# Annual Report 2012

BANK OF ENGLAND

# Bank of England Annual Report 2012

Presented to Parliament by the Chief Secretary to the Treasury by Command of Her Majesty

ISSN 1467-016x
Printed by Park Communications Limited

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 on page 1 was endorsed by Court in May 2012.

**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.

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

In under a year from now the Financial Services Bill is likely to have become law. If so, the Financial Policy Committee will have been given statutory powers of direction in the macroprudential sphere, while the Prudential Regulation Authority (PRA), a subsidiary of the Bank, will be established in Moorgate as the Bank's microprudential arm, and the Bank itself will have statutory responsibility for central counterparties and settlement systems.

Within the Bank and the Financial Services Authority, work continues to prepare for these organisational changes — the transfer of staff, new premises, the extension of the Bank's IT estate — and, most importantly, to refine and implement the new, focused and judgement-led regulatory approach that is intended to distinguish the PRA from its predecessor.

The PRA will add about 1,300 full-time equivalent staff to the Bank's current establishment of some 1,800, and will substantially increase our consolidated operating budget. None of us on the Court underestimates the management challenge involved, both operationally around the point of transition, and subsequently as the Bank seeks to realise the benefits of integration.

The Financial Policy Committee (FPC) has been established on an interim basis as a committee of Court and has now held 4 quarterly policy meetings. It has made a number of specific recommendations to the regulators and to the banks, and has also made recommendations to the Treasury on the powers that it should be given when it achieves its final, statutory form as envisaged in the Financial Services Bill.

The growing size and authority of the Bank, and the effectiveness of its governance has been a topic of serious debate over the past year. Most notably, the Commons' Treasury Committee, after a number of hearings, published a review of the 'Accountability of the Bank of England'. This recommended that Court should keep both the FPC and the Monetary Policy Committee (MPC) under active scrutiny, with access to meetings and papers and a mandate to report on performance and policy outcomes as well as procedures.

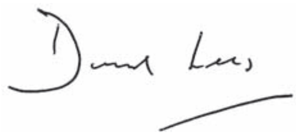
Court's response to the Committee was published in January. We proposed a non-executive Oversight Committee to keep the performance and procedures followed by the MPC and FPC under review. We felt that it would be wrong for the Oversight Committee itself to take a position on policy — the concern was rather to explore the way in which policy was made — but we nevertheless thought that commissioning independent experts to comment retrospectively on policy outcomes would be a way of challenging the Policy Committees and ensuring that lessons, where necessary, were learned. The proposed Oversight Committee would also become responsible for the functions currently undertaken by the existing Committee of Non-executive Directors (NedCo). Separately the Bank agreed a new 'crisis' memorandum of understanding with the Treasury; that is now reflected in the Financial Services Bill, as is the proposal, strongly supported by Court, that in future a Governor of the Bank should serve a single eight-year term.

The role of Court and the other Committees of Court and the Bank is detailed in pages 4–6 of this *Report*.

It is established practice for an annual review of the effectiveness of the board to be undertaken by the Chairman periodically. I have again conducted a review of the effectiveness of Court in the last year by carrying out interviews with each individual member of Court and summarising the results in a paper for collective discussion. This concluded that Court was operating effectively and proposed some action points for further improvement in 2012/13, including finding more time for strategic reviews and succession planning.

It was a pleasure to welcome Michael Cohrs as a member of Court in June 2011. Michael is also a member of the interim Financial Policy Committee. Brendan Barber was first appointed to Court in June 2003 and retires having served three terms. Mark Tucker, who subsequently became Group Chief Executive and President of AIA Group in Hong Kong, and Harrison Young, who is resident in Australia, were appointed to Court in June 2009 and their terms end in May 2012 and May 2014 respectively. For personal reasons Mark has not sought reappointment and Harrison decided to retire at the end of May. All three retiring members have served the Court with considerable dedication and I take this opportunity of thanking them for their service.

Readers of this *Annual Report* cannot fail to be struck by the significant amount of work that has been and is being undertaken by so many people in the Bank as we prepare to take on the additional responsibilities the Government plans to delegate to us. At a time when remuneration has been frozen for all staff it would be remiss of Court not to recognise in words that extra effort.



20 June 2012

# Foreword by the Governor

**Sir Mervyn King** Governor

The Bank is facing its biggest challenges for decades. We must pilot the economy through a period of recovery and rebalancing following the financial crisis and deep global recession. We must play our part in restoring to health an overextended banking system suffering because of its exposure to the euro area. And we must play a central role in implementing the reforms that are necessary to prevent such a costly financial crisis from happening again.

In the aftermath of the financial crisis, economic conditions over the past year remained difficult. Inflation was above the 2% target and peaked at 5.2% in September, boosted by increases in VAT, import prices and energy prices. It has fallen back as the effect of those temporary factors fades, although it remains above target. Wage growth has remained subdued and, as external price pressures ease, inflation should fall back to around the target next year.

Output, meanwhile, has been broadly flat through 2011 and remains significantly below its pre-crisis level. A gradual recovery and rebalancing is in prospect, but developments in the euro area — our largest trading partner — pose a significant threat to the outlook for the UK. Faced with temporary pressures pushing inflation above the target in the short term and subdued growth and higher unemployment threatening to push inflation below the target in future years, the Monetary Policy Committee (MPC) has had to strike a delicate balance. In October the MPC voted to resume its programme of asset purchases.

The Financial Policy Committee (FPC) is now up and running. Its most immediate concern has been the threat to UK banks stemming from events in the euro area. In response the FPC has urged banks to build capital levels to increase resilience, while supporting lending in the UK. The FPC has also published its view on what tools it will need in future to improve the resilience of the financial system, and so help limit the chance of future crises.

The uncertainty created by the problems in the euro area mean that banks face challenges of funding and liquidity, as well as capital. That is why the Bank set up and has now activated its Extended Collateral Term Repo facility and is working with the Treasury to provide funding for lending to households and firms. These measures will help provide our banks, and our economy, a bridge to calmer times.

Next year, HMT plans for the Bank to take statutory responsibility for the prudential regulation of banks and insurance companies. The transition of these functions to the Bank is an enormously challenging exercise. But we have made good progress. The nascent Prudential Regulation Authority (PRA) is taking shape within the FSA. And, in 20 Moorgate, we have secured a building that will allow the Bank and PRA to work closely together. Our key aim for the PRA is to change the culture of regulation away from box-ticking and towards judgement-based supervision, focusing on the big risks facing the financial sector. In that way we can make a vital contribution to preventing future crises, as well as reducing the cost of regulation.

We must carry out our new responsibilities with openness and transparency, and be held accountable for them to Parliament and the public, just as we are for monetary policy. The Bank's non-Executive Directors will play an important role by commissioning reviews — like those recently announced — to ensure we capture the lessons from our experiences.

Bank staff have had to grapple with the challenges of our expanding responsibilities while enduring the second year of a pay freeze. I remain extremely grateful for the contribution of each and every one of them. We recognise that only by retaining and nurturing the most talented among Bank staff and those staff transferring from the FSA can we hope to fulfil our responsibilities, new and old.

This year we have said goodbye to Jenny Scott, Executive Director for Communications. I am very grateful to Jenny for her huge contribution during an exceptional period. I am very pleased to welcome Nils Blythe as her replacement. I would also like to thank Hector Sants as he departs from his role as Chief Executive of the FSA. He contributed enormously to preparing the ground for the Bank to take responsibility for prudential regulation. The MPC bids farewell to Adam Posen. I would like to thank him for his outstanding contribution. We wish each of them well in their future roles.

The pace of change at the Bank shows no signs of slowing. But our rapid progress in taking on the Bank's new responsibilities shows that we are ready for the challenges ahead.

20 June 2012

# The Role of Court, its Committees and the MPC

The framework for governance and accountability is set by the Bank of England Act 1998, as amended. The Court acts as a unitary board of directors with executive and non-executive members; but the Non-executive Directors Committee also meets separately to keep the executive's performance under review.

## 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 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 Court as of 29 February 2012 are shown on pages 8–9. Three new members were appointed in May 2012: Bradley Fried, Tim Frost and Dave Prentis.

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, through the Financial Stability Committee, consulted about financial support for institutions.

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.

## 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, Michael Cohrs and Sir David Lees. The Committee's Report on Remuneration is on pages 44–46.

## Audit and Risk Committee (ARCo)

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 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 and Mark Tucker. The Deputy Governors, the Executive Director for Markets, Sir David Lees, the Finance Director, the Secretary, the Executive Director for Human Resources, the Head of Internal Audit and the external auditors normally attend the meetings of the Committee.

### 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 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).

The current Financial Services Bill contains clauses that would remove the statutory basis for the Committee. The functions would then revert to Court.

### Interim Financial Policy Committee

The interim FPC is a committee of Court, formed to carry out preparatory work and analysis ahead of the creation of the permanent FPC. It monitors developments affecting financial stability in the United Kingdom and internationally. The Committee will also 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. It reviews and approves the Bank's *Financial Stability Report*, which will set out its assessment and any recommendations that the Committee may have made. And it has made recommendations to the Treasury about the direction powers to be given to the permanent FPC.

The members of the Committee are: the Governor (Chairman); the two Deputy Governors; Lord Adair Turner, the Executive Chairman of the Financial Services Authority; Executive Directors of the Bank for Financial Stability and Markets; Andrew Bailey, the Head of the Prudential Business Unit of the Financial Services Authority; and four external members nominated by the Treasury — Alastair Clark, Michael Cohrs, Robert Jenkins and Donald Kohn. There are also two non-voting members: the Chief Executive designate of the Financial Conduct Authority Martin Wheatley; and a representative of the Treasury.

### 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 Role of Court, its Committees and the MPC

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 the Governors are set out on page 11. The responsibilities of the Executive Directors are set out on pages 12–13.

# The Court of Directors as at 29 February 2012


**Sir Mervyn King** Governor


**Charlie Bean** Deputy Governor


**Paul Tucker** Deputy Governor


**Sir David Lees** Chairman of Court


**Brendan Barber**


**Sir Roger Carr**


**Michael Cohrs**


**Lady (Susan) Rice, CBE**


**John Stewart**


**Mark Tucker**


**Lord (Adair) Turner**


**Harrison Young**

**Sir David Lees***
Chairman of Court
Appointed 1 June 2009.
Term expires on 31 May 2015.

- 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.
Retired 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
- Visiting Fellow of the Saïd Business School

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

- Chairman, Centrica plc
- Senior Adviser, KKR
- 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

**Michael Cohrs****
Appointed 21 June 2011.
Term expires on 31 May 2015.

- Member of the European Advisory Board of Deutsche Bank
- Non-executive Director, SurfCast Inc, USA

**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
- Non-executive Director, Big Capital Society
- Chairman, Edinburgh International Book Festival
- Non-executive Director, Scotland's Futures Forum
- Regent, Royal College of Surgeons, Edinburgh
- Fellow, Royal Society of Edinburgh

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

- Chairman, Legal and General Group plc

**Mark Tucker**
Appointed 1 June 2009.
Retired 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
- Member of IFCR's International Advisory Council

**Lord (Adair) Turner**
Appointed 20 September 2008.
Term expires on 31 May 2015.

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

**Harrison Young**
Appointed 1 June 2009.
Retired 31 May 2012.

- Chairman, NBNCo Limited
- Chairman, Better Place (Australia) Pty Limited
- Non-executive Director, Commonwealth Bank of Australia
- Board member of Financial Services Volunteer Corps

* Sir David Lees has indicated that he will retire from Court in December 2013.
** Michael Cohrs, a member of the Financial Policy Committee, was 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

**Nils Blythe** Executive Director Communications

**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

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.

