main functions of the Markets area include: conducting operations in the sterling money markets to implement the Monetary Policy Committee's decisions; providing liquidity insurance to the banking system; 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. Market intelligence is co-ordinated by a dedicated team.

The Risk Management Division is responsible for identifying, measuring and, with the front-office divisions, managing risks from financial operations. The Markets Strategy and Risk Operations Division provides strategic management support and risk reporting across the Markets Directorate.

Financial Stability

Andy Haldane
Nicola Anderson – Risk Assessment
Martin Brooke – International Finance
Paul Chilcott – Payments & Infrastructure
Victoria Saporta – Prudential Policy
Alastair Wilson – Financial Institutions

The Financial Stability area leads on a number of the Bank's financial stability functions. It works closely with HM Treasury and the FSA under the terms of the Memorandum of Understanding, which was revised in March 2006, and under the terms of the Banking Act 2009, which has placed the Bank's financial stability role on a statutory footing.

Internally, a high-level Financial Stability Executive Board guides the financial stability work of the Bank, 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, Paul Tucker.

The area seeks to detect risks to the structure and functioning of the UK financial system and to develop measures to strengthen regulatory systems and infrastructure at home and abroad to reduce those risks. This includes its statutory responsibilities for overseeing UK payments systems. 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*.

Banking Services

Andrew Bailey
Victoria Cleland – Notes
Toby Davies – Market Services
Joanna Place – Customer Banking

Customer Banking Division provides banking services to the Government and other customers, principally financial institutions and other central banks. This includes the provision of custody services, including for gold.

Notes Division manages the issue of Bank of England notes, including the relationship with De La Rue, the supplier of notes to the Bank, and members of the Note Circulation Scheme. Since November 2009 it has also been responsible for the regulation of note issuance by Scottish and Northern Ireland note-issuing banks.

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.

Special Resolution Unit

Peter Brierley – Resolution Policy
Mike Mitchell – Resolution Implementation

The Special Resolution Unit was created in February 2009. Reporting to Andrew Bailey as the responsible Executive Director, it develops and co-ordinates the Bank's response to the resolution of individual institutions, using the powers of the Banking Act 2009, and undertakes analysis to enhance the resolution regime going forward.

Finance

Warwick Jones
Simon Politzer – Projects, Property & Business Services
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 Bank-wide project support and risk oversight, provides advice and support on procurement and supplier management and manages the Bank's property and facilities.

Central Services

John Footman
Stephen Collins – Business Continuity
Andrew Hauser – Private Secretary to the Governor
John Heath – Legal
Simon Moorhead – Chief Information Officer
Don Randall – Security

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, business continuity, the Governors' private offices, and legal services.

Human Resources

Human Resources Executive Director – Vacant
Jonathan Curtiss – HR Services

The Human Resources function is responsible for recruitment and development of staff, talent management and succession planning, employee relations and administration of the Bank's payroll and pensions.

Communications

Jenny Scott
Andrew Wardlow – Public Communications & Information

The Public Communications and Information Division manages the Bank's public and media relations and its work to build public understanding; it includes the press office, the Bank's website, public enquiries, education and community programmes, and the Bank's museum. It also manages internal Bank-wide staff communications.

Internal Audit

Stephen Brown

Internal Audit assists the Court of Directors and Executive Team 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.

Review of 2009/10

The strategic priorities endorsed by Court for 2009/10 and published in last year's *Annual Report* were:

Strategic priority 1 Return inflation to the 2% target, and keep it on track to meet the target, while sustaining support for the monetary policy framework.

- Enhance the contribution of the forecast process.
- Deepen analysis of monetary data.
- Review MPC communications.
- Improve efficiency of data handling and analysis.
- Enhance monitoring of bank lending and work with Government to ensure lending is adequate.

Strategic priority 2 Enhance the sterling monetary framework to enable the Bank to provide liquidity to the system in normal and stressed conditions.

- Implement revised 'Red Book' for market operations.
- Implement the Asset Purchase Facility.
- Manage the operational and collateral management risks in the Bank's expanded market operations.

Strategic priority 3 Discharge the Bank's enhanced role for financial stability.

- Ensure the Bank is equipped to implement the Special Resolution Regime.
- Strengthen communication on financial stability.
- Enhance the Bank's oversight of payment systems.
- Play a full role in the management of the financial crisis together with the FSA and HM Treasury.
- Integrate analysis of individual institutions and systemic risk, without becoming a shadow supervisor.

Strategic priority 4 Strengthen co-operation and communication between central banks.

- Improve design of liquidity and capital regulation.
- Contribute to the G20 debate on reform of the international system, under United Kingdom's chairmanship.

Strategic priority 5 Deliver efficient and effective notes issuance and banking services.

- Continue to implement the customer banking strategy.
- Ensure public demand for banknotes is met — particularly for the £5 note.

Strategic priority 6 Enhance public understanding of the Bank's role through development of a robust communication strategy.

- Implement a revised public communication strategy.
- Enhance regular engagement with financial sector.

Strategic priority 7 Increase accountability and efficiency across the organisation.

- Implement the new governance arrangements for the Bank.
- Strengthen the system of performance measurement.
- Improve the partnership between central services and business areas.
- Improve talent management in the Bank.
- Use IT to improve information sharing.

1 – Monetary policy

The Bank's first strategic priority is to meet the inflation target set by the Government. The target was reconfirmed by the Chancellor in April 2009 as 2%, measured by the twelve-month increase in the consumer prices index (CPI). CPI inflation had been above target at the start of the year, but fell back to 1.1% in September 2009, before rising sharply to 3.7% in April 2010. This necessitated an open letter from the Governor to the Chancellor under the requirements of the monetary policy framework. Much of the variation in annual inflation during the year reflected fluctuations in energy prices and the temporary cut in the VAT rate.

GDP in 2009 Q4 was 3.1% lower than a year earlier, as the global financial crisis took its toll. Output stabilised in the second half of 2009 and a period of gradual expansion is in prospect. The Labour Force Survey measure of the unemployment rate rose in the first half of 2009, before flattening off, standing at 7.8% of the workforce in the fourth quarter.

The prospect of a persistent margin of spare capacity in the economy increased the risk that inflation would be below the 2% target in the medium term. In response, the MPC cut Bank Rate to 0.5% in March 2009 and held it there throughout the year. With Bank Rate close to zero, the Committee also chose to use the Asset Purchase Facility (see page 18) to finance asset purchases through the issuance of central bank reserves ('quantitative easing'), with an initial target of £75 billion. Although this was a new instrument, the objective of monetary policy was unchanged — to meet the inflation target of 2%.

Central bank asset purchases inject extra money directly into the economy by providing the sellers of assets with extra cash. This then triggers a range of further adjustments. Ultimately, these adjustment processes will lead money spending, and hence inflation, to be higher than they otherwise would have been.

The MPC subsequently voted to increase the size of the asset purchase programme in May and August, and again in November when it was increased to £200 billion. At some future date, the Asset Purchase Facility will be run down. The MPC will determine the timing of any sales or further purchases of assets financed by central bank reserves, in conjunction with the level of Bank Rate, based on the outlook for inflation relative to the target.

The decisions of the MPC, together with its analysis and forecasts, are published in the minutes of its 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. The Bank conducts an annual survey of MPC members' general satisfaction with the various inputs to the policy process, and this is supplemented by individual meetings between the Chairman of Court and individual MPC members, from which a summary report is prepared for Court. The latest survey suggests that MPC members remain happy with the conjunctural and forecast material that they receive. The general level of satisfaction was higher than found in the previous year's survey.

The Bank continues to improve support for the MPC. To help the Bank and MPC analyse the effects of quantitative easing, the frequency of collection and publication of data on money and credit excluding intermediate other financial corporations (OFCs) was increased from quarterly to monthly with effect from July 2009. Monetary and Financial Statistics Division (MFSD) additionally started a new monthly data collection on banks' holdings of gilts, broken down by maturity, in March 2009. Also in MFSD, the Bank Lending Monitoring Team continued to gather more timely statistics and intelligence on bank lending. A new Bank publication — *Trends in Lending* — was set up to enhance monitoring of bank lending and published for the first time in April 2009.

The project to further automate production of the statistical chart pack used by the MPC — which had been delayed due to transfer of resources to more pressing issues during the height of the crisis — was successfully completed in late 2009.

Building on improvements from the previous year, further small changes were made to the forecast process. In particular, more time and attention was paid to the discussion of risks in the forecast round, as opposed to the central projection.

The *Inflation Report* mirrored the changes to the forecast process by moving away from discussion of the central projection, and talking more about the risks. A further innovation in the November *Inflation Report* was the inclusion of a fan chart of the level of GDP.

Review of 2009/10 continued

Members of the Monetary Policy Committee

Mervyn King Governor

Charlie Bean Deputy Governor

Paul Tucker Deputy Governor

Kate Barker(1)

Spencer Dale

Paul Fisher

David Miles

Adam Posen

Andrew Sentance

During the year, the Bank's analytical support for the MPC included: the likely boost to the economy from the easing in monetary policy; the prospects for the world economy and the ability of UK companies to benefit from sterling's depreciation by switching resources towards the production of tradable goods and services; the prospects for banks and bank lending; the impact of public and private debt on spending; the impact of the recession on the supply capacity of the economy; the sensitivity of inflation to economic slack; the timing and magnitude of the pass-through of higher import prices to inflation; risks to commodity prices; and risks to inflation expectations.

Monetary policy communications

The MPC's asset purchase programme has been a particular focus of the Bank's communication effort over the past year. An article explaining the MPC's policy of purchasing assets to inject money directly into the economy was published in the 2009 Q2 edition of the *Quarterly Bulletin* and a pamphlet — *Quantitative Easing Explained* — was published in July 2009, supplemented by a nationwide series of meetings and visits by Charlie Bean to explain the policy.

More generally, the Bank has continued to promote understanding of its monetary policy framework and decisions. The *Inflation Report* and MPC minutes explain monetary policy decisions and the MPC's judgements about the outlook for the economy and inflation, and the *Quarterly Bulletin* includes articles on monetary policy and other aspects of the Bank's work. Throughout the year, MPC members gave a total of 32 formal published speeches. The Governor, other members of the MPC and senior Bank staff attended a total of fourteen parliamentary hearings during the year covering both monetary policy and reforms to the financial system. In 2009/10 the Bank attended ten hearings of the Treasury Committee of the House of Commons. The Committee held five hearings on the Bank's *Inflation Report* and three appointment hearings for MPC members.

(1) Kate Barker's third term on the MPC expires on 31 May 2010.

Regional Agents


Peter Andrews
Greater London


Neil Ashbridge
Wales


Kevin Butler
South West


Graeme Chaplin
West Midlands & Oxfordshire


Alastair Cunningham
East Midlands


William Dowson
Scotland


Phil Eckersley
South East & East Anglia


Paul Fullerton
Yorkshire & The Humber


Frances Hill
Northern Ireland


Chris Piper
Central Southern England


Rosie Smith
North East


John Young
North West

Last year saw the second and third 'Monetary Policy Roundtable' conferences. These provide a forum for economists to discuss key issues affecting the design and operation of monetary policy in the United Kingdom. Participants included economists from a range of private sector institutions, academia and public sector bodies. These will continue to be held regularly and two further Roundtables are planned for 2010.

