Annual Report 2011

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 2011.

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. This is pursued through the Bank's financial and other operations, including lender of last resort, oversight of key infrastructure and the surveillance and policy roles delegated to the Financial Policy Committee.

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

Following its formation in May 2010, the Coalition Government has outlined substantial increases in the Bank's responsibilities, which will give it both opportunities and new challenges. In anticipation of these new responsibilities considerable preliminary work has already been undertaken in relation to governance of the Bank including Matters Reserved to Court. This will be finalised when the new legislation is enacted.

Draft legislation is to be scrutinised in Parliament over the coming months. This will outline the macroprudential powers to be exercised by the Financial Policy Committee (FPC), a Committee of the Court that was established on an interim basis in February; it will also provide for a Prudential Regulation Authority (PRA), established as part of the Bank of England group, to take over from the FSA responsibility for the prudential regulation of banks and insurance companies.

These initiatives are intended to reduce systemic risks and threats to the financial system as a whole. As the Government said in its February 2011 consultation document, setting both new bodies in the Bank, 'will ensure that systemic and firm-specific regulation are coordinated, and that the market knowledge and economic expertise of the central bank is fully brought to bear on financial stability'.

Within the Bank a very substantial programme of work has started, with the objective of housing the new PRA (ideally in premises very close to the Bank), providing it with standard Bank services including IT systems, and ensuring that the PRA has access to the regulatory systems it needs. Court will shortly approve a detailed budget for the transition of the Bank's new responsibilities from the FSA to the PRA and together with the Audit and Risk Committee is already receiving full reports on the programme which is probably the largest and certainly the costliest project that the Bank has undertaken over the past ten years. Hector Sants, who as chief executive elect of the PRA will in due course become a Deputy Governor of the Bank, has been invited to join Court meetings to report as chair of the PRA Programme Board.

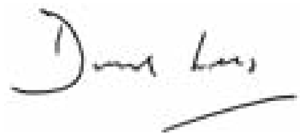
With the possibility of a significant property transaction, Court has formed a sub-committee comprising Sir Roger Carr, Lady Rice and myself to review from a value for money perspective proposals put forward by the executive.

A separate programme, involving both Bank and FSA staff, is developing the new regulatory approach of the PRA: an outline for banking was published on 19 May and this was followed in June by a further outline for insurance. This obviously has important implications for the practical planning, as the Government's intention, fully shared by the Bank, is that there will be a fundamental change in the way that the new regulatory authorities carry out their functions so as to deliver more judgment-led, focused and effective regulation of the financial sector.

Apart from the new regulatory framework, a particular concern of Court over the past year has been ensuring the Bank has and retains the numbers and particularly the quality of the staff it needs. For its core central banking and policy functions the Bank necessarily recruits the best people it can and then invests in retaining them: that process requires effective HR management and I have been delighted this year to welcome Catherine Brown as our new HR Director. I am conscious that we have made her job no easier by deciding to follow the Government's two-year pay freeze for the public sector: but this makes it all the more important to focus on the active management of talent and career development making the Bank an even more rewarding place in which to work.

The new Court that came into being in 2009 has benefited from a second year of working together. Its present role, which will expand as a result of the Bank's new responsibilities referred to above, is described in further detail in pages 4 to 6 that follow. Court provides both support and challenge to the Bank's executive and is an effective body, confirmed by the Court Effectiveness Review which was finalised in the first quarter of this year. I am grateful to my colleagues both executive and non-executive for their many contributions across the Bank.

I would also like to record my gratitude to António Horta-Osório, who left the Bank in February on becoming Chief Executive of Lloyds Banking Group, for his significant contribution to the Court and to two of its Committees.



June 2011

Foreword by the Governor

Sir Mervyn King Governor

It has been an exacting year for the Bank of England. The conduct and explanation of monetary policy has presented many challenges. At the same time, the Bank has taken significant steps towards acquiring a wide set of responsibilities for financial regulation.

The Bank's first strategic priority is to meet the 2% inflation target set by the Government. Inflation was above that target throughout the year. But that does not mean the Bank's Monetary Policy Committee (MPC) has forgotten the task it has been set. Three large shocks have helped to push up the price level during the past four years: the depreciation of sterling during 2007 and 2008; sharp increases in commodity prices; and changes in the standard rate of VAT. The most likely outcome is that these factors will not continue to push up the price level in the future. So inflation should fall back towards the target during the next two years.

It would have been unwise to have tightened policy sharply during 2010 in order to bring inflation back to the target rapidly. If the MPC had raised Bank Rate significantly, inflation might well have started to fall, but only because the recovery would have been even slower and unemployment higher than now. By allowing inflation to remain above target and trying to support output growth, the Committee was acting in strict accordance with its remit. That remit explicitly allows the Committee to judge whether trying to keep inflation at target in all circumstances would lead to undesirable volatility in output.

Our second priority is financial stability. During the past year, the new Government announced the creation of a new Financial Policy Committee (FPC). The FPC will be a committee of Court, and will play a key role in ensuring future financial stability. It will identify, monitor, and take action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. Alongside this, the Bank will be given statutory responsibilities for the supervision of central clearing counterparties and securities settlement systems.

The Government also announced plans for a new subsidiary of the Bank, the Prudential Regulation Authority (PRA). The PRA will contribute to the stability of the UK financial system by assessing the safety and soundness of individual financial firms. It will build on the improvements to regulation already made by the FSA over the past three years, based more on judgement and less on compliance.

Appropriate accountability for our performance in delivering financial stability will be a keystone of the new regulatory framework. The Bank must be accountable to Parliament and the public.

In its June 2010 *Budget*, the Government announced a two-year pay freeze for public sector workforces. As one of the most prominent parts of the public sector, the Bank must take part in this freeze. This will be difficult for our staff. We must do all that we can to ensure that their long-held commitment to public service will be undiminished.

At the end of May, Andrew Sentance leaves the MPC after five years on the Committee. It has been a pleasure to work with Andrew and I would like to thank him for the role he has played. I look forward to working with his successor, Ben Broadbent. I am pleased that Hector Sants has agreed to remain at the FSA and then move to the Bank to become the first chief executive of the PRA. I also welcome the opportunity to work with Adair Turner and the new External members of the interim FPC: Alastair Clark, Michael Cohrs and Donald Kohn.

The Bank has to cope with enormous changes in the coming years. With the support of our highly talented staff, the Executive Team and I are ready to cope with the further challenges we will face.

June 2011

The Role of Court, its Committees and the MPC

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 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. Since the 2009 Banking Act ('the 2009 Act'), the Bank has had 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. 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. Details of the current Court are set out on pages 8–9.

Court delegates the day-to-day management of the Bank to the Governor and through him to other members of the executive. But it reserves to itself the right to agree:

- The Bank's strategy and objectives.
- The Bank's expenditure budget.
- Major capital projects.
- The Bank's financial framework.
- The Bank's risk management policies.
- Approval of the accounts and the appointment of auditors.
- The remit for management of the Bank's balance sheet.
- The Bank's facilities in the money market.
- Senior appointments within the Bank.
- Changes in remuneration and pension arrangements.
- The Bank's succession plan.
- The establishment of sub-committees of Court, their terms of reference and membership.

And Court is consulted about financial support for institutions through the Financial Stability Committee.

Court keeps its procedures under close review and each year an annual Effectiveness Review is conducted on which a report is made to Court.

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 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 Remuneration Committee (see below) advises NedCo on this last responsibility. To a large extent NedCo's work is done through Court, and references in this report to 'Court/NedCo' indicate work carried out in this way. However the Committee meets separately from Court to agree its Annual Report, which is on pages 43–45. NedCo also meets separately to review the Governor's performance against the personal objectives set by the Committee and to endorse the objectives for the coming year as agreed with the Governor by the Chairman of Court.

Financial Stability Committee (FSC)

The FSC was created by the Banking Act 2009. It consists of the Governors, the 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). The Committee may co-opt further members.

Under the 2009 Act the Committee has the following 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 Banking Act 2009 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 Banking Act 2009 (interbank payment systems).

Court has delegated to the Committee the following additional functions:

- To monitor the Bank's exercise of its functions under Part 6 of the 2009 Banking 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.

Until the creation of the interim Financial Policy Committee (FPC) in February 2011, Court had also delegated to the Committee the final approval of the Bank's *Financial Stability Report* prior to publication. The interim FPC has now become the main conduit for the Bank's risk assessment and market intelligence, although the FSC remains concerned with the process by which the Bank's intelligence is gathered and the assessment developed.

Interim Financial Policy Committee

The interim FPC was announced in February 2011 in anticipation of legislation to create a Financial Policy Committee (FPC), as outlined in the Government's consultation document *A new approach to financial regulation: building a stronger system* which was published on 17 February 2011. The interim FPC is a committee of Court, and will carry out preparatory work and analysis in advance of the creation of the permanent FPC; monitor developments affecting financial stability in the United Kingdom and internationally, give advice to the FSA and other bodies it feels appropriate about emerging risks in the financial system and recommend possible means of mitigating these risks; consider making recommendations to the Treasury about the regulatory perimeter and review and approve the Bank's *Financial Stability Report* which will set out its assessment and any recommendations that the Committee may have made. The interim Committee will meet at least four times a year and will publish a record of its discussions.

The members of the interim Committee are the Governor (Chairman), the two Deputy Governors, Hector Sants (in his capacity as future Deputy Governor of the Bank of England for Prudential Regulation and Chief Executive of the Prudential Regulation Authority), the Chairman of the Financial Services Authority, Executive Directors of the Bank for Financial Stability and Markets, and four external members nominated by the Treasury — thus far Alastair Clark, Michael Cohrs and Donald Kohn. There will also be two non-voting members, the Chief Executive designate of the Financial Conduct Authority Martin Wheatley and a representative of the Treasury.

Remuneration Committee

The Remuneration Committee advises NedCo on the remuneration of the Bank's most senior executives, including the Governors, the Executive Directors (who are not members of Court), the Advisers to the Governors and the members of the Monetary Policy Committee appointed by the Chancellor of the Exchequer (the external MPC members).

The members of the Remuneration Committee are Sir Roger Carr (Chairman), Brendan Barber and Sir David Lees. António Horta-Osório was a member until his resignation from Court on 28 February 2011. The Committee's Report on Remuneration is on pages 40–42.