# Management structure

**Stephen Brown** 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
- **Nils Blythe**
  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
  - **Andrew Gracie**
    Director Special Resolution Unit

# Organisation overview

## Monetary Analysis and Statistics

**Spencer Dale**
James Bell – Structural Economic Analysis
Gill Hammond – Centre for Central Banking Studies
Simon Price – Senior Adviser
Gareth Ramsay – Inflation Report & Bulletin
Mark Robson – Monetary & Financial Statistics
Fergall Shortall – International Economic Analysis
James Talbot – Monetary Assessment & Strategy
Robert Woods – Conjunctural Assessment & Projections
Tony Yates – Senior Adviser
Chris Young – Macro Financial Analysis

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
Andrew Hauser – 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.

## 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

**Andrew Gracie**
Peter Brierley – Resolution Policy

The Special Resolution Unit was created in February 2009. Reporting to the Deputy Governor for Financial Stability, 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

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.

## Central Services

**John Footman**
Alex Brazier – 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

**Nils Blythe**
Mark Cornelius – Public Communications & Information
Andrew Wardlow – Strategic Communications Adviser

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

## Internal Audit

Stephen Brown

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

# Review of 2011/12

The year has again been dominated by the Government's regulatory initiatives. The Financial Policy Committee has begun to operate on an interim, non-statutory basis, advising on the tools that it might be given by legislation, and making recommendations to the regulators. The project to establish the Prudential Regulation Authority (PRA) has made steady progress, both within the FSA, which has established a Prudential Business Unit, and in the Bank. And within the Financial Stability area preparations are under way to exercise new statutory powers in relation to central counterparties and settlement systems.

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 was above target over the course of the year, peaking at 5.2% in September, and necessitating four open letters from the Governor to the Chancellor under the requirements of the monetary policy framework. Past increases in the prices of energy and other imported goods and services contributed to above-target inflation throughout the year. In addition, the rise in VAT in January 2011 pushed the annual rate up considerably during 2011. Excluding these effects, prices would probably have increased at a rate below the 2% inflation target. Inflation had fallen to 3.4% by February 2012, in part reflecting the earlier increase in VAT having fallen out of the twelve-month comparison.

GDP grew at well below its long-run average rate, and was estimated to have contracted slightly in the fourth quarter of 2011. Consumption had been particularly weak, falling by an estimated 1.0% in the year to the fourth quarter, as the impact of higher energy and commodity prices and the rise in VAT squeezed households' real incomes. Unemployment picked up further in the fourth quarter, to 8.4% on the Labour Force Survey measure. Together with surveys of spare capacity within companies, this indicated a margin of slack in the economy.

Headwinds from tight credit conditions and the fiscal consolidation continued to weigh on the outlook for growth. The United Kingdom's external environment weakened markedly, as concerns about the indebtedness and competitiveness of some euro-area countries became more acute.

As the second half of 2011 progressed, the Monetary Policy Committee (MPC) judged that the outlook for the UK economy had worsened, increasing the risk that the strength of demand would prove insufficient to absorb the margin of spare capacity in the economy, and so causing inflation to undershoot the target. At the same time, the upside risk remained that the period of elevated inflation would persist for longer than the MPC expected. The MPC's best collective judgement was that the balance of risks to the medium-term outlook for inflation had shifted to the downside since the summer.

Against this backdrop, the MPC voted to increase the stock of asset purchases financed by the issuance of central bank reserves by £75 billion in October and by a further £50 billion in February, to a total of £325 billion. Bank Rate has been left unchanged at 0.5% since March 2009.

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.

### Foreign exchange reserves

The Bank holds foreign exchange reserves, which can be used by the MPC to intervene in the foreign exchange market in pursuit of its monetary policy objectives. Those reserves are financed through annual foreign currency bond issuance in the international capital markets. Since 2007, the Bank has funded the reserves by issuing an annual US$2 billion bond. Each bond has been issued with a three-year maturity, so at any one point in time, these liabilities have financed foreign currency assets of approximately US$6 billion.

Given their policy purpose, the proceeds from bond issuance are invested in high-quality sovereign bonds that trade in consistently deep and liquid markets, and are denominated in US dollars, euro and yen. These are the three most-traded currencies in the foreign exchange market and together account for the majority of the sterling effective exchange rate index. Currently, the holdings comprise nominal securities issued by the governments of France, Germany, Japan and the United States. The maturities of these securities broadly match the respective liabilities and any resulting mismatches are hedged for both interest rate and currency risk.

The Bank regularly reviews its reserve assets to ensure they meet their policy purpose. This requires ongoing assessment of the credit quality and liquidity of the Bank's sovereign bond holdings. For more details about the Bank's foreign exchange reserves portfolio, see page 194 of the Bank's 2011 Q3 *Quarterly Bulletin*.

### Support for the Monetary Policy Committee

The MPC is not a Committee of Court, but 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 quality of support they receive, and this is supplemented by meetings between the Chairman of Court and individual MPC members. The latest survey suggested that MPC members remained 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, a new central forecasting platform has been introduced; this includes a smaller, more tractable model which has simplified the forecasting process, allowing more time to be spent on analysing the underlying economic issues. Alongside the new smaller model, the platform has been developed to make it easier for insights from a broad suite of alternative economic models to be incorporated into the forecast process.

The Bank has continued to encourage its staff to bring a broad range of ideas to their analytical work, and to challenge the received wisdom, to ensure that a well-rounded view of the issues facing monetary policy is presented to the MPC.

During the year, the Bank's analytical support for the MPC focused particularly on: further research into the impact of quantitative easing (on which the Bank hosted an international conference in November); the prospects for the world economy and the relative strength of the channels through which events abroad may be transmitted to the UK real economy; the outlook for bank lending; the impact of the recession on the supply capacity of the economy and the associated margin of spare capacity; prospects for household spending; and risks to inflation expectations.

## Members of the Monetary Policy Committee

**Mervyn King** Governor

**Charlie Bean** Deputy Governor Monetary Policy

**Paul Tucker** Deputy Governor Financial Stability

**Ben Broadbent**[1]

**Spencer Dale**

**Paul Fisher**

**David Miles**

**Adam Posen**

**Martin Weale**

(1) Ben Broadbent began his term on 1 June 2011, replacing Andrew Sentance.

# Review of 2011/12 continued

In 2012/13 the Bank's analytical support for the MPC will remain focused on ensuring that the Committee 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 and production, global price pressures and inflation expectations.

The Bank will also continue to analyse the impact of quantitative easing, including the impact of the second round of asset purchases which started in October 2011.

In addition, work will continue into the nature and strength of any interactions and interdependencies between monetary and macroprudential policy tools.

## 2 – Market operations

The Bank's operations in the sterling money markets have two objectives stemming from its monetary policy and financial stability responsibilities — to implement the MPC'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 Bank's Asset Purchase Facility (APF) provides the MPC with an additional tool of monetary policy, by targeting the level of asset purchases financed by the creation of central bank reserves. 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)]

### Asset Purchase Facility

Since its creation in January 2009, the APF has served two functions. Its first function is to provide 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. Although the MPC has maintained the level of Bank Rate at 0.5% since March 2009, over the past year, it has announced two extensions to its asset purchase programme. On 6 October 2011, the MPC announced that the APF would purchase an additional £75 billion of gilts over a four-month period. That programme was completed on 1 February 2012. On 9 February 2012, the MPC announced a further £50 billion of gilt purchases, to be conducted over the three months to mid-May, taking the stock of asset purchases financed by the issuance of central bank reserves to £325 billion, up from £200 billion at the end of the 2010/11 financial year. In addition, the auction arrangements were adjusted slightly after the February meeting. This operational change was intended to help reduce the risk of undesirable frictions in the functioning of the gilt market arising from the concentration of the Bank's holdings of gilts in certain maturity sectors.

The second purpose of the APF is to improve liquidity in secondary private credit markets, by acting as a backstop provider of liquidity. During its existence, the APF has stood ready to transact in the corporate bond, commercial paper, secured commercial paper and guaranteed bank debt markets (ie bonds issued by banks under HMG's Credit Guarantee Scheme). The various schemes largely achieved their objectives during 2009 and 2010. There was no use of the commercial paper scheme during 2011 and it was closed on 15 November 2011. The corporate bond scheme continued to act as a backstop purchaser of bonds, but more bonds were sold than purchased. By the end of February 2012, the corporate bond portfolio stood at around £400 million, down from its peak of £1.6 billion in June 2010.

The Bank announced the eligibility of a secured commercial paper programme on 15 November 2010, and the first transactions were made in early December of that year. Only small amounts of paper were offered to the Bank during 2011, peaking at around £30 million. By the end of the financial year there were no holdings outstanding, although the Scheme remained open should any new programmes be submitted for eligibility. The quarterly reports of the APF contain further details of all the transactions made.[(2)]

### Sterling Monetary Framework

The Bank's Sterling Monetary Framework is designed to allow it to meet its objectives of implementing the MPC's decisions on Bank Rate, and providing liquidity insurance to the banking system without any conflict.

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. Since

(1) Available at www.bankofengland.co.uk/markets/Documents/money/publications/redbookdec11.pdf.
(2) Available at www.bankofengland.co.uk/publications/Pages/other/markets/apf/quarterlyreport.aspx.

then, all reserves balances have been remunerated at Bank Rate. It is the Bank's intention to reintroduce the reserves averaging system as and when monetary conditions normalise. Those elements of the SMF designed to provide liquidity insurance to the banking system have remained in operation throughout.

The Bank offers a range of liquidity insurance facilities. The monthly indexed long-term repo operations (ILTRs) offer eligible counterparties three-month or six-month cash, via a competitive auction mechanism, against either the Bank's 'narrow' or 'wider' collateral sets.(1) As the degree of financial stress in the system increases, the auction permits allocation of a higher proportion of the funds against the wider collateral set.(2)

The Bank also stands ready to provide 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 covered bonds, as well as (since April 2011) portfolios of unsecuritised 'raw' loans. Over the past year, the Bank has been encouraging eligible counterparties to pre-position collateral in the DWF, to ensure that they are capable of drawing on the facility at short notice, if required.

In December 2011, in the face of strains in financial markets and uncertainty around the outlook for a number of indebted sovereigns in the euro area, the Bank augmented its liquidity insurance operations by introducing a new, Extended Collateral Term Repo (ECTR) facility. Although it is a contingent facility, to be rolled out if and when market conditions warrant it, the ECTR is a permanent addition to the Bank's SMF, enabling the Bank to provide liquidity to the banking system as a whole against pre-positioned DWF collateral. No operations were conducted under the ECTR facility during the financial year. On 15 June 2012, the Bank announced that it would run regular ECTR auctions from 20 June, offering six-month sterling liquidity against collateral pre-positioned for use in the Bank's DWF.(3)

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 2011/12, commercial banks made steady progress refinancing their previously illiquid assets in the market, and repaying the Treasury bills lent under the SLS. The Scheme closed, with all drawings repaid, at the end of January 2012. The surplus of £2.3 billion from the Scheme was paid to HM Treasury on 5 April 2012 (see page 52).