The Bank's Agents have again played an important role in explaining monetary policy to businesses and other organisations, as well as providing intelligence about business conditions for the MPC. Building on this, an extensive programme of visits across the United Kingdom was undertaken by members of the MPC. A total of 56 visits were undertaken outside Greater London in 2009/10.

The Bank continues to provide information and learning resources about monetary policy through its museum, website and schools' programme. The Bank's museum attracted over 98,000 visitors in 2009/10, an increase of 7% from the previous year. There has also been further demand for the Bank's school materials and films, which are used in over 12,000 primary and secondary schools. The Bank's annual economics competition for schools and colleges, Target Two Point Zero, reached its tenth year in 2009/10 with 285 schools and colleges taking part.

2 – Implementing MPC decisions

Sterling money market

The Bank sets interest rates through its operations in the sterling money markets: the normal framework for these operations is set out in the Sterling Monetary Framework (SMF). However these have been partly in abeyance since gilt purchases under the Asset Purchase Facility were started. Reserves averaging under the SMF was suspended from March 2009 and all commercial bank reserves were remunerated subsequently at Bank Rate. Planned developments to the SMF, outlined in a consultation paper in October 2008, were put on hold. Changes are planned in due course, and ahead of that, an outline of new, permanent long-term repo operations was issued in March 2010.

Review of 2009/10 continued

Asset Purchase Facility operations

In January 2009 the Chancellor authorised the Bank to set up an Asset Purchase Facility (APF) with the objective of improving liquidity in private credit markets. The APF started buying sterling commercial paper in February and sterling corporate bonds in March. Those facilities were intended to improve the functioning of those markets. A contingent scheme to buy bank debt guaranteed by the Government was announced in March and a Secured Commercial Paper (SCP) scheme was announced in July. In January 2010, consistent with the aim of improving secondary market liquidity, the APF also offered to sell small quantities of corporate bonds as well as continuing to buy them. At its peak, the stock of commercial paper purchases reached £2.4 billion in April 2009 and the stock of corporate bonds purchased reached £1.5 billion in December. Both markets exhibited a sharp narrowing of spreads after the schemes were introduced and gross corporate bond issuance was at a record level in 2009. The SCP scheme has not yet been used.

The Asset Purchase Facility also provided a means for the MPC to add liquidity directly into the economy through purchasing large quantities of assets, including gilts (quantitative easing). Under quantitative easing, APF purchases were financed by increases in central bank money, or reserves (rather than by issuance of Treasury bills as would otherwise be the case). Asset purchases financed by central bank reserves began in March 2009 and stood at £200 billion in February 2010. In order to avoid undue disruption to the gilt market, a gilt-for-gilt lending scheme was introduced in August, co-ordinated through the existing lending facilities of the Debt Management Office.

Quantitative easing has led to an increase in the banking sector's reserve balances held at the Bank, to levels much higher than they had previously chosen as voluntary targets. From March 2009, open market operations were used to ensure that commercial bank reserves were increased one-for-one with asset purchases, and reserves peaked at £164 billion in August. At this point, when it was clear that banks were holding reserves very substantially in excess of what they would have chosen, the link to asset purchases was broken and the level of reserves became a residual item, determined by the continuing asset purchases, the note issue and other flows across the Bank's balance sheet.

The quarterly reports of the Asset Purchase Facility contain further details of transactions made as part of the facility.

Market intelligence

In assessing risks to the UK and global financial system, and in determining appropriate responses, it is crucial to understand developments in financial markets. Partly as a result of its expanded operations to provide liquidity insurance and implement unconventional monetary policy over the past year, the Bank has deepened its operational expertise and expanded its global network of contacts in banking and capital markets. In addition to its many bilateral contacts, and thematic rounds of meetings in London, Edinburgh, New York and elsewhere, the Bank meets with market participants formally through the Sterling Money Market Liaison Group, London Foreign Exchange Joint Standing Committee, the Securities Lending and Repo Committee and other groups. As well as contributing to monetary policy, the market intelligence gathered through these various processes is a key component in policy formulation and dissemination of the Bank's work on financial stability.

3 – Financial stability

The Bank contributes to financial stability through the liquidity insurance facilities that it provides to the market as a whole; through specific liquidity assistance that it may in extreme circumstances provide to individual banks; through provision of the final settlement facility for sterling payments; through its oversight of payment systems; and through acting as special resolution authority for banks and building societies. The Banking Act 2009 made the last two statutory responsibilities of the Bank.

More generally the Bank contributes by identifying threats to the financial system and promoting improvements to the resilience of the system, and crisis management.

Banking Act 2009

The Banking Act 2009 also gave the Bank a financial stability objective. This is 'to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'. Court, consulting the Treasury, is required to determine a financial stability strategy to achieve that objective; and a Financial Stability Committee of Court was created by the Act to oversee the Bank's work in this area.

The Financial Stability Committee met for the first time on 10 June 2009. The Committee established a work programme and agreed a financial stability strategy and implementation plan which has subsequently been adopted by Court following consultation with the Treasury. This is reproduced on pages 26–27.

Liquidity insurance

Liquidity provision through long-term repo operations and the Special Liquidity Scheme (SLS) continued in 2009, though the amounts outstanding in these facilities fell. The stock of long-term repos declined to £21 billion at the end of February 2010 compared with a peak of £190 billion in January 2009. The amount outstanding in the SLS declined from £185 billion to £165 billion over the same period. In co-ordination with other central banks, the Bank's dollar liquidity operations, which had been steadily falling in size during the year, ceased in January 2010 (but were subsequently re-established in May 2010).

During 2009 attention was focused on making firms aware of the Discount Window Facility (DWF), which had been announced in 2008, and encouraging them to make preparations (such as signing legal documentation and pre-positioning collateral), should the Facility need to be used. In March 2010 the Bank published a short consultation paper about how the collateral eligible in the DWF might be extended to include loans, and also how the Bank could improve the efficiency of its risk management of asset-backed securities (ABS) and covered bonds by requiring enhanced disclosure of information relating to these securities.

Further details on the Bank's balance sheet and its operations through the crisis were reported in an article in the 2010 Q1 *Quarterly Bulletin*.

Small bank access to liquidity operations

An innovation over the past year was the expansion in the range of firms that are eligible to hold reserves accounts. Previously, only large institutions (with 'Eligible Liabilities' of £500 million or more), who placed Cash Ratio Deposits (CRDs)(1) with the Bank were eligible for reserves accounts. That size restriction was lifted so that smaller banks and building societies could have access to the Bank's liquidity operations and hence directly hold part of their liquidity buffers as central bank money. This change could potentially allow over 200 smaller institutions to gain access to the Bank's facilities.

Collateral management

Since the start of the financial crisis the Bank has built up its capacity to manage the new risks on its balance sheet. In particular it has undertaken extensive work to establish risk management processes around the securities taken as collateral in its operations and facilities. This work has been led by a dedicated collateral management team.

ELA disclosure

For many years the Bank has made it clear that, to avoid potential adverse consequences to the stability of the financial system, it might not disclose emergency liquidity assistance (ELA) to institutions at the time such facilities are granted. The financial effects of the ELA would always be reflected in the Bank's published accounts, but the individual transactions would not be revealed until the need for confidentiality had ceased. This is permitted under the Bank of England Act 1998.

In November 2009 the Governor announced that the Bank had provided ELA as lender of last resort to RBS and HBOS during the autumn of 2008. Total use of ELA across both banks peaked at £61.6 billion on 17 October. At this point the two banks were providing collateral to the Bank in respect of the ELA with a total value in excess of £100 billion. In its 2008/09 Accounts the Bank decided to limit the extent of disclosure in its financial statements, as it was judged that the risks to stability at the time outweighed the public interest case in favour of disclosure. The Audit Committee of Court and the Bank's auditors were aware of this decision. However, with the completion of RBS's participation in the Government's Asset Protection Scheme and with Lloyds Banking Group having embarked on its alternative strategy for capital raising at the start of November 2009, the Bank judged that it was at that stage appropriate to disclose details of the ELA.

The assets taken as collateral comprised government-issued debt, residential mortgages, and personal and commercial loans. The assets were thus either directly eligible in the Bank's market-wide facilities or were of a type eligible to be taken in securitised form in these facilities. The Bank determined the valuations and haircuts of this collateral — and thus the amount of support it was prepared to give — in a prudent manner, consistent with the valuations and haircuts applied in its market-wide facilities.

(1) The CRD scheme is described on page 28.

Review of 2009/10 continued

As the level of support provided to HBOS and RBS increased through early October 2008 and became very large relative to the Bank's capital, the Bank approached HM Treasury for an indemnity to cover additional facilities. HM Treasury indemnified the Bank for any additional support after 13 October. This indemnity provided a second line of defence and covered the residual risk on the ELA facilities after significant collateralisation. At its peak, the indemnity covered £18 billion of the assistance given.

Both banks were charged for the use of ELA. Over the course of the ELA facilities as a whole, the rate incurred by the two banks was broadly equivalent to a cost of funds around 2% higher than the banks' equivalent marginal funding rate. During the 2008/09 financial year, the Bank earned £176 million of income from the provision of ELA, of which £19 million was passed to HM Treasury in return for the provision of the indemnity.

Special Resolution Regime

The Special Resolution Unit (SRU) was established in February 2009 to enable the Bank to fulfil its responsibilities for resolving distressed banks and building societies, as established by the Special Resolution Regime (SRR) in the Banking Act 2009. The Unit is headed by Andrew Bailey as the responsible Executive Director. It comprises a core team of Bank staff with experience of financial crisis management and resolutions together with external experts with backgrounds in areas such as law, accountancy and commercial banking operations. SRU's role is to co-ordinate the Bank's response to a distressed firm, including decisions on which tools in the Act provide the best outcome with respect to financial stability, public confidence in the banking system, the protection of depositors, the use of public funds, and avoiding interference with property rights.

Over the past year, the Banking Liaison Panel — a body established by HM Treasury to, among other things, provide advice to HM Treasury on the impact of the SRR on financial markets — has begun to review the SRR Code of Practice (the Code supports the legal framework of the SRR and provides guidance as to how, and in what circumstances, the SRR tools will be used). The Bank is contributing to the Panel's review and has also engaged with key stakeholders to ensure it is ready to implement a resolution if needed.

The SRU works closely with the Financial Services Authority (FSA), HM Treasury and the Financial Services Compensation Scheme (FSCS) and maintains a regular dialogue with resolution authorities in other countries. Over the past year the Bank has formalised two of these relationships with the signing of Memoranda of Understanding with the FSCS in the United Kingdom and with the Federal Deposit Insurance Corporation in the United States.

Dunfermline Building Society

In March 2009 the Bank used the Special Resolution Regime (SRR) provisions of the Banking Act for the first time, to resolve Dunfermline Building Society.

On 30 March 2009, following the FSA's determination that Dunfermline was likely to fail to meet the threshold conditions for authorisation, the Bank and HM Treasury announced that core parts of Dunfermline (including its retail and wholesale deposits, head office and originated residential mortgages) had been transferred to Nationwide Building Society under the SRR provisions of the Banking Act 2009. At the same time, Dunfermline's social housing loan book and related deposits were transferred to DBS Bridge Bank Ltd., a 100% subsidiary of the Bank of England set up for this purpose, while a permanent solution was secured. The remainder of Dunfermline's business, including its commercial loans, acquired residential mortgages, subordinated debt and most of its treasury assets, were placed into the Building Society Special Administration Procedure.

DBS Bridge Bank Ltd. was authorised and regulated by the FSA. The directors of DBS Bridge Bank Ltd. were employees of the Bank of England. In accordance with the SRR Code of Practice, the directors sought to ensure that the social housing business was run on a conservative basis, to protect its value and to provide continuity of banking services.

The Bank subsequently, and in accordance with the SRR Code of Practice, established a competitive auction process to sell Dunfermline's social housing business. On 17 June 2009, following consultation with the Bank's Financial Stability Committee, and with the FSA and HM Treasury, the Bank announced that Nationwide had been selected as the preferred bidder. The transfer completed on 1 July.

Recovery and Resolution Plans

The Financial Services Act 2010, which received Royal Assent in April, requires the FSA, in consultation with the Bank of England, to produce rules requiring firms to produce Recovery Plans and to provide information enabling the authorities to draw up Resolution Plans.

Following a pilot with a small number of UK banks during the first half of 2010, a consultation process will commence, involving the production of a Consultation Paper by the FSA during 2010/11. The Recovery and Resolution Plans (RRPs) work has two main purposes: to reduce the probability of a firm's failure and ensure continuity of critical financial services under severely adverse conditions; and to facilitate the effective resolution of a firm, should it enter severe distress or failure.

Reflecting its role as the United Kingdom's resolution authority and in light of its statutory financial stability objective, the Bank has a particular interest in the Resolution Plans element. The Bank has been closely involved with the FSA to develop a framework by which RRPs can be assessed and will take an active role in assessing RRPs going forward.

Financial stability communications

The biannual *Financial Stability Report* (*FSR*) provides the Bank's current assessment of conditions affecting financial stability and discusses ways to strengthen the financial system in the future. This year's *FSR*s have placed increasing emphasis on the policy reforms needed to tackle the root causes of this and previous systemic crises: excessive risk-taking in the upswing of the credit cycle and insufficient resilience in the subsequent downturn, exacerbated by institutions perceived as 'too important to fail'. In particular, the December 2009 *FSR* discussed a range of complementary policy measures to enhance resilience under the broad headings of the regulation, structure and the resolution of banks.

In relation to one part of the policy debate, the Bank published a discussion paper on macroprudential policy in November 2009. The paper noted that if prudential regulation is calibrated to individual institutions' balance sheet characteristics alone, it may overlook the build-up of risk across the system as a whole. Macroprudential instruments might fill a gap in the current policy framework between monetary policy on the one hand and microprudential policy on the other. The Bank has discussed this paper widely both with market participants and with authorities internationally, including in the Basel Committee on the Global Financial System, and also the Basel Supervisors Committee.

The Governors and other senior Bank staff have delivered a number of speeches on key aspects of the reform agenda, including several delivered to audiences in financial centres outside London. These included a speech in Edinburgh in October 2009 where the Governor highlighted that at the heart of the difficulty in managing and regulating the financial system is the 'too important to fail' problem — that some banks' incentives are distorted by the knowledge that in a crisis the government would stand behind them.

Payment system oversight

The Banking Act 2009 provided the Bank with statutory responsibility and new powers to oversee certain interbank payment systems, enhancing the system of informal oversight which existed previously. Under the new regime, payment systems which meet the criteria set out in the Act may be recognised by HM Treasury and brought within the Bank's oversight regime. In early 2010, HM Treasury identified seven systems (BACS, CHAPS, CLS, CREST, LCH.Clearnet Ltd, Faster Payments Service and ICE Clear Europe) as sufficiently important to the United Kingdom that they should be recognised for oversight. Of these, three (CREST, LCH and ICE Clear Europe) are embedded in settlement and clearing systems.

In September 2009, the Bank published a paper explaining how it intended to fulfil its responsibilities in this area, including principles to which operators of recognised payment systems must have regard. The Act gives the Bank a graduated range of powers and sanctions to help it fulfil this role. For example, the Bank has new powers to collect information on payment systems, request changes to system rules, appoint inspectors, and take a range of actions in cases of non-compliance. The Bank has also agreed a Memorandum of Understanding with the FSA clarifying how the two authorities will work together in relation to payment systems, including payment systems that are embedded in FSA-regulated organisations.

Banking system monitoring

The Bank's analytical expertise, together with experience in providing banking services and as a participant in financial markets, have supported its contribution to the

Review of 2009/10 continued

assessment and mitigation of risks to the financial system. The Bank has been involved in a range of initiatives, including monitoring and assessing developments across financial markets (including drawing on insights from its market intelligence activities) and contributing to assessment of particular sectors.

4 – International

The Bank has contributed to a wide-ranging agenda of initiatives to reform the financial architecture and to strengthen prudential regulation, working alongside other UK authorities and with counterparts internationally, including in the BIS committees, the Financial Stability Board (FSB) and in European fora. The Basel Committee embarked on an extensive review of capital and liquidity standards and in December 2009 announced a set of interim proposals, including the use of macroprudential instruments to curb the credit cycle. The Bank is contributing to the development and top-down calibration of these proposals. The Bank also contributed to the design of the FSA's new prudential liquidity regime on which the FSA published a Policy Statement in October 2009.

The G20, which is playing a leading role in co-ordinating the international response to the current global economic problems, asked the FSB (which was expanded to include all G20 countries) to take forward reforms to the regulation, structure and resolution of financial institutions. Paul Tucker has chaired the FSB working group on cross-border crisis management, which was asked to co-ordinate Crisis Management Groups for the largest cross-border banks and to establish whether those firms could produce recovery and resolution plans.

In relation to the international monetary system, the Bank co-hosted, with the Reserve Bank of India, a workshop 'The Causes of the Crisis: Key Lessons' in Mumbai. This workshop discussed the role played by macroeconomic and monetary factors in the crisis and in its propagation around the world and considered possible reforms to the international monetary system and to the international financial institutions. In September 2009, G20 Leaders agreed to create a *Framework for Strong, Sustainable and Balanced Growth*, which is aimed at securing improved global outcomes through policy co-ordination.

5 – Banknotes and banking

Note circulation

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 £46.1 billion. Last year the Bank issued 905 million new notes and, at the year end, the number of Bank of England notes in circulation was 2.6 billion.

The Bank manages the circulation of its banknotes via the Note Circulation Scheme (NCS). The NCS is a contractual scheme for managing the circulation of banknotes in wholesale quantities and has five members comprising G4S Cash Centres, Bank of Scotland, the Post Office, Royal Bank of Scotland and Vaultex. Its principal aims are (i) to foster confidence in banknotes by ensuring that, when processed by the NCS members, banknotes are authenticated as genuine and (ii) to encourage efficiency gains in the cash industry.

Over the past year the Bank completed an extensive review of the NCS and in March 2010 began a consultation with the cash industry on proposed reforms. While these will not alter the structure of the NCS, they should make the Bank's ability to influence the mix of denominations of notes entering circulation a central part of its design. Particularly, they should support the increased circulation of the £5 denomination. The proposed reforms were in part informed by evidence from two pilot studies conducted in 2009 on the business case for dispensing £5 notes from ATMs and for supermarkets ordering more £5 notes to use as change items.

Since the launch, in March 2007, of the £20 note featuring Adam Smith, the Bank has been working with the cash industry to replace the Elgar £20 note with the newer design. As at end-February 2010, the Adam Smith design is estimated to account for around 90% of the £30 billion of £20 notes in circulation. The Bank has announced that legal tender status will be withdrawn from the Elgar £20 on 30 June 2010. The Bank also announced in May 2009 that Matthew Boulton and James Watt would feature on a new £50 note design, to be launched around the end of 2010.

In 2009/10 the Bank completed the implementation of a new IT system to meet requirements in the Notes business area. This covered matters such as the management of notes held in secure storage, recording counterfeit and mutilated banknotes, the return of used notes, improved electronic links to the members of the NCS and the Scottish and Northern Ireland note-issuing banks (see below), as well as improved management information.

Counterfeits

During calendar year 2009, 566,000 counterfeit Bank of England notes were taken out of circulation with a face value of £11 million; this represented a 20% fall on 2008. About 85% of these were taken out of circulation during machine sorting of notes by the members of the Bank's NCS. In 2009 around 12 billion banknotes were machine sorted in the NCS so that the share of counterfeit notes found in this total was 0.0046%. The equivalent figures for the previous two years were 0.0059% (2008) and 0.0027% (2007).

Technical analysis suggests that organised criminal gangs are behind the vast majority of all counterfeits detected and that three major gangs were responsible for approaching 90% of the counterfeits passed during 2009. The Bank continues to work closely with law enforcement agencies to detect and stop counterfeiting. During 2009, the police successfully disrupted one of the major sources; the police have also shut down a number of other smaller operations and achieved successful convictions. The Bank is grateful for the support of the Serious Organised Crime Agency and the police forces around the country. It is important that counterfeiters are stopped as rapidly as possible.

The Bank makes available, free of charge, to police, retailers, banks and the public, a range of educational and training materials to help identify genuine banknotes. Information is provided on the Bank's website, in leaflets and posters, in a short film guide and on a computer-based training CD Rom aimed at professional cash handlers. Further details can be found on the Bank's website.

Scottish and Northern Ireland notes

Prior to 23 November 2009, responsibility for regulating the issuance of banknotes by the seven Scottish and Northern Ireland note-issuing banks rested with Her Majesty's Revenue and Customs (HMRC). The seven banks (or their predecessors) issued banknotes, and were regulated by the Stamp Office (now part of HMRC) until Part 6 of the Banking Act 2009 came into force on 23 November 2009, repealing the previous legislation.

The primary purpose of the new legislation is to update and modernise the framework for commercial note issuance to provide enhanced noteholder protection, while ensuring that local banknote issuance can continue in accordance with longstanding tradition. The Banking Act 2009 and its subordinate Scottish & Northern Ireland Banknote Regulations 2009 give the Bank responsibility for regulating the authorised banks' note issuance. The operational details of the regulation of the authorised banks are contained within the Scottish & Northern Ireland Banknote Rules, made by the Bank and approved by HM Treasury. The Bank publishes the Rules on its website.

Under the new legislation, the banks are required to back their note issue at all times — through a combination of Bank of England notes, UK coin and an interest-bearing account held at the Bank. As part of the regime, the Bank may impose financial penalties on institutions which do not comply with the Rules.

Over the autumn of 2009 the Bank worked with the note-issuing banks to implement the new framework, including a new reporting regime and has undertaken an extensive programme of meetings and visits to ensure that the banks were prepared for the requirements of the new regime when it came into force on 23 November.

Under the Regulations, the Bank is required to publish a report on the discharge of its functions at least annually. The Bank has published a standalone report to fulfil this obligation, which is available on the Bank's website.

Banking strategy

The Bank's customer banking strategy continues to focus on those banking activities that enable the Bank to fulfil its responsibilities as the central bank of the United Kingdom. To this end, during 2009/10 the Customer Banking Division continued to migrate government retail banking business away from the Bank to commercial arrangements. This process is expected to be completed at the end of 2010. Thereafter, the Bank will continue to provide wholesale banking services to government, and will continue as banker to other central banks and financial infrastructure companies. The Bank will likewise continue to provide custodial services to a range of customers. As of 28 February 2010, total assets held by the Bank as custodian were around £430 billion, of which £125 billion were holdings of gold. In addition the Bank will provide

Review of 2009/10 continued

banking services to support the maintenance of financial stability where there is a clear reason to do so.

RTGS

The Bank's Real Time Gross Settlement (RTGS) platform, introduced in 1996 to provide real-time settlement for CHAPS payments in sterling, was available for 99.99% of operating hours in 2009, compared with 99.81% in 2008. The average daily payments values in the two main payment and settlement systems which use the RTGS platform — the CHAPS high-value sterling payment system and the CREST delivery-versus-payment system — were £239 billion and £505 billion respectively. RTGS's principal purpose is to eliminate interbank credit risk in the sterling payment and securities markets. Without compromising this, the Bank has begun work with the CHAPS settlement banks to consider options to increase the liquidity efficiency of RTGS.

6 – Communication

Enhancing public understanding of the Bank's role across all its functions was a key priority for 2009/10, and the sections above set out how the Bank has approached the task of communicating and explaining its monetary policy and financial stability roles and policies. For the Bank as an institution, effective communication is essential to build trust in the policy framework and in the Bank's own effectiveness. To monitor public opinion and awareness of the Bank and its role, regular opinion polls are undertaken. In the February 2010 poll, carried out by NOP, 48% 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; 20% were 'dissatisfied', with the remainder neutral or undecided. The net satisfaction rating of 28% compared with 10% in February 2009.

7 – Accountability and efficiency

New governance arrangements

The changes in Court resulting from the Banking Act 2009 were implemented on 1 June and the first meetings of the new Court and Financial Stability Committee took place on 10 June. The new Court has reviewed its own procedures and the arrangements for delegation; and has reviewed and approved the Bank's strategy and budget. Towards the end of the year a review of Court's effectiveness was completed.

Performance measurement

The Court has also taken a close interest in the range and quality of management reporting, on risk and on performance. The Finance Directorate continued to lead a Bank-wide initiative to improve the Bank's internal approach to organisational performance measurement and management. A steering group was formed in 2009 to oversee the work, to share experience and to help formulate a consistent view of performance across the organisation. Performance reporting to Executive Team and Court has been improved, with greater integration between strategy, performance, risk and budget information. Progress has also been made in introducing more rigorous performance measurement in Directorates, where each business area's objectives and plans are linked to those of the organisation as a whole.

Talent management in the Bank

The Bank is committed to the development of all staff and provides extensive training targeted at all levels. Managers are developed through a number of coaching, mentoring and training programmes. A development programme was introduced in 2009 for the Initial Entry Scheme (generally A-level entrants) offering an initial induction followed by work placements and further training over their early years in the Bank. The graduate intake forms an important part of the Bank's talent pipeline, and also receives a wide range of development opportunities, particularly in the first few years with the Bank. For the second year running, the Bank won the Association of Graduate Recruiters' award for the Best Graduate Development Programme. However the development of a structured talent management system within the Bank has not proceeded as rapidly as hoped and remains a priority for the coming year.

The Bank's priorities in 2010/11

The strategic priorities endorsed by Court for 2010/11 are:

Strategic Priority 1 Keep inflation on track to meet the 2% target, and sustain support for the monetary policy framework and the benefits of low inflation.
- Ensure price stability remains the central focus of monetary policy.
- Be prepared to implement and communicate a decision by MPC to withdraw the exceptional level of monetary stimulus.
- Review how and what the MPC communicates to the public when it explains its decisions.
- Strengthen and broaden the suite of models used to analyse medium-term influences on inflation.

Strategic Priority 2 Ensure the Bank has the policies, tools and infrastructure in place to implement monetary policy, provide liquidity insurance to the banking system and manage the risks on its balance sheet effectively.
- Design and make available a broader set of instruments for implementing monetary policy, especially when Bank Rate is close to zero.
- Design and make available frameworks for providing liquidity insurance to a wide range of banks, including at times of financial stress.
- Develop the framework of market operations to allow for a wider range of collateral and, subject to achieving the policy objectives, minimise the financial and operational risks arising from the Bank's market operations.
- Improve the Bank's framework for managing collateral.

Strategic Priority 3 Discharge the Bank's enhanced role for financial stability.
- Contribute to the domestic and international debate on the appropriate future structure of the financial system.
- Contribute to developing an operational macroprudential policy framework.
- Promote more robust and simple regimes for capital and liquidity regulation.
- Promote and contribute to the development of effective recovery and resolution plans, and strengthen the Bank's Special Resolution Regime.
- Design and promote more resilient financial market infrastructures, including through use of the Bank's payment system oversight powers.

Strategic Priority 4 Enhance the Bank's surveillance capacity to gather and analyse intelligence from external sources in order to support its policy objectives.
- Shift the focus of high-level Market Intelligence to support the Bank's new financial stability strategy.
- Shift the balance of the Bank's Agents' work towards the analysis of the information which they currently collect.
- Use the information available to the Bank in its relationships with the banks to monitor and assess their liquidity positions.

Strategic Priority 5 Influence the design and functioning of the international monetary and financial framework.
- Contribute concrete proposals for reform of the international monetary system and role of the IMF/IFIs.
- Increase the Bank's contribution to the redesign of international financial and regulatory standards, frameworks and structures.

Strategic Priority 6 Reinforce public confidence in the Bank's role in the monetary and financial stability framework through a focused communication strategy.
- Promote public understanding of the Bank's Core Purposes of monetary and financial stability.
- Provide communications support to the Executive Team in delivering its strategic priorities.
- Continue development of the Bank's website to enhance public understanding.

Strategic Priority 7 Deliver efficient and effective notes issuance, banking and payment services.
- Ensure that the customer banking strategy incorporates services needed to support financial stability and resolution activities.
- Ensure that the impact of new liquidity regulations is understood and acted upon by payment system operators and participants.
- Review and enhance the way the Bank interacts with the wholesale cash distribution industry.
- Ensure the smooth operation of the new statutory regime for Scottish & Northern Ireland banknotes.

Strategic Priority 8 Ensure the Bank has the organisational capacity and the right people and skills to carry out its strategic priorities.
- Implement an effective career development strategy, and improve succession planning throughout the Bank.
- Run new development programmes for high potential staff.
- Create a working environment in which we protect the time devoted to longer-term analysis and research, in order to enhance the Bank's capability to achieve its strategic objectives.
- Improve service standards and strengthen controls through better delivery of information and technology.
- Implement tools to enable collaborative working across the organisation.
- Improve the focus and consistency of information used to manage the Bank's performance.
- Enhance project management skills and capabilities.

The Bank's priorities in 2010/11 continued

In 2008 the Governor set out a vision for his second term: that the Bank should promote monetary and financial stability in the United Kingdom; retain its focus on achieving the inflation target; and also discharge its revised financial stability responsibilities. The Bank should play an active role in the international and financial community and should aim for the highest possible standards in all it does.

The strategic priorities for the year 2010/11 are designed to continue to deliver that vision, reflecting current challenges and priorities. They have been endorsed by Court along with a business plan and budget for 2010/11.

1 – Monetary policy

During the course of 2010/11 the Bank's analytical capabilities will remain focused on ensuring that the MPC has the information it needs to make decisions about monetary policy. This will include a full assessment of options for the continued use of unconventional measures should it be necessary, as well as developing robust plans for reducing the stimulus and 'exiting' from the programme when the time is right. Work is also under way to strengthen the Bank's ability to analyse and model medium-term influences on inflation, including money, credit, the labour market and international imbalances.

A project is in progress to improve the quality of support for the MPC by replacing the current central forecast model. The new model should be smaller and more tractable, but the project should also deliver a robust IT infrastructure to make it easier to incorporate insights from a range of alternative economic models.

For monetary policy, communication is an essential part of the policy implementation process. A review of MPC communications began in 2009/10 and should be completed this year.

2 – Market operations

In March 2010 the Bank published a consultation paper on eligible collateral in the DWF and information transparency for asset-backed securitisations.

The Bank has started projects to improve collateral management processes and to enhance its ability to manage risks arising from expanded market operations. The aim is to develop a robust and efficient platform for the long term, reducing financial and operational risk, and improving access to critical management information.

3 – Financial stability

Discharging the Bank's enhanced financial stability role under the Banking Act 2009 is a key priority, particularly at a time when domestic and international debate is focused on the lessons from the recent crisis. The strategic priorities and plans in this area over the coming year, including those outlined in the section on surveillance and intelligence below, reflect the Bank's financial stability strategy, agreed by the Financial Stability Committee (see box on pages 26–27).

The Bank aims to play a leading role in the debate over how to create a robust financial system for the future. This includes working to reduce the risk in the structure of individual institutions and designing and promoting improved infrastructures for financial markets. A key part of that agenda lies in establishing a new macroprudential framework for financial stability; agreement on the high-level regime is targeted for December 2010.

The Special Resolution Unit will further strengthen its ability to resolve banks in the coming year. And, with the FSA, will review and assess Recovery and Resolution Plans submitted by banks participating in the FSA pilot exercise and the FSB process.

Work continues on full establishment of the payment systems oversight regime, and a relaunch of the *Payment Systems Oversight Report* is planned for December. The Bank is also contributing to revisions to international standards, in particular CPSS IOSCO(1) recommendations for central clearing counterparties.

In 2010/11 communication on financial stability will be strengthened; the *Financial Stability Report* will be combined with systematic engagement with market participants and wider coverage of financial stability issues via the Bank's Agents and through published speeches on financial stability.

4 – Surveillance and intelligence

The Bank plans to enhance its surveillance capacity, in particular to analyse and integrate intelligence from

(1) The Committee on Payment and Settlement Systems (CPSS) of the International Organization of Securities Commissions (IOSCO).

external sources and reflect this in regular briefings. The Bank's Agents will undertake increased analysis of the information which they currently collect, and work more closely with colleagues in Head Office.

Ongoing IT investment in data management and systemic risk monitoring tools is also expected to provide enhanced information sets to contribute to the Bank's systemic risk assessments.

5 – International monetary and financial framework

The Bank will continue to engage in discussions in international fora such as the International Monetary Fund (IMF), the Basel Committee on Banking Supervision, and the Group of Twenty (G20) Finance Ministers and Central Bank Governors. In 2010, the Bank and HM Treasury will work closely with the IMF and international authorities toward making the G20 *Framework for Strong, Sustainable and Balanced Growth* operational.

The Bank is actively contributing to the debate on macroprudential regulation, engaging with the FSA, HM Treasury and central banks around the world to improve the resilience of the global financial system. Other priorities for the international regulatory agenda will be to promote improvements in the design of liquidity and capital regulation, including by increasing the countercyclicality of the regulatory regime, and to strengthen the cross-border crisis resolution framework.

6 – Communication

Public understanding of the Bank's role in the monetary and financial stability framework is key to maintaining public confidence in monetary and financial stability. The Bank is continuing to develop online tools to enhance public understanding, and to improve the website further. The Governor's programme of regular contacts with financial sector participants has been expanded, and senior staff have started a programme of visits around the United Kingdom focused on financial stability issues, to reinforce messages in the *Financial Stability Reports*.

7 – Banking services and banknote operations

The Bank will be withdrawing legal tender status from the Elgar £20 at the end of June 2010. As announced on 29 May 2009, work is also under way to develop and launch a new £50 banknote, featuring the 18th century engineers Matthew Boulton and James Watt.

The Bank has begun discussions with the commercial cash industry on changes to the arrangements for circulating banknotes through the Bank's Note Circulation Scheme (NCS).

As part of the Bank's customer banking strategy, the project to migrate the government banking business to commercial banks is expected to conclude in 2010, with account run-off activity continuing into 2011.

The Bank, working with the FSA and payment system operators and participants, is reviewing the implications for RTGS of the FSA's proposals to strengthen liquidity standards. This may influence the way that payment system participants use collateral, and policy discussions are planned for the year ahead to ensure efficient use of collateral, consistent with robust payment and settlement systems.

8 – Skills and organisational capacity

A key priority in the coming year is to ensure that the Bank has the right people and skills to meet its objectives. Recruitment is under way for a new Executive Director, Human Resources, to lead a number of planned improvements in the coming year including: the introduction of a new career development strategy with a stronger focus on talent management, improved succession planning and a new development programme for high potential staff. Human Resources service delivery is to be supported by a new technology platform due for completion in the first half of 2011.

One of the main drivers of the Bank's IT strategy is to improve support for analytical work. A new set of collaboration tools have been piloted and are due to be implemented across the Bank during 2010. The aim is to make use of new technologies to enable teams to share data and analysis in an efficient way. IT investment is also planned, to improve service standards and strengthen security and controls.

The Bank will continue to develop its performance measurement framework. The focus for the coming year will be on ensuring consistency of management processes and information from the high-level objectives of the Bank down to the work of teams and individuals. Finance is introducing a series of new reporting capabilities to help to underpin strengthened budgetary controls in 2010/11.

The Bank's priorities in 2010/11 continued

A strategy for the Bank's financial stability mission

In addition to determining the objectives and strategy for the Bank under Section 2(2) of the Bank of England Act 1998, Court, consulting the Treasury, must determine the Bank's strategy in relation to the financial stability objective introduced by the Banking Act 2009. The financial stability strategy set out below was proposed by the Financial Stability Committee and, following consultation with the Treasury, was agreed by Court in December 2009.

As the central bank of the United Kingdom, the Bank of England is committed to doing everything within its powers to sustain financial stability.

Consistent with the Bank's Core Purposes, the Banking Act 2009 gives the Bank the following umbrella responsibility: 'to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'. In this context, 'contribute' means using the instruments available to the Bank; namely, the power of voice, and the powers derived from the specific responsibilities listed below. The Bank controls few of the levers itself and therefore needs to work closely with HM Treasury and FSA in the United Kingdom's Council for Financial Stability and with its international partners.

The purpose of preserving financial stability is to maintain the three vital functions which the financial system performs in our economy:

- providing the main mechanism for paying for goods, services and financial assets;
- intermediating between savers and borrowers, and channelling savings into investment, via debt and equity instruments; and
- insuring against and dispersing risk.

The Bank has the following specific responsibilities:

- provision of the final settlements service in sterling and of liquidity insurance;
- statutory oversight of payment systems; and
- operating the Special Resolution Regime (SRR).

More generally, the Bank contributes to identifying threats to the system, promoting enhancements to the resilience of the system, and crisis management.

Architecture

- To contribute to improvements in the structure and regulation of the UK and international financial system, including measures likely to attenuate the 'Too Big/Important To Fail' problem.
- To contribute to developing a framework for macroprudential instruments, leading to a reduction in systemic risk.
- To assess which, if any, financial markets or non-bank institutions could either enhance or threaten the stability of the financial system.
- Through the G20, to promote an International Monetary System less likely to generate stability-threatening global imbalances.
- To contribute to establishing a European Systemic Risk Board.

Surveillance of threats to stability

- To enrich the assessment of risks to UK stability from foreign banking systems and global capital markets and flows of funds.
- To ensure that the Bank's high-level Market Intelligence supports the Bank's new statutory financial stability objective.
- To use the information available to the Bank in its relationships with the banks to monitor and assess their liquidity positions, sharing the assessments with the FSA and, in aggregate, discussing them in the Financial Stability Board (FSB).

Prudential policy

- To promote more robust and simple regimes for capital and liquidity regulation.
- To contribute to developing funding arrangements for deposit insurance that enhance stability and reduce moral hazard.
- To identify key issues in the regulation of markets and non-bank institutions that might be relevant to financial stability.

Infrastructure policy

- Under the Bank's payment system oversight powers, to reduce risks to UK payment and settlement systems.

- To step up the Bank's involvement in promoting resilient market infrastructure, including central-counterparty clearing houses and for trading systems, working with the FSA as statutory regulator where relevant.

Liquidity insurance and crisis management

- Working with the FSB and the FSA, to contribute to the production of resolution plans for UK banks and international large complex financial institutions (LCFIs).
- To work with the FSA to ensure proper information flows for SRR contingency planning, and to keep under review the need for statutory powers for the Bank.
- To promote the use of private sector contingent capital, and the development of principles for a public sector capital of last resort regime that distributes risk back to the private sector.
- To deliver operationally for a wide range of banks, the Bank's Discount Window Facility and other liquidity insurance operations.

Communication and stakeholders

- To step up the Bank's communication of its work, both via the *Financial Stability Report* and through more systematic engagement with the market on policy initiatives.
- For the Bank's Agents to facilitate Executive Team members in explaining the Bank's financial stability role and work in the United Kingdom's regional financial centres.

Risks to delivery

There are risks to the delivery of this business plan. External risks will be discussed in the Bank's regular *Financial Stability Reports*. Two main internal risks are:

- not having the statutory powers to engage directly with banks in preparing contingency plans for the exercise of the Bank's Special Resolution Regime responsibilities; and
- not having sufficient senior, experienced staff with the necessary expertise and knowledge of the financial system and the capacity to engage effectively in international policy debates.

Financial Stability Committee and Court

The Financial Stability Committee, which is a sub-committee of the Court of Directors of the Bank, has agreed this strategy.

- Financial Stability Committee will review the content of the strategy periodically, including plans for delivery and resources.
- As part of its quarterly review of strategy, Court will monitor the delivery of these particular strategic objectives.

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 — having regard to 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 unless otherwise agreed.

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

Spending in 2009/10

Net expenditure on the Bank's policy functions in 2009/10 was £123.0 million, £1.7 million above the budgeted amount. The Bank faced extra costs in relation to its responsibilities as Special Resolution Authority. These were only partially offset by lower spending elsewhere; some project spending was deferred.

Remunerated functions generated net income of £19.3 million, compared to a small deficit in the budget for 2009/10. That reflected higher income from banking services, relating to higher customer volumes.

Spending on the Bank's policy functions was higher than CRD income in 2009/10. The level of CRDs increased over the period but, due to lower interest rates, the overall level of CRD income fell below the budgeted £107.0 million, to £99.7 million. This follows a number of years of CRD income being in excess of policy spending.

Bank expenditure by function(1)

£ millions	2008/09 Actual	2009/10 Budget	**2009/10 Actual**	2010/11 Budget
Policy functions				
Monetary policy	66.7	68.2	68.3	69.2
Financial stability	46.5	51.1	54.7	52.2
Contingency reserve	–	2.0	–	1.0
Expenditure on policy functions	**113.2**	**121.3**	**123.0**	**122.4**
Remunerated functions				
Note issue	69.6	72.9	69.5	77.2
Government agency services	8.9	9.6	9.3	8.9
Payment and settlement	9.8	10.0	9.0	10.4
Banking services	31.1	29.0	30.2	29.9
Other	25.0	19.9	23.4	22.1
Expenditure on remunerated functions	**144.4**	**141.4**	**141.4**	**148.5**
Legacy costs(2)	7.0	6.7	7.0	7.9
Total expenditure	**264.6**	**269.4**	**271.4**	**278.8**

(1) Net of recoveries (includes some restatements of prior year figures). Figures are from the Bank's management accounts and contain reporting differences to the statutory financial accounts, such as the inclusion of notional interest charges and the treatment of pensions.

(2) Pensioner benefits and interest on severance provisions.

Financial review continued

Budget for 2010/11

The budget for the Bank's policy functions in 2010/11 has been set at £122.4 million and remains under pressure from additional costs arising from work in response to the financial crisis and from the need for further IT investment. As reported last year, the level of policy spending is above that assumed in the 2008 CRD review, in part reflecting the Bank's new responsibilities. It remains Court's policy to set budgets over time that imply no real increase in the Bank's policy costs — meaning 2% nominal growth, in line with the inflation target. The current budget for 2010/11 is higher than the 'baseline' set last year; however the intention is to bring costs down in 2011/12 to compensate so that broadly, total policy expenditure over the next three years remains equal to the amount previously planned.

The forecast for CRD income contained in the budget for 2010/11 is £111.2 million, with income forecasts remaining sensitive to the future path of interest rates.

Although the Bank's policy spending is expected to exceed CRD income in 2010/11, the deficit is not considered significant enough for Court to request a review of the CRD scheme at this time. The balance between the Bank's CRD income and related expenditure will be kept under review.

The net spending projection for the Bank's remunerated functions in 2010/11 is for a surplus of £5.8 million. This is consistent with the Bank's objective for these activities to be broadly self-financing over the medium term.

The budget for 2010/11 includes proposals for £40 million of project-related expenditure in 2010/11, of which £23.5 million relates to additions to the Bank's fixed or intangible assets. The level of cash spending represents a step increase from the prior year. Around 60% of the 2010/11 investment plan is on IT maintenance, replacement and upgrade projects and on premises and plant. Of the remainder, a substantial portion supports the Bank's policy functions directly, such as implementation of changes to the sterling monetary framework, collateral management improvements and the development of forecasting models in Monetary Analysis and Financial Stability.

Proposals for major projects supporting the strategic priorities in 2010/11 include:

Strategic priority	Project	*2010/11 cost (£ millions)	*Total cost (£ millions)	Forecast completion
1. Monetary policy	New Forecasting Model	1.4	2.4	2011/12
2. Market operations	Sterling Market Operations Review (Phases 1 & 2)	1.2	2.1	2011/12
	Collateral Management Risk Monitoring	2.1	3.5	2011/12
	Collateral Operations Platform	1.6	4.0	2012/13
3. Financial stability	Banking Sector Monitoring (Phase 2)	0.8	1.0	2010/11
	Risk Assessment Model for Systemic Institutions (RAMSI)	0.2	1.1	2010/11
7. Banking services and banknote operations	Notes Storage and Security projects	7.8	11.8	2011/12
	RTGS-related projects	2.9	6.2	2013/14
	Banking Platform Upgrade and Simplification	0.9	2.6	2013/14
8. Skills and organisational capacity	HR Services and Systems	0.7	1.4	2010/11
	Collaboration and Knowledge-sharing Systems	1.1	5.4	2014/15

*Non-recurrent costs.

Profit before tax

£ millions	2004/05	2005/06	2006/07	2007/08	2008/09	**2009/10**
Banking Department	106	99	191	197	995	**231**
Issue Department	1,618	1,698	1,653	2,327	2,188	**491**

Financial statements

The Banking Department's financial statements for the year ended 28 February 2010 are given on pages 48–92, and show a profit before tax of £231 million (2008/09: £995 million). After a tax charge of £37 million (2008/09: £162 million), the profit transferred to reserves amounts to £97 million (2008/09: £417 million). The amount payable in lieu of dividend amounts to £97 million (2008/09: £417 million), being half of the post-tax profit for the year.

The profits of the Banking Department have been elevated in recent years as a consequence of the Bank's policy actions, in particular income from long-term repo operations. In 2008/09, it also reflected the financial effects of emergency liquidity assistance, as outlined on page 17.

The statements of account for the Issue Department (which are given on pages 93–95) show that the profits of the note issue were £491 million (2008/09: £2.2 billion). These profits are all payable to HM Treasury.

The level of Bank Rate is the main driver of the profits of the Issue Department, and explains the lower profit outturn in 2009/10.

Banking Department balance sheet

The balance sheet of the Banking Department expanded during the year from £147.9 billion at 28 February 2009 to £223.1 billion at 28 February 2010. This was primarily the result of the increased lending to Bank of England Asset Purchase Facility Fund Ltd (BEAPFF), partly offset by the decline in loans and advances to banks.

The loan to BEAPFF at 28 February 2010 was £199.9 billion, up from £810 million at 28 February 2009, while loans and advances to banks declined, to £12.5 billion from £136.8 billion, largely as a result of a reduction in the use of three-month reverse repos.

The composition of the Banking Department liabilities also changed during 2009/10. Deposits from banks and other financial institutions, mainly reserves balances, were £169.9 billion at 28 February 2010 (2008/09: £42.2 billion) and there were no money market instruments in issue (2008/09: £42.2 billion). Deposits from central banks declined to £11.4 billion (2008/09: £24.4 billion), mainly reflecting the end of US dollar reverse repo operations funded by borrowing from the US Federal Reserve.

At 28 February 2010, the Banking Department balance sheet contained £4.1 billion of liabilities associated with the management of the Bank's foreign exchange reserves (2008/09: £3.0 billion). In March 2009, the Bank launched a $2 billion three-year RegS/144A Eurobond; a further $2 billion bond was issued shortly after the balance sheet date, replacing the maturing 2007 bond. Proceeds are invested in foreign currency assets, and swaps are held to minimise exposure to interest rate, currency and liquidity risks.

The level of Cash Ratio Deposits (CRDs) increased to £2.6 billion at 28 February 2010 (2008/09: £2.4 billion), and capital and reserves increased to £4.2 billion (2008/09: £3.3 billion), mainly reflecting the surplus from the Special Liquidity Scheme (SLS), indemnified by HM Treasury. Excluding that part relating to the SLS, capital and reserves, together with CRDs, are predominantly invested in gilts and supranational sterling bonds. The Banking Department's holdings of gilt securities were £3.3 billion at 28 February 2010 (2008/09: £2.6 billion) and holdings of other supranational sterling bonds were £636 million (2008/09: £980 million).

Issue Department balance sheet

Banknote liabilities continued to increase year on year, and were £50.2 billion on 28 February 2010 (2008/09: £48.6 billion).

Gilt purchases on Issue Department, introduced in January 2008, were put on hold during the year while the BEAPFF undertook gilt purchase operations. The market valuation of gilts on Issue Department was £5.3 billion at year end (2008/09: £5.4 billion). The Ways and Means advance to HM Treasury was £370 million at 28 February 2010

Financial review continued

Summary combined balance sheet	2010 £m	2009 £m
Assets		
Ways and Means advance	370	4,142
Loans and advances	230,817	148,958
Securities held at fair value through profit or loss	4,085	3,334
Derivative financial instruments	361	287
Available for sale securities	9,699	9,380
Other assets	1,337	1,210
Total assets	**246,669**	**167,311**
Liabilities		
Notes in circulation	50,220	48,608
Money market instruments in issue	–	42,212
Deposits	187,029	68,955
Derivative financial instruments	263	81
Foreign currency bonds in issue	4,126	2,965
Other liabilities	807	1,169
Capital and reserves	4,224	3,321
Total equity and liabilities	**246,669**	**167,311**

(2008/09: £4.1 billion). Reverse repos outstanding at 28 February 2010 were £17.9 billion (2008/09: £9.8 billion), and the Issue Department's deposit with the Banking Department, netted out in the consolidated balance sheet, was £26.7 billion (2008/09: £29.2 billion).

Combined balance sheet

The separation of Banking from Issue in the Accounts is required by statute. A summary combined Bank balance sheet as at 28 February 2010 is set out above. It is provided for information purposes only, to assist comparison with other central banks.

In summary, the combined balance sheet increased by £79.4 billion. The bulk of the movement in assets was in 'loans and advances' as a result of the increased lending to BEAPFF while the stock of three-month reverse repos declined. The funding of asset purchases through BEAPFF by increasing bank reserves explains the increase in deposits of £118.1 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 £203 million in April 2009 and £214 million in October 2009 in respect of the year to 28 February 2009. On 1 April 2010, the Bank paid the first payment of £47 million in respect of the financial year ended 28 February 2010, based on provisional full-year figures. The balance will be paid on 5 October 2010.

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 28 February 2010 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 as at 28 February 2010 and for the year to that date.

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 of the Accounts. 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 51–59.

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.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Bank's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Risk management and business practices

Risk management

The Court of Directors is responsible for the system of internal control in the Bank and its subsidiaries. The responsibility for day-to-day operations is delegated to the executive management. The system of internal control is based upon what Court considers to be appropriate to the Bank's activities, to the materiality of the financial and other risks inherent in those activities and to the relative costs and benefits of implementing specific controls. It is designed to manage rather than eliminate the risk of failure to achieve business objectives and, as such, provides reasonable, but not absolute, assurance against material misstatement or loss.

In accordance with the Financial Reporting Council's Revised Guidance for Directors on Internal Control within the Combined Code, Court has reviewed the effectiveness of the system of internal control and confirms that an ongoing process of identifying, evaluating and managing the Bank's risks has operated throughout the year covered in this *Annual Report* and up to the date of its approval. To facilitate Court's review and confirmation, the Executive Directors have certified their compliance with the Bank's risk management and internal control requirements. This certification included a review of the risk and control issues identified and reported during the year.

The Bank's risk framework

In order to effectively and efficiently deliver its Core Purposes and strategy the Bank is required to identify, assess and manage a wide range of risks. The Bank's risks are managed through an overarching framework in order to apply consistency and transparency of risk management across the organisation. The framework identifies the roles and responsibilities of key parties in the risk management process, the policies for how risks are managed, the tools and processes used and the reporting outputs that are generated.

The framework organises risk into three high-level categories, although there can be overlap between these:

- **Strategic:** Policy risks, governance issues or external factors which directly impact the Bank's ability to meet its Core Purposes.
- **Operational:** Risk arising as a result of weaknesses in business processes, systems, or through staff or third-party actions which have an impact on the delivery of the Bank's key business functions or on its reputation.
- **Financial:** Risks to the Bank's capital that may arise through crystallisation of market, credit or liquidity risks in the Bank's balance sheet.

The risk framework is designed to ensure that the above risk types are managed in a consistent and efficient way, and that decisions to accept or mitigate risks are taken expediently and transparently. This includes ensuring risk tolerance levels are set, exceptions and incidents are monitored and that decisions and actions are taken where necessary.

Risk policies

The Bank's approach to managing strategic and policy risk is described in a strategic and policy risk statement, reviewed by the Business Risk Committee and approved by the Governor. For operational risk the Bank's risk policy and appetite is articulated in an overarching operational risk policy document, which is underpinned by a set of seven operational risk standards. In addition there are three financial risk standards, which describe the Bank's policy and appetite for market, credit and liquidity risk. The management of financial risk is discussed in note 33 to the Financial Statements.

The risk standards are a high-level articulation of how key categories of risk are identified, assessed, controlled and monitored within the Bank. Each standard is owned by a member of the Executive Team and is reviewed at least annually.

Risk governance

The development and implementation of the Bank's risk framework is overseen by the Business Risk Committee (BRC). This includes reviewing the Bank's risk policies set out in the risk standards (see above) before their approval by the Governor. BRC also reviews the Bank's operational risk profile. The BRC is supported in these activities by the Risk Oversight Unit (ROU).

The Assets and Liabilities Advisory Committee (ALCO) supports the Executive Director for Markets (ED Markets) in reviewing the financial risk profile of the Bank. ED Markets reports to the Governors quarterly on risk issues, and notifies the Governors of any significant breaches of risk tolerance as they arise. Reports on financial risk are also provided to the BRC for information.

The strategic risks faced by the Bank, including policy risks, and key operational and financial risks that impact on the Bank's ability to deliver on its Core Purposes, are reported quarterly by management to Executive Team and to Court, through a report produced by the ROU.

The following paragraphs provide further detail on the responsibilities of committees and organisational units with respect to risk governance:

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 Audit and Risk Committee: The Audit and Risk 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. It is supported by the Bank's Internal Audit function. The Committee receives reports on the operation of the risk framework and the risk management processes and systems in place in the Bank.

The Governors: The Governors approve the risk standards, which set out the Bank's risk policies in relation to specific categories of risk (see above) following their review at BRC. The Governors receive a quarterly high-level report on financial risk from ED Markets.

The Executive Team (ET): ET members are responsible for managing the risks within their Directorates, and ET itself is responsible for managing overarching issues and risks faced by the whole institution. ET reviews quarterly reports on strategic, policy, operational and financial risks, prior to their discussion at Court.

The Business Risk Committee (BRC): The BRC ensures that the risk framework provides the operational risk information required by the Bank's senior management to manage the Bank's risk profile. This includes ensuring that the framework delivers risk profile reports, that associated exception items are cleared, and that action plans are implemented by the risk owners on a timely basis.

Responsibilities can be summarised in three areas:

- Framework oversight — ensuring that the risk framework is fit for purpose and operates effectively.
- Operational risk profile oversight — ensuring that the Bank's operational risk profile is managed within the Bank's risk appetite.
- Risk reporting — ensuring that the appropriate operational risk profile issues are reported to ET and Court. This includes significant risk issues, incidents, and past due action plans.

Assets and Liabilities Advisory Committee (ALCO): ALCO supports and advises ED Markets on the management of the Bank's balance sheet under the terms of the annual Balance Sheet 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.

Risk Oversight Unit (ROU): The Risk Oversight Unit is responsible for providing senior management with the Bank-wide risk profile; the two key reporting outputs being the Quarterly Risk Report to BRC and the Quarterly Risk Report to Executive Team and Court. ROU supports BRC, acting as a secretariat function and reporting to BRC on the implementation and operation of the risk framework throughout the Bank.

Risk Management Division (RMD): RMD is responsible for analysing the financial risks faced by the Bank in its operations in financial markets, whether on behalf of HM Government or on the Bank's own account. RMD is responsible for the development of the appropriate framework, and articulation of appetite, for the management of financial risks, as set out in the three financial risk standards. This includes analysis of the creditworthiness of counterparties, issuers and central bank customers to whom the Bank and/or EEA may have credit exposures and the establishment of eligibility criteria for assets taken as collateral.

Markets Strategy and Risk Operations Division (MSROD): MSROD is responsible for the implementation of the agreed risk framework, including reporting on credit, market and liquidity risk. It is also responsible for

Risk management and business practices continued

operational risk management processes across the Markets Directorate and for preparations for contingencies with respect to financial operations.

Governance of operational risk management within Directorates

Each Directorate has staff that are given responsibility for co-ordinating risk management activities for that business area. In the case of Banking Services and Markets there are dedicated organisational units set up to deliver the risk framework locally; for Markets this responsibility lies with Markets Strategy and Risk Operations Division (MSROD) (see above), in Banking Services and the Special Resolution Unit the Banking Risk Unit (BRU) is responsible for developing and implementing a framework to ensure that risks are effectively managed. The responsibilities of BRU cover:

- Operational Risk and Control (including Compliance).
- Credit and Regulatory Risk (including Anti-Money Laundering).
- Business Continuity.

BRU liaises with Risk Oversight Unit, Risk Management Division and MSROD on an ongoing basis in its performance of these functions.

Other risk management committees

The executive committees and organisational units described above are in place to provide assurance to the Governors, Executive Team and Court on the management of operational, financial and strategic risks. A number of additional committees exist within business areas to manage specific risk types. Outputs from all of these committees feed into the overarching framework described above.

Collateral management

The range of collateral eligible under the Bank's market operations has expanded significantly in the past two years. The Risk Management Division in Markets Directorate is responsible for the risk management of non-sovereign collateral accepted under the Special Liquidity Scheme, Discount Window Facility and extended long-term repo operations. Investment has also been made in new systems to manage collateral, and further projects to improve systems and processes are planned for 2010/11.

The management of financial risk is discussed in note 33 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).

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 Report and Accounts* published by HM Treasury.

Employees

At the end of February 2010 the Bank employed 1,685 full-time staff and 219 part-time staff; 1,721 of these staff were on permanent contracts, up from 1,666 as at end-February 2009. In total this is approximately 3% more staff than at end-February 2009. During the period, 281 individuals joined the Bank and 235 left (including temporary staff). Of the staff recruited, 147 were recruited on permanent contracts, a decrease from 172 in 2009. Of these new permanent staff, 31 were new graduates (down from 38 the year before), 56 were experienced hires appointed to analytical and management roles (a decrease from 64 the year before) and 60 were appointed to clerical or non-technical roles (down from 70 the year before). The increase in staff numbers was due to the extra workload brought on by the Bank's new responsibilities.

The Bank maintains its arrangements for consulting staff on matters affecting their interests including with representatives of the recognised trade union, Unite.

In the past year, under the executive sponsorship of Andrew Bailey, the Bank continued to progress its Diversity Strategy. A new Diversity and Inclusion Forum was introduced, open to all staff to join, in order to get wider employee involvement on a broad agenda of diversity topics and issues. The proportion of women in senior roles stood at 25% at the end of February 2010, up slightly from 24% at end-February 2009. The proportion of staff from ethnic minority backgrounds decreased to 9%, down from 10% at end-February 2009, and within our graduate intake in 2009 they represented 16%. Part-time staff constitute 12% of all Bank staff and 8% of those at analyst and managerial level.

Health and safety

Effective health, safety and risk management is a priority for the Bank. The Bank's safety management system delivers a safe working environment by continuous and effective assessment. Health and safety issues and incidents are monitored by the Bank's Safety, Health and Environment Committee.

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 plant and 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 received a Display Energy Certificate rating of Band G, with an improved score of 158 compared to 169 last year. Projects taking place over the next two years to replace end-of-life heating and cooling plant are expected to improve energy efficiency further. The Bank is also in the process of gaining the Carbon Trust Standard for all its sites, and is preparing for the introduction of the Carbon Reduction Commitment.

The Bank's Head Office building was awarded the Corporation of London's Clean City Gold award for waste management in 2009. More than 99% (1,281 tonnes) of waste; including paper, packaging, glass and electrical goods used by the Bank at its two main sites in London and Essex is recycled or reused in some form.

The Bank's publications, including this *Report*, are 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

The Bank continued to play an active role in community initiatives. During 2009/10 the Bank contributed an estimated total of £641,000 in support of its community programme (2008/09: £582,000).

Cash donations totalled £384,000 (2008/09: £331,000), including:

- £55,000 to community organisations via the Staff Volunteering Award Scheme;
- £32,000 matched funding under the Payroll Giving Scheme;
- £15,000 via the Bank of England Court Awards through which donations are made to community organisations in recognition of outstanding volunteering contributions by members of staff;
- £5,000 for the David Sharp School Governor Awards; and
- £110,000 in donations to support academic research (2008/09: £61,000).

The Bank may grant staff paid leave to perform voluntary duties in the community, or to undertake public and civic duties. The Bank estimates the total value of non-cash community contributions, including time spent by staff on community involvement, travel costs for volunteers and the costs of hosting charitable events at the Bank, to be £257,000 in 2009/10 (2008/09: £251,000), of which £77,000 was for staff time involved in volunteering or civic duties.

No donation was made for any political purpose. No paid leave was granted to staff for political purposes in 2009/10 (2008/09: nil).

Policy on payment of suppliers

The Bank is an approved signatory to The Prompt Payment Code.(1) Standard payment terms are 30 days but the Bank aims to pay invoices as quickly as possible. Measured in terms of the number of working days between receipt of an invoice and payment by the Bank, average trade creditor payment days were estimated to be 9.9 in 2009/10 (2008/09: 10.9).

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

Remuneration of Governors, Directors and MPC members

Court determines the remuneration of the Bank's most senior executives, including the Governors, Executive Directors, Advisers to the Governors and the external MPC members. It is advised by the Remuneration Committee, the composition of which is shown on page 5. 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.

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 affect 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. The five-yearly reviews set the rate for each job and the policy by which salaries will be increased each year and by which bonuses will operate for Executive Directors.

The last review was carried out in 2006 with the assistance of Towers Perrin. The conclusions regarding the external MPC members were that their salary was appropriate for the role and that cash levels in lieu of pension and life assurance were also sufficient. However, the review for the Governor found that the salary was low for the size and responsibilities of the role, although the benefits accrued in the Court executive pension scheme 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 the Governor should be composed of a salary starting between £375,000–£400,000, with automatic increases of 2.5% per annum, and a pension contribution of 30% of salary. The package for a Deputy Governor would be on similar terms but starting at a salary level of £315,000 per annum. All new appointees are now offered the new terms although those with contractual entitlements to more generous pension benefits are also offered the option of retaining these and accepting a lower starting salary. When the Governor was appointed for a second term, from July 2008, he chose not to accept the new package, and has remained on his previous salary, although his pension is now fully accrued. Mr Bean chose to retain his existing pension terms on his appointment to Deputy Governor, Monetary Policy on 1 July 2008 as did Mr Tucker on his appointment to Deputy Governor, Financial Stability on 1 March 2009.

To consolidate the new remuneration package, the Court Pension Scheme, which had previously been open to all new executives from outside or on promotion, was closed to new members on 30 July 2007. For administrative simplicity the Court Pension Scheme was merged with the Staff Pension Fund at the same time. The Final Salary section of this Fund was also closed to new staff members on 30 September 2007. Existing members of both the Court and the Final Salary sections of the Fund continue to accrue benefits under the terms of the section they joined. For example, new Executive Directors promoted from inside the Bank are able to retain pre-existing membership of the Final Salary section. Those from outside the Bank are now offered either membership of the Career Average pension section of the Fund, as are all new staff, or a salary supplement of 30% in lieu of pension.

The Court and the Final Salary sections are both non-contributory and have a normal pension age of 60. The accrual rate for the Court section allows members to achieve a maximum pension of two thirds of their pensionable salary at normal pension age after 20 years' service. The accrual rate for the Final Salary section allows members to achieve the same maximum at normal pension age after 40 years' service. Both sections provide payment of a lump sum of up to four times pensionable salary in the event of death in service, and 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.

Remuneration structure of 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 purdah 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 has been the appointment to the FSA Board held by Paul Tucker.

Base salaries

On 1 July 2009 the salary of the Governor was increased by 2.5% from £297,920 to £305,368. On 1 March 2009, the salaries of the Deputy Governors were increased by 2.5% from £246,338 to £252,497. The Governor and the Deputy Governors do not receive bonuses.

In relation to 2010 and 2011 the Governor has advised the Remuneration Committee that he does not wish to receive any increase in his salary.

Pensions

Mr King's pension was fully accrued at the end of his first term on 30 June 2008. For his second term of office from 1 July 2008 to 30 June 2013 he earns no annual pension contribution from the Bank.

Pension benefits for the current Deputy Governors are provided through the Court section, supplemented in one instance by an unfunded scheme as described below. For executives joining the Court Pension Scheme before 2005 who were subject to the pensions earnings cap introduced in the Finance Act 1989, the Bank contracted to provide additional unfunded pensions so that their total pensions broadly matched what would have been provided by the Scheme in the absence of the cap. During the year ended 28 February 2010, unfunded entitlements were provided to Mr Bean. Provision for these unfunded benefits is made in the Bank's financial statements. Court decided not to grant unfunded benefits to members joining after 2005.

Remuneration of members of Court

	Salary £	Benefits(1) £	Total 2009/10 £	Total 2008/09 £
Governor				
Mr M A King	302,885	2,878	305,764	296,818
Deputy Governors				
Mr C Bean (appointed 1 July 2008)	252,497	1,795	254,292	165,028
Mr P Tucker (appointed 1 March 2009)	252,497	5,617	257,664	–
Non-executive Directors(2)	122,250	310	122,560	92,200
Total	**930,129**	**10,151**	**940,280**	**554,046**

(1) Includes the provision of facilities which give rise to a tax liability.

(2) Lord Turner sits on Court as Chairman of the Financial Services Authority, and Paul Tucker as Deputy Governor for Financial Stability, has been appointed a director of the FSA. Lord Turner waived remuneration from the Bank of £12,750 in 2009/10, and Paul Tucker waived remuneration from the FSA of £28,000.

Remuneration of Governors, Directors and MPC members continued

Pension entitlements and accruals (including unfunded entitlements)

	Cash equivalent as at 28.2.09 (£)	Cash equivalent as at 28.2.10 (£)	Increase in cash equivalent (£)	Accrued pension as at 28.2.09 (£pa)	Accrued pension as at 28.2.10 (£pa)	Increase in accrued pension (£pa)	Cash equivalent of additional pension earned during year ended 28.2.10 (£)
Mr C Bean	1,435,700	1,972,600	536,900	55,700	70,700	15,000	418,500
Mr P M W Tucker	2,300,900	3,017,100	716,200	93,100	110,800	17,700	481,300

Note: Mr King's pension was fully accrued at the end of his first term as Governor, on 30 June 2008. Since then he has received no further pension benefits from the Bank. His accrued pension as at 30 June 2008 was £198,200.

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 28 February 2010.

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. With effect from 1 June 2009, these rates were set at £15,000 per annum for Directors, £20,000 for Committee Chairmen and the Deputy Chairman of Court and £30,000 for the Chairman of Court. Non-executive Directors do not receive any post-retirement or medical benefits from the Bank or any additional fees for serving on Committees. The Bank does, however, meet appropriate travel and subsistence expenses.

Remuneration of external Monetary Policy Committee members

Court determines the terms and conditions of service of the four external members of the MPC appointed by the Chancellor of the Exchequer. These members are appointed for terms of three years on a part-time basis averaging three days a week. External MPC members must not retain or accept other appointments or interests that would create a conflict with their MPC responsibilities during their term of office as determined by the Chancellor on the Governor's advice.

The external members of the MPC were each paid £98,890 in 2009/10. They do not earn bonuses. They were also paid a 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. To the extent that they receive income from employment that does not conflict with their former MPC responsibilities, however, their income from the Bank is reduced.

The salaries of Executive Directors of the Bank who are also members of the MPC are given here for consistency. Spencer Dale's salary in 2009/10 was £168,100 and Paul Fisher's salary was £164,000.

Other senior executives

The table below shows the remuneration ranges for all staff with remuneration in excess of £150,000, apart from the Governors whose individual remuneration is disclosed in the tables above. The figures relate to 2009/10 and include base pay, benefit allowances and bonuses where applicable.

Remuneration range	Number in range
£220,000 – 229,999	2
£210,000 – 219,999	1
£200,000 – 209,999	–
£190,000 – 199,999	–
£180,000 – 189,999	4
£170,000 – 179,999	1
£160,000 – 169,999	4
£150,000 – 159,999	–

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 refers where relevant to other sections of this *Annual Report*.

The Bank of England Act requires NedCo to review the Bank's performance in relation to the strategy and objectives as determined by Court, to monitor the extent to which its financial management objectives have been achieved, to review the Bank's internal financial controls and to review the procedures of the Monetary Policy Committee.

The Non-executive Directors also have responsibilities for the remuneration of the executive members of Court and MPC members, which are undertaken by the Remuneration Committee.

The operation of NedCo

The role of the Non-executive Directors in the Bank is similar to that in any commercial organisation and on any board they would have similar responsibilities. They are not involved with day-to-day decision-making but they do provide an independent and critical challenge for the management of the Bank.

The new governance arrangements introduced following the 2009 Act are described on pages 4–5. The Act reduced the number of Directors and set a new minimum for the number of meetings of Court each year. Four non-executive members of the previous Court were reappointed to the new one; five joined the Court for the first time, including the Chairman of Court (although he had previously served as a Director between 1991 and 1999).

Induction programmes were arranged for the new members, and the smaller Court has facilitated a more participative discussion. The new arrangements are working well, although agendas in some of the early meetings were compressed. The new Court has reviewed its own procedures and has reviewed and approved a new statement of delegations to the Executive, and also the terms of reference of all Court Committees.

The table on page 43 sets out attendance by the Bank's Non-executive Directors at meetings of Court, NedCo, FSC, Audit and Remuneration Committees. The figures in brackets refer to the total number of meetings during the financial year. Attendance by other members of Court is also listed.

The appointment of a non-executive Chairman of Court has significantly changed the manner in which NedCo carries out its review functions: to a greater extent than previously NedCo has in effect done its work in and through Court meetings, and there have been very few separate meetings of the Committee.

Four members are also members of the new Financial Stability Committee. That Committee met seven times in 2009/10, usually immediately before Court, although a special meeting was also arranged to deal with the sale of assets arising from the resolution of Dunfermline Building Society.

Reviewing performance

Directors have continued to receive quarterly reports on implementation of the Bank's strategy, finance, project management, risk management and progress against the Bank's high-level outcomes. These reports are helpful monitoring mechanisms and provide the basis for discussion with management across a wide range of issues. NedCo has also reviewed the Governor's personal objectives for 2010/11, following discussion between the Chairman of Court and the Governor.

The Bank's performance in relation to its strategy and objectives is reviewed on pages 12–22 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 2009/10.

Reviewing financial management

The Bank's budget for 2010/11 is discussed on page 30. The Bank has been successful in containing costs over the past five years, and Court's policy with respect to finances has been and remains to set budgets over time that imply no real increase in the Bank's policy costs — meaning 2% nominal growth, in line with the inflation target.

Report by the Non-executive Directors continued

Regular reporting to Court on the Bank's performance, financial position, risk profile and value for money outcomes is of high quality and supports well-directed debate on the main issues. Non-executive Directors have been kept appraised of the effect that the greatly expanded market operations have had on the Bank's balance sheet, and the related indemnity arrangements with HM Treasury. In addition, Directors have discussed the Bank's capital position, while recognising that there is no indisputable standard for a central bank's level of capital.

During the year a sub-committee of the Audit Committee was set up to review whether, in the light of the Bank's greatly expanded balance sheet and the wider range of collateral accepted, changes needed to be made to the governance, management and reporting of risk in the Bank. The Committee considers that present standards and controls are robust. The review will conclude with a report to Court later in the year. At its meeting in April 2010 Court decided to rename the Audit Committee to the Audit and Risk Committee, reflecting a greater emphasis in its work on risk management.

The Audit and Risk Committee assists Court in meeting its responsibilities for ensuring that the Bank has an effective system of financial reporting, internal control, risk and value for money management. Over the past year it also has focused on the demands on the Bank's balance sheet and resources arising from its increased market operations, and the need for new or strengthened controls. The Committee has reviewed the effectiveness of the system of internal financial controls and risk management that operated during 2009/10, and this is reported in the 'Risk management and business practice' section of the *Annual Report* (pages 34–37) which, so far as appropriate, forms part of NedCo's report.

In November 2009 the Bank announced that it had, in the autumn of 2008, extended emergency liquidity assistance to two institutions, HBOS and RBS. Usage of the facilities peaked at £61.6 billion in October 2008 and the facilities were fully repaid in January 2009. The Bank used its powers under the 1998 Banking Act to limit the extent of disclosure in the 2009 *Annual Report*; but, consistent with existing Bank policy, they were revealed once the need for secrecy was passed. The then Audit Committee was aware of the facilities and reviewed the decision to limit disclosure.

MPC procedures

Non-executive Directors are responsible for keeping the procedures followed by the MPC under review and to ensure that the Committee 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 Court to discuss both the *Inflation Report* and MPC procedures. 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. In addition a formal questionnaire is completed each year by each MPC member, and the results are reviewed by Court. The Chairman of Court holds individual discussions with MPC members and these too are reported to Court.

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

Remuneration

The Remuneration Committee assesses the remuneration of the executive members of Court, the Bank's Executive Directors and other senior executives. It also recommends to Court 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 2009/10 is set out on pages 38–40 and, so far as appropriate, forms part of this report.

Attendance	Court (9)	NedCo (2)	FSC (7)	Audit (4)	RemCo (4)
*Sir David Lees – Attendances as an observer at Audit Committee and NedCo/Court May only	7 of 7	1 of 1	7	3 of 3	2 of 2
Mr Barber	7	1			2 of 2
Mr Carr – Member of FSC June-November 2009, Member of Audit June-December 2009	8	2	5 of 5	1 of 2	4
Lady Rice	8	2		4	
Lord Turner	6	1			
*Mr Horta-Osório	6 of 6			3 of 3	2 of 2
*Mr M Tucker	4 of 6		6	3 of 3	
**Mr Stewart – Attendance as an observer at December Audit Committee	2 of 2		2 of 2	1 of 2	
*Mr Young	4 of 6		7		
#Sir John Parker – Attendance as an observer at Audit Committee and RemCo	2 of 3	2		0 of 1	2 of 2
#The Hon Peter Jay	2 of 3	2			2 of 2
#Dr Potter	2 of 3	2			2 of 2
#Ms Fawcett	2 of 3	2		1 of 1	
#Mr Wilkinson	2 of 3	2			1 of 2
#Mr Sarin	0 of 3	0			0 of 2
#Professor Rhind	2 of 3	2			2 of 2
#Mr Wigley	2 of 3	2		0 of 1	
#Mr Strachan	2 of 3	2		1 of 1	
Mr King	9	2†	7		
Mr Bean	6	2†	5		
Mr P Tucker	7	2†	6		

* Appointed 1 June 2009.
** Appointed 1 December 2009.
\# Resigned 31 May 2009.
† Attendance by invitation.

Report of the Independent Auditor

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

We have audited the financial statements of the Banking Department ('financial statements') for the year ended 28 February 2010, set out on pages 46 to 90, and the statements of account of the Issue Department ('statements of account') for the year ended 28 February 2010, set out on pages 91 to 93. The financial reporting framework that has been applied in their preparation is applicable law and the accounting policies set out therein.

This report is made solely to the Governor and 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 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 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 the auditor

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 the bases of preparation set out in note 2 on pages 51 to 59 and note 1 on page 92 respectively are described in the Statement of the responsibilities of the Court of Directors in relation to the financial statements on pages 32 to 33.

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 51 to 59 and note 1 on page 92 respectively. We also report to you whether, in our opinion, the information given in the Remuneration report, the Financial Review, the Risk Management and Business Practices report, and the Report by the Non-executive Directors on pages 28 to 43 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 or 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 2 on pages 51 to 59, and in the statements of account, the basis of which is described in note 1 on page 92.

Opinion

In our opinion:

- The financial statements of the Banking Department on pages 46 to 90 for the year ended 28 February 2010 have been properly prepared in accordance with the basis of preparation set out in note 2 on pages 51 to 59.
- The statements of account of the Issue Department on pages 91 to 93 for the year ended 28 February 2010 have been properly prepared in accordance with the basis of preparation set out in note 1 on page 92.

The information given in the Remuneration report, Financial Review, the Risk Management and Business Practices report, and the Report by the Non-executive Directors is consistent with the financial statements and statements of account.

M StJ Ashley
for and on behalf of KPMG Audit Plc
Chartered Accountants, Registered Auditor
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27 May 2010