Report of the Independent Auditor

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

We have audited the financial statements of the Banking Department ('financial statements') for the year ended 29 February 2012, set out on pages 52 to 96, and the statements of account of the Issue Department ('statements of account') for the year ended 29 February 2012, set out on pages 97 to 99. The financial reporting framework that has been applied in their preparation is applicable law and the accounting policies set out therein.

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

Respective responsibilities of Members of Court and auditor

As explained more fully in the Statement of the Responsibilities of the Court of Directors set on page 39, the Members of Court are responsible for the preparation of the financial statements and statements of account in accordance with applicable law and the bases of preparation set out in note 2 on pages 57 to 65 and note 1 on page 98 respectively.

Our responsibility is to audit, and express an opinion on, the financial statements and statements of account in accordance with applicable law and International Standards on Auditing (United Kingdom and Ireland). Those standards require us to comply with the Auditing Practice's Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements and statements of account

An audit involves obtaining evidence about the amounts and disclosures in the financial statements and statements of account sufficient to give reasonable assurance that the financial statements and statements of account are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Bank's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Members of Court; and the overall presentation of the financial statements and statements of account. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and statements of account. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements and statements of account

In our opinion:

- the financial statements of the Banking Department on pages 52 to 96 for the year ended 29 February 2012 have been properly prepared, in all material respects, in accordance with the basis of preparation set out in note 2 on pages 57 to 65.

- the statements of account of the Issue Department on pages 97 to 99 for the year ended 29 February 2012 have been properly prepared, in all material respects, in accordance with the basis of preparation set out in note 1 on page 98.

Opinion on other matter

In our opinion the information given in the Remuneration Report, the Financial Review, the Risk Management and Business Practices Report, and the Report by the Non-executive Directors for the financial year for which the financial statements and statements of account are prepared is consistent with the financial statements and statements of account.

David A T Todd
for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
15 Canada Square
Canary Wharf
London
E14 5GL

20 June 2012

Banking Department
Income Statement for the year to 29 February 2012

	Note	2012 £m	2011 £m
Profit before tax	4	82	132
Corporation tax net of tax relief on payment to HM Treasury	7	(10)	(5)
Profit for the year attributable to shareholder		**72**	**127**

The Special Liquidity Scheme ('SLS') was launched on 21 April 2008 to improve the liquidity in the United Kingdom banking system. The SLS was conducted under an indemnity from HM Treasury and as such the surplus arising on the SLS was designated as a capital contribution recognised in the Statement of Changes of Equity and not the Income Statement.

The Scheme came to an end on 30 January 2012 and the gross surplus of £2,262 million was paid to HM Treasury as a payment in lieu of dividend on 5 April 2012.

The notes on pages 57 to 96 are an integral part of these financial statements.

Statement of Comprehensive Income
for the year to 29 February 2012

	Note	2012 £m	2011 £m
Profit for the year attributable to shareholder		72	127
Other comprehensive income:			
Revaluation of available for sale securities	14	382	(16)
Revaluation of properties	16	(5)	27
Actuarial gains/(losses) on retirement benefits	18	324	(139)
Corporation tax relating to components of other comprehensive income	7	(171)	49
Other comprehensive income for the year, net of tax		530	(79)
Total comprehensive income for the year		**602**	**48**

The notes on pages 57 to 96 are an integral part of these financial statements.

Balance Sheet as at 29 February 2012

	Note	2012 £m	2011 £m
Assets			
Cash and balances with other central banks	9	372	326
Loans and advances to banks and other financial institutions	10	15,157	17,570
Other loans and advances	11	286,582	199,808
Securities held at fair value through profit and loss	12	4,782	4,752
Derivative financial instruments	13	461	314
Available for sale securities	14	5,340	4,941
Investments in subsidiaries	15	–	–
Property, plant and equipment	16	218	216
Intangible assets	17	10	10
Retirement benefit assets	18	564	191
Other assets	19	1,986	1,471
Total assets		**315,472**	**229,599**
Liabilities			
Deposits from central banks	20	14,806	13,836
Deposits from banks and other financial institutions	21	217,623	154,405
Other deposits	22	70,163	50,043
Foreign currency bonds in issue	23	5,104	5,037
Derivative financial instruments	13	232	366
Current tax liabilities		44	16
Deferred tax liabilities	24	201	105
Retirement benefit liabilities	18	252	231
Other liabilities	25	3,660	1,137
Total liabilities		**312,085**	**225,176**
Equity			
Capital	26	15	15
Retained earnings		2,477	3,800
Other reserves		895	608
Total equity attributable to shareholder		**3,387**	**4,423**
		315,472	229,599

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

Sir Mervyn King Governor
Mr C R Bean Deputy Governor
Sir David Lees Chairman of Court
Mr W R Jones Finance Director

The notes on pages 57 to 96 are an integral part of these financial statements.

Statement of Changes in Equity
for the year to 29 February 2012

	Attributable to equity shareholder				
	Share capital £m	Available for sale reserve £m	Property revaluation reserve £m	Retained earnings £m	Total £m
Balance at 1 March 2010	15	465	123	3,634	4,237
Comprehensive income for the period	–	(7)	27	28	48
Post-tax surplus from indemnified operations	–	–	–	202	202
Payable to HM Treasury in lieu of dividend	–	–	–	(64)	(64)
Balance at 28 February 2011	**15**	**458**	**150**	**3,800**	**4,423**
Comprehensive income for the period	–	292	(5)	315	602
Post-tax surplus from indemnified operations	–	–	–	26	26
Tax recoverable on surplus from indemnified operations	–	–	–	634	634
Payable to HM Treasury in lieu of dividend	–	–	–	(2,298)	(2,298)
Balance at 29 February 2012	**15**	**750**	**145**	**2,477**	**3,387**

The notes on pages 57 to 96 are an integral part of these financial statements.

Statement of Cash Flows for the year to 29 February 2012

	Note	2012 £m	2011 £m
Cash flows from operating activities			
Profit before taxation		82	132
Adjustment for:			
Amortisation of intangibles	17	3	6
Depreciation of property, plant and equipment	16	10	9
Dividends received	4	(14)	(32)
Net movement in accrued interest and provisions, including pensions		83	73
Changes in operating assets and liabilities:			
(Increase)/decrease in loan advanced to the Bank of England Asset Purchase Facility Fund Ltd	11	(86,775)	128
Net decrease/(increase) in other advances		681	(1,863)
Net increase in securities held at fair value through profit or loss		(39)	(90)
Net increase in deposits		84,457	5,082
Net decrease in foreign currency bonds in issue		(10)	(16)
Net (increase)/decrease in financial derivatives	13	(281)	150
Net decrease in other accounts		–	(7)
Corporation tax paid		(42)	(32)
Net cash (outflow)/inflow from operating activities		**(1,845)**	**3,540**
Cash flows from investing activities			
Purchase of available for sale securities		(323)	(911)
Proceeds from redemption of available for sale securities	14	257	260
Dividends received	4	14	32
Purchase of intangible assets	17	(3)	(3)
Purchase of property, plant and equipment	16	(17)	(17)
Net cash outflow from investing activities		**(72)**	**(639)**
Cash flows from financing activities			
Cash generated from indemnified operations		53	316
Tax on financing activities		(15)	(193)
Payment to HM Treasury under Section 1 (4) of the Bank of England Act 1946		(64)	(97)
Net cash (outflow)/inflow from financing activities		**(26)**	**26**
Net (decrease)/increase in cash and cash equivalents		**(1,943)**	**2,927**
Cash and cash equivalents at 1 March	27	8,115	5,188
Cash and cash equivalents at 29 February	**27**	**6,172**	**8,115**

The notes on pages 57 to 96 are an integral part of these financial statements.