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 Bank of England Act 1998 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, which meets regularly, has detailed terms of reference that include: receiving reports from, and reviewing the work of, the internal and external auditors; reviewing the annual financial statements prior to their submission to Court; considering the appropriateness of the accounting policies

The Role of Court, its Committees and the MPC

and procedures adopted; making recommendations on the appointment of the external auditors, their independence and their fees; and reviewing the Bank's risk matrix and specific business controls.

The members of the Committee are Lady Rice (Chairman), John Stewart, Mark Tucker and from 1 March Sir David Lees. António Horta-Osório was a member until his resignation from Court on 28 February. The Deputy Governors, the Executive Director for Markets, the Finance Director, the Secretary, the Head of Internal Audit and the external auditors normally attend the meetings of the Committee.

Nominations Committee

In 2010 a Nominations Committee was formed, *inter alia*, to make recommendations to Court on the appointment of Executive Directors, the Secretary, and the Internal Auditor of the Bank, appointments to sub-Committees (other than the interim FPC), as to whether likely conflicts of interest are sufficiently severe to prevent a Member of Court continuing to serve as such and to review succession plans with particular regard to those appointments for which Court's approval is required.

The Members of the Committee, which meet as required, are Sir David Lees (Chairman), the Governor, Lady Rice and Sir Roger Carr.

The Monetary Policy Committee (MPC)

The Bank of England Act 1998 establishes the MPC as a Committee of the Bank, subject to the oversight of Court/NedCo, and sets a framework for its operations. 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 15.

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

The Chairman of Court meets each member of the MPC on a one-to-one basis each year to ensure that they are receiving sufficient support from the Bank to enable them to carry out their responsibilities, and to ensure that any particular issues needing attention are surfaced. A report is made to Court summarising the results of those meetings.

Management structure

The executive management of the Bank lies with the Governors and Executive Directors. The responsibilities of Governors are set out below. The responsibilities of the Executive Directors are set out on pages 12–13.

The Court of Directors

Sir Mervyn King Governor

Charlie Bean Deputy Governor

Paul Tucker Deputy Governor

Sir David Lees Chairman of Court

Brendan Barber

Sir Roger Carr

Lady (Susan) Rice, CBE

Lord (Adair) Turner

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, Royal Opera House Enterprises Limited
- Trustee, Royal Opera House Endowment Fund
- Governor, Royal Ballet School
- Governor, Shrewsbury International School in Bangkok

Brendan Barber
Appointed 1 June 2003.
Term expires on 31 May 2012.

- 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

Sir Roger Carr
Appointed 1 June 2007.
Term expires on 31 May 2014.

- Chairman, Centrica plc
- Senior Adviser, KKR
- Deputy President, CBI
- Fellow of the Royal Society for the Encouragement of the Arts
- Companion of Institute of Management
- Visiting Fellow of the Saïd Business School
- Commissioner on the Commission for Ownership

Lady (Susan) Rice, CBE
Appointed 1 June 2007.
Term expires on 31 May 2014.

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

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

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

- Group Chief Executive & President, AIA Group Limited
- Chairman, American International Assurance Company Limited
- Chairman, American International Assurance Company (Bermuda) Limited
- Board Member, Edinburgh Festival Centre Limited
- Board Member, Edinburgh International Festival Society

Harrison Young
Appointed 1 June 2009.
Term expires on 31 May 2014.

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

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

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

On 21 June it was announced that Michael Cohrs, a member of the Financial Policy Committee, had been appointed for the remainder of António Horta-Osório's term, to 31 May 2012.

The Executive Team

Mervyn King Governor

Charlie Bean Deputy Governor
Monetary Policy

Paul Tucker Deputy Governor
Financial Stability

Andrew Bailey Executive Director
PRA Transition

Catherine Brown Executive Director
HR

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

Chris Salmon Executive Director
Banking Services and Chief Cashier

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 12–13.

*Jenny Scott is currently away from the Bank and Nils Blythe is acting as Interim Executive Director, Communications.

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
- **Catherine Brown** Executive Director HR
  - Human Resources
- **Warwick Jones** Executive Director Finance
  - Finance
  - Projects
  - Risk Oversight
  - Property
- **John Footman** Executive Director Central Services Secretary of the Bank
  - IT
  - Business Continuity
  - Security
- **Jenny Scott*** Executive Director Communications
  - Public Communications & Information
- **Andrew Bailey** Executive Director PRA – Deputy CEO designate
  - PRA Transition
- **Paul Tucker** Deputy Governor Financial Stability
  - **Andy Haldane** Executive Director Financial Stability
    - Financial Stability
  - **Chris Salmon** Executive Director Banking Services
    - Banking Services
  - Special Resolution Unit

*Jenny Scott is currently away from the Bank and Nils Blythe is acting as Interim Executive Director, Communications.

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
Simon Price – Senior Adviser
James Proudman – Monetary Assessment & Strategy
Gareth Ramsay – Inflation Report & Bulletin
Mark Robson – Monetary & Financial Statistics
Robert Woods – Macro Financial Analysis
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 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
Roger Clews – Special Adviser
Michael Cross – Foreign Exchange
Graeme Danton – Markets Strategy & Risk Operations
Sarah John* – Sterling Markets
Alan Sheppard – Risk Management

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
Simon Hall – Macroprudential Strategy
Lowri Khan – Financial Institutions
Victoria Saporta – Prudential Policy
Edwin Schooling Latter – Payments & Infrastructure

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, and working with other directorates, it provides support to the interim Financial Policy Committee.

Internally, a high-level Financial Stability Executive Board, chaired by the Deputy Governor for Financial Stability, Paul Tucker, guides the financial stability work of the Bank executive.

In supporting the interim FPC and FSC, working with other directorates, the area seeks to detect risks to the functioning of the UK financial system and to develop measures to strengthen regulatory systems and infrastructure at home and abroad to reduce those risks.

The area includes the team delivering the Bank's statutory responsibilities for overseeing UK payments systems. It also works with other directorates, HM Treasury and the FSA to improve the arrangements for managing a financial crisis.

*Sarah John is acting as Interim head of Sterling Markets Division.

Banking Services

Chris Salmon
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 and 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) and liquidity insurance operations.

Special Resolution Unit

Head of Special Resolution Unit – vacant
Peter Brierley – Resolution Policy
Mike Mitchell – Resolution Implementation

The Special Resolution Unit was created in February 2009. Reporting to Paul Tucker, 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
Tim Porter – Finance Division

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
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

Catherine Brown
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.

*Jenny Scott is currently away from the Bank and Nils Blythe is acting as Interim Executive Director, Communications.

Review of 2010/11

To a degree, the objectives set by Court for 2010/11 were overtaken by the Coalition Government's announcement, in June 2010, that the Bank would become responsible both for macroprudential regulation and for the regulation, as prudential supervisor, of individual firms. Following the first announcement, the Bank was involved in the drafting of the Treasury's two consultative documents (July 2010 and February 2011), in thinking through and finally establishing in interim form the new Financial Policy Committee intended to advise on, and in time to exercise, the macroprudential powers envisaged by the Government, in designing, with the FSA, a new approach to prudential regulation of banks and insurance companies, and in the planning of a major programme to transfer some FSA functions and staff to the Bank and PRA. This work is continuing and its scope and operational impact on the Bank is described further below.

It has been and will remain important that these new activities are not allowed to overshadow the Bank's other core priorities, of which the first is monetary policy.

1 – Monetary policy

The Government's inflation target remains 2%, measured by the twelve-month increase in the consumer prices index (CPI). CPI inflation remained above target over the course of the year, necessitating four open letters from the Governor to the Chancellor under the requirements of the monetary policy framework. It reached 4.4% in February 2011. Three factors accounted for the high level of inflation: the rise in VAT relative to a year earlier; the continuing consequences of the fall in sterling in late 2007 and 2008; and increases in commodity prices, particularly energy prices. Excluding these effects, prices would probably have increased at a rate below the 2% inflation target.

GDP began to recover at the end of 2009, following the sharp falls during the financial crisis. It was temporarily depressed by heavy snowfall in 2010 Q4, but would otherwise have been around 2% higher than a year earlier. Nevertheless, the level of output remained well below that implied by a continuation of its pre-crisis trend, indicating a margin of spare capacity in the economy. Unemployment remained elevated but stable over the course of the year, standing at 7.9% on the Labour Force Survey measure in the fourth quarter.

Monetary policy has had to balance substantial, but opposing, risks to the medium-term outlook for inflation. Inflation has been above the MPC's 2% target for most of the past five years, and is likely to remain so throughout 2011. If that causes expectations of inflation to rise, it may lead to upward pressure on wages and prices. But as the effects of higher VAT and imported inflation diminish, there is also a risk that weak growth and a persistent margin of spare capacity may cause inflation to fall well below target. Against this backdrop, the MPC left monetary policy unchanged throughout the year, with Bank Rate at 0.5% and the stock of asset purchases financed by the issuance of central bank reserves at £200 billion.

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 MPC is not a Committee of Court, but the Court is responsible for ensuring that the Bank provides the Committee with high-quality and comprehensive support. The Bank conducts an annual survey of MPC members' general satisfaction with the various inputs to the policy process, and this is supplemented by meetings between the Chairman of Court and individual MPC members. The latest survey suggests that MPC members remain happy with the conjunctural and forecast material they receive. The general level of satisfaction was similar to that found in the previous year's survey.

To improve further the support for the MPC, work has continued over the year on a new central forecasting platform; this includes a smaller, more tractable model which should simplify the forecasting process, allowing more time to be spent on analysing the underlying economic issues. Alongside the new smaller model, the platform will include software that is being developed to make it easier for insights from a broad suite of models to be incorporated into the forecast process.

More generally, the forecast process has continued a recent trend of focusing more on the risks rather than the central projection. The *Inflation Report* has followed suit, with greater emphasis placed on communicating the overall distributions underlying the fan charts. New charts have also been introduced to provide

Members of the Monetary Policy Committee


Mervyn King Governor


Charlie Bean Deputy Governor


Paul Tucker Deputy Governor


Spencer Dale


Paul Fisher


David Miles


Adam Posen


Andrew Sentance (1)


Martin Weale

greater information about the projected distribution for inflation.

During the year, the Bank's analytical support for the MPC focused particularly on: further research into the impact of quantitative easing; the prospects for the world economy and the impact of the earlier depreciation of sterling on trade; the outlook for bank lending; the impact of the recession on the supply capacity of the economy and the associated margin of spare capacity; the prospects for household spending; the impact of VAT and imported inflation on CPI inflation; and risks to inflation expectations.