### Foreign currency liquidity insurance

Alongside the Bank's sterling liquidity insurance operations, the Bank stands ready to provide foreign currency liquidity to the banking system, should it be required.

Following their reintroduction in May 2010, 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 has been offering US dollar liquidity in regular weekly operations, against the wider collateral set. Those operations provide a backstop for US dollar funding to UK banks and building societies should they require it. On 30 November 2011, following signs of stress in dollar funding markets, the group of central banks agreed to extend the life and reduce the cost of the swap facilities. As at end-February 2012, there had been no usage of the reinstated facility in the United Kingdom. But changes to the network of operations had succeeded in helping to reduce the costs of euro-dollar currency swaps in the market. In addition, the six central banks agreed to broaden existing arrangements by setting up a network of bilateral reciprocal swap lines, such that any one central bank would be able to provide liquidity to its banking system in any of the other currencies, if required.(4)

Since December 2010, the Bank has also maintained a temporary swap agreement with the ECB, to enable the provision of sterling liquidity to ECB counterparties if required, subject to a limit of £10 billion. During the year, the term of the agreement was extended until September 2012. At end-February 2012, there were no outstanding transactions under this facility.

(1) 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 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.
(2) For more information, see Fisher (2011), 'Recent developments in the sterling monetary framework', available at www.bankofengland.co.uk/publications/Documents/speeches/2011/speech487.pdf.
(3) See www.bankofengland.co.uk/publications/Pages/news/2012/060.aspx for more details.
(4) See www.bankofengland.co.uk/publications/Pages/news/2011/138.aspx for more details.

## Review of 2011/12 continued

### Managing risk on the balance sheet

In November 2010, the Bank announced a new initiative which required greater transparency regarding residential mortgage-backed securities (RMBS) and covered bonds. Transactions which failed to meet those requirements would gradually become ineligible in the Bank's wider collateral pool. Over the past year, that has resulted in a significant increase in the quantity of publicly available risk management information, including loan-level data, transaction documents and cash-flow models, which should help facilitate and improve detailed analysis of these transactions by both the Bank and market participants alike.

In December 2011, the Bank announced that it would expand this transparency initiative, by setting similar requirements for transactions backed by commercial mortgages, SME loans and asset-backed commercial paper.[1] Those transparency requirements will come into effect on 1 January 2013.

The Bank is also now progressing work on the system which will be used to implement the Single Collateral Pool (SCP) model. The model will 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. The SCP is expected to be operational in 2013.

### Market intelligence

The Bank runs a market intelligence (MI) programme to support its core purposes of maintaining monetary stability and ensuring the resilience of the financial system. It provides an insight into the behavioural drivers underlying movements in financial market prices, can help fill in data gaps where reliable statistical information does not yet exist, and can provide an immediate read on emerging themes and risks.

MI is gathered through a continuous series of meetings and conversations between Bank staff and external contacts, to gather and analyse information from market participants. The Bank is uniquely positioned to run such a programme, given its public policy objectives, its own sterling and foreign currency operations, and its location within one of the world's foremost international financial centres. The Bank's external contact base is extensive, internationally diverse, and covers a wide range of markets.

Over the past year, the Bank's MI function has focused on a wide range of issues. That list includes: the financial market impact of the euro-area sovereign debt crisis; developments in bank funding markets, including the risks associated with complex and opaque bank funding instruments (such as collateral swaps, synthetic exchange-traded funds and structured notes) and the extent to which higher funding costs are being passed through to retail rates; the impact of the MPC's programme of asset purchases, on the gilt market and other asset markets more generally; the degree of banking sector dis-intermediation, including corporate access to the capital markets; developments in the UK commercial mortgage-backed securities market; and the role of high-frequency trading in foreign exchange markets. The resulting insights have provided valuable information for both the MPC and the interim FPC in their policy deliberations.

## 3-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 £54.4 billion. Last year the Bank issued 977 million new notes and, at the year end, the number of Bank of England notes in circulation was 2.83 billion.

The Bank of England's direct involvement in wholesale processing and distribution is limited to the issue of new notes, withdrawing notes superseded by new designs, and the authentication and destruction of notes that are no longer fit for circulation. The wholesale distribution and circulation of Bank of England banknotes is managed under the Note Circulation Scheme (NCS) which promotes the processing and distribution of notes by the commercial sector. To make this arrangement economically viable, the NCS allows its members (commercial banks, cash-in-transit companies and the

(1) See www.bankofengland.co.uk/markets/Documents/marketnotice111220.pdf for more details.

Post Office) to hold notes in custody for the Bank within their network of cash centres. The rules of the NCS are framed to minimise the risks to the Bank that arise by virtue of allowing the custody of its notes to be held in this way by commercial organisations, and to promote efficiency in the distribution and processing of notes in a way that meets the demands of cash users.

In October 2011, following industry consultation, the Bank implemented reforms to the NCS. Although these reforms did not alter the structure, they were designed to enhance the Bank's ability to influence the mix of denominations of notes entering circulation, in particular, to support the increased availability and quality of the £5 denomination. During the past year, the main ATM operators increased the outflow of £5 notes to a level consistent with the Bank's target of £2 billion of £5 notes being issued into circulation from ATMs in 2012.

On 2 November 2011, the Bank of England began issuing a new-style £50 note featuring Matthew Boulton and James Watt on the reverse. The note design incorporates a range of new and enhanced security features including a motion thread featuring images of the £ symbol and the number 50 which appear to move and switch when the note is tilted.

### Counterfeits

During calendar-year 2011, 374,000 counterfeit Bank of England notes were taken out of circulation with a face value of £6.3 million. About 90% of these were taken out of circulation during machine sorting of notes by the members of the Bank's NCS. In 2011 around 13.4 billion banknotes were machine sorted in the NCS, so the total number of counterfeit notes as a share of the total number processed was 0.0028%. The equivalent figures for the previous three years were 0.0024% (2010), 0.0047% (2009) and 0.0059% (2008). The Bank continues to work closely with law enforcement agencies to detect and stop counterfeiting.

Organised criminal gangs are behind the vast majority of all counterfeits detected. During 2011, the police successfully disrupted or shut down a number of operations and achieved several 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 2011 the Bank further developed its 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.(1) Businesses are encouraged 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, including information about the new £50 note. Information is also provided on the Bank's website, in leaflets and posters, in a short film and via computer-based training. These materials are supplemented by targeted training sessions, for example for retailers and police forces.

### Scottish and Northern Ireland notes

The Bank has responsibility for regulating the note issuance of the seven commercial note-issuing banks in Scotland and Northern Ireland. 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.

Under the Regulations, the Bank is required to publish at least annually a report on the discharge of its functions. This report and other information about the Regulations are available on the Bank's website.

### RTGS

The Bank's Real Time Gross Settlement (RTGS) platform was available for 100% of operating hours in 2011, as also achieved in 2010. The average daily payments values in the two main payment and settlement systems which use the RTGS platform — the CHAPS high-value sterling payment system and the CREST delivery-versus-payment system — were £249 billion and £322 billion respectively. The RTGS platform is also used for the settlement of a range of deferred net settlement systems — Bacs, Cheque & Credit Clearing, Faster Payments and Link — with an aggregate daily settled value of £3.9 billion.

(1) See www.bankofengland.co.uk/banknotes/Pages/retailers/framework.aspx.

## Review of 2011/12 continued

RTGS's principal purpose is to eliminate interbank credit risk in the sterling payment and securities markets. The Bank has recently begun development work on a project to increase the liquidity efficiency of RTGS by introducing a Liquidity Saving Mechanism and is working with the CHAPS settlement bank community to ensure its smooth introduction in Spring 2013.

Notwithstanding the strong track record of system availability, the Bank has been considering means to enhance its resilience further. In July, the Bank entered an agreement with SWIFT to develop an additional contingency facility which would operate in the event that the Bank's existing facilities simultaneously failed. The new facility is planned to be available from 2014.

### Banking operations

The Bank's customer banking strategy focuses on those banking activities that enable the Bank to fulfil its responsibilities as the central bank of the United Kingdom. That involves providing wholesale banking services to Government, acting as banker to other central banks, financial infrastructure companies and certain other financial sector firms on a case-by-case basis. Over the past year, the roll-off period for the retail banking services previously provided to Government by the Bank completed.

As part of this strategy the Bank also provides custodial services for a range of customers. As of 29 February 2012, total assets held by the Bank as custodian were £684 billion, of which £197 billion were holdings of gold.

## 4 – Financial stability

As part of its proposed reform of the UK regulatory system, the Government intends to establish a Financial Policy Committee (FPC) with statutory responsibility and powers to 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. In February 2011 the Court established an interim FPC to undertake, as far as possible, the future body's role. The work of the interim FPC is discussed in more detail on pages 22–24.

The Bank has undertaken work in a range of areas to support the FPC and, more broadly, to discharge its financial stability responsibilities.

### Surveillance and market intelligence

Sovereign and banking risks emanating from the euro area were the most significant and immediate threat to UK financial stability in 2011. In the second half of the year, market concerns about the sustainability of government debt positions broadened from smaller economies to some large euro-area economies. Surveillance of risks has included detailed intelligence on market developments and bank funding instruments.

While the direct exposures of UK banks to sovereign debt of the most vulnerable economies were limited, exposures were larger to the private sectors of some of the weaker euro-area countries. UK institutions were also exposed to German and French institutions, which in turn had large exposures to weaker euro-area countries. UK banks had taken significant steps to improve their resilience since the height of the financial crisis. But progress on building capital and funding resilience in the UK banking sector slowed in the latter part of 2011 as the environment deteriorated and the outlook for profitability worsened. Fears increased that this could lead to a renewed tightening in credit conditions for borrowers, against a backdrop of still weak growth of lending by UK banks, particularly to small businesses.

In addition to the MI gathered in the Bank's Markets area (see Section 2), other surveillance themes have included: an assessment of bank forbearance and associated provisioning practices in relation to lending to the household and corporate sectors; the stability of banks' funding models; cross-border capital flows between advanced economies; the resilience of key foreign banking systems and their interlinkages to the UK financial system; developments in the international flow of funds; and bank performance indicators and incentive structures.

In developing processes to support surveillance, the Bank has operationalised its new Risk Assessment Modelling of Systemic Institutions (RAMSI) system to help examine the potential impact of various stress scenarios on the UK financial system. In particular, the toolkit was used in the 2011 IMF review of the United Kingdom under its Financial Sector Assessment Program.

Progress has continued on a number of international and domestic data initiatives which support surveillance and policy work. The Bank continued to contribute to work by the Financial Stability Board (FSB) to establish a common data template for globally systemically important banks (G-SIBs) to help authorities address the data gaps in systemic risk assessment identified during the crisis. The Bank also participated in international work by the Committee on Payments and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) on data reported to trade repositories on OTC derivatives and associated work to create a common, global standard for identifying all legal entities trading in financial markets. These initiatives should improve the capacity of macroprudential authorities to map the financial network. Domestic initiatives have included work to identify the data needed to implement potential macroprudential tools. In addition, as part of preparatory work to integrate the PRA into the Bank, consideration was given to how the Bank's Banking Sector Monitoring (BSM) tool could be used by the PRA and Bank to improve both peer group review of institutions and analysis of regulatory data.

**Prudential policy**

In September 2011, the Basel Committee on Banking Supervision (BCBS) agreed a framework for strengthening the loss-absorbing capacity of globally systemically important banks (G-SIBs). The Bank contributed significantly towards securing this agreement. The new framework specifies an assessment methodology for identifying G-SIBs and sets out a schedule of additional capital requirements, depending on a bank's systemic importance. These standards are a key ingredient of the policy framework to tackle the 'too-big-to-fail' problem.

Throughout 2011, the Bank contributed to ongoing BCBS work to finalise outstanding elements of the Basel III package to raise capital and liquidity requirements. While the focus of BCBS work has been shifting from policy development towards implementation of international standards, key areas of prudential policy reform remain in progress, including a fundamental review of capital requirements against trading book exposures, work related to large exposures and capital requirements against central counterparties.

In Europe, 2011 saw the start of the process for translating the Basel III package into European legislation. The draft Capital Requirements Regulation (CRR), together with the Capital Requirements Directive (CRD), will implement Basel III in European Union law. At its September 2011 meeting, the Financial Policy Committee judged that the maximum harmonisation approach embedded in the CRR risked fundamentally impeding its ability to meet its proposed statutory objective. The Bank, in collaboration with HM Treasury and the FSA, has worked to mitigate that risk, while also ensuring that the internationally agreed Basel III minimum standards are implemented faithfully in Europe. The maximum harmonisation approach is also embedded in other European legislation, such as the European Markets and Infrastructure Regulation (EMIR) and the forthcoming Markets in Financial Instruments Regulation (MiFIR).

2011 also saw the establishment of the new European Supervisory Authorities (ESAs) as well as the European Systemic Risk Board (ESRB). Andrew Bailey, the Head of the Prudential Business Unit of the FSA, is a member of the Management Board of the European Banking Authority (EBA). The Bank is a voting member of the ESRB; the Governor is also the first Vice-Chair of the ESRB. The Bank has actively contributed to analytical and policy work of the ESRB. In particular, the Bank chaired an expert group assessing risks from EU banks' US dollar funding, which led to related policy recommendations by the ESRB. The Bank also contributed to ESRB work to develop guidelines for macroprudential policy frameworks, which led to the ESRB Recommendation to Member States on the macroprudential mandate of national authorities.

The Bank has also been closely engaged with the policy reform agenda of the FSB. In collaboration with other international standard setting bodies, the FSB has been developing recommendations to strengthen the oversight and regulation of the shadow banking system, including work on securities lending and repo markets.

**Infrastructure policy and payment system oversight**

The Bank has participated in international work to improve the robustness and transparency of derivatives markets. That has included contributing to the development of new international standards for central counterparties (CCPs) and other financial market infrastructures (FMIs) by the CPSS and IOSCO. The Bank is also working within the CPSS and IOSCO on resolution arrangements for FMIs. The derivatives market reforms will result in greater use of central clearing, increasing the importance of establishing effective resolution arrangements for CCPs. In March 2012, the Deputy Governor for Financial Stability, Paul Tucker, was appointed Chairman of the CPSS.

In April 2012, the Bank published its *Payment Systems Oversight Report 2011*.(1) This described the Bank's conduct

(1) Available at www.bankofengland.co.uk/publications/Documents/psor/psor2011.pdf.

## Review of 2011/12 continued

of payment systems oversight over the previous year and identified the most significant risks to financial stability from payment systems of systemic importance to the United Kingdom. The implementation of a number of reforms required by the Bank has reduced the potential for systemic problems to arise in some important areas — for example, enhancements to the default arrangements for Bacs have established rules to enable completion of settlement in the event of even severe member defaults. Work is also under way to reduce the potential systemic risks from tiering in the payment arrangements of central counterparties and in governance and contingency arrangements for systemically important UK payment systems.

### Special Resolution Regime and crisis management

A key objective has been further development of the UK resolution regime, including through a bail-in tool and through banks' recovery and resolution plans.

The Special Resolution Unit (SRU) was established in February 2009 for 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. The Investment Bank Special Administration Regime Regulations, which established insolvency arrangements for investment firms and are operated by the FSA, subsequently came into force on 8 February 2011. Over the past year, the SRU has worked closely with the FSA, HM Treasury and the Financial Services Compensation Scheme 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.

In relation to cross-border matters, SRU staff maintain a regular dialogue with resolution authorities in other countries and have participated during the year in various workstreams under the auspices of the Financial Stability Board (FSB). The FSB's Key Attributes of Effective Resolution Regimes (Key Attributes) were agreed by G20 leaders in November 2011; the SRU is currently engaged in the implementation of these recommendations which require the preparation of resolvability assessments, recovery and resolution plans, and cross-border co-operation agreements for the 29 globally systemically important financial institutions (G-SIFIs) identified by the FSB.

The SRU has also been involved in developing proposals for enhancing the SRR, in particular in relation to widening the scope to non-banks and to 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), in order to ensure that the Bank has at its disposal the range of resolution powers set out in the Key Attributes. The forthcoming EU Directive on recovery and resolution should provide an opportunity to make these enhancements.

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 statutory responsibility as resolution authority, the Bank has a particular interest in Resolution Plans.

### 5 – The new regulatory regime

In June 2010 the Chancellor announced the Government's intention to make substantial changes to the UK regulatory system. These were outlined in further detail in consultation documents in July 2010 and February 2011 and in a White Paper in January 2012. The proposals were that the Bank will be given 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. The FSA's present responsibilities for microprudential supervision will be passed to the Bank and become the responsibility of the PRA, 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 remain with the FSA, to be renamed the Financial Conduct Authority, which will remain separate from the Bank. The Bank will, however, have direct powers to regulate clearing and settlement systems.

A Financial Services Bill was introduced to Parliament on 26 January 2012. It proposes that legislation should be enacted later this year, with a view to the new system becoming operational in early 2013.

### Interim FPC

As noted above, the Government envisages that the FPC will contribute to the Bank's financial stability objective by identifying, monitoring, and taking action to remove or to reduce systemic risks, with a view to protecting and enhancing the resilience of the UK financial system. Anticipating the new legislation, at the Government's

## Members of the Interim Financial Policy Committee


**Sir Mervyn King** Governor


**Paul Tucker** Deputy Governor Financial Stability


**Charlie Bean** Deputy Governor Monetary Policy


**Andrew Bailey**


**Alastair Clark**


**Michael Cohrs**


**Paul Fisher**


**Andy Haldane**


**Robert Jenkins**


**Donald Kohn**


**Lord (Adair) Turner**

request the Bank's Court established an interim FPC in February 2011 to prepare for, and to a degree undertake, the forthcoming statutory FPC's macroprudential role. The FPC has held four policy meetings to date. These have been preceded by briefing sessions at which staff from across the Bank and FSA have updated the Committee on current market, economic and regulatory conditions and meetings to discuss key issues. The FPC has issued a range of recommendations, including on UK bank capital levels, balance sheet management, disclosure, forbearance and on the need for flexibility in EU regulatory policy legislation. The decisions of the FPC, together with its analysis, are published in the *Record* of its policy meetings and in the *Financial Stability Report*, as discussed on page 27.

An important task for the FPC has been to undertake preparatory work and analysis into potential macroprudential tools. The Government's consultation papers requested that the FPC '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'.

# Review of 2011/12 continued

In December 2011, a discussion paper on macroprudential tools was issued for comment.

In March 2012 the FPC issued advice to HM Treasury on the set of tools over which it believes it would need statutory directive powers to meet its proposed responsibilities. It advised that the statutory FPC should initially have powers of direction over: (i) the countercyclical capital buffer, which would act as a time-varying buffer over and above minimum bank capital requirements; (ii) sectoral capital requirements, through which financial institutions' capital against exposures to specific sectors could be varied over time; and (iii) a leverage ratio, which would allow for the setting of a maximum ratio of total liabilities to capital and variation in that maximum over time.

**PRA transition**

Under the new regulatory regime, the PRA will be responsible for the microprudential supervision of over 2,000 firms, of which around half will be deposit-takers and certain investment firms, with the remainder insurers.

Since the Government's announcement in 2010, work has been under way to prepare for the integration of supervision into the Bank (more information is included in the box on page 25). Part of this work involves the FSA internally splitting into a Prudential Business Unit and a Conduct Business Unit — so-called 'internal twin peaks'. This will give the opportunity for work to begin in shifting the supervisory approach of the FSA towards the PRA model.

**Transition of CCP/SSS supervision**

Under the new regulatory regime, the supervision of central counterparties (CCPs) and securities settlement systems (SSSs) will become the responsibility of the Bank. In combination with the Bank's existing statutory responsibility for the oversight of payment systems, this will bring together the supervision of all systemically significant post-trade infrastructure within the Bank. The Bank has been working closely with the FSA to ensure the smooth transfer of supervisory responsibility. The Financial Services Bill introduces a range of powers and, if necessary, potential sanctions over CCPs and SSSs that will be available to the Bank to ensure it can effectively fulfil this responsibility. The Bank intends to publish a paper during 2012 setting out its proposed approach to the supervision of CCPs and SSSs.

## PRA transition

### PRA vision for supervision

In 2011 two documents were published to explain the high-level principles that the PRA would use to supervise banks and insurance companies, focusing on the importance of using forward-looking, risk-based judgement in supervision.

The PRA's role will be to contribute to the promotion of the stability of the UK financial system. It will aim to promote the safety and soundness of regulated firms, and will meet this objective primarily by seeking to minimise any adverse effects of firm failure on the UK financial system and by ensuring that firms carry on their business in a way that avoids adverse effects on the system. As recognised in its statutory objective, it will not be the PRA's role to ensure that no PRA authorised firm fails. That responsibility lies with each firm's management, board of directors and shareholders.

During 2012 the Bank, together with the FSA, will publish an update on the work carried out and further details on the new supervisory process.

Following announcement of the Government's proposed changes, a Transition Steering Committee, chaired by the Governor, was formed to consider the strategic decisions required for the PRA to provide effective forward-looking, judgement-based supervision.

Across the Bank and the FSA there are a number of projects being undertaken jointly to deliver the vision for the PRA that the Bill sets out.

### Changes to supervision in 2012

On 2 April, the FSA began operating in 'internal twin peaks'; this change split the FSA into a Prudential Business Unit, which is presumptively the core of the PRA, and a Conduct Business Unit which will become the Financial Conduct Authority.

The purpose of the change was to begin the delivery of, as far as is possible, a model that will mirror the future supervision of the PRA from 2013. It also allowed the organisation an opportunity to begin to ensure that effective interfaces between the two future authorities are in place for dealing with responsibilities that have an impact on both, for example, the authorisation of a new institution.

### Change programme

As well as changes to the supervisory model, a joint programme of work is being undertaken by the Bank and the FSA on the practical implications of the planned changes to regulation, and how the PRA will operate as part of the Bank when it is established in early 2013.

The PRA's physical location will be important in linking prudential supervision of individual financial institutions (the responsibility of the PRA) to the monetary policy, market operations and financial stability functions of the Bank, including the Special Resolution Unit and the macroprudential regulation of the financial system as a whole. The benefits to be gained from strong links between these functions mean that locating PRA staff close to the rest of the Bank is highly desirable.

The PRA will be able to draw on the Central Services of the Bank, including Communications, Finance, HR, Internal Audit, IT and Legal, to maximise efficiency benefits. The Bank's firm intention continues to be that prudential regulation will operate in the future at a lower real cost than it does now as part of the FSA.

The Bank is also looking ahead at how to continue to transform the supervisory approach over the coming years. Part of the programme includes work on developing changes to how the PRA collects data and uses IT to support its supervisory approach, for delivery in the early years of the PRA.

# Review of 2011/12 continued

### 6 – Communication

Effective communication of the Bank's work is important both in implementing the Bank's monetary and financial stability policies and in ensuring that the Bank is accountable for its decisions. For these reasons, during 2011/12 the Bank has developed its approach to communications further, with a view to maintaining public trust both in the monetary and financial stability policy framework and in the Bank's own effectiveness.

The MPC has continued to publish the minutes of its monthly policy meetings. Its quarterly *Inflation Reports* are accompanied by press conferences, which allow the MPC's decisions and judgements about the outlook for the economy and inflation to be explained in more detail. When the MPC decided at its October 2011 meeting to increase the size of the Asset Purchase Facility, the Governor gave broadcast interviews to several media outlets on the day of the decision, and all the members of the MPC gave interviews in the succeeding months to explain the move.

During the visit by the MPC in October 2011 to the North West, the fourth such annual regional visit by the Committee as a whole, the Governor and several other MPC members gave speeches and media interviews. Indeed, all MPC members have given published speeches, to explain their approach to monetary policy issues. MPC members have also undertaken a total of 55 visits outside Greater London in 2011/12, meeting with the Bank's Agents' business contacts and other organisations to explain monetary policy and to pick up intelligence regarding regional business conditions. The Bank's Agents themselves have continued to play an important role in the communication of monetary policy across the United Kingdom. In addition, during 2011/12, two further 'Monetary Policy Roundtable' conferences were held with economists from a range of private sector institutions, academia and public sector bodies, with summaries of discussions published on the Bank's website.

## 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

**Juliette Healey**
Yorkshire & The Humber

**Frances Hill**
Northern Ireland

**Chris Piper**
Central Southern England

**Rosie Smith**
North East

**John Young**
North West

The Bank's launch of its new £50 note in November 2011 was accompanied by several media interviews by the Bank's Chief Cashier and the Head of the Bank's Notes Division, to build awareness of the new note, including its security features.

Regarding financial stability communications, the *Financial Stability Report (FSR)* was published twice during 2011/12 — for the first time under the guidance of the FPC. These *Reports* set out the Committee's assessment of the outlook for the stability and resilience of the financial sector. New chapters were added to explain the policy actions that the Committee advised to mitigate risks to stability and, from December 2011, to review progress in their implementation. The publication of each of these *Reports* was accompanied by a press conference, which allowed for the FPC's assessment and advice to be set out in more detail. The FPC's inaugural *FSR* was also accompanied by a number of print and broadcast media interviews to raise public awareness of the work of the Committee.

Alongside the *FSR*, the Committee published *Records* of each of its quarterly policy meetings. In quarters in which there was no *FSR*, the FPC issued a press statement outlining the decisions it had taken. In December 2011, the Bank published for comment a discussion paper on instruments of macroprudential policy.

Members of the FPC and other senior Bank staff working on financial stability have held extensive discussions with market participants and other contacts to explain and discuss current financial stability developments and key aspects of the reform agenda to business and other contacts. This has included several visits to financial centres outside London, including Birmingham, Edinburgh, Glasgow, Leeds, Manchester and key financial centres internationally. FPC members and other Bank staff have delivered several formal speeches on aspects of financial stability. In November 2011, the Bank also began regular publication of results of a *Systemic Risk Survey*, which seeks to quantify and track, on a biannual basis, market participants' perceptions of systemic risks. Specifically on microprudential regulation, the launch in 2011/12 of the two documents which explained the high-level principles that the PRA would use to supervise banks and insurance companies was accompanied by two conferences, in which a wide range of industry practitioners and other interested parties took part. Senior Bank staff working on PRA transition gave a number of speeches on microprudential regulation.

A key mechanism for transparency and accountability are parliamentary hearings. The Bank's Non-executive Directors, the Governor, other members of the MPC, FPC and senior Bank staff were present at a total of fifteen parliamentary hearings during the year. Of those, fourteen 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*, a one-off hearing on quantitative easing, an appointment hearing for an MPC member, appointment hearings for four FPC members, a hearing on the *Financial Stability Report* and two hearings for the Committee's report on 'Accountability of the Bank of England'. Given the Government's proposals for reform of financial regulation, the Governor and senior Bank staff also attended one hearing specifically on financial regulation, and also appeared in front of the Joint Committee of the Draft Financial Services Bill. In addition, the Governor, in his role as first Vice-Chair of the European Systemic Risk Board, appeared at the European Parliament's Committee on Economic and Monetary Affairs.

Enhancing public understanding of the Bank's role across all its functions was a key priority for 2011/12. As well as the approach and activities described in the sections above, the Bank established a new unit in its Public Communications and Information Division to lead a campaign to build and strengthen the constituencies for monetary and financial stability. The Bank also extended its use of social media channels via the web to promote public understanding of its work. In addition, the Bank continues to provide information and learning resources through its museum, website and schools' programme. The Bank's museum attracted over 116,000 visitors in 2011/12, an increase of over 9% from the previous year and a record number since it opened in 1988. 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 twelfth year in 2011/12 with 284 schools and colleges taking part.

# Review of 2011/12 continued

### 7 – Organisational capacity

The Bank has continued to develop 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. Ensuring the Bank can attract and retain talented individuals is essential in meeting its core purposes.

During 2011/12 considerable emphasis was placed on talent management, including a comprehensive career development framework, succession planning for senior roles, and a greater emphasis on diversity and inclusion initiatives in recruitment and career advancement.

In 2012/13 the Bank will continue implementing its talent management strategy, with a comprehensive review of its overall career model, performance management and promotion processes, in preparation for the expansion of the Bank in 2013. HR will lead this work and is planning extensive consultation with all areas of the Bank. It will also introduce central banking leadership training for senior executives.

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. Centralised risk systems support reporting to the Executive Team, ARCo and Court. A dedicated team of professionals is in place to manage the Bank's key projects including collateral management and information assurance. Further work to rationalise the Bank's financial operations and accounting is in progress.

# The Bank's strategic priorities in 2012/13

## The strategic priorities endorsed by Court for 2012/13 are:

*Core Purpose 1 — Monetary Stability*

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

- Respond effectively and decisively to the evolving risks posed by the European debt crisis in order to ensure that inflation remains on track to meet the inflation target.
- Advance the Bank's understanding of the evolving macroeconomic environment and the impact of unconventional monetary instruments.
- Understand and communicate the interface between monetary and macroprudential policies.
- Exploit the new suite of models in forecasting and analysis.

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

- Implement further asset purchases as required by the MPC and stand ready to undertake sales.
- Be prepared to reintroduce reserves averaging framework if required.
- Meet demand for the required volume and denomination of banknotes efficiently and effectively, including preparations for the 2012 London Olympics.

*Core Purpose 2 — Financial Stability*

Strategic Priority 3 Maintain stability and improve the resilience of the financial system.

- Influence domestic and international reform, including (with HMT) the new UK regulatory bill.
- Continue to develop the EU and UK resolution regimes, including through a bail-in tool and, with the FSA, through banks' recovery and resolution plans and a regime for CCPs.
- Develop the contribution of market intelligence to policy debates.
- Review the Bank's contribution to financial system business continuity planning.

Strategic Priority 4 Deliver macroprudential policy, operating through the Financial Policy Committee.

- With HMT and FSA, influence the international framework for macroprudential regulation, including through the European Systemic Risk Board.
- Support FPC in developing recommendations to HMT on instruments for macroprudential regulation.
- Develop an effective interface between macro and microprudential regulation, including turning FPC measures into PRA and FCA actions.
- Develop analysis on the functioning and regulation of the non-bank financial sector, including insurance and assessing 'regulatory perimeter' issues.

Strategic Priority 5 Complete the transition of microprudential supervision and infrastructure oversight.

- Prepare to implement the new supervisory framework and the PRA's operating model.
- Develop the operational framework for the oversight in the Bank of central counterparties and securities settlement systems.
- Establish effective co-operation with the Financial Conduct Authority.

*Supporting Core Purposes 1 and 2:*

Strategic Priority 6 Build and sustain public support for the Bank's governance and for its monetary policy, macro and microprudential frameworks.

- Work to support appropriate accountability mechanisms for the Bank, including parliamentary scrutiny, with clear roles for Court and its sub-committees.
- Actively explain the Bank's governance and activities.
- Continue to make the case for inflation targeting and the monetary policy framework, including through new media.
- Influence the international debate on monetary policy, and the international monetary system.
- Develop a constituency that supports financial stability and the aims of macro and microprudential regulation.
- Promote public understanding of the role of FPC and PRA.

Strategic Priority 7 Ensure the Bank has the right people and processes to carry out its core purposes — in particular during this period of transition.

- Complete practical preparations for integrating the PRA into the Bank, including the IT and data collection infrastructure for both 'Day 1' and steady state.
- Prepare enhanced central services to provide support across the Bank, including the PRA.
- Implement findings of the efficiency review of Banking Services and ensure ongoing budget discipline and value for money.
- Implement talent management and rewarding career paths for staff, and conduct a strategic pay review.
- Ensure that the Bank focuses on the big issues and risks by fostering a culture of creativity and challenge and protecting the time devoted to longer-term research.
- With HMT and FSA, complete the five-yearly review of the Bank's CRD funding and agree the PRA's future funding model.
- Improve resilience of IT system security.
- Identify areas where Heads of Division and other senior Bank staff can assume more responsibility, and delegated authority, from the Bank Governors and Directors.
- Maintain the highest level of risk management across all the Bank's activities.
- Exercise financial control to keep expenditure within budget and obtain value for money.

The Bank's strategic priorities in 2012/13 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, such as asset purchases — 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 Chancellor of the Exchequer in the annual *Budget* statement; presently it is to achieve a CPI inflation rate of 2%. The framework recognises, however, that inflation will depart from the target because of shocks and disturbances and that in such circumstances attempts to hold it there would lead to undesirable volatility in output. The MPC's aim is therefore to set policy so that inflation is brought back to the target within a reasonable time period but without creating undue instability in output. 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 remains a challenging one for monetary policy. Inflation was well above the Government's target during 2010 and 2011 but has begun to fall back as the effect of temporary influences, such as last year's increase in VAT and energy prices, drop out of the calculation. Towards the end of 2011, heightened financial tensions and signs that output growth was slowing at home and abroad raised the likelihood that inflation would undershoot the target in the medium term and prompted the MPC to re-start its programme of asset purchases. Judging, executing and explaining the appropriate stance of monetary policy over 2012/13 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 to 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 and availability of banknotes, particularly in the context of the Olympics.
- Continue preparations for the tender of note printing in 2013.
- Conclude planned changes to the Note Circulation Scheme and assess whether actions to increase the availability and quality of £5 notes have been successful.
- Prepare for the withdrawal of the Houblon £50 note.
- Identify denomination and provisional timetable for issuance of the next new note.
- Undertake analysis of the long-term demand for, and distribution of, cash.

### 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, ensuring that it is well targeted at the needs of MPC members.
- Deepen analysis of the effects of asset purchases and other unconventional monetary instruments.
- Exploit fully the new 'suite' of economic models in forecasting and policy analysis.
- Further develop understanding of the interface between monetary and macroprudential policies, including incorporating the impact of the latter into the forecast.

- Enhance capacity to service future MPC needs through an appropriate research programme, and through the development and maintenance of key skills.
- Guard against 'group think' by being open to external analysis and fostering a culture of creativity and challenge.

### Implementation of monetary policy

- Implement further asset purchases as instructed by MPC and the Bank's executive, and stand ready to undertake asset sales.
- Be prepared for a return to reserves averaging in the Sterling Monetary Framework.
- Look for potential cost savings in the management of the EEA.
- Continue to 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.
- 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

Key risks are:

- The reputational consequences of inflated public expectations of what monetary policy can achieve in the face of a continuing adverse economic environment.
- An inability to recruit and retain sufficiently experienced staff able to exercise the necessary critical judgement in providing analytical support to MPC and implementing monetary policy.
- Preparations for taking on the Bank's new supervisory and macroprudential responsibilities distract attention from the pursuit of monetary stability.
- The reputational consequences of ineffective implementation of monetary policy and/or poor management of the associated risks to the Bank's balance sheet.
- The reputational consequences of a failure to handle the special challenges posed by the Olympics to the distribution of banknotes.

### 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.
- Annually, the Executive Director for Monetary Analysis and Statistics, after consultation with the rest of MPC, will provide a report to Court on the adequacy of the support provided to the MPC by the Bank.
- The Chairman of Court will also meet annually with each of the members of MPC individually in order to identify any failings in the support provided or in MPC's processes.

The Bank's strategic priorities in 2012/13 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 2012.**

Under the Bank's Core Purposes, the Bank of England, as the central bank of the United Kingdom, is committed to doing everything within its powers to sustain financial stability.

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. Consistent with that, an interim Financial Policy Committee (FPC) has been established, and the Bank is working with FSA on the transfer of prudential supervision of deposit-takers, insurers and certain investment firms. But those changes have not yet been enacted. At present, the key statute remains the Banking Act 2009, which 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 currently 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;
- operating the Special Resolution Regime; and
- supporting the interim FPC, which can make recommendations to FSA on actions to sustain stability, and is asked to make recommendations to HMT on macroprudential instruments for the statutory FPC.

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 following plan, much of which relates to the transition to the new UK regulatory architecture, will drive the strategy for the Bank's financial stability mission in 2012/13.

### Architecture

- Support HMT in concluding Parliament's processing of the regulatory reform Bill, including encouraging the shift to judgement-based prudential supervision and a clear demarcation between Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) responsibilities.
- Working with HMT, FPC and the European Systemic Risk Board (ESRB), develop instruments for the FPC's macroprudential mandate, and an EU framework to permit it.
- Develop processes for turning FPC conclusions into implementable policies by PRA, FCA et cetera.
- Establish liaison with the Financial Reporting Council on matters potentially relevant to financial stability in general and the FPC in particular.
- Working closely with FSA, prepare to implement, including completing policies for, the PRA's supervising framework and operating model.
- Complete practical preparations to integrate oversight of clearing and settlement systems.
- Establish effective Bank co-operation with the Financial Conduct Authority, including finalising the PRA/FCA Memorandum of Understanding.
- Support the Bank's membership and the work of the new ESRB.
- Develop much better links with EU decision-taking bodies, co-operating with FSA/FCA and HMT.
- Review the structure and governance of the Bank's financial stability functions in the light of the reforms, which *inter alia* are likely to include the creation of an Oversight Committee of Court.

### Surveillance of threats to stability and analytical support for FPC

- Identify systemic risks and fault lines, including from financial infrastructure, regulatory policies and overseas systems.
- Develop assessments of the functioning and regulation of the non-bank financial sector and markets, including for structured advice to FPC on 'regulatory perimeter' issues.
- Develop the contribution of market intelligence to policy debates.

### Prudential policy

- Influence domestic and international efforts to improve the structure and regulation of the financial system.
- With FSA, the Basel Committee of Banking Supervisors (BCBS) and Financial Stability Board (FSB), contribute to implementing policy on 'greater loss-absorbing capacity' for domestic bank and non-bank systemically important financial institutions.
- Contribute actively to the fundamental review of Basel Accord capital requirements for banks' trading books and of use of internal models.
- Help to complete FSB work on shadow banking.
- Develop framework for advising FPC on accounting and disclosure policies relevant to stability, in particular provisioning.

### Infrastructure policy

- Deliver payment system oversight responsibilities, and especially reduction in risks from tiering in the wholesale payment systems.
- Working with FSA, decide on an operational framework for Bank oversight of central counterparties (CCPs) and securities settlement systems.
- With the settlement banks, deliver new governance structures of key payment/market infrastructures.
- Contribute to international policy on trading platforms.
- Promote practices in key capital markets that underpin system stability.

### Liquidity insurance and crisis management

- Work with HMT to implement the FSB Key Attributes for resolution regimes and a planned EU Directive, including through legislation for a bail-in tool.
- With FSB and the Committee on Payment and Settlement Systems (CPSS)/International Organisation of Securities Commissions (IOSCO), develop a resolution regime for CCPs and other financial market infrastructure.
- As part of implementing G20 policy, actively pursue work with FSA to produce realistic resolution plans for banks.
- Maintain efforts on developing funding arrangements for deposit insurance that enhance stability and reduce moral hazard.
- Review and reinforce Bank structures for contingency planning for financial sector resilience to a major operational disruption.
- To be able to provide liquidity to the market as required.

### Communication and stakeholders

- Contribute actively to developing appropriate accountability mechanisms for FPC and PRA, including identifying metrics of stability.
- Identify key stakeholders for FPC, and establish more effective communication.
- Promote public understanding of the role and mandate of FPC, PRA and the wider Bank, including through the Agents.
- Establish the *Financial Stability Report* and the Record of FPC meetings as key channels for communicating FPC decisions and analysis.

### 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*. Three immediate internal ones are:

- not having the statutory powers to engage directly with banks in preparing contingency plans for the exercise of the Bank's Special Resolution Regime responsibilities;
- 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 and to design the implementation of FPC decisions; and
- not having sufficient resources immediately available in the event of a sudden worsening of the crisis.

### 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.

- The 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.

Court will also plan the machinery to monitor the Bank's financial stability work, including determination of the terms of reference and reporting arrangements of the proposed Oversight Committee.

# 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 Bank of England Act 1998.

## Financial results in 2011/12

Net expenditure on the Bank's policy functions in 2011/12 was £120.6 million, £7.7 million below the budgeted amount. That reflected a combination of lower-than-budgeted staff costs and some deferrals in project spending. As vacancies that existed at the start of the year in some areas have gradually been filled, staff numbers have increased steadily, to end the year broadly in line with budgeted numbers.

On a management accounts basis, remunerated functions generated net income of £16.1 million, above the forecast surplus position in the budget for 2011/12. That reflected higher income from banking services.

As in 2010/11, spending on the Bank's policy functions was higher than CRD income. The level of CRD income was £99.2 million in 2011/12, compared to a budget of £104.7 million; both the level of CRDs and market interest rates were below budgeted assumptions. For a number of years prior to 2009/10, CRD income was in excess of policy spending.

The Bank's preparations for the creation of the Prudential Regulation Authority (PRA) continued in 2011/12. Programme costs of £14.7 million were expensed in the Income Statement during the year. There is provision within the new Financial Services Bill for the Bank to recover these costs.

**Bank expenditure by function[1]**

| £ millions | 2010/11 Actual | **2011/12 Actual** | 2011/12 Budget | 2012/13 Budget |
|---|---|---|---|---|
| **Policy functions** | | | | |
| Monetary policy | 65.1 | 66.1 | 68.3 | 68.6 |
| Financial stability | 49.4 | 53.8 | 56.5 | 62.0 |
| Information assurance[2] | – | 0.7 | 2.5 | 2.3 |
| Contingency reserve | – | – | 1.0 | 1.0 |
| **Expenditure on policy functions** | **114.5** | **120.6** | **128.3** | **133.9** |
| **Remunerated functions** | | | | |
| Note issue | 72.7 | 70.8 | 74.3 | 79.5 |
| Government agency services | 8.5 | 8.0 | 8.4 | 8.4 |
| Payment and settlement | 9.7 | 10.2 | 10.4 | 11.5 |
| Banking services | 28.2 | 26.8 | 28.6 | 29.3 |
| Other functions | 21.6 | 18.3 | 18.5 | 11.7 |
| Information assurance[2] | – | 0.4 | 1.8 | 1.9 |
| **Expenditure on remunerated functions** | **140.7** | **134.5** | **142.1** | **142.3** |
| **Legacy costs[3]** | **7.9** | **7.7** | **8.0** | **9.0** |
| **Total expenditure[4]** | **263.1** | **262.8** | **278.4** | **285.2** |

(1) 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.
(2) Costs associated with the information assurance programme, approved by Court to upgrade IT security, allocated between policy and remunerated functions.
(3) Mainly pensioner benefits and interest on severance provisions.
(4) In addition, £14.7 million of costs were expensed in 2011/12 (£1.5 million in 2010/11) in relation to PRA Transition. There is provision in the new Financial Services Bill for the Bank to recover these costs.

# Financial review continued

### Budget for 2012/13

The budgeted expenditure for the Bank's policy functions in 2012/13 is £133.9 million, 47% of the Bank's total expenditure by function.

Over the past year, the Bank has built up resources required to support the interim Financial Policy Committee, in line with the Bank's new responsibilities as the macroprudential authority, and to strengthen the resilience of the Bank's IT security.

As anticipated last year, a larger proportion of the cost of risk management activity will fall to the policy budget in 2012/13, following the closure of the Special Liquidity Scheme. The higher policy budget for risk management reflects the fact that acceptance of a wider range of collateral is now a permanent feature of the Bank's sterling liquidity operations (such as the Discount Window Facility, indexed long-term repo operations and the Extended Collateral Term Repo facility). 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 that over time imply no real increase in the Bank's policy costs.

The budget for 2012/13 takes into account the final year of 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 2012/13 is £90.2 million, with income forecasts remaining sensitive to the future path of interest rates and growth in the level of CRDs.

CRD income is projected to be below the Bank's policy budget but, having built up reserves when CRD income was higher than expenditure in the run-up to the 2008 CRD Review, Court has not requested an alteration to the CRD ratio of 0.11% of eligible liabilities this year. The Bank's expectation is that the next formal review of the CRD scheme will be later this year, effective from June 2013, at which point a change in CRD parameters is likely to be appropriate.

The projection for the Bank's remunerated functions in 2012/13 is for a surplus of £5.6 million. That is consistent with the Bank's objective for these activities to be broadly self-financing over the medium term.

The budget for 2012/13 includes proposals for £39.8 million of project-related expenditure (excluding PRA Transition), of which £21.6 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 in relation to the Bank's new macroprudential 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.

Planning for the PRA is at an advanced stage. £16.7 million of costs, including £0.5 million of capital expenditure, have been incurred to the end of the 2011/12 financial year. Costs for the five months to end-July 2012 are budgeted at £28.6 million. The full costs to the Bank are currently estimated to be just under £100 million to completion. It is envisaged that the costs of the programme necessary to ensure an orderly transition will be recovered from levy payers once the PRA is up and running. Support services will in general be based on an integrated model across the Bank and PRA, with the Bank's existing support functions expanded to support the front-line operations of the PRA. The Bank's intention is that the PRA will operate, in the medium term, at lower cost than the equivalent part of the FSA. PRA transition costs are a one-off item and are therefore shown separately from the Bank's normal total expenditure.

**Proposals for major projects supporting the strategic priorities in 2012/13 include:**

| Strategic priority | Project | 2012/13 budget £m | Total cost £m | Project completion |
|---|---|---|---|---|
| 2. Policies, tools and infrastructure for monetary policy and banknotes | Markets Operations Review Phase 2 | 0.2 | 1.4 | 2012/13 |
| 3. Resilience of the financial system | RTGS Liquidity Savings Mechanism | 0.6 | 1.1 | 2012/13 |
| | RTGS Resilience Enhancement | 0.4 | 4.2 | 2014/15 |
| 4. Macroprudential policy | Model Management | 0.8 | 2.5 | 2015/16 |
| 7. Right people and processes | New Collateral Operations | 3.2 | 5.9 | 2013/14 |
| | Information Assurance | 2.3 | 4.5 | 2013/14 |
| | Financial Operations Processes & Accounting | 0.7 | 1.9 | 2012/13 |
| | Banking Platform Upgrade | 0.9 | 1.8 | 2012/13 |
| | Desktop IT Strategy and Delivery | 3.5 | 6.0 | 2015/16 |

## Financial statements

The Banking Department's financial statements for the year ended 29 February 2012 are given on pages 52–96 and show a profit before tax of £82 million (2010/11: £132 million). After a tax charge of £10 million (2010/11: £5 million), the profit transferred to reserves amounts to £36 million (2010/11: £63 million). The amount payable in lieu of dividend amounts to the remaining £36 million (2010/11: £64 million) of the post-tax profit for the year plus £2,262 million in relation to the surplus from the Special Liquidity Scheme (SLS) (including the recovery of past related tax payments) which closed in January 2012 and had been indemnified against loss by HM Treasury.

The statements of account for the Issue Department (which are given on pages 97–99) show that the profits of the note issue were £851 million (2010/11: £475 million). The level of Bank Rate is the main driver of the profits of the Issue Department; in addition, in 2011/12 there was a marked increase in the market value of gilts held on Issue Department. The profits of the Issue Department are payable in full to HM Treasury.

**Profit before tax**

| £ millions | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
|---|---|---|---|---|---|---|---|---|
| Banking Department | 106 | 99 | 191 | 197 | 995 | 231 | 132 | **82** |
| Issue Department | 1,618 | 1,698 | 1,653 | 2,327 | 2,188 | 491 | 475 | **851** |

## Banking Department balance sheet

The balance sheet of the Banking Department increased during the year, from £229.6 billion at 28 February 2011 to £315.5 billion as at 29 February 2012.

The main change in the components of Banking Department assets was an increase in 'other loans and advances', from £199.8 billion at 28 February 2011 to £286.6 billion at 29 February 2012, mainly the advance to the Bank of England Asset Purchase Facility Fund Ltd (BEAPFF) for asset purchases on behalf of the Monetary Policy Committee.

On the liabilities side, deposits from banks and other financial institutions, mainly reserves balances, increased from £154.4 billion at end-February 2011 to £217.6 billion at 29 February 2012. Other deposits also increased to £70.2 billion (2010/11: £50.0 billion), reflecting deposits from other central banks, deposits from BEAPFF (mainly gilt coupon receipts) and from the Issue Department. The latter nets out in the consolidated balance sheet (see overleaf).

At 29 February 2012, the Banking Department balance sheet contained £5.1 billion of liabilities associated with the management of the Bank's foreign exchange reserves

## Financial review continued

(2010/11: £5.0 billion). On 27 February 2012, the Bank launched a $2 billion three-year bond replacing the 2009 bond which matured on 13 March 2012. Proceeds were invested in foreign currency assets, with swaps used to minimise exposure to interest rate, currency and liquidity risks.

The level of Cash Ratio Deposits (CRDs) remained at £2.4 billion at 29 February 2012 (2010/11: £2.4 billion), and capital and reserves decreased to £3.4 billion (2010/11: £4.4 billion), reflecting the payment of the SLS surplus to 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 £4.4 billion at 29 February 2012 (2010/11: £4.0 billion) and holdings of other supranational sterling bonds were £446 million (2010/11: £557 million).

### Issue Department balance sheet

Banknote liabilities continued to increase year on year, and were £54.9 billion on 29 February 2012 (2010/11: £52.2 billion).

Gilt purchases for 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 £5.4 billion at 29 February 2012 (2010/11: £5.3 billion). The Ways and Means advance to HM Treasury remained at £370 million during 2011/12.

Reverse repos outstanding at 29 February 2012 were £1.6 billion (2010/11: £10.2 billion), and the Issue Department's deposit with the Banking Department, netted out in the consolidated balance sheet, was £47.6 billion (2010/11: £36.3 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 29 February 2012 is set out below. It is provided for information purposes only, to assist comparison with other central banks.

In summary, the combined balance sheet increased by £77.3 billion. The largest movement in assets was an increase in 'loans and advances' by £75.8 billion, with small increases across other balance sheet categories. On

**Summary combined balance sheet**

| | **2012 £m** | 2011 £m |
|---|---|---|
| **Assets** | | |
| Ways and Means advance | 370 | 370 |
| Loans and advances | 303,721 | 227,927 |
| Securities held at fair value through profit or loss | 4,782 | 4,752 |
| Derivative financial instruments | 461 | 314 |
| Available for sale securities | 10,719 | 10,258 |
| Other assets | 2,778 | 1,888 |
| **Total assets** | **322,831** | **245,509** |
| **Liabilities** | | |
| Notes in circulation | 54,921 | 52,194 |
| Deposits | 255,030 | 182,000 |
| Foreign currency bonds in issue | 5,104 | 5,037 |
| Derivative financial instruments | 232 | 366 |
| Other liabilities | 4,157 | 1,489 |
| Capital and reserves | 3,387 | 4,423 |
| **Total equity and liabilities** | **322,831** | **245,509** |

the liabilities side, 'deposits' increased by £73.0 billion, while 'notes in circulation' increased by £2.7 billion and other categories increased by £0.3 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. The surplus of the SLS was also paid to HM Treasury as a payment in lieu of dividend.

On 5 April 2012, the Bank paid the first instalment of £2,279 million in respect of the financial year ended 29 February 2012, of which £2,262 million related to SLS, based on provisional full-year figures. The balance will be paid on 5 October 2012.

In respect of the year to 28 February 2011, the Bank paid £26 million in April 2011 and £38 million in 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 29 February 2012 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 Acts 1928 and 1954, the National Loans Act 1968 and the Currency Act 1983. The Court of Directors is responsible for ensuring that the statements of account are prepared in accordance with these requirements as at 29 February 2012 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 57–65.

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 risk management and internal control systems in the Bank and its subsidiaries. The responsibility for day-to-day operations is delegated to the executive management. The risk management and internal control systems are 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. They are designed to manage rather than eliminate the risk of failure to achieve the Bank's strategic priorities and, as such, provide reasonable, but not absolute, assurance against material misstatement or loss.

In accordance with the Financial Reporting Council's Revised Guidance for Directors on the UK Corporate Governance Code, Court has reviewed the effectiveness of the risk management and internal control systems 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 risk is described in a strategic 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 28 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 Governors. 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 management and internal control systems.

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. As part of its continuing activities, 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). ET reviews quarterly reports on strategic, policy implementation, operational and financial risks, prior to their discussion at ARCo and 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.

The Operational Risk Committee (ORC): The ORC, set up during the year, provides support to BRC by reviewing outstanding actions, risk profile issues and framework updates and recommending proposed courses of action to BRC. It is also a forum where specific risk issues can be covered in greater depth, such as reports on specific risk profile items which may require additional investigation and reporting.

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 ORC and BRC, acting as a secretariat function and reporting to ORC and 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

# Risk management and business practices continued

analysis of the creditworthiness of counterparties, issuers and central bank customers to whom the Bank and/or EEA (see below for an explanation of the EEA) may have credit exposures and the establishment of eligibility criteria for assets taken as collateral.

Markets Strategy and Risk Operations Division (MSROD): MSROD is responsible for the implementation of the agreed risk framework, including reporting on credit, market and liquidity risk. It is also responsible for 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, 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 Risk Management Division in the Markets Directorate is responsible for the risk management of both sovereign and non-sovereign collateral accepted under the Discount Window Facility and long-term repo operations. The management of financial risk is discussed in note 28 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 2012 the Bank employed 1,791 full-time staff and 254 part-time staff; 1,898 of these staff were on permanent contracts, up from 1,763 as at end-February 2011. Since end-February 2011, including temporary staff, 403 individuals joined the Bank and 196 left. Of the staff recruited, 206 were recruited on permanent contracts, an increase from 105 in 2011. Of these new permanent staff, 54 were new graduates (up from 18 the year before), 81 were experienced hires appointed to analytical and management roles (an increase from 38 the year before) and 71 were appointed to clerical or non-technical roles (up from 49 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 Spencer Dale, the Bank continued to progress its Diversity Strategy. The proportion of women in senior roles stood at 30% at the end of February 2012, up from 28% at the end of February 2011.

The proportion of staff from ethnic minority backgrounds was up slightly at 10% (9% in 2011). Part-time staff constitute 12% of all Bank staff and 9% of those at analyst and managerial level.

During 2011, the Bank assumed its new Public Sector Equality Duty, introduced by the Equality Act 2010. The Equality Duty relates to the way the Bank provides employment opportunities and the way it engages with business and the public with respect to its public functions. In January 2012 the Bank published its first Equality Report for the period 2012–2015, which sets out its ongoing commitment to promoting equality and diversity in relation to its staff, and details the Bank's public accountability responsibilities.(1)

## 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 (SHE) Committee.

## The environment

The SHE Committee also monitors the impact of the Bank's operations on the environment. The Bank tries to minimise that impact through better power efficiency and improved waste management.

The Bank's Head Office building received a Display Energy Certificate and retaining its rating of F with a score of 150, compared to 147 last year, and has maintained the Carbon Trust Standard for all its sites. A project to replace end-of-life heating and cooling plant at Head Office has now completed and a similar project is under way at the Bank's site in Debden.

More than 99% of waste (2011: 99%), or 960 tonnes (2011: 1,380 tonnes), generated 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 2011/12 the Bank contributed an estimated total of £688,000 in support of its community programme (2010/11: £670,000). Cash donations totalled £449,000 (2010/11: £385,000), including:

- £60,000 to community organisations via the Staff Volunteering Award Scheme;
- £60,000 to charities supported by the Bank's regional 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;
- £157,000 made to charitable and other organisations;
- £5,000 for the David Sharp School Governor Awards; and
- £95,000 in donations to support academic research (2010/11: £101,000).

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 contribution, including time spent by staff on community involvement, travel costs for volunteers and the costs of hosting charitable events at the Bank, to be £239,000 in 2011/12 (2010/11: £285,000), of which £107,000 was for staff time involved in volunteering and civic duties.

No donation was made for any political purpose in 2011/12 (2010/11: nil). No paid leave was granted to staff for political purposes in 2011/12 (2010/11: nil).

## Policy on payment of suppliers

The Bank is an approved signatory to The Prompt Payment Code.(2) 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 12.2 in 2011/12 (2010/11: 12.5).

(1) The Equality Report is available at www.bankofengland.co.uk/publications/Documents/other/equalityreport/equalityreport2012_2015.pdf.
(2) For details about the Code, see www.payontime.co.uk.

# Remuneration of Governors, Directors, MPC and FPC 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 and FPC members. Court is advised by the Remuneration Committee, the composition of which is shown on page 4. 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 in 2011, in July 2010 the Governor informed the Committee that he wished to freeze his salary for two years. In May 2012, the Governor requested that his salary remain frozen until the end of his term. Subsequent to the Governor's salary being frozen in 2010, and 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 next review is therefore due for the year commencing 1 March 2013.

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 Team 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 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 29 February 2012, 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 2011/12 £ | Total 2010/11 £ |
|---|---|---|---|---|
| **Governor** | | | | |
| Sir Mervyn King[2] | 305,368 | 2,424 | 307,792 | 308,252 |
| **Deputy Governors** | | | | |
| Mr C R Bean[2] | 258,809 | 1,592 | 260,401 | 260,988 |
| Mr P M W Tucker[2] | 258,809 | 4,211 | 263,020 | 263,063 |
| **Non-executive Directors**[3] [4] | 145,000 | 21,062 | 166,062 | 150,241 |
| **Total** | **967,986** | **29,289** | **997,275** | **982,544** |

(1) Includes the provision of facilities which give rise to a tax liability.
(2) The table excludes business-related travel expenses taxable under HMRC rules of £5,999 (including tax).
(3) Lord Turner sits on Court as Chairman of the Financial Services Authority, and Paul Tucker, as Deputy Governor for Financial Stability, is a director of the FSA. Lord Turner waived remuneration from the Bank of £15,000 in 2011/12 and Paul Tucker waived remuneration from the FSA of £35,000.
(4) Does not include Mr Cohrs's remuneration as a member of the FPC, reported on page 46.

### Pension entitlements and accruals (including unfunded entitlements)

| | Cash equivalent as at 28.2.11 £ | Cash equivalent as at 29.2.12 £ | Increase in cash equivalent £ | Accrued pension as at 28.2.11 £pa | Accrued pension as at 29.2.12 £pa | Increase in accrued pension £pa | Cash equivalent of additional pension earned during year ended 29.2.12 £ |
|---|---|---|---|---|---|---|---|
| Mr C R Bean | 2,520,400 | 3,555,600 | 1,035,200 | 89,200 | 101,900 | 12,700 | 443,100 |
| Mr P M W Tucker | 3,656,600 | 5,006,600 | 1,350,000 | 132,600 | 142,000 | 9,400 | 331,400 |

The cash equivalent for additional pension earned during year ended 29 February 2012 is calculated using the assumptions adopted for the 2011 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 76–81).

#### 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 29 February 2012.

### 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

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

# Remuneration of Governors, Directors, MPC and FPC members continued

2009, these rates were set at £15,000 per annum for Directors, £20,000 for Committee Chairmen, £25,000 for the Senior Independent Director 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 meets appropriate travel and subsistence expenses.

### Remuneration of external MPC and interim FPC 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 2011/12. 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.

The external members of the interim FPC are paid at the rate of £55,000 per annum. They receive no other benfits.

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 interim FPC or MPC responsibilities, and to require continued adherence to the interim FPC or MPC guidelines, which sets rules for public speaking and media contacts. For MPC members, to the extent that they receive income from employment that does not conflict with their former MPC responsibilities, their income from the Bank is reduced.

### Executive Directors' salaries and benefits

The table below shows the basic salaries and taxable benefits of the Executive Directors as at 29 February 2012.

| | £ |
|---|---|
| Andrew Bailey | 202,429 |
| Nils Blythe | 160,983 |
| 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 |
| Chris Salmon | 175,963 |

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' salaries and benefits

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 2011/12 and show the full-time equivalent salary and include base pay and any taxable benefit allowances, but exclude bonus and pension contribution.

| Remuneration range (£) | Number in range |
|---|---|
| 160,000 – 169,999 | 3 |
| 150,000 – 159,999 | 3 |
| 140,000 – 149,999 | 1 |
| 130,000 – 139,999 | 6 |
| 120,000 – 129,999 | 19 |
| 110,000 – 119,999 | 13 |
| 100,000 – 109,999 | 23 |
| 90,000 – 99,999 | 33 |
| 80,000 – 89,999 | 71 |
| **Total** | **172** |

### Bonuses

In line with previous years, 2011/12 bonus payments were made to Executive Directors, other senior executives and staff on an individual performance-related basis from a pool equivalent to 6% of the total salaries of Executive Directors, other senior executives and staff.

# Report by the Non-executive Directors

This section contains the Report from the Committee of (non-executive) Directors required by Section 4(2)(a) of the Bank of England Act 1998. It describes the responsibilities of the Committee, and how it has discharged them. The Report refers where appropriate to other sections of this *Annual Report*.

The Bank's non-executive Directors have specific responsibilities under the Bank of England Act for keeping under review the Bank's performance in relation to its strategy and objectives; for monitoring achievement of its financial management objectives; for keeping internal financial controls under review; for reviewing the procedures of the Monetary Policy Committee, and for determining the remuneration of the executive members of Court and other MPC and interim FPC members. These responsibilities are focused on a statutory Committee of Directors, commonly known as NedCo.

In part the Committee exercises its reviewing function through meetings of the full Court, where the Non-executive Directors provide an independent, informed and critical challenge to the Bank executive. Scrutiny of executive pay and internal controls are conducted respectively by the Remuneration Committee and the Audit and Risk Committee. Members of the Committee hold regular informal meetings with the external members of the MPC and the FPC, and with the Executive Directors and during the year held an informal meeting with the Governor to discuss succession planning. Because of the frequency of Court, and of sub-Committees, the Committee itself met formally only once, to agree its report, to review the performance of the Governor against his objectives for the previous year, to set the Governor's objectives for the following year and to review the procedures of the MPC.

### Reviewing performance

Directors receive comprehensive quarterly reports on the implementation of the Bank's strategy, the management of major projects and any risks to delivery. These provide a sound basis for discussion with executive management. Reports on the development of the PRA transition programme have been discussed at every meeting of Court during the year, and in more detail at every Audit and Risk Committee.

The Bank's performance in relation to its strategy and objectives is reviewed on pages 14–28 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 2011/12.

### Reviewing financial management

The Bank's budget for 2012/13, and the outcome for the previous year, is discussed on pages 34–37. The Bank has remained successful in controlling its costs over the past five years, and Court's general objective remains to set budgets that imply no real increase in the Bank's policy costs, after making allowance for its new responsibilities. During the financial crisis additional spending was agreed, and the Court has also agreed and monitors a transition budget for creation of the PRA, which including capital expenditure, amounts to £45 million to the end of July 2012 and is likely to be just under £100 million to completion.

### Audit and Risk

The Audit and Risk Committee assists Court in making sure that the Bank has an effective system of financial reporting, internal control and risk management. During the past year the Committee has kept under review the impact of the PRA programme on the Bank's organisational and delivery capacity, and the evolution of the programme itself which is the largest the Bank has ever undertaken. The Committee has reviewed contingency planning for a future crisis, the resilience of the Bank's systems to external shocks, and the programme of improvements to IT security. The Committee has reviewed the effectiveness of the system of internal financial controls and risk management and this is reported on pages 40–42 of this *Report*.

### Value for money

In 2011 NedCo decided to commission one value for money (VFM) review each year. The first reported in February 2012, and looked at the scope for savings in the delivery of payment and settlement services. The review, conducted by PwC, identified net savings, which together with savings already planned by management, totalled £500,000 a year. Additional potential savings in relation to renewal of IT contracts were identified. A further VFM study is planned for 2012/13.

Another transaction that NedCo has kept under close review is the prospective re-tendering in 2015 of the contract to print banknotes at the Debden site.

# Report by the Non-executive Directors continued

## Premises for the PRA

During the year a sub-committee of Directors — Sir David Lees, Sir Roger Carr and Lady Rice — reviewed the Bank's proposal to acquire a leasehold interest in 20 Moorgate as accommodation for the bulk of the PRA. The committee agreed that there would be significant cultural, presentational, business integration and security benefits from locating the PRA close to the Bank, rather than with the FCA at Canary Wharf, though the committee determined that there should be an absolute limit on what the Bank paid for them. Following an extensive review taking account of rents, rent-free periods, fit-out costs, including for technology and security, and service charges the committee calculated that, based on conservative assumptions, the latest estimate of the cost difference between the preferred City property and taking over the FSA floors in Canada Square would amount to less than £1 million per year over the next fifteen years which was within the limit set by the committee. The Bank will bear any cost of any unlet space at Canada Square currently occupied by the FSA.

## MPC procedures

The Directors are responsible for keeping the procedures followed by the MPC under review, and to ensure that the MPC has adequate resources to support its work. This includes reviewing the regional, sectoral and other information used by the MPC for the purposes of formulating monetary policy. Support for the Monetary Policy Committee is covered on pages 15–16 of this *Report*. Directors receive a written monthly report from the MPC, and every three months, following publication of the *Inflation Report*, individual MPC members are invited to attend Court to discuss both the *Inflation Report* and MPC procedures. Directors periodically attend pre-MPC meetings as part of their review. 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.

The Directors have begun to institute similar arrangements for the FPC. For both Committees, Court has reviewed during the year the guidelines covering the conduct of members of the Committees, especially those relating to public statements. Members of both Committees are subject to the Bank's personal dealing rules.

## 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 the members of the Monetary Policy Committee and the Financial Policy Committee. The report of the Remuneration Committee is set out on pages 44–46 and so far as appropriate forms part of this *Report*.

## Attendance

The table on page 49 sets out attendance by the Bank's Non-executive Directors at meetings of Court, NedCo, the Financial Stability Committee, the Audit and Risk Committee and the Remuneration Committee. Attendance by other Court members is also listed.

| Attendance (number of meetings) | Court (8) | NedCo (1) | FSC (7) | Audit & Risk (6) | RemCo (2) | Nominations (2) |
|---|---|---|---|---|---|---|
| Sir David Lees | 8 | 1 | 7 | 6** | 2 | 2 |
| Mr Barber | 8 | 1 | – | – | 2 | – |
| Sir Roger Carr | 8 | 1 | – | – | 2 | 1 |
| Lady Rice | 8 | 1 | – | 6 | – | 2 |
| Lord Turner | 8 | 1 | – | – | – | – |
| Mr M Tucker | 4 | 1 | 4 | 2 | – | – |
| Mr Stewart | 6 | 0 | 6 | 6 | – | – |
| Mr Young | 6 | 1 | 6 | – | – | – |
| Mr Cohrs* | 5 of 6 | – | – | – | 1 of 1 | – |
| Sir Mervyn King | 7 | – | 1 | – | – | 2 |
| Mr Bean | 6 | – | 6 | 4** | – | – |
| Mr P Tucker | 7 | – | 7 | 2** | – | – |

* Appointed 21 June 2011.
** Sir David Lees, Mr Bean and Mr P Tucker are in attendance.