Notes to the Banking Department Financial Statements

1 General information

The Bank of England is the central bank of the United Kingdom and is incorporated under a Royal Charter of 1694. Legislation covering its operations includes the Bank Charter Act 1844, the Bank of England Acts 1946 and 1998 and the Banking Act 2009. The Core Purposes of the Bank are set out on page 1.

The Bank Charter Act 1844 requires that the Bank's note issue function be separated from its other activities. Accordingly, for accounting purposes, the Bank is divided into Issue Department and Banking Department, which are accounting designations and reporting entities. Neither is an organisational unit of the Bank. The Issue Department is solely concerned with the note issue and the assets backing the issue. The statements of account of the Issue Department are given on pages 97 to 99, and show the note issue, the assets backing the issue, the income generated by those assets and the costs incurred in production, issue, custody and payment of notes. The net income of the Issue Department is paid over to HM Treasury. The Banking Department comprises all other activities of the Bank. The post-tax profits of the Banking Department are effectively shared equally with HM Treasury unless the Bank and HM Treasury agree otherwise (see note 8).

2 Bases of preparation

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

a Form of presentation of the financial statements

The financial statements of the Banking Department comprise the Income Statement, the Statement of Comprehensive Income, the Balance Sheet, the Statement of Changes in Equity, the Statement of Cash Flows and related notes.

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

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

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

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

In exceptional circumstances, as part of its central banking functions, the Bank may act as 'lender of last resort' to financial institutions in difficulty in order to prevent a loss of confidence spreading through the financial system as a whole. In some cases, confidence can best be sustained if the Bank's support is disclosed only when conditions giving rise to potentially systemic disturbance have improved. Accordingly, although the financial effects of such operations will be included in the Banking Department's financial statements in the year in which they occur, these financial statements may not explicitly identify the existence of such support. However, the existence of such support will be reported in the Annual Report when the need for secrecy or confidentiality has ceased.

Notes to the Banking Department Financial Statements continued

2 Bases of preparation continued

As a result, the financial statements of the Banking Department disclose less detail of certain elements than would be required under either adopted IFRS or the Companies Act. Disclosure limitations include:

- Constituent elements of the Income Statement.
- Note disclosures for income and expenses, particularly relating to net interest income and provisions and related disclosures in the Balance Sheet and Statement of Cash Flows.
- Operating segments.
- Contingent liabilities and guarantees.
- Information on credit risk.
- Individual usage of the Special Liquidity Scheme.
- Fair value of collateral pledged and held.
- Related party disclosure.

b New and amended accounting standards

The Bank has considered the potential effect of EU endorsed standards which have not been adopted in the financial statements; of these IAS 19 Employee Benefit is expected to materially impact the Bank. Note 18 to the financial statements includes an estimate of the expected impact.

c Consolidation

The financial statements of the Bank of England Asset Purchase Facility Fund Ltd (BEAPFF) have not been consolidated as the Bank has no economic interest in its activities. BEAPFF's operations are fully indemnified by HM Treasury and in return any surplus for these operations after deduction of fees, operating costs and any tax payable is due to HM Treasury.

The Bank's non-trading subsidiaries have not been consolidated because, in the opinion of the Members of Court, the effect of including their assets, liabilities and results within those of the Banking Department would not be material.

Investments in subsidiaries are stated in the balance sheet at cost, less any provision for impairment in value. Dividends from subsidiaries are recognised in the income statement when declared.

d Foreign currency translation

i Functional and presentational currency

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

ii Transactions and balances

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

e Financial instruments: assets

i Classification of financial assets

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

Loans and advances

Loans and advances are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides money or services directly to a counterparty with no intention of trading the receivable. Assets in this category exclude reverse repurchase agreements which are designated at fair value through profit or loss.

Financial assets at fair value through profit or loss

A financial asset is classified in this category if it is acquired principally for the purpose of selling in the short-term or if so designated by management.

The Bank does not currently hold any financial assets for trading but designates the following at fair value through profit or loss at inception:

- Assets matching the Bank's issued foreign currency securities.
- Assets matching the fixed-term deposits placed at the Bank by other central banks.

This designation is to eliminate, or significantly reduce, inconsistencies that would otherwise arise from measuring assets and liabilities on different bases. The relevant assets and liabilities (including derivatives) are managed together and internal reporting is evaluated on a fair value basis.

Available for sale

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

ii Initial recognition of financial assets

Loans and advances and reverse repurchase agreements designated at fair value through profit or loss are recognised on a settlement date basis. Purchases of all other categories of financial assets are recognised on a trade date basis. All financial assets are initially recognised at fair value.

iii Subsequent valuation of financial assets

Gains and losses arising from changes in the fair value of assets classified as fair value through profit or loss are included in the income statement in the period in which they arise.

Gains and losses arising from changes in the fair value of financial assets that are available for sale are recognised as other comprehensive income until the financial asset is derecognised or impaired (see (iv) below), at which time the cumulative gain or loss previously recognised as other comprehensive income is recognised in the income statement. Any premium or discount paid on the purchase of available for sale debt instruments is amortised through the income statement using the effective interest rate method.

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

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all of the risks and rewards of ownership.

Notes to the Banking Department Financial Statements continued

2 Bases of preparation continued

iv Impairment of financial assets

Loans and advances

At each balance sheet date the Bank assesses whether there is objective evidence that a financial asset or group of assets is impaired. If there is objective evidence that an impairment loss on loans and advances has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows relating to that loan discounted at the asset's original effective interest rate. The carrying amount of the asset is reduced and the amount of the loss is recognised in the income statement. A loan is normally written off, either partially or in full, when there is no realistic prospect of recovery of the principal amount and, for a collateralised loan, after taking into account any value of the security which has been realised.

Available for sale financial assets

At each balance sheet date the Bank assesses whether there is objective evidence that a financial asset or group of assets is impaired. If such evidence exists for financial assets that are available for sale, the cumulative loss, measured as the difference between acquisition cost and the current fair value, less any impairment loss previously recognised, is removed from equity and recognised in the income statement.

If, in a subsequent period, the fair value of a debt instrument designated as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement.

If, in a subsequent period, the fair value of an equity investment designated as available for sale increases the impairment loss is not reversed through the income statement except on realisation.

v Interest income

Interest income is recognised in the income statement using the effective interest method.

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

vi Dividends

Dividends on equity investments that are available for sale are recognised in the income statement when declared.

f Derivative financial instruments

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

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

g Offsetting financial instruments

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

h Property, plant and equipment

i Initial recognition

Expenditure on property, plant and equipment is capitalised if the asset is expected to have a useful economic life of three years or more. The amount capitalised at initial recognition is the purchase price of the asset along with any further costs incurred in bringing the asset to its present condition and location.

ii Subsequent valuation

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

Professional valuations of the Bank's properties are carried out each year with subsequent additions included at cost, and provisions made for depreciation as explained below.

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

iii Depreciation

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

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

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

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

iv Gain or losses on the disposal of property, plant and equipment

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

Notes to the Banking Department Financial Statements continued

2 Bases of preparation continued

i Leases

i As lessee

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

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

ii As lessor

Long leases granted on property owned by the Bank are treated as finance leases. Finance lease receivables are stated in the balance sheet at the amount of the net investment in the lease being the minimum lease payments and any unguaranteed residual value discounted at the interest rate implicit in the lease. Finance lease income is allocated across accounting periods giving a constant periodic rate of return before tax on the net investment. Unguaranteed residual values are subject to regular review to identify potential impairment. If there has been a reduction in the estimated unguaranteed residual value, the income allocation is revised and any reduction in respect of amounts accrued is recognised immediately.

j Intangible assets

Intangible assets primarily consist of computer software and the costs associated with the development of software for internal use. Costs associated with externally purchased software and costs directly associated with the internal production of unique and separately identifiable software products, which are controlled by the Bank and which will probably generate economic benefits exceeding those costs are recognised as intangible assets. These costs are amortised over the expected useful lives of the software, which range from three to five years. Costs associated with maintaining software programs are recognised as an expense when incurred. Intangible assets are tested for impairment annually. Intangible assets are also subject to an impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

k Financial instruments: liabilities

i Classification of financial liabilities

The Bank classifies its financial liabilities in the following categories: liabilities measured at amortised cost and financial liabilities at fair value through profit and loss.