During the course of 2011/12 the Bank's analytical capabilities will remain focused on ensuring that the MPC has the information it needs to make decisions about monetary policy. Work is under way to strengthen the Bank's ability to analyse and model medium-term influences on inflation, including the productive capacity of the economy, shifts in the pattern of demand, global price pressures and inflation expectations. The Bank will also continue to analyse the impact of quantitative easing and host a conference on the topic later in 2011.

2 – Communications

For the Bank as an institution, effective communication is essential to build trust in the policy framework and in the Bank's own effectiveness.

Through its *Inflation Report* and through the published minutes of its meetings, the MPC seeks both to promote understanding of the monetary policy framework and to account for its decisions and explain its judgements about the outlook for the economy and inflation. Individual MPC members appear regularly before the Treasury Committee of the House of Commons, and last year gave a total of 34 formal published speeches as well as articles and informal speeches.

(1) Andrew Sentance's term on the MPC expired on 31 May 2011, and Ben Broadbent began his term on 1 June 2011.

Review of 2010/11 continued

During the past year, two 'Monetary Policy Roundtable' conferences were held. 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.

The Bank's Agents continue to play 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, a programme of visits across the United Kingdom was undertaken by members of the MPC. A total of 42 visits were undertaken outside Greater London in 2010/11, including the third annual visit by the MPC as a whole to a particular region, this time to the West Midlands.

Senior Bank staff with responsibility for financial stability have also made several visits to financial centres outside London, including Birmingham, Bristol and Edinburgh. These provide an opportunity to explain key aspects of the reform agenda to a broad range of business contacts alongside other communication tools. Bank staff have delivered 16 formal speeches on aspects of financial stability and three *Financial Stability Papers* were published. The biannual *Financial Stability Reports* were published in June and December, see below.

A key mechanism for transparency and accountability are parliamentary hearings. The Governor, other members of the MPC and senior Bank staff attended a total of seven parliamentary hearings during the year. Of those, five hearings were in front of the Treasury Committee of the House of Commons. These included the usual quarterly hearings on the Bank's *Inflation Report* and an appointment hearing for an MPC member. Given the Government's proposals for regulatory reform, the Governor and senior Bank staff also attended two hearings specifically on financial regulation. Enhancing public understanding of the Bank's role across all its functions was a key priority for 2010/11. As well as the approach and activities described in the sections above, the Bank continues to provide information and learning resources through its museum, website and schools' programme. A redesigned website was launched in March 2010 and the Bank's museum attracted over 106,000 visitors in 2010/11, an increase of almost 8% from the previous year. The Bank's school materials and films continue to be used in primary and secondary schools and the Bank's annual economics competition for schools and colleges, Target Two Point Zero, reached its eleventh year in 2010/11 with 289 schools and colleges taking part.

3 – Market operations

Sterling Monetary Framework

The Bank's operations in the sterling money markets have two objectives, stemming from its monetary policy and financial stability responsibilities — to implement the Monetary Policy Committee's decisions in order to meet the inflation target; and to reduce the cost of disruption to the liquidity and payment services supplied by banks to the UK economy. The framework for the Bank's operations in the sterling money markets, known as the Sterling Monetary Framework (SMF), is set out in the Bank's 'Red Book',[1] which was updated and revised in December 2010.

In 2009, the Bank decided to expand the range of firms that are eligible to hold reserves accounts, allowing smaller banks and building societies to access the Bank's liquidity operations and directly hold part of their liquidity buffers as central bank money. A significant number of new counterparties were signed up in 2010 and early 2011.

Elements of the normal SMF have been in abeyance since the start of the MPC's asset purchase programme in 2009. In particular, the system of reserves averaging, whereby commercial banks set their own target levels for holdings of central bank reserves in the period between one MPC decision date and the next, was suspended in March 2009, and all reserves balances have since been remunerated at Bank Rate.

The Bank also uses the SMF to provide liquidity insurance to the banking system. In June 2010, the Bank introduced new indexed long-term repo (ILTR) operations, which offer liquidity insurance without distorting banks' incentives for prudent liquidity management, and while minimising the risk being taken onto the Bank's own balance sheet. The new ILTRs permanently replaced the extended-collateral long-term repo operations initiated during the crisis to accommodate increased demand for liquidity by commercial banks. In ILTR operations, counterparties can bid for funds against either (or both) of two collateral sets.

(1) www.bankofengland.co.uk/markets/money/publications/redbookdec10.pdf.

Agents

Peter Andrews
Greater London

Neil Ashbridge
Wales

Graeme Chaplin
West Midlands & Oxfordshire

Stephen Collins
South West

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

The 'narrow' collateral set includes those securities issued in the deepest and most liquid markets which, in the Bank's view, are likely to remain liquid in all but the most extreme circumstances. The 'wider' collateral set comprises of high-quality securities which would normally be expected to trade in liquid markets, and which satisfy the Bank's criteria for the suitability of assets as wider collateral. As the degree of financial stress in the system increases, and counterparties want to submit more of their less liquid collateral, the auction permits allocation of a higher proportion of the funds against the wider collateral set.

The Bank also provides liquidity insurance via its Discount Window Facility (DWF). The pool of DWF-eligible collateral is broader than the 'wider' collateral set, and includes own-name securities and own-name covered bonds. On 30 November 2010, the Bank announced that it would begin accepting 'raw' unsecuritised loan portfolios as eligible collateral in the DWF from April 2011, and that it would begin to process applications from interested participants from January 2011.[1] The Bank continues to encourage counterparties to pre-position collateral in the DWF, so that the facility could be drawn upon at short notice if required.

Collateral policy

Since the start of the financial crisis the Bank has been building up and improving its capacity to manage new risks in its operations and facilities. Those risks include managing private sector collateral, posted by counterparties in the various liquidity insurance operations. The Bank's framework for collateral management is discussed in more detail in the 2010 Q2 *Quarterly Bulletin*.[2]

Over the past year, the Bank has made a number of important changes in its collateral management work. For example, on 30 November the Bank published detailed

(1) www.bankofengland.co.uk/markets/marketnotice101130dwf.pdf.
(2) www.bankofengland.co.uk/publications/quarterlybulletin/qb100201.pdf.

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eligibility requirements for residential mortgage-backed securities (RMBS) and covered bonds deliverable in the Bank's wider collateral pool.[1] Those requirements demand a greater degree of transparency in the provision of loan-level information, investor reporting, cash-flow modelling and transaction overviews. The Bank also requires that the key transaction documents are made publicly available, in a bid to impart some of the benefits of greater transparency to the market as a whole. And on 11 February 2011, as part of its long-term review of collateral policy, the Bank announced changes to the allocation of sovereigns and supranationals across its narrow and wider collateral sets.[2] The changes better align the collateral sets with the policy objectives that they are designed to serve. For example narrow collateral, which is used to back the Bank's monetary policy operations, now contains only the highest-quality, most highly liquid securities, which will stay liquid in almost all scenarios.

The Bank is also planning to introduce a Single Collateral Pool (SCP) model to simplify the process for managing the collateral provided in the Bank's operations, with the aim of enhancing operational efficiency and reducing operational risk. At present many of the Bank's operations are 'repo' transactions where individual securities are held as collateral against the Bank's exposures to that participant. The proposed SCP model would aggregate a participant's collateral position, and lead to a significant reduction in the number of transactions needed to provide collateral to the Bank. After a positive consultation with counterparties in October 2010, the Bank is aiming to take forward implementation this year and next.

Asset Purchase Facility

Since its creation in January 2009, the Bank's Asset Purchase Facility (APF) has served two functions.

First, it provided a means for the MPC to relax monetary policy by purchasing assets financed by the creation of central bank reserves and hence injecting liquidity directly into the economy. Second, by acting as a backstop provider of liquidity, it provided a means to improve liquidity in secondary private credit markets, notably those for commercial paper and corporate bonds.

During the financial year 2010/11, there have been no further asset purchases on behalf of the MPC, although small-scale purchases and sales of private sector securities continued. The overall stock of assets purchased remained broadly unchanged, at close to £200 billion. The gilt-for-gilt lending scheme, introduced in August 2009 to avoid undue disruption to the gilt market and co-ordinated through the existing lending facilities of the Debt Management Office (DMO), also remained available to market participants.

Since the introduction of the commercial paper facility and the Secondary Market Corporate Bond Scheme, conditions in secondary credit markets have improved markedly. Spreads on commercial paper fell sharply, such that financing in the market became cheaper than selling paper to the APF. As a result, use of the scheme fell to zero, and the Bank gave notice on 15 November 2010 that the commercial paper facility would close twelve months later. At its peak in April 2009, the stock of commercial paper purchases had reached £2.4 billion. In November 2010 the Bank also announced the withdrawal of the contingent scheme to buy bank debt guaranteed by the Government. This scheme was announced in March 2009, but never called upon. Conditions in the sterling corporate bond markets also improved markedly after the introduction of the Bank's scheme, such that as of January 2010 the APF also offered to sell small quantities of corporate bonds as well as continuing to buy them. By 15 November 2010 conditions had improved sufficiently that the Bank announced it would change the scheme's reserves pricing to permit relatively more sales of bonds in the future. At the end of February, the corporate bond portfolio stood at £1.3 billion, down from its peak of £1.6 billion in June 2010.

In July 2009, the Bank announced the introduction of a Secured Commercial Paper (SCP) scheme. The objective of the SCP facility is to support the flow of credit to a broader range of UK companies than the other corporate APF schemes, by supporting the financing of working capital. The Bank announced the eligibility of an SCP programme on 15 November 2010, and the first transactions were made in early December.

The quarterly reports of the APF contain further details of all the transactions made.[3]

(1) www.bankofengland.co.uk/markets/marketnotice101130abs.pdf.
(2) www.bankofengland.co.uk/markets/marketnotice110211.pdf.
(3) www.bankofengland.co.uk/publications/other/markets/apf/quarterlyreport.htm.

Other liquidity insurance operations

The Special Liquidity Scheme (SLS), which was introduced in April 2008, exchanged commercial banks' high-quality illiquid collateral for Treasury bills, borrowed from the DMO. When the drawdown period for the SLS closed at the end of January 2009, £185 billion of UK Treasury bills had been lent under the SLS. Over 2010/11, commercial banks made steady progress refinancing their previously illiquid assets in the market, and hence repaying the bills lent under the SLS. By end-February 2011, £94 billion had been repaid. The Bank has continued to engage with commercial banks to ensure a smooth aggregate repayment profile running to the Scheme's expiry in January 2012.

In May 2010, following the re-emergence of strains in the US dollar funding markets, the Bank, in conjunction with the US Federal Reserve, the European Central Bank (ECB), the Bank of Japan, the Bank of Canada and the Swiss National Bank agreed to reinstate their US dollar liquidity lines, which had been suspended in January 2010. The swap lines provide a backstop for US dollar funding to UK banks and building societies should they require it. In December, the same group of central banks agreed to extend the term of the swap facility until 1 August 2011. As at end-February 2011, there had been no usage of the reinstated facility in the United Kingdom.

On 17 December 2010, the Bank announced that it had established a temporary reciprocal swap agreement with the ECB. This precautionary measure would enable the ECB to provide sterling liquidity to its counterparties if required. The Bank of England agreed to provide the ECB with sterling in exchange for euro up to a limit of £10 billion. The agreement expires on 30 September 2011.

4 – Financial stability

The Bank's strategic objectives for the year noted the Bank's 'enhanced role for financial stability': this referred not to the new Government's proposals, but to the changes made by the 2009 Banking Act and the 2010 Financial Services Act, which together gave the Bank a statutory objective of contributing to financial stability that included: responsibility for managing bank resolutions; involvement with the FSA in preparing Recovery and Resolution plans for banks; and statutory responsibility for oversight of payment systems. The Financial Stability Committee (FSC)(1) was created by the 2009 Banking Act to recommend to Court a financial stability strategy, to monitor the Bank's performance under it, and to keep under review the Bank's delivery of its new statutory responsibilities.

The Financial Stability Committee has thus overseen the Bank's financial stability work. This will change following the formation of the interim Financial Policy Committee in February 2011, as described on page 21.

The following paragraphs briefly review the major issues covered by the Bank during the year.

Surveillance and market intelligence

Sovereign strains in parts of Europe have been a key focus of risk surveillance work. Problems intensified in the autumn, leading to a financial support package for Ireland. Risks of contagion in Europe are likely to remain a key source of financial system risk. The Bank will be engaged in contributing to stability in the European Union through its membership of the European Systemic Risk Board.

Together, the Bank, HMT and FSA have been working to assess banks' liquidity positions and funding plans going forward. As part of this, senior Bank staff held a series of meetings with banks' treasurers on funding conditions and strategies, including their plans to unwind Special Liquidity Scheme collateral swaps. The Bank has also been liaising with the FSA to improve the data provided by banks.

Other surveillance themes have included signs of overheating in some emerging markets, ongoing strains in the balance sheets of some non-financial borrowers, including in the commercial property sector; and innovation in the exchange-traded fund market.

In terms of the processes supporting surveillance, the Bank concluded a Banking Sector Monitoring (BSM) project during the year. This provides an IT platform for analysing peer groups of institutions, drawing up regulatory returns, published accounts data and market-based indicators for over 200 institutions. The Bank also completed the Risk Assessment Modelling of Systemic Institutions (RAMSI) project. Subject to the limitations of all models, RAMSI will help the Bank to examine the potential impact of various stress scenarios on the UK financial system.

(1) Pages 4–5.

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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 two years, 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, Asia 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.

In late 2009, the IMF and FSB submitted a report for G20 finance ministers and central bank governors identifying information gaps revealed by the financial crisis. In a series of 20 recommendations, the report set out a strategy for filling these gaps. This work has progressed over the past year, with the Bank actively involved in several initiatives. These include work led by the FSB to expand the data available to macro and microprudential policymakers to monitor interlinkages between systemically important banks, and work led by the Committee on the Global Financial System to enhance the BIS International Banking Statistics.

Prudential policy

In Autumn 2010 Governors and Heads of Supervision agreed a new package of measures to strengthen the regulation of bank capital and liquidity — Basel III. The Bank contributed towards securing this agreement. The new framework includes a significant increase in the loss-absorbing capital requirements for banks, including a countercyclical buffer that can be varied to maintain bank resilience throughout the credit cycle. Basel III also introduces international liquidity rules for the first time, requiring banks to hold a buffer of high-quality liquid assets to enable them to survive short-term funding and liquidity shocks and promoting greater use of stable funding such as retail deposits and long-term wholesale funds. The new requirements are to be implemented over an extended transition period to enable banks to build strength gradually and not cut back on lending.

In addition, in Autumn 2010, the G20 leaders agreed a high-level plan from the Financial Stability Board for systemically important financial institutions, including that they should carry greater loss-absorbing capacity than the Basel standard and need to be resolvable through reform to resolution regimes and cross-border co-operation. The Financial Stability Board also published principles on reducing reliance on external credit ratings and started work on shadow banking. The Bank contributed actively across the FSB's work, in particular chairing the FSB's work on enhanced resolution regimes and the use of rating agency ratings.

Infrastructure policy

The new statutory framework for oversight of payment systems was introduced on 31 December 2009. In March 2011 the FSC approved the first *Payment Systems Oversight Report*(1) since introduction of the new regime: this set out the work undertaken by the Bank to implement the statutory framework for oversight under Part 5 of the Banking Act 2009 and the main developments in individual systems. The *Report* also set out areas where, in the Bank's view, further measures are needed to reduce potential systemic risks, including around tiering, payment arrangements for central counterparties (CCPs), contingency arrangements and governance.

The Bank has played a role in promoting the resilience of market infrastructure, including through its involvement in the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO). A key dimension of this relates to strengthening the standards required of central counterparties, which are becoming increasingly important for clearing trades.

Special Resolution Regime and crisis management

The Special Resolution Unit (SRU), which was established in February 2009, enables the Bank to fulfil its responsibilities for resolving distressed UK banks and building societies under the Special Resolution Regime (SRR) introduced in the Banking Act 2009. Over the past year, the SRU has worked closely with the FSA, HM Treasury and the Financial Services Compensation Scheme (FSCS) in relation to cases where contingency planning has been required and more generally with stakeholders to ensure it is ready to implement a resolution if needed.

(1) www.bankofengland.co.uk/publications/psor/psor2010.pdf.

During the past year the SRU has been involved in developing proposals for enhancing the SRR, in particular in relation to widening its scope and augmenting its toolkit with possible bail-in options (which would allow a going-concern restructuring of a failing bank with shareholders and uninsured creditors exposed to losses). The SRU has also contributed to HM Treasury proposals to establish new insolvency arrangements for investment firms, and the Investment Bank Special Administration Regime Regulations came into force on 7 February 2011. In addition, the SRU helped to draft changes to the SRR Code of Practice (which supports the legal framework of the SRR and provides guidance as to how the SRR tools will be used), the revised version of which was published in November 2010.[1]

In relation to cross-border matters, senior SRU staff have maintained a regular dialogue with resolution authorities in other countries and have participated in various workstreams proposed by the FSB, chaired by the Deputy Governor for Financial Stability, including working within the Crisis Management Groups, with the FSB's Cross-Border Crisis Management Working Group. The SRU has also contributed to developing a joint response by the UK authorities to the European Commission's January 2011 consultation on an EU framework for cross-border crisis preparation and management.

The Financial Services Act 2010 requires the FSA, in consultation with the Bank, to produce rules requiring firms to produce Recovery Plans and to provide information enabling the authorities to draw up Resolution Plans. Reflecting its role as resolution authority and in light of its statutory financial stability objective, the Bank has a particular interest in the Resolution Plan element of RRPs. This will be an emphasis going forward.

Financial Stability Report and communications

The six-monthly *Financial Stability Report (FSR)* provides the Bank's current assessment of risks to UK financial stability and its views on the wider policy reform agenda. This year's *FSR*s shifted to a more macroprudential focus. Going forward, further changes to the structure will be implemented as the *FSR* becomes a communication channel for the FPC.

The December 2010 *Report* noted that banks had made progress in building their resilience, including in refinancing their debt and raising capital buffers. It discussed rising risks to financial stability from sovereign strains, as well as more medium-term risks, such as an emerging search for yield and latent distress in balance sheets of some overextended borrowers. Against that backdrop, the *Report* argued that banks should build resilience, but gradually through retention of earnings, which could be helped by restraint on payouts to shareholders and staff. The *Report* also presented the results from a survey of senior executives and risk managers, to identify the key sources of risk to the UK financial system. Over the past year the Bank started to step up its communication on financial stability issues outside London. There were presentations of the *FSR* in Leeds and Edinburgh, and regional visits by Andrew Bailey and Andy Haldane.

5 – The new regulatory regime

In June 2010 the Chancellor announced the Government's intention to bring about changes in the regulatory regime. These were outlined in more detail in consultation documents in July 2010 and in February 2011. The Bank will have statutory responsibility for protecting and enhancing the stability of the financial system and — in contrast to the present regime — will have the necessary powers to do so. Macroprudential powers will be vested in a Financial Policy Committee — a Committee of the Bank's Court but with independent members appointed by the Chancellor. Microprudential regulation will be the responsibility of a Prudential Regulation Authority, created as a subsidiary of the Bank, chaired by the Governor and with its chief executive a deputy governor of the Bank.

Conduct and market regulation will be the responsibility of the Financial Conduct Authority, the successor of the FSA. The Bank will also have direct powers to regulate clearing and settlement systems. Legislation should be introduced later this year, with a view to the new system becoming operational in early 2013. The Bank, working closely with the Treasury and the FSA, is actively preparing to take on its new responsibilities.

Interim FPC

The Government envisages that the FPC will contribute to the Bank's financial stability objective by identifying, monitoring, and taking action to remove or reduce,

(1) www.hm-treasury.gov.uk/d/bankingact2009_code_of_practice.pdf.

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systemic risks with a view to protecting and enhancing the resilience of the UK financial system. Anticipating the new legislation, and to prepare the ground, at the Government's request the Bank's Court has established an interim FPC, which will undertake, as far as possible, the forthcoming statutory FPC's macroprudential role. An important initial task will be to undertake preparatory work and analysis into potential macroprudential tools. The Government's consultation document states that the interim FPC 'will play a key role in the development of the permanent body's toolkit by sharing its analysis and advice on macroprudential instruments with the Treasury, to help inform the Government's proposals for the FPC's final macroprudential toolkit'.

Preparatory work has been under way to develop thinking on the macroprudential framework in terms of the objectives, instruments and transmission mechanisms. A new division has been created within the Financial Stability Directorate to help co-ordinate work for the FPC and to develop processes and outputs. This division will also co-ordinate the Bank's contributions to the newly formed European Systemic Risk Board, which is responsible for macroprudential oversight of the EU financial system and for which the Governor has been appointed first Vice-Chair.

The composition of the interim FPC's membership resembles closely that of the proposed statutory body. It is chaired by the Governor and includes both of the Bank's present Deputy Governors, Hector Sants (as future Deputy Governor for Prudential Regulation of the Bank of England and Chief Executive of the Prudential Regulation Authority); the Chairman of the Financial Services Authority, Adair Turner; the Bank's Executive Director for Financial Stability, Andy Haldane; and the Bank's Executive Director for Markets, Paul Fisher. The Chancellor has appointed three out of four external members to the interim FPC: Alastair Clark, a former Executive Director of the Bank for Financial Stability, Michael Cohrs, formerly of Deutsche Bank, and Donald Kohn, until recently Vice Chairman of the Federal Reserve Board.

There will also be two non-voting members of the interim FPC: the Chief Executive designate of the Financial Conduct Authority, Martin Wheatley, and a representative of the Treasury.

The Government's consultation document states that the interim FPC will meet at least four times a year and will publish a record of its formal meetings. It will also be responsible for the Bank's biannual *Financial Stability Report*, which from now on will explain the analysis behind the interim FPC's conclusions.

PRA

The Bank and the FSA have been working together to realise the Government's desire for the PRA to deliver a different style of regulation: in May the Bank and the FSA published a launch document describing the PRA's approach to banking supervision. A companion document covering insurance supervision was published in June.

The Board of the FSA has agreed a formal division of its organisation into a Prudential Business Unit, which is presumptively the core of the PRA, and a Conduct Business Unit which forms the core of the FCA.

The Bank and the FSA have formed a joint transition board to oversee the creation of the PRA as a subsidiary of the Bank: it reports to a steering group chaired by the Governor, and consisting of Paul Tucker, Hector Sants and Andrew Bailey.

It has been helpful that, during a period of reform, the IMF has this year been undertaking the second Financial Sector Assessment Programme (FSAP) for the United Kingdom. Its report will be published in the summer and will provide a critique of the UK financial sector and regulatory framework and recommendations to improve it.

6 – Banknotes and banking

Note circulation

The Bank is responsible for maintaining confidence in the currency, by meeting demand with good-quality genuine banknotes that the public can use with confidence. The average value of notes in circulation over the past year was £48.3 billion. Last year the Bank issued 936 million new notes and, at the year end, the number of Bank of England notes in circulation was 2.7 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 Bank of Scotland plc, G4S Cash Centres (UK) Ltd, Post Office Ltd, Royal Bank of Scotland plc and Vaultex UK Ltd. 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. During 2010 the Bank undertook a series of consultations with the cash industry on proposed reforms to the NCS. These resulted in a revised policy which will be implemented during 2011. The changes will not alter the structure of the NCS but should enhance the Bank's ability to influence the mix of denominations of notes entering circulation. In particular, they should support the increased availability and quality of the £5 denomination. The main ATM operators have committed to increase the annual outflow of £5 notes from ATMs to £2 billion in 2012.

Following a publicity campaign, and working closely with the cash industry, the Bank withdrew legal tender status from the Elgar £20 on 30 June 2010. The £20 note featuring Adam Smith is now the only £20 with this status. The Bank is developing a new £50 note featuring Matthew Boulton and James Watt to be launched later this year.

Counterfeits

During calendar-year 2010, 300,000 counterfeit Bank of England notes were taken out of circulation with a face value of £5.9 million; this represented a 48% fall on 2009. About 88% of these were taken out of circulation during machine sorting of notes by the members of the Bank's NCS. In 2010 around 12 billion banknotes were machine sorted in the NCS so that the share of counterfeit notes found in this total was 0.0024%. The equivalent figures for the previous three years were 0.0047% (2009), 0.0059% (2008) and 0.0027% (2007). The Bank continues to work closely with law enforcement agencies to detect and stop counterfeiting. Technical analysis suggests that organised criminal gangs are behind the vast majority of all counterfeits detected. During 2010, the police successfully disrupted three of the major sources; the police have also shut down a number of other smaller operations and achieved successful convictions. These were important developments and 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.
During 2010 the Bank set up a new voluntary framework for testing automatic cash accepting and processing machines. Model names of machines that pass our tests are published on the Bank's website. We encourage businesses to use only machines that have been proven to work against the latest counterfeit threats.

The Bank develops and circulates, 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 (a new version of which was released in 2010) and via computer-based training. Further details can be found on the Bank's website. These materials are supplemented by target training sessions for example for retailers and police forces.

Scottish and Northern Ireland notes

The Banking Act 2009 and its subordinate Scottish & Northern Ireland Banknote Regulations 2009 gave the Bank responsibility for regulating the note issuance of the seven commercial note-issuing banks in Scotland and Northern Ireland. The operational details of the regime are contained within the Scottish & Northern Ireland Banknote Rules, made by the Bank and approved by HM Treasury. The primary purpose of the regime is to provide enhanced protection for noteholders while ensuring that local banknote issuance can continue in accordance with long-standing tradition.

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. The Bank may impose financial penalties on institutions that do not comply with Regulations or the Rules. The Bank has a dedicated team and a governance structure to support this work.

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

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 100% of operating hours in 2010, compared with 99.99% in 2009. 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

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and the CREST delivery-versus-payment system — were £238 billion and £307 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 increase the liquidity efficiency of RTGS by introducing a Liquidity Saving Mechanism. Notwithstanding the strong track record of system availability, the Bank is also working with the industry to explore ways of further increasing the resilience of RTGS.

Banking strategy 2010/11

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. With this purpose in mind, the Bank has continued its withdrawal from providing government retail banking services. All remaining retail banking services were moved from the Bank to commercial providers in 2010, and the 'run off' period is expected to complete by end-May 2011, at which point the last residual government retail bank accounts will be closed.

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 2011, total assets held by the Bank as custodian were around £545 billion, of which £156 billion were holdings of gold. In addition the Bank will provide banking services to support the Bank's financial stability objectives.

7 – Organisational capacity

The Bank has continued developing its people and skills, as well as supporting processes, to help it carry out its core purposes.

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. New entrants are offered a comprehensive induction programme, in particular for the Bank's Initial Entry Scheme (generally A-level entrants) and the graduate intake. The first phase of a new Human Resources technology platform was introduced in August 2010 and completion of all phases, including a new recruitment tool, is expected by Summer 2011.

In 2011/12 the Bank will focus on implementing a comprehensive talent management strategy, covering career development, performance management and training. HR will lead this work and is planning extensive consultation with all areas of the Bank. The talent management strategy will be focused on giving staff the best opportunity to succeed, and developing those with exceptional talent to become effective leaders.

The Finance Directorate has continued to lead Bank-wide initiatives to improve the Bank's approach to organisational performance measurement, the reporting and management of operational risk, and to strengthen project management. Each Directorate has a framework setting out that area's objectives and plans and linking them to those of the organisation as a whole, and then tracking performance over time. New centralised risk systems have been implemented to enhance reporting to the Executive Team, ARCo and Court. Project management skills have also been enhanced, with a dedicated team of professionals managing the Bank's key projects including collateral management, as well as work to further rationalise the Bank's financial operations and accounting.

The past year has also seen the rollout of IT tools to enable collaborative working across the organisation. And further strengthening of the Bank's information assurance and IT security, which will continue over the course of 2011/12.

The Bank's priorities in 2011/12

The strategic priorities endorsed by Court for 2011/12 are:

Core Purpose 1 — Monetary Stability

Strategic Priority 1 Keep inflation on track to meet the Government's 2% target.

- Remain at the forefront of the theory and practice of monetary policy.
- Advance the Bank's understanding of the changing nature of the inflation process and the impact of unconventional monetary instruments.
- Develop understanding of the interface between monetary and macroprudential policy.
- Embed enhanced suite of models for forecasting and analysis.

Strategic Priority 2 Ensure the Bank has the policies, tools and infrastructure in place to implement monetary policy and issue banknotes.

- Have available appropriate instruments for implementing monetary policy, especially when Bank Rate is close to zero, and ensure that those policies are fully communicated.
- Be prepared to implement and communicate any future decision by the MPC to withdraw or expand the exceptional level of monetary stimulus.
- Meet demand for the required volume and denomination of banknotes efficiently and effectively.

Strategic Priority 3 Sustain public support for the monetary policy framework and the benefits of low inflation.

- Continue to make the case for inflation targeting and the framework for monetary policy, and anchor inflation expectations.
- Influence the international debate on monetary policy, and the international monetary system.

Core Purpose 2 — Financial Stability

Strategic Priority 4 Maintain stability and improve the resilience of the financial system.

- Identify systemic threats including from financial infrastructure, regulatory policies and international events.
- Integrate and develop market intelligence and analytical tools to improve the analysis of the stability and resilience of the financial system.
- Continue to develop the United Kingdom's resolution regime, including through a bail-in tool and through banks' recovery and resolution plans.
- Complete the deployment of the Bank's enhanced facilities for liquidity insurance.
- Manage the Special Liquidity Scheme to an orderly conclusion in January 2012.
- Influence domestic and international efforts to improve the structure and regulation of the financial system, including supporting HMT in the development of a new regulatory bill for submission to Parliament.

Strategic Priority 5 Develop the framework and instruments for the Bank's new role in macroprudential policy, operating through the Financial Policy Committee.

- Working with HMT, develop objectives, functions and possible instruments for macroprudential regulation in the United Kingdom.
- Provide effective secretarial, analytical and data support to the 'interim FPC'.
- Develop an effective interface between macro and microprudential regulation, including the role of market intelligence.
- Develop analysis on the functioning and regulation of the non-bank financial sector, including insurance.
- Support the Bank's membership and the work of the new European Systemic Risk Board.

Strategic Priority 6 Prepare for the transition to the Bank of responsibility for microprudential supervision (through the Prudential Regulation Authority) and infrastructural oversight.

- Design the new supervisory framework and the PRA's operating model, working closely with FSA.
- Undertake practical preparations for integrating the PRA into the Bank.
- Design an operational framework for the regulation of central counterparties and securities settlement systems.

Strategic Priority 7 Build and sustain public support for the micro and macroprudential frameworks.

- Promote public understanding of the role of FPC and PRA.
- Contribute actively to developing appropriate accountability mechanisms for FPC and PRA.

Supporting Core Purposes 1 and 2:

Strategic Priority 8 Ensure the Bank has the right people and processes to carry out its core purposes.

- Develop talent management and rewarding career paths for staff.
- Create a working environment that protects the time devoted to longer-term analysis and research in order to enhance the Bank's capability to achieve its core purposes.
- Foster a culture of creativity and challenge so that the Bank focuses on the big issues and risks.
- Maintain budget discipline and ensure value for money.
- Improve information assurance business practices and controls.
- Manage risks to the Bank's balance sheet and improve the efficiency of the framework for managing collateral.
- Communicate effectively to staff how micro and macroprudential supervision will be conducted and interact with monetary policy.

Strategic Priority 9 Promote public trust and confidence in the Bank's activities.

The Bank's priorities in 2011/12 continued

The strategy for the Bank's monetary stability mission

As the central bank of the United Kingdom, the Bank of England is committed to safeguarding public confidence in the nation's currency and its value in terms of what it will purchase. In so doing, it ensures that the currency can perform its dual role as a medium of exchange and a stable store of value, an essential cornerstone of a prosperous market economy and a necessary condition for the achievement of high and stable growth and employment.

An essential ingredient in public confidence in the currency is collective trust that the nation's banknotes are readily exchangeable. Counterfeits must be minimal. And the supply of banknotes must meet the public's demand for them at all times, including the appropriate mix of denominations and their physical integrity.

Public confidence in the currency also requires stability in its value. That is the task of monetary policy. The Bank of England Act 1998 delegates to the Bank's Monetary Policy Committee (MPC) the task of setting the Bank's policy rate — and other monetary instruments as required — in order to:

- maintain price stability, and
- subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

The exact definition of price stability is laid out annually by the Government; presently it is to achieve a CPI inflation rate of 2%. The Act also commits the Bank to operating an open and accountable policymaking regime, to explaining the decisions of the MPC transparently and to implementing them effectively in the money markets.

The present conjuncture is a challenging one for monetary policy. The global financial crisis and the associated deep recession left the UK economy with a substantial, albeit uncertain, margin of unused resources, though a recovery has begun. Inflation has been volatile, but has been well above the Government's target since the beginning of 2010, in part reflecting temporary influences. In order to secure the recovery and ensure that inflation meets the target in the medium term, the stance of monetary policy has been highly stimulatory, including through a programme of asset purchases. Judging, executing and explaining the appropriate stance of monetary policy over 2011/12 against that background represents a particular challenge. The business plan below reflects that challenge.

All areas of the Bank are involved in the Bank's monetary stability mission in some degree, but especially Banking Services, Markets, and Monetary Analysis and Statistics, supported by Central Services.

The following business plan will drive the Bank's work on maintaining monetary stability over the coming year and beyond:

Banknote issuance

- Continue to ensure the integrity of banknote supply and begin preparations for a tender of note printing.
- Implement planned changes to the Note Circulation Scheme and achieve targets for increased issuance of £5 notes.
- Launch new £50 note design containing additional security features, commence withdrawal of the Houblon note and consider adoption of improved resilience features in the £5 note.
- Complete the new note storage vault.

Analytical support to MPC decisions

- Maintain the high-quality support already provided through key outputs such as pre-MPC, the forecast round and analytical notes.
- Deepen analysis of the effects of asset purchases and other unconventional monetary instruments.
- Develop a more tractable and flexible economic model, incorporate it into the forecast process and give active meaning to the Bank's use of a 'suite' of economic models in that process.
- Continue to enhance the use of Agencies' and market intelligence in analysis of the conjuncture.
- Develop understanding of the interface between monetary and macroprudential policies, including incorporating the impact of the latter into the forecast.
- Build capacity to service future MPC needs through an appropriate research programme, and through the development and maintenance of key skills.
- Develop a culture in which staff are encouraged to think creatively about potential risks and to challenge conventional wisdom.

Implementation of monetary policy

- Prepare for winding down or increasing asset purchases as instructed by MPC or the Bank executive, and for a return to reserves averaging in the Sterling Monetary Framework (SMF).
- Complete transition to new arrangements for the SMF, including expansion in range of counterparties and widening of eligible collateral pool.
- Maintain the Bank's own pool of foreign currency reserves and manage the EEA according to the remit from HM Treasury.
- Rationalise and improve systems and processes supporting market operations, especially those related to new initiatives.

External engagement

- Continue advocacy of an inflation target and communication of the framework for monetary policy, including the use of unconventional policy instruments.
- Advance the explanation of monetary policy decisions by taking forward the conclusions of the communications review.
- Enhance the explanation of the Bank's framework for implementing monetary policy.
- Influence the external debate on monetary policy and the reform of the international monetary system.

Risks to delivery

The main risk to the delivery of this business plan relates to the recruitment and retention of sufficiently experienced staff who are able to exercise the necessary critical judgement in providing analytical support to MPC and implementing monetary policy. Another risk is that preparations for taking on the Bank's new responsibilities distract attention from the pursuit of monetary stability.

MPC and Court

The Court of Directors of the Bank has no locus of responsibility in regard to the monetary policy decisions of the MPC. NedCo does, however, have responsibility: for keeping the procedures followed by the MPC under review; for ensuring that the MPC collects the regional, sectoral and other information necessary to formulate monetary policy; and for ensuring that the Bank devotes appropriate resources in support of the MPC. To that end:

- The Bank's executive, liaising with the MPC when necessary, 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.

The Bank's priorities in 2011/12 continued

The 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 February 2011.

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. At present, those are 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 HMT and FSA 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.

At present, 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.

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

A number of areas of the Bank are involved in the Bank's financial stability mission and need to work together effectively, especially Banking Services, Financial Stability, Markets and the Special Resolution Unit.

The Government plans a major reform of the UK regulatory regime which will significantly increase and broaden the Bank's role and responsibilities for financial stability. The following plan, much of which relates to the transition, will drive the strategy for the Bank's financial stability mission in 2011/12.

Architecture

- Support HMT in developing a Bill for submission to Parliament, including a clear demarcation between Prudential Regulation Authority and Financial Conduct Authority responsibilities.
- Working with HMT, develop objectives, functions and possible instruments for the FPC's macroprudential mandate, and framework within EU to permit it.
- Establish interim FPC, with effective support.
- Develop a framework for effective interface between macro and microprudential regulation, including the role of market intelligence.
- Working closely with FSA, design the new supervisory framework and the PRA's operating model.
- Undertake practical preparations for integrating the PRA into the Bank.
- Undertake practical preparations to integrate oversight of clearing and settlement systems.
- Support the Bank's membership and the work of the new European Systemic Risk Board.
- With FSA and HMT, develop much better links in EU decision-taking bodies, enhancing contacts and level of representation.
- Review the structure and governance of the Bank's financial stability functions in the light of the reforms.

Surveillance of threats to stability

- Identify systemic risks and fault lines, including from financial infrastructure, regulatory policies and overseas systems.
- Integrate and develop market intelligence inputs to assessment of financial system risks, including framework for pursuing key action points.

- Develop assessments of the functioning and regulation of the non-bank financial sector and markets, including insurance and the Solvency II capital regime in particular.

Prudential policy
- Influence domestic and international efforts to improve the structure and regulation of the financial system.
- With FSA and international colleagues, prepare introduction of 'greater loss-absorbing capacity' for bank and non-bank systemically important financial institutions.
- Contribute actively to the fundamental review of Basel Accord capital requirements for banks' trading books.
- Contribute to FSB work on shadow banking and regulatory arbitrage.
- Encourage greater liaison between auditors and supervisors, and engage with key debates on accounting policies and their behavioural effects.

Infrastructure policy
- Deliver payment system oversight responsibilities.
- Working with FSA, decide on an operational framework for Bank oversight of central counterparties and securities settlement systems.
- Reduce credit and liquidity risks from excessive tiering in the wholesale payment systems.
- Review governance structures of key payment/market infrastructures.
- Contribute to international review of policy on trading platforms.
- Promote practices in key capital markets that underpin system stability.

Liquidity insurance and crisis management
- Complete the deployment of the Bank's enhanced facilities for liquidity insurance.
- Manage the Special Liquidity Scheme to an orderly conclusion in January 2012.
- Continue to develop the United Kingdom's resolution regime, including through a bail-in tool for the United Kingdom and in the EU.
- As part of international efforts, work with FSA to make banks' recovery and resolution plans realistic.
- Developing funding arrangements for deposit insurance that enhance stability and reduce moral hazard.
- Complete split-site working preparations for business continuity contingency planning.

Communication and stakeholders
- Adapt *Financial Stability Report* to establishment of interim FPC, and convey messages and policy implications more effectively to the market.
- Promote public understanding of the role of FPC, PRA and the wider Bank, including through the Agents.
- Contribute actively to developing appropriate accountability mechanisms for FPC and PRA.

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

- not yet 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 broadly 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 2010/11

Net expenditure on the Bank's policy functions in 2010/11 was £114.5 million, £7.9 million below the budgeted amount. Staff costs were lower than budgeted, with vacancies in some areas, and some project spending was deferred.

Remunerated functions generated net income of £13.7 million, above the forecast surplus position in the budget for 2010/11. That reflected higher income from banking services.

As in 2009/10, spending on the Bank's policy functions was higher than CRD income. The level of CRD income was £106.1 million in 2010/11, compared with a budget of £111.2 million, with the level of CRDs and market interest rates below budgeted assumptions. For a number of years prior to 2009/10, CRD income was in excess of policy spending.

Bank expenditure by function

£ millions	2009/10 Actual	**2010/11 Actual**	2010/11 Budget	2011/12 Budget
Policy functions				
Monetary policy	68.3	65.1	69.2	68.3
Financial stability	54.7	49.4	52.2	56.5
Information assurance(1)	–	–	–	2.5
Contingency reserve	–	–	1.0	1.0
Expenditure on policy functions	**123.0**	**114.5**	**122.4**	**128.3**
Remunerated functions				
Note issue	69.5	72.7	77.2	74.3
Government agency services	9.3	8.5	8.9	8.4
Payment and settlement	9.0	9.7	10.4	10.4
Banking services	30.2	28.2	29.9	28.6
Other functions	23.4	21.6	22.1	18.5
Information assurance(1)	–	–	–	1.8
Expenditure on remunerated functions	**141.4**	**140.7**	**148.5**	**142.1**
Legacy costs(2)	7.0	7.9	7.9	8.0
Total expenditure(3)	**271.4**	**263.1**	**278.8**	**278.4**

(1) Costs associated with the Information assurance programme, approved by Court to upgrade IT security, allocated between policy and remunerated functions.
(2) Pensioner benefits and interest on severance provisions.
(3) From the Bank's management accounts, net of recoveries; figures contain reporting differences to the statutory financial accounts, such as the inclusion of notional interest charges and the treatment of pensions.
Note: In addition, £1.5 million of costs were incurred in 2010/11 in relation to PRA Transition.

Financial review continued

Budget for 2011/12

The budgeted expenditure for the Bank's policy functions in 2011/12 is £128.3 million, 46% of the Bank's total expenditure by function, and has been set above the budget level for 2010/11 to take into account three main developments.

First, the 2011/12 budget takes into account resource requirements in respect of the Bank's new responsibilities arising from the Financial Regulation Bill, primarily to support the Financial Policy Committee.

Second, the budget allows for the carry forward of some underspend of investment in 2010/11 and additional investment deemed necessary to maintain the security of the Bank's IT systems.

And third, the Bank's risk management activities were stepped up during the financial crisis, to support a number of measures including the Special Liquidity Scheme (SLS). Although the SLS draws to a close in January 2012, the acceptance of a wider range of collateral in the Bank's sterling liquidity operations is now a permanent feature — one of the lessons of the crisis. The budget for 2011/12 allows that risk management activity to continue; a further increase in costs is anticipated in 2012/13. These additional costs are more than offset by income generated by changes to the Bank's operations.

After 2012/13, nominal spending growth of 2% per year, in line with the CPI inflation target, is assumed. It remains Court's policy to set budgets over time that imply no real increase in the Bank's policy costs.

The budget for 2011/12 takes into account a two-year pay freeze for staff earning more than £21,000 per year, consistent with the pay restrictions imposed on the rest of the public sector.

The forecast for CRD income contained in the budget for 2011/12 is £104.7 million, with income forecasts remaining sensitive to the future path of interest rates and growth in the level of CRDs.

Although the Bank's policy spending is expected to exceed CRD income in 2011/12, 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 Bank's working assumption is that the next formal review of the CRD scheme will be in 2012, effective from June 2013.

The projection for the Bank's remunerated functions in 2010/11 is for a surplus of £3.5 million. That is consistent with the Bank's objective for these activities to be broadly self-financing over the medium term.

The budget for 2011/12 includes proposals for £40.9 million of project-related expenditure in 2011/12, of which £20.7 million relates to additions to the Bank's fixed or intangible assets. A substantial portion supports the Bank's policy functions directly, such as the development of new economic models and data tools, including a start on those relating to the Bank's new responsibilities, or systems and processes for current and future requirements in implementing the Bank's policy operations. The remainder of the investment plan is mainly on IT systems and processes, and property and security.

Finally, the Bank is drawing up plans to establish the Prudential Regulation Authority and ensure an orderly transition for the FSA.

Proposals for major projects supporting the strategic priorities in 2011/12 include:

Strategic priority	Project	2011/12 budget £m	Total cost £m	Project completion
1. Keep inflation on track	New Forecast Platform (Compass)	1.1	2.8	2011/12
2. Policies, tools and infrastructure for monetary policy and banknotes	New Debden Vault	3.3	11.3	2012/13
	Markets Operations Review Phase 2	1.3	1.6	2011/12
4. Stability and resilience of the financial system	RTGS Liquidity savings mechanism	0.7	1.1	2012/13
8. Right people and processes	Collateral Operations	2.5	5.0	2012/13
	Information Assurance	3.0	5.9	2012/13
	Financial Operations Process & Accounting Project	1.2	1.9	2012/13
	T24 Banking Platform Upgrade	1.0	2.0	2012/13

Financial statements

The Banking Department's financial statements for the year ended 28 February 2011 are given on pages 48–93, and show a profit before tax of £132 million (2009/10: £231 million). After a tax charge of £5 million (2009/10: £37 million), the profit transferred to reserves amounts to £63 million (2009/10: £97 million). The amount payable in lieu of dividend amounts to £64 million (2009/10: £97 million), being half of the post-tax profit for the year.

The profits of the Banking Department have been elevated in past years as a consequence of the Bank's policy actions, and are now starting to return to pre-crisis levels.

The statements of account for the Issue Department (which are given on pages 94–96) show that the profits of the note issue were £475 million (2009/10: £491 million). These profits are all payable to HM Treasury. The level of Bank Rate is the main driver of the profits of the Issue Department.

Profit before tax

£ millions	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	**2010/11**
Banking Department	106	99	191	197	995	231	**132**
Issue Department	1,618	1,698	1,653	2,327	2,188	491	**475**

Banking Department balance sheet

The balance sheet of the Banking Department did not change significantly during the year, from £223.1 billion at 28 February 2010 to £229.6 billion at 28 February 2011.

The main change in the components of Banking Department assets was an increase in 'loans and advances to banks and other financial institutions', from £12.5 billion at 28 February 2010 to £17.6 billion at 28 February 2011.

There was a little more change in the composition of Banking Department liabilities. Deposits from banks and other financial institutions, mainly reserves balances, declined, from £169.9 billion at end-February 2010 to £154.4 billion at 28 February 2011. Deposits from central banks increased, to £13.8 billion at 28 February 2011 (2009/10: £11.4 billion), as did other deposits, to £50.0 billion (2009/10: £32.3 billion), reflecting increases in deposits from Bank of England Asset Purchase Facility Fund Ltd (BEAPFF) and from the Issue Department. The latter movement nets out in the consolidated balance sheet view (see overleaf).

At 28 February 2011, the Banking Department balance sheet contained £5.0 billion of liabilities associated with

Financial review continued

the management of the Bank's foreign exchange reserves (2009/10: £4.1 billion). In March 2010, the Bank launched a $2 billion three-year bond replacing the 2007 bond which matured on 22 March 2010; a further $2 billion bond was issued on 28 February 2011, replacing the 2008 bond which matured on 17 March 2011. 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) decreased to £2.4 billion at 28 February 2011 (2009/10: £2.6 billion), and capital and reserves increased to £4.4 billion (2009/10: £4.2 billion).

Excluding that part relating to the SLS, which is indemnified by HM Treasury, capital and reserves together with CRDs are predominantly invested in gilts and supranational sterling bonds. The Banking Department's holdings of gilt securities were £4.0 billion at 28 February 2011 (2009/10: £3.3 billion) and holdings of other supranational sterling bonds were £557 million (2009/10: £636 million).

Issue Department balance sheet

Banknote liabilities continued to increase year on year, and were £52.2 billion on 28 February 2011 (2009/10: £50.2 billion).

Gilt purchases on Issue Department, introduced in January 2008, remained 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 28 February 2011 (2009/10: £5.3 billion). The Ways and Means advance to HM Treasury remained at £370 million during 2010/11.

Reverse repos outstanding at 28 February 2011 were £10.2 billion (2009/10: £17.9 billion), and the Issue Department's deposit with the Banking Department, netted out in the consolidated balance sheet, was £36.3 billion (2009/10: £26.7 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 2011 is set out below. It is provided for information purposes only, to assist comparison with other central banks.

Summary combined balance sheet	**2011 £m**	2010* £m
Assets		
Ways and Means advance	370	370
Loans and advances	227,927	230,817
Securities held at fair value through profit or loss	4,752	4,085
Derivative financial instruments	314	361
Available for sale securities	10,258	9,699
Other assets	1,888	1,317
Total assets	**245,509**	**246,649**
Liabilities		
Notes in circulation	52,194	50,220
Deposits	182,000	187,029
Foreign currency bonds in issue	5,037	4,126
Derivative financial instruments	366	263
Other liabilities	1,489	774
Capital and reserves	4,423	4,237
Total equity and liabilities	**245,509**	**246,649**

*Comparative figures have been restated as outlined in note 2b on page 54.

In summary, the combined balance sheet decreased by £1.1 billion. The largest movement in assets was a decrease in 'loans and advances' by £2.9 billion, partly offset by small increases across other balance sheet categories. On the liabilities side, 'deposits' decreased by £5.0 billion, while 'notes in circulation' increased by £2.0 billion and other categories increased by £1.9 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 £47 million in April 2010 and £50 million in October 2010 in respect of the year to 28 February 2010. On 5 April 2011, the Bank paid the first payment of £26 million in respect of the financial year ended 28 February 2011, based on provisional full-year figures. The balance will be paid on 5 October 2011.

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 2011 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 2011 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 53–60.

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 the Bank's strategic priorities 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 compliance with the Bank's risk management and internal control requirements by the areas for which they are responsible. This attestation 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 Governors. For operational risk the Bank's risk policy and appetite is articulated in an overarching operational risk policy document, which is supported 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 and alerts Executive Team, Audit and Risk Committee (ARCo) and Court to any significant out-of-tolerance operational risk issues, and actions that are required to mitigate risks. 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 the Executive Team, ARCo 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 (ARCo): ARCo 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 Bank's risk profile, the operation of the risk framework and the risk management processes and systems in place in the Bank.

The Governors: The Governors approve key risk policies and 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 the ED Markets.

The Executive Team (ET): ET members are responsible for managing the risks within their Directorates (and for risk standards where applicable), 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, ARCo 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 ROU is responsible for providing senior management with the Bank-wide risk profile; the two key reporting outputs being the Quarterly Business Risk Committee Report to BRC and the Quarterly Risk Report to Executive Team, ARCo 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 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 (see overleaf for explanation of EEA) may have credit exposures and the establishment of eligibility criteria for assets taken as collateral.

Risk management and business practices continued

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 operational risk management 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 three years. The Risk Management Division in the Markets Directorate is responsible for the risk management of both sovereign and non-sovereign collateral accepted under the Special Liquidity Scheme, Discount Window Facility and long-term repo operations. Investments have been made in new systems to manage collateral. Projects to improve systems and processes will be completed in 2011.

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. ED Markets reports quarterly to HMT on major risks, incidents and control issues on the EEA.

Employees

At the end of February 2011 the Bank employed 1,613 full-time staff and 226 part-time staff; 1,763 of these staff were on permanent contracts, up from 1,721 as at end-February 2010. Since end-February 2010, 220 individuals joined the Bank and 284 left (including temporary staff). Of the staff recruited, 105 were recruited on permanent contracts, a decrease from 147 in 2010. Of these new permanent staff, 18 were new graduates (down from 31 the year before), 38 were experienced hires appointed to analytical and management roles (a decrease from 56 the year before) and 49 were appointed to clerical or non-technical roles (down from 60 the year before). The Bank is continuing to take steps to address its staffing requirements, in particular in respect of its 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. The proportion of women in senior roles stood at 28% at the end of February 2011, up from 25% at the end of February 2010. The proportion of staff from ethnic minority backgrounds was unchanged at 9%. Part-time staff constitute 12% of all Bank staff and 9% 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 with an improved rating of F and a score of 147, compared to 158 last year. A project to replace end-of-life heating and cooling plant at Head Office is drawing to a close and energy savings are starting to be realised. The Bank is in the process of gaining the Carbon Trust Standard for all its sites, having put preparations on hold for a period while assessing the impact of proposed changes to the Government's Carbon Reduction Commitment scheme.

The Bank's Head Office building was awarded the Corporation of London's Clean City Gold award for waste management in 2010. More than 99% (1,380 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 2010/11 the Bank contributed an estimated total of £670,000 in support of its community programme (2009/10: £641,000).

Cash donations totalled £385,000 (2009/10: £384,000):

- £55,000 to community organisations via the Staff Volunteering Award Scheme;
- £60,000 to charities supported by the Bank's Agencies;
- £25,000 to match staff fundraising for the staff charities of the year;
- £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;
- £92,000 made to partner charitable organisations and membership subscriptions;
- £5,000 for the David Sharp School Governor Awards; and
- £101,000 in donations to support academic research (2009/10: £110,000).

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 £285,000 in 2010/11 (2009/10: £257,000), of which £131,000 was for staff time involved in volunteering, civic duties or charity-related secondments (2009/10: £77,000).

No donation was made for any political purpose. No paid leave was granted to staff for political purposes in 2010/11 (2009/10: 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 12.5 in 2010/11 (2009/10: 9.9).

(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 has been 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: its conclusions, and the actions flowing from them, have been summarised in previous *Annual Reports*.

Although a further review would have been expected this year, in July 2010 the Governor informed the Committee that he wished to freeze his salary for two years; and subsequently, in line with Government policy for the public sector, Court decided that for the remainder of the executive group, and indeed the whole of the Bank, pay should be frozen for two years from 1 March 2011.

The Governor and the two Deputy Governors currently receive less pay than was recommended in the most recent review: this proposed a rate of £375,000 to £400,000 for the Governor, and £315,000 for the Deputy Governors, in all cases with smaller pension benefits. 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. He receives no pension benefit, his Bank pension having been fully accrued at the end of his first term. 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. They receive benefits in the Bank's Court pension scheme. That scheme, along with the Bank's final salary scheme for staff, is now closed to new members. Unless already a member of one of these schemes, any new member of the Executive is now appointed on the basis of joining the Career Average section of the Bank Pension Fund, which is the standard for all new entrants, or receiving a salary supplement of 30% in lieu of pension.

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 March 2010, the salaries of the Deputy Governors were increased by 2.5% from £252,497 to £258,809: they have since been frozen. The review for the Governor's salary was due on 1 July 2010; as noted above he chose to accept no increase. The Governor and the Deputy Governors do not receive bonuses.

Pensions

The Governor'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 of the Pension Fund, which allows members to achieve a maximum pension of 2/3rds at a normal pension age of 60 after 20 years service. This is 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 pension 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 2010/11** £	Total 2009/10 £
Governor				
Sir Mervyn King(2)	305,368	2,884	308,252	305,764
Deputy Governors				
Mr C Bean	258,809	2,179	260,988	254,292
Mr P Tucker	258,809	4,254	263,063	257,664
Non-executive Directors(3)	141,250	8,991	150,241	122,560
Total	**964,236**	**18,308**	**982,544**	**940,280**

(1) Includes the provision of facilities which give rise to a tax liability.
(2) The table excludes business-related, but taxable under HMRC rules, expenses of £7,205 (including tax).
(3) 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 £15,000 in 2010/11, and Paul Tucker waived remuneration from the FSA of £35,000.

Pension entitlements and accruals (including unfunded entitlements)

	Cash equivalent as at 28.2.10 £	**Cash equivalent as at 28.2.11** £	**Increase in cash equivalent** £	Accrued pension as at 28.2.10 £pa	**Accrued pension as at 28.2.11** £pa	**Increase in accrued pension** £pa	**Cash equivalent of additional pension earned during year ended 28.2.11** £
Mr C Bean	1,972,600	2,520,400	547,800	70,700	89,200	18,500	522,900
Mr P M W Tucker	3,017,100	3,656,600	639,500	110,800	132,600	21,800	602,900

The Deputy Governors' pension benefits are calculated using pensionable remuneration averaged over a three-year period, and so in each case reflect the impact of their promotions in 2008 and 2009 respectively. The cash equivalent for additional pension earned during year ended 28.2.11 is calculated using the assumptions adopted for the 2008 Pension Fund valuation, under which scheme liabilities were valued on an index-linked gilts yield discount rate and no credit is taken in advance for the possibility that returns on investments held by the Fund would exceed the long-term interest rate. This differs from the IAS 19 measure of pension liabilities where the discount rate assumption reflects the investment return on high-quality corporate bonds at the balance sheet date; had this been used the cash-equivalent values above would be lower. Further details on the valuation of pension benefits are provided in Note 18 to the Banking Department Financial Statements (pages 72–78).

Remuneration of Governors, Directors and MPC members continued

Other benefits

The Remuneration Committee also keeps under review other benefits available to the Governors. Medical insurances and health checks were the principal non-salary benefits received during the year to 28 February 2011.

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.(1) With effect from 1 June 2009, these rates were set at £15,000 per annum for Directors, £20,000 for Committee Chairmen 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 £101,362 in 2010/11. 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, and to require continued adherence to the MPC guidelines, which sets rules for public speaking and media contacts. 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.

(1) This function is delegated by Court to the Governor's Committee on Non-executive Directors' remuneration.

Executive Directors' pay

The table below shows the basic salaries and taxable benefits of the Executive Directors as at 28 February 2011.

	£
Andrew Bailey	202,429
Catherine Brown	209,133
Spencer Dale	187,733
Paul Fisher	187,733
John Footman	195,014
Andy Haldane	187,733
Warwick Jones	209,967
Graham Nicholson	179,375
Jenny Scott	166,642

In 2010/11 bonus payments were made to Executive Directors on an individual performance-related basis from a pool equivalent to 6% of Executive Directors' remuneration. The figures above exclude any entitlement to bonus.

In addition Executive Directors accrue pension in the final salary pension scheme or in the career average scheme depending on their date of joining. As an alternative to membership of the career average scheme, Executive Directors may take a salary supplement of 30%. The figures above exclude any salary supplements.

Other senior executives

The table below shows the remuneration ranges for all staff with remuneration in excess of £80,000, apart from those disclosed above. Consistent with recent disclosures in the public sector, the figures relate to 2010/11 and show the full-time equivalent salary and include base pay and any taxable benefit allowances, but exclude bonus and pension contribution. In 2010/11 bonus payments were made to staff on an individual performance-related basis from a pool equivalent to 6% of staff and other senior executive remuneration.

Remuneration range (£)	Number in range
160,000 – 169,999	1
150,000 – 159,999	3
140,000 – 149,999	3
130,000 – 139,999	6
120,000 – 129,999	21
110,000 – 119,999	13
100,000 – 109,999	19
90,000 – 99,999	35
80,000 – 89,999	68
Total	**169**

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. As explained on page 4, this is largely done through Court.

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. They are not involved with day-to-day decision making, but they do provide — beyond the statutory functions described above — an independent, informed and critical challenge to the Bank executive.

By and large such discussions take place in Court. However NedCo has met separately on two occasions: once to discuss performance against the Governor's personal objectives for the previous year and to review those for 2011/12, and once to discuss the proposed new regulatory arrangements and their implications for the Bank.

In approving the Bank's strategy for the coming year, Non-executive Directors stressed the importance of ensuring that policy and project management resources were adequate to deliver the new framework.

Following discussion between the Chairman of Court and the Governor both achievements by the Governor against his 2010/11 personal objectives and his agreed personal objectives for 2011/12 were reviewed by NedCo.

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.

The Bank's performance in relation to its strategy and objectives is reviewed on pages 14–24 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 2010/11.

Reviewing financial management

The Bank's budget for 2011/12 is discussed on page 32. 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.

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.

Court will take particular interest in 2011/12 in ensuring that the transition of the FSA's present microprudential responsibilities to the proposed Prudential Regulation Authority proceeds to time and to budget.

Audit and Risk

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. During the past year the Audit and Risk Committee considered strains to organisational capacity, including those arising as a consequence of the Bank's planned new responsibilities and the establishment of the PRA. The Committee also focused on the need to strengthen information assurance and IT security, as well as 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 2010/11, and this is reported in the 'Risk management and business practices'

Report by the Non-executive Directors continued

section of the *Annual Report* (pages 36–39) which, so far as appropriate, forms part of NedCo's report. During the past year, the Committee also oversaw the retender of the Bank's external audit contract, resulting in the re-appointment of KPMG.

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 2010/11 is set out on pages 40–42 and, so far as appropriate, forms part of this report.

Attendance

The table on page 45 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.

Attendance	Court (7)	NedCo (2)	FSC (8)	Audit & Risk (4)	RemCo (4)
Sir David Lees	7	2	8	4*	4
Mr Barber	6	2	–	–	4
Sir Roger Carr	7	2	–	–	4
Lady Rice	6	2	–	4	–
Lord Turner	7	2	–	–	–
**Mr Horta-Osório	7	2	–	4	3
Mr M Tucker	6	2	6	3	–
Mr Stewart	6	2	7	4	–
Mr Young	6	1	8	–	–
Sir Mervyn King	6	–	8	–	–
Mr Bean	6	–	8	3*	–
Mr P Tucker	7	–	8	4*	–

* Attendance as an observer.
** Resigned 28 February 2011 following his appointment as Chief Executive Officer of Lloyds Banking Group plc.