Liabilities measured at amortised cost

Short-term customer deposits held are carried at cost with interest expense accruing on an effective interest rate basis. Cash Ratio Deposits are taken to fund certain activities of the Bank in accordance with the Bank of England Act 1998. These deposits are held at cost and are interest free. Money market instruments are carried at cost and are issued at a discount which is amortised through the income statement on an effective interest rate basis.

Financial liabilities at fair value through profit or loss

The Bank designates the following financial liabilities at fair value through profit or loss:

- Four three-year bonds denominated in US dollars, which were issued as part of the Bank's annual medium-term issuance programme; and
- Fixed-term deposits placed by other central banks.

ii Initial recognition of financial liabilities

Fixed-term deposits taken from central banks are recognised on a settlement date basis. Money market instruments issued, short-term deposits and bonds issued by the Bank are recognised on a trade date basis.

iii Subsequent valuation of financial liabilities

Gains and losses arising from changes in the fair value of liabilities classified at fair value through profit or loss are included in the income statement in the period in which they arise.

The fair values of these liabilities are based on current offer prices.

Financial liabilities are derecognised when the right to pay cash flows relating from the financial liabilities have expired. If the Bank buys any of its own securities as part of its operations, these are removed from the balance sheet.

l Current and deferred tax

Corporation tax payable on profits, based on the United Kingdom tax laws, is recognised as an expense in the period in which profits arise. Tax relief on payments to HM Treasury is credited directly to the income statement in accordance with paragraph 52B of IAS 12. The Bank has additionally been granted corporation tax credit in relation to the Special Liquidity Scheme surplus payment made to HM Treasury.

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

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

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

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

Notes to the Banking Department Financial Statements continued

2 Bases of preparation continued

m Retirement benefits

The Bank operates a non-contributory defined-benefit pension scheme providing defined benefits based on final and career average pensionable pay. The final salary element of the scheme is closed to new members. The assets of the scheme are held by the Bank in an independent trustee-administered fund. The asset recognised in the balance sheet in respect of the defined-benefit pension scheme is the fair value of the scheme's assets less the present value of the defined-benefit obligation at the balance sheet date. The defined-benefit obligation is calculated annually by an independent actuary using the projected unit method. The present value of the defined-benefit obligation is determined by discounting the estimated cash outflows using interest rates of high-quality sterling corporate bonds that have terms to maturity approximating to the terms of the related pension liability. Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised immediately in equity and reflected in other comprehensive income. Current and past service costs are recognised immediately in the income statement. Any net defined-benefit surplus is limited to the benefit that is available to the Bank.

The Bank also provides other post-retirement benefits, principally related redundancy provisions and healthcare for certain pensioners, which are accounted for on a similar basis to that used to account for pension obligations.

n Equity capital

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

Under Section 1 (4) of the Bank of England Act 1946, as amended by the Bank of England Act 1998, subsequent to the end of each year HM Treasury receives payments of half the post-tax profits unless the Bank and HM Treasury agree otherwise. The payments are deductible for corporation tax and charged to equity in the year to which they relate on the basis agreed at the end of the relevant year.

o Cash and cash equivalents

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

p Fees and commission income

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

q Provisions

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

r Indemnified operations

The Bank may enter into arrangements where it is fully indemnified from loss by HM Treasury. Should a surplus arise from such indemnified operations, after the deduction of fees, operating costs and tax, it is treated as a capital contribution and taken directly to equity as distributable reserves.

s Collateral pledged under sale and repurchase agreements

Securities sold subject to repurchase agreements are assets provided as collateral where the transferee has the right by contract or custom to sell the collateral. These securities remain on the balance sheet and the liability is included in deposits from banks and other financial institutions. Securities purchased under agreements to resell ('reverse repurchase agreements') are not recognised on the balance sheet; the asset is included in loans and advances to banks and other financial institutions. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements.

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

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

t Special Liquidity Scheme

The Special Liquidity Scheme involved borrowing UK Treasury bills from the United Kingdom Debt Management Office (DMO) and swapping them for securities held by banks and building societies. The scheme ended on 30 January 2012.

The accounting for securities borrowing and lending has been determined in accordance with the recognition principles set out in IAS 39. Neither the bills borrowed from the DMO nor the collateral received from the counterparties to whom the bills were lent were recognised on the balance sheet as the Bank did not obtain substantially all the risks and rewards of ownership of those instruments.

u Commitments on behalf of HM Treasury

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

3 Significant accounting estimates and judgements in applying accounting policies

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

a Post-retirement benefits

Post-retirement benefits are long-term liabilities whose value can only be estimated using assumptions about developments over a long period. The Bank has employed actuarial advice in arriving at the figures in the financial statements (see note 18, which includes relevant sensitivity analysis). Members of Court consider the assumptions used by the actuary in their calculations to be appropriate for this purpose.

b Fair value of equity investments that are available for sale

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

c Intangible assets

Management has made certain judgements when capitalising intangible assets. Various costs incurred in the production of an internal project are capitalised if a number of criteria are met. Management has made judgements and assumptions when assessing whether a project meets these criteria and when measuring the costs and economic life attributable to such projects.

Notes to the Banking Department Financial Statements continued

4 Profit before tax

	Note	2012 £m	2011 £m
Income includes			
Charges for services to HM Government (including charges to the Issue Department in respect of the Note Issue)		82	87
Banking charges and tariff income		19	16
Dividend income		14	32
Expenses includes			
Staff costs	5	155	140
Legal fees		2	2
Amortisation of intangible assets	17	3	6
Depreciation of property, plant and equipment	16	10	9
Software expenditure		6	7
Operating lease rentals — property		1	1
— other		–	–
Other administrative expenses		108	98

The expenses above include £14.7 million of costs incurred in the year to 29 February 2012 (2011: £1.5 million) in relation to the Prudential Regulation Authority transition.

5 Staff costs

	Note	2012 £m	2011 £m
Wages and salaries		97	93
Social security costs		10	9
Pension and other post-retirement costs	18	48	38
		155	**140**

Wages and salaries include £2 million of costs capitalised as intangible assets (2011: £1 million).

Average number of employees

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

	2012	2011
Governors and other members of Executive Team	14	11
Managers and analysts	790	732
Other staff	1,151	1,102
	1,955	**1,845**

The number of persons employed by the Bank at the end of February 2012 was 2,045, of which 1,791 were full-time and 254 were part-time (2011: 1,839; of which 1,613 full-time and 226 part-time).

6 Auditor's remuneration

	2012 £000	2011 £000
Audit fees for the Bank's audit:		
— Fees relating to current year	260	285
— Fees relating to prior year	(5)	(9)
Fees payable to the Auditor for services provided to the Bank:		
— Audited related services	65	25
— Tax services	27	42
— All other services	21	48
	368	**391**

In addition, fees of £30,000 for audit services and £nil for tax services in relation to Bank of England Asset Purchase Facility Fund Ltd paid by the Bank were recovered via a management fee (2011: £40,000 and £3,000 respectively). Audit related services includes £30,000 for providing assurance to HM Treasury on the allocation of costs (2011: £25,000) and £35,000 for the submission for Whole of Government Accounts (2011: £nil) for both the 2010/11 and 2011/12 financial years.

7 Taxation

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

	2012 £m	2011 £m
Current United Kingdom corporation tax	1	1
Prior year corporation tax	–	(4)
Deferred tax — current year	9	10
— prior year	–	(2)
Tax charge on profit	**10**	**5**

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

	2012 £m	2011 £m
Profit before tax	82	132
Tax calculated at rate of 26.17% (2011: 28%)	21	37
Tax relief on payment to HM Treasury	(9)	(18)
Non-deductible expenses	–	–
Dividend not subject to corporation tax	(4)	(9)
Movement in unrecognised deferred tax on properties	1	–
Prior year items	–	(6)
Change in tax rate to 25% (2011: 27%)	1	1
Total tax charge for the period	**10**	**5**

Notes to the Banking Department Financial Statements continued

7 Taxation continued

Tax (credited)/charged to equity comprises:

	2012 £m	2011 £m
The tax charged/(credited) to equity through the Statement of Comprehensive Income		
Current United Kingdom corporation tax	84	3
Deferred tax	87	(52)
	171	**(49)**
Other tax (credited)/charged directly to equity		
Current UK corporation tax	(634)	78
Tax (credited)/charged to equity	**(463)**	**29**

Tax (credited)/charged to equity is attributable as follows:

	2012 £m	2011 £m
Tax charged/(credited) to equity through the Statement of Comprehensive Income		
Revaluation of available for sale securities	100	(5)
Actuarial gains on retirement benefits	84	(39)
Change in tax rate to 25% (2011: 27%)	(13)	(5)
	171	**(49)**
Other tax (credited)/charged directly to equity		
Surplus from indemnified operations	(634)	78
Tax (credited)/charged to equity	**(463)**	**29**

The main UK corporation tax rate reduced from 27% to 25% with effect from 1 April 2012. The rate reduction on the deferred tax balances as at 29 February 2012 has been disclosed in note 24.

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

	2012 £m	2011 £m
Payable 5 April	2,279	26
Payable 5 October	19	38
	2,298	**64**

The Bank of England Act 1946, as amended by the Bank of England Act 1998, requires the Bank to pay HM Treasury, in lieu of dividend on the Bank's capital, on 5 April and 5 October, a sum equal to 25% of the Banking Department's post-tax profit for the previous financial year or such other sum as the Bank and HM Treasury may agree. When the due date falls on a non-business day, the payment is made on the last business day before the due date. These payments have been accrued and charged to equity at 29 February 2012. The payments are deductible for corporation tax in the year to which the payments relate. The overall effect is that the Bank and HM Treasury will normally share Banking Department's post-tax profits equally. This year the Bank and HM Treasury have agreed to an additional payment in lieu of dividend of £2,262 million relating to the gross surplus arising from the Special Liquidity Scheme, which ended on 30 January 2012.

9 Cash and balances with other central banks

	2012 £m	2011 £m
Cash	–	–
Balances with other central banks	372	326
	372	**326**

Balances with other central banks are correspondent accounts with other central banks used for Bank and customer business.

10 Loans and advances to banks and other financial institutions

	2012 £m	2011 £m
Items in course of collection	–	1
Reverse repurchase agreements held at amortised cost	1,755	3,019
Reverse repurchase agreements held at fair value through profit or loss	12,984	12,536
Other loans and advances	418	2,014
	15,157	**17,570**

These balances include advances and reverse repurchase agreements arising as part of the Bank's open market operations, as well as advances matching the deposits taken (notes 20 to 22). Amounts are stated after provisions for impairment, where appropriate. The level and composition of the Bank's open market operations, including the split between Banking and Issue Departments, depends on movements in the Bank's balance sheet as described in the published *Framework for the Bank of England's Operations in the Sterling Money Markets* (updated December 2011).

At 29 February 2012 loans and advances to banks and other financial institutions included cash and cash equivalents of £5.7 billion (2011: £7.4 billion) which are disclosed in note 27i.

11 Other loans and advances

	2012 £m	2011 £m
Overdrafts	–	–
Loan to the Bank of England Asset Purchase Facility Fund Ltd	286,579	199,804
Term loans	3	4
	286,582	**199,808**

Loan to Bank of England Asset Purchase Facility Fund Ltd (BEAPFF)

Upon receipt of notification of BEAPFF's intention to draw down under the loan, the Bank is required to make the advance and may only obtain repayment with the agreement of BEAPFF. The loan is ultimately repayable on termination of BEAPFF's operations.

Notes to the Banking Department Financial Statements continued

12 Securities held at fair value through profit or loss

	2012 £m	2011 £m
Money market instruments	129	385
Listed foreign government securities	4,653	3,892
Other listed foreign currency securities	–	475
	4,782	4,752

The holdings of foreign government and other foreign currency securities are funded by the Bank's issuance of medium-term securities (note 23). In the current year, the securities issued related entirely to the Bank's foreign exchange reserves portfolio. As at 29 February 2012 this portfolio was financed by four $2 billion three-year bonds (2011: four $2 billion three-year bonds) issued through the Bank's annual programme of syndicated foreign currency bond issuance. In February 2012, the Bank launched a $2 billion three-year bond replacing the 2009 bond which matured on 19 March 2012. The assets in the portfolio are denominated in US dollars, euros and Japanese yen.

At 29 February 2012 securities held at fair value through profit or loss included cash and cash equivalents of £0.1 billion (2011: £0.4 billion) which are disclosed in note 27i.

13 Derivative financial instruments

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

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

At 29 February 2012 securities with a fair value of £265 million (2011: £25 million) and cash collateral of £nil (2011: £53 million) were held as collateral in respect of derivative financial instruments.

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

a As at 29 February 2012

	Contract notional amount £m	Fair values Assets £m	Liabilities £m
Cross-currency interest rate swaps — positive value	2,301	35	–
— negative value	1,383	–	(62)
	3,684	**35**	**(62)**
Interest rate swaps — positive value	5,729	56	–
— negative value	5,050	–	(75)
	10,779	**56**	**(75)**
Forward exchange contracts — positive value	7,940	370	–
— negative value	6,206	–	(95)
	14,146	**370**	**(95)**
Total recognised derivative assets/(liabilities)		**461**	**(232)**

b As at 28 February 2011

	Contract notional amount £m	Fair values Assets £m	Liabilities £m
Cross-currency interest rate swaps — positive value	972	39	–
— negative value	1,924	–	(101)
	2,896	**39**	**(101)**
Interest rate swaps — positive value	5,312	75	–
— negative value	6,154	–	(63)
	11,466	**75**	**(63)**
Forward exchange contracts — positive value	5,411	200	–
— negative value	7,912	–	(202)
	13,323	**200**	**(202)**
Total recognised derivative assets/(liabilities)		**314**	**(366)**

Notes to the Banking Department Financial Statements continued

14 Available for sale securities

	2012 £m	2011 £m
Debt securities at fair value		
British Government securities listed on a recognised UK exchange	4,406	3,967
Other sterling securities listed on a recognised exchange	446	557
	4,852	4,524
Unlisted equity investments at fair value	488	417
	5,340	**4,941**

The movement in available for sale securities comprises:

	2012 £m	2011 £m
Available for sale debt securities		
At 1 March	4,524	3,957
Purchases	323	868
Redemptions	(257)	(260)
Mark-to-market movements through equity	311	–
Amortisation of premium/discount	(49)	(44)
Movement in accrued interest	–	3
At 29 February	**4,852**	**4,524**
Available for sale unlisted equity investments		
At 1 March	417	433
Revaluation of securities	71	(16)
Disposal of securities	–	–
At 29 February	**488**	**417**
	5,340	**4,941**

A gain of less than £1 million on the sale of available for sale securities was transferred to the Income Statement during the year (2011: £nil).

a Debt securities

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

All debt securities have fixed coupons.

b Unlisted equity investments

The unlisted equity investments held by the Bank are held as part of its functions as a central bank and are thus of a long-standing nature. The Bank's holdings in any particular institution may change from time to time as part of realignments of holdings among the shareholders and participants. Fair values of unlisted equity investments reflect the price that a knowledgeable willing party would pay in an arm's length transaction.

The Bank's investment in the Bank for International Settlements (incorporated in Switzerland) consists of shares of 5,000 Special Drawing Rights, which are 25% paid. At 29 February 2012 the holding represents 8.7% (2011: 8.7%) of the issued share capital. The investment has been valued on a dividend yield basis providing a value of £484 million (2011: £412 million) at the year end. The key inputs to the valuation model are dividend growth and discount rate. A discount rate of 6.3% (2011: 7.0%)

was used. Increasing the discount rate by 1 percentage point would deflate the valuation by £117 million, while decreasing the discount rate by 1 percentage point would inflate the valuation by £230 million.

The Bank's holding in the European Central Bank (ECB) represents 0.90% (2011: 1.10%) of the European Central Bank's paid-up share capital. In accordance with the Treaty on the Functioning of the European Union, and in line with other non euro area national central banks, the Bank is only required to pay up 'a minimal percentage' by way of contribution to the operational costs of the ECB; in the Bank's case this is currently 3.75% amounting to €59million (2011: 3.75% amounting to €59 million) of its total allocation of the ECB's subscribed capital of €1.6 billion (2011: €1.6 billion). If the United Kingdom were to participate in Economic and Monetary Union a further contribution would be required and the Bank's paid-up share capital would then amount to 14.5% (2011: 14.5%). Contributions are non-refundable and as a non euro area member the Bank is not entitled to any dividends. The fair value of the holding has therefore been assessed as £nil (2011: £nil).

15 Investments in subsidiaries

Bank of England Asset Purchase Facility Fund Ltd (BEAPFF) is a wholly-owned subsidiary of the Bank. The investment of 100 ordinary shares of £1 are held at cost on the Bank's balance sheet.

HM Treasury have indemnified BEAPFF and the Bank against any loss arising from the activities of BEAPFF and in return will receive any surplus. The Bank has not consolidated BEAPFF in its financial statements as it has no economic interest in its activities.

The Bank has a number of other non-trading subsidiaries, which are wholly-owned. They are stated in the Bank's balance sheet at an aggregate cost under £1 million and have not been consolidated with those of the Banking Department because, in the opinion of the Members of Court, the effect of including their assets, liabilities and results with those of the Banking Department would not be material. These are:

Prudential Regulation Authority Ltd	1 ordinary share of £1
The Securities Management Trust Ltd	1,000 ordinary shares of £1
Houblon Nominees Ltd	2 ordinary shares of £1
Bank of England Nominees Ltd	2 ordinary shares of £1
BE Pension Fund Trustees Ltd	2 ordinary shares of £1

The aggregate net assets of these subsidiary companies are £1.2 million (2011: £1.2 million), which consist of balances held with the Bank.

Minories Finance Ltd, a wholly-owned subsidiary, was in members' voluntary liquidation throughout the year ended 29 February 2012, and was dissolved post year end on 12 March 2012. During the year a distribution of £0.2 million was received from the liquidators which had been accrued during the year to 28 February 2011. The Bank has not consolidated Minories Finance Ltd in its financial statements on the grounds of immateriality.

BE Museum Ltd, a wholly-owned subsidiary, was liquidated during the year. The Bank received a liquidation distribution of less than £0.1 million.

Notes to the Banking Department Financial Statements continued

16 Property, plant and equipment

For the year to 29 February 2012

	Freehold land and buildings £m	Equipment* £m	Total £m
Cost or valuation			
At 1 March 2011	203	49	252
Additions	12	5	17
Disposals	–	(4)	(4)
Revaluation of properties	(11)	–	(11)
At 29 February 2012	**204**	**50**	**254**
Accumulated depreciation			
At 1 March 2011	–	36	36
Charge for the year	6	4	10
Disposals	–	(4)	(4)
Revaluation of properties	(6)	–	(6)
At 29 February 2012	**–**	**36**	**36**
Net book value at 1 March 2011	203	13	216
Net book value at 29 February 2012	**204**	**14**	**218**

*Net book value of equipment at 29 February 2012 included £4 million held under finance leases.

For the year to 28 February 2011

	Freehold land and buildings £m	Equipment* £m	Total £m
Cost or valuation			
At 1 March 2010	167	59	226
Additions	14	3	17
Disposals	–	(12)	(12)
Reclassification	1	(1)	–
Revaluation of properties	21	–	21
At 28 February 2011	**203**	**49**	**252**
Accumulated depreciation			
At 1 March 2010	–	45	45
Charge for the year	5	4	9
Disposals	–	(12)	(12)
Reclassification	1	(1)	–
Revaluation of properties	(6)	–	(6)
At 28 February 2011	**–**	**36**	**36**
Net book value at 1 March 2010	167	14	181
Net book value at 28 February 2011	**203**	**13**	**216**

*Net book value of equipment at 28 February 2011 included £5 million held under finance leases.

The figures for freehold land and buildings reflect independent professional valuations on a market value basis as at 29 February 2012 by Deloitte LLP (trading as Drivers Jonas Deloitte), members of the Royal Institution of Chartered Surveyors (RICS). These valuations have been incorporated into the financial statements and were performed in accordance with the RICS Valuation Standards.

17 Intangible assets

	2012 £m	2011 £m
Cost		
At 1 March	33	40
Additions	3	3
Disposals	(1)	(10)
At 29 February	**35**	**33**
Accumulated amortisation		
At 1 March	23	27
Charge for the year	3	6
Disposals	(1)	(10)
At 29 February	**25**	**23**
Net book value at 1 March	10	13
Net book value at 29 February	**10**	**10**

Intangible assets primarily comprise computer software and related costs.

Notes to the Banking Department Financial Statements continued

18 Retirement benefits

The Bank operates a non-contributory defined-benefit pension scheme providing benefits based on final and career average pensionable pay. The final salary element of the scheme is closed to new members. The assets of the scheme are held by the Bank in an independent trustee-administered fund. The Bank also provides other post-retirement benefits, principally healthcare, for certain pensioners.

The investment policy of the pension fund is to invest in assets which match the scheme's accrued liabilities.

The assumptions used for the purposes of the valuation under IAS 19 are different from those used for the funding valuation. The effect of the liability matching investment policy is not therefore fully reflected in the accounting figures.

Valuation for funding purposes

The main pension scheme, the Bank of England Pension Fund, is valued for funding purposes at intervals of not more than three years by an independent qualified actuary, with interim reviews in the intervening years. The latest valuation for funding purposes was as at 28 February 2011; it used the current unit method, and thus the funding target was based on each active member's current earnings, with the effect of future earnings increases on the accrued liabilities being included in the normal future service contribution.

The valuation as at 28 February 2011	£m
Value of Fund assets	2,522
Actuarial value of scheme liabilities	(2,627)
Scheme deficit	**(105)**
Funding level	96%

The future service contribution rate at 29 February 2012 was set at 29.7% (2011: 24.1%).

For the 2011 valuation, the liabilities were valued by the actuary on an index-linked gilts yield discount rate, and no credit was taken in advance for the possibility that returns on investments held by the Fund would exceed the long-term interest rate. Allowance was made for past and prospective mortality improvements. The rate of RPI inflation used in the valuation and the pension increase assumption was 3.1%.

The Bank and the Pension Fund Trustees had previously agreed a deficit reduction plan following the 2008 valuation. This was reviewed after the valuation in 2011. A total of £50m of deficit reduction payments were made in the year and at the balance sheet date three payments of £27 million of the previously agreed plan remain to be paid.

Excluded from the contribution rate is the cost of administration and other services.

Summary of amounts recognised in the financial statements under IAS 19

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

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

Effect of applying revised IAS 19

The amendments to IAS 19 endorsed by the EU on 5 June 2012 have not been adopted by the Bank. As a consequence of the revision to the standard, the basis of the calculation of the income statement expense has changed, the effect of this would be to reduce the net expense to £32 million from £48 million. All changes would be made retrospectively in line with IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors), with prior year expense restated from £38 million to £26 million.

Amounts recognised as assets/(liabilities) in the balance sheet

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Funded pension scheme	564	191	269	294	404
Unfunded post-retirement benefits:					
Redundancy provisions	(78)	(75)	(70)	(64)	(61)
Other pension schemes	(7)	(7)	(6)	(6)	(6)
Healthcare benefits	(167)	(149)	(132)	(108)	(117)
	312	**(40)**	**61**	**116**	**220**

Pension expense recognised in the income statement	**2012 £m**	2011 £m
Funded pension schemes	36	27
Unfunded post-retirement benefits:		
Redundancy provisions	4	3
Other pension schemes	–	–
Healthcare benefits	8	8
	48	**38**

Gains/(losses) recognised in other comprehensive income	**2012 £m**	2011 £m
Funded pension scheme	342	(118)
Unfunded post-retirement benefits:		
Redundancy provisions	(4)	(7)
Other pension schemes	–	(1)
Healthcare benefits	(14)	(13)
	324	**(139)**

Funded pension scheme

As described above, the Bank operates a non-contributory defined-benefit pension scheme providing benefits based on final and career average pensionable pay. The final salary element of the scheme is closed to new entrants. The assets of the scheme are held by the Bank in an independent trustee-administered fund.

Redundancy provisions

As part of redundancy arrangements with staff in place until 5 April 2010, the Bank could give enhanced pension entitlement in the form of added years service or early pension rights. The costs of such benefits cannot be charged to the Pension Fund. The costs are therefore borne in the Bank's accounts, and represent the future cost of decisions that have already been taken. Provision was made for the costs of these benefits at the time the redundancy offer was announced based on actuarial advice. No further similar entitlements will be given by the Bank.

The valuation of these provisions has been performed using the relevant assumptions applied for the IAS 19 valuation of pension schemes and updated annually.

Notes to the Banking Department Financial Statements continued

18 Retirement benefits continued

Other pension schemes

As explained in the Remuneration section of the *Annual Report* on pages 44 to 46, for Governors subject to the pensions earnings cap introduced in the Finance Act 1989, the Bank offers additional unfunded pensions so that their total pensions broadly match what would have been provided by the former Court scheme in the absence of a cap. Provision is made for these in the Bank's accounts. In addition certain former Governors and Directors and the widows of some former Governors and Directors were granted *ex-gratia* pensions. Provision for these was made in the Bank's accounts when the grants were made.

The valuation of this scheme has been performed by using the relevant assumptions applied for the IAS 19 valuation of pension schemes and updated annually.

Healthcare benefits

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

Components of pension expense in the Income Statement

	2012			2011		
	Main scheme £m	Other pensions* £m	Healthcare benefits £m	Main scheme £m	Other pensions £m	Healthcare benefits £m
Current service cost	32	–	1	32	–	1
Interest cost	111	4	7	102	3	7
Expected return on assets	(107)	–	–	(107)	–	–
Total pension expense	**36**	**4**	**8**	**27**	**3**	**8**

Gains/(losses) recognised in other comprehensive income

	2012			2011		
	Main scheme £m	Other pensions* £m	Healthcare benefits £m	Main scheme £m	Other pensions £m	Healthcare benefits £m
Cumulative actuarial (losses)/gains recognised at the beginning of the year	(101)	(17)	(39)	17	(9)	(26)
Actuarial losses on schemes' liabilities	(98)	(4)	(14)	(204)	(8)	(13)
Actuarial gains on schemes' assets	440	–	–	86	–	–
Cumulative actuarial gains/(losses) recognised at 29 February	**241**	**(21)**	**(53)**	**(101)**	**(17)**	**(39)**

Reconciliation of return on assets

	2012			2011		
	Main scheme £m	Other pensions* £m	Healthcare benefits £m	Main scheme £m	Other pensions £m	Healthcare benefits £m
Expected return on schemes' assets (net of expense)	107	–	–	107	–	–
Actuarial gain on schemes' assets	440	–	–	86	–	–
Actual return on schemes' assets (net of expense)	**547**	**–**	**–**	**193**	**–**	**–**

Reconciliation of present value of defined-benefit obligation

	2012 Main scheme £m	2012 Other pensions* £m	2012 Healthcare benefits £m	2011 Main scheme £m	2011 Other pensions £m	2011 Healthcare benefits £m
Present value of defined-benefit obligation at 1 March	2,327	82	149	2,090	76	132
Current service cost	32	–	1	32	–	1
Interest cost	111	4	7	102	3	7
Actuarial loss relating to schemes' liabilities	98	4	14	204	8	13
Benefits paid out	(98)	(5)	(4)	(101)	(5)	(4)
Present value of defined obligation at 29 February	**2,470**	**85**	**167**	**2,327**	**82**	**149**

Reconciliation of the fair value of assets

	2012 Main scheme £m	2012 Other pensions* £m	2012 Healthcare benefits £m	2011 Main scheme £m	2011 Other pensions £m	2011 Healthcare benefits £m
Fair value of schemes' assets at 1 March	2,518	–	–	2,359	–	–
Actual return on schemes' assets	547	–	–	193	–	–
Bank contributions	67	5	4	67	5	4
Benefits paid out	(98)	(5)	(4)	(101)	(5)	(4)
Fair value of schemes' assets at 29 February	**3,034**	**–**	**–**	**2,518**	**–**	**–**

*Other pensions comprise redundancy provisions and other pension schemes.

Experience gains and losses

Main scheme

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Experience (loss)/gain on defined-benefit obligation	(14)	(15)	66	(16)	(29)
Experience (loss)/gain on Funds' assets	440	86	161	(214)	126

Redundancy provisions

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Experience (loss)/gain on defined-benefit obligation	**(2)**	**(1)**	**2**	**(1)**	**1**

Notes to the Banking Department Financial Statements continued

18 Retirement benefits continued

Summary of assumptions

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

The significant financial assumptions used by the independent actuary to calculate scheme liabilities over the life of the scheme on an IAS 19 basis were:

	2012 %	2011 %
Discount rate	4.5	4.9
Rate of increase in salaries	4.6	4.6
Rate of increase of pensions in payment*	3.1	3.1
Rate of increase for deferred pensioners*	3.1	3.1

*This represents a weighted average of RPI and CPI, which are the indices used in the scheme.

The discount rate assumption reflects the investment return on a high quality corporate bond at the balance sheet date.

The assumption on salary growth is for the long-term over the life of the scheme. For the purpose of the valuation this assumption has been modified to reflect the Bank continuing the pay freeze for 2012/13 and abiding by public sector guidelines for the following two years.

An age-related promotion scale has been added to the increase in salaries assumption.

The assumption for life expectancy for the scheme assumes that a male member reaching 60 in 2012 will live for 29 years (2011: 28 years) and a female member 30 years (2011: 30 years), and a male member reaching 60 in 2032 will live for 32 years (2011: 31 years) and a female member 33 years (2011: 33 years).

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

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

	2012			2011		
	Long-term rate of return expected %	**Value** £m	**Percentage of total value** %	Long-term rate of return expected %	Value £m	Percentage of total value %
Bonds	2.9	3,012	99.3	4.2	2,497	99.2
Cash and other assets		22	0.7		21	0.8
Total market value of investments		**3,034**	**100.0**		**2,518**	**100.0**

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

Main scheme

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Present value of defined-benefit obligations	(2,470)	(2,327)	(2,090)	(1,851)	(1,812)
Assets at fair value	3,034	2,518	2,359	2,145	2,216
Defined-benefit asset	**564**	**191**	**269**	**294**	**404**

A +/- 0.1% change to the discount rate would change the surplus on the pension scheme by +/- £52 million (2011: +/- £40 million). If mortality rates were adjusted such that individuals were assumed to live for an additional year, the scheme's liabilities at the year end would increase by approximately £72 million (2011: £68 million).

The Bank expects to pay contributions of £48 million in the forthcoming year (2011: £67 million).

Redundancy provisions

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Unfunded defined-benefit liability	**(78)**	**(75)**	**(70)**	**(64)**	**(61)**

The Bank expects to make payments of £5 million in the forthcoming year (2011: £5 million).

Other pension schemes

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Unfunded defined-benefit liability	**(7)**	**(7)**	**(6)**	**(6)**	**(6)**

The Bank expects to make payments of less than £1 million in the forthcoming year (2011: less than £1 million).

During the year to 29 February 2012 the Bank incurred services costs of less than £1 million (2011: less than £1 million).

Healthcare benefits

Summary of assumptions

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

	2012	2011
Initial medical trend	6.5%	7.5%
Ultimate medical trend	5.0%	5.0%
Years to ultimate	2	3

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Unfunded defined-benefit liability	**(167)**	**(149)**	**(132)**	**(108)**	**(117)**

Sensitivity analysis provided by the actuary indicates that a 0.1% decrease in the discount rate would change the deficit on the other post-retirement benefits by £3 million (2011: £3 million) and a 1% increase in the rate of medical claims by £33 million (2011: £30 million). If mortality rates were adjusted such that individuals were assumed to live for an additional year, the other post-retirement liabilities at the year end would increase by approximately £7 million (2011: £5 million).

The Bank expects to pay premiums of £4 million in the forthcoming year (2011: £4 million).

Notes to the Banking Department Financial Statements continued

19 Other assets

	2012 £m	2011 £m
Items in course of settlement	1,247	1,366
Finance lease receivables	6	6
Short-term debtors and other assets	733	99
	1,986	**1,471**

20 Deposits from central banks

	2012 £m	2011 £m
Deposits repayable on demand	1,216	869
Term deposits held at fair value through profit or loss	13,590	12,967
	14,806	**13,836**

21 Deposits from banks and other financial institutions

	2012 £m	2011 £m
Deposits repayable on demand:		
Sterling	214,719	151,289
Non-sterling	270	188
Repurchase agreements	248	431
Cash collateral for derivatives	–	53
Cash Ratio Deposits	2,386	2,444
	217,623	**154,405**

Cash deposits in US dollars are taken from counterparties as collateral for certain derivatives.

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

22 Other deposits

	2012 £m	2011 £m
Deposit by Issue Department	47,562	36,284
Public deposits:		
Repayable on demand	1,234	1,309
Other deposits repayable on demand	21,367	12,450
	70,163	**50,043**

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

23 Foreign currency bonds in issue

All changes in fair values since 1 March 2011 are considered attributable to changes in prevailing interest rates and movements in relative foreign currency exchange rates.

At 29 February 2012, as part of the Bank's annual medium-term security issuance programme the Bank had four $2 billion three-year dollar bonds in issue (2011: four $2 billion three-year dollar bonds); the first maturing on 19 March 2012, the second on 18 March 2013, the third on 7 March 2014 and the fourth on 6 March 2015.

The most recent bond (the sixth in the overall programme) was issued on 27 February 2012 with settlement on 6 March 2012. This bond matures on 6 March 2015.

	2012		2011	
	£m Fair value	$m Nominal	£m Fair value	$m Nominal
Total amounts issued to third parties	**5,104**	**8,000**	**5,037**	**8,000**

Of the above liabilities to third parties, £1,282 million (2011: £1,260 million) fall due within one year.

24 Deferred tax liabilities

Deferred tax is calculated on all temporary differences under the liability method using an effective tax rate of 25% (2011: 27%).

A reduction in the rate from 26% to 25% (effective from 1 April 2012) was substantively enacted on 5 July 2011 and therefore the effect of the rate reduction on the deferred tax balances as at 29 February 2012 has been included in the figures below.

A further reduction to 24% (effective from 1 April 2012) was substantively enacted on 26 March 2012 and therefore the effect of the rate would create an additional reduction in the deferred tax liability of approximately £8 million. This has not been reflected in the figures below as it was not substantively enacted at the balance sheet date.

The 2012 Budget on 21 March 2012 also announced that the UK corporation tax rate will be further reduced to 22% by 2014. The overall effect of the further reductions from 25% to 22%, if these applied to the deferred tax balance at 29 February 2012, would be to reduce the deferred tax liability by approximately £24 million.

The movement on the deferred tax account is as follows:

	Note	2012 £m	2011 £m
Deferred tax			
Net liability at 1 March		(105)	(149)
Income statement charge	7	(9)	(8)
Tax (charged)/credited directly to equity		(87)	52
Net liability at 29 February		**(201)**	**(105)**

Notes to the Banking Department Financial Statements continued

24 Deferred tax liabilities continued

	2012 £m	2011 £m
Deferred tax liability relates to:		
Available for sale securities	(127)	(121)
Pensions and other post-retirement benefits	(77)	11
Other provisions	3	5
	(201)	**(105)**

25 Other liabilities

	Note	2012 £m	2011 £m
Items in course of collection		1,260	992
Payable to HM Treasury	8	2,298	64
Short-term creditors and other liabilities		102	81
		3,660	**1,137**

26 Capital

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

The Bank regards its shareholder's funds as the capital it uses to support its normal operations. For special operations it may also obtain indemnities from HM Treasury, as for example in relation to the Special Liquidity Scheme.

27 Cash and cash equivalents

i Analysis of cash balances

	Note	At 1 March 2011 £m	Cash flows £m	At 29 February 2012 £m
Cash and balances with other central banks	9	326	46	372
Loans and advances to banks and other financial institutions	10	7,404	(1,733)	5,671
Securities held at fair value through profit or loss	12	385	(256)	129
		8,115	**(1,943)**	**6,172**

ii Stock of liquidity

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

28 Financial risk management

The Bank is required to manage the financial risks that arise on its balance sheet and as a consequence of its operations to deliver its policy objectives. These include credit risk, market risk and liquidity risk.

The Bank's management seek to ensure that effective risk management processes exist for assessing, managing and monitoring risk, within clear risk policies. There are governance arrangements set out in a Balance Sheet Remit and financial risk standards approved by the Governor to the Bank's senior management, and documented delegated authorities for implementation of financial risk management and oversight of the Bank's operations.

Specialist teams and committees support senior management in ensuring that agreed standards and policies are followed.

The Risk Management Division (RMD) within the Bank's Markets Directorate is responsible for analysing the financial risks faced by the Bank in its operations in financial markets. RMD is responsible for the development of the appropriate framework for the management of financial risks. The Market Strategy and Risk Operations Division (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 processes across the Markets Directorate and for preparations for contingencies with respect to financial operations.

a Credit risk

Credit risk is the risk of loss arising from the failure of a borrower, issuer, counterparty or customer to meet its financial obligations to the Bank. The Bank is exposed to credit risk both through direct exposures and through contingent exposures, such as via collateral or insurance contracts. The primary source of credit risk arises as a result of the Bank providing liquidity to financial institutions via the Sterling Monetary Framework; intraday in the Bank's provision of liquidity to facilitate the operation of the sterling high-value payment system (CHAPS) and the securities settlement system, CREST; and elsewhere in the Bank's management of its balance sheet, for example in the investment of the Bank's own funds and in the course of the banking services it provides to its customers. In addition, the Bank incurs credit risk in connection with any support operations it may undertake.

The Bank's credit risk policies define high-level risk parameters under which credit risk is monitored and controlled. Credit exposures are controlled by a system of limits based on internal credit ratings. This system applies to all unsecured credit exposures, including intra-day exposures, foreign exchange settlement exposures and exposures arising from settling securities trades for customers. Separately, limits exist to control the maximum outright (uncollateralised) exposures to a single entity. Credit assessments are performed on all market counterparties, issuers and customers to which the Bank may be exposed. These are performed both regularly, following a timetable that reflects the risk of the actual or potential exposure, and dynamically, in response to market or specific entity conditions.

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

Credit risk on the securities held outright by the Bank is managed by: holding only internally rated as equivalent to investment-grade securities in routine circumstances, which are issued chiefly by governments, government agencies and supranational organisations; and by a schedule of credit limits that vary based on internal rating.

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

Notes to the Banking Department Financial Statements continued

28 Financial risk management continued

Collateral management

In providing liquidity via the Bank's Sterling Monetary Framework operations and, intra-day, via the Bank's operation of wholesale payment systems, credit risk is managed by ensuring that exposures are fully collateralised (with appropriate haircuts) by internally rated as equivalent to investment-grade securities in routine circumstances, which are issued chiefly by governments, government agencies and supranational organisations. A summary of eligible collateral can be found on the Bank's web site.(1)

In the Bank's Indexed Long-Term Repo Operations, Discount Window Facility and Extended Collateral Term Repo Operations, the Bank may take a range of private sector collateral. Depending on the facility, the collateral may include mortgage-backed securities, covered bonds backed by mortgages or public sector securities and other asset-backed securities (such as asset-backed securities backed by credit card receivables, student loans or auto loans). The collateral must meet published eligibility criteria.

The Bank manages the risk in this wider collateral portfolio by applying haircuts to market or, where necessary, model prices to take account of liquidity (price) risk and credit risk. Where appropriate the Bank undertakes stress testing of securities in order to ensure that haircuts are sufficient to protect against idiosyncratic risk in the underlying collateral pool and counterparty risk. The Bank may vary haircuts at its discretion, including on individual securities.

The Bank values securities daily and calls for additional collateral where the haircut adjusted value is less than the value of its exposure. Where possible, the Bank uses a market price to value securities. Where no such market price exists, the Bank uses a model price designed to deliver a price that is as close as possible to what a market price would be had such a price existed. The valuations methodology, the use of spreads in models and the collateral are under review regularly. A Collateral Risk Committee chaired by the Head of RMD reviews issues relating to the wider collateral portfolio and considers policy issues relating to stress testing, valuation and eligibility of collateral including in response to market specific entity conditions.

In the Discount Window Facility and Extended Collateral Term Repo Operations, the Bank may also take portfolios of loans in unsecuritised form as collateral. A Collateral Eligibility Committee chaired by the Head of RMD reviews eligibility of a counterparty to pledge portfolios of loans as collateral, based on an assessment of the firm's risk management policies. The Committee also reviews eligibility of individual portfolios and maximum advance rates.

In non-routine circumstances, the Bank will seek appropriate methods of mitigating credit risk, including indemnities from HM Treasury. The Bank had such an indemnity from HM Treasury in relation to the Special Liquidity Scheme.

Geographical concentration of assets and liabilities

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

	2012 £m	2011 £m
Assets		
United Kingdom	304,263	215,498
Rest of Europe	8,854	12,558
Rest of the world	2,355	1,543
	315,472	**229,599**
Liabilities & Equity		
United Kingdom	300,174	213,376
Rest of Europe	3,471	2,996
Rest of the world	11,827	13,227
	315,472	**229,599**

(1) See www.bankofengland.co.uk/markets/pages/money/eligiblecollateral.aspx.

b Market risk

Market risk is defined as the risk of loss as a result of changes in market risk factors, including prices of securities, interest rates, foreign exchange rates, commodity prices and credit spreads. The Bank is exposed to market risk, as a consequence of its operations to deliver its policy objectives in the course of managing the Bank's balance sheet, principally through changes in the relative interest rates received on its assets and paid on its liabilities. Limited exposure may also be incurred to changes in exchange rates (see below) and to shifts in general market conditions, such as the liquidity of asset markets.

The Bank's market risk policies set out high-level risk management parameters, governance and control frameworks as well as reporting arrangements for key risk indicators.

The Bank is exposed to interest rate risk in the sterling bond portfolio through the investment of the Bank's capital and Cash Ratio Deposits in high-quality securities. These are bought and held to maturity in normal circumstances with the intention of maintaining the value of the Bank's capital and generating income to pay for the Bank's policy functions.

Value at Risk measurement

The Bank measures the Value at Risk (VaR) of all its positions. VaR estimates, to a confidence level of 99%, the potential loss that might arise if existing positions were unchanged for ten business days under normal market conditions, given the historical volatility of the returns on different assets, and the historical correlation between those returns.

VaR on the Bank's balance sheet is calculated against the risk factors to which the Bank is exposed. During the year VaR arose mostly from market volatility on the Bank's sterling bond portfolio.

Value at Risk	2012 £m	2011 £m
At 29 February	92.0	83.6
Average	84.5	96.4

Although VaR is an important tool for measuring market risk, the assumptions on which the model is based do give rise to some limitations, including the following:

- A 99% confidence level does not reflect losses that may occur beyond this level. Even within the model used there is a 1% probability that losses could exceed the VaR.
- A ten-day holding period assumes that it is possible to hedge or dispose of positions within that period. This may not be realistic in a situation where there is severe market illiquidity.
- VaR data is calculated on an end-of-day basis and does not reflect exposures that may arise on positions during the day.
- The model uses historical data from 1 March 2010 to 29 February 2012 as a basis for determining the possible ranges of outcomes and may not always cover all possible scenarios, especially those of an exceptional nature.

The Bank back tests its VaR by comparing actual profit or loss to the VaR estimation. The results of the back-testing process are one of the methods by which the Bank monitors the ongoing suitability of its VaR model.

The Bank also undertakes stress tests on positions on its balance sheet. The results of the stress testing complement the VaR measure in informing management about financial risk on the balance sheet.

Notes to the Banking Department Financial Statements continued

28 Financial risk management continued

Currency risk

The Bank may take currency risk in the context of foreign exchange intervention, though no such operations were conducted in the current or preceding year. Additionally, limited foreign currency exposures may arise in the course of balance sheet management. However, the majority of these potential exposures are matched, mainly through the use of forward exchange contracts and currency swaps, and residual foreign exchange exposures are hedged on a regular basis. Therefore the Bank has no significant net foreign currency exposure, other than the Bank's investment in the Bank for International Settlements which is denominated in Special Drawing Rights and held at fair value of £484 million (2011: £412million). Excluding this, the Bank's net foreign exchange exposure at 29 February 2012 was £8 million (2011: £4 million).

c Liquidity risk

Liquidity risk is the risk of encountering difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

In sterling, liquidity risk does not arise as the Bank is able to create sterling liquidity through its market operations.

For foreign currency, in addition to holding appropriate cash balances, the Bank manages liquidity through cash-flow matching and the use of forward exchange contracts and currency swaps; the Bank also holds a portfolio of liquid foreign exchange reserves. Throughout 2011/12 the Bank continued weekly tender operations (which had recommenced in May 2010) to lend US dollar funds for 7 days against eligible collateral. Since October 2011, monthly US dollar tender operations with a 3-month term have also been offered. US dollar funding to facilitate these operations would be provided through a reciprocal swap agreement with the US Federal Reserve.

The Bank's Balance Sheet Remit and Liquidity Risk standard and supporting policies set out risk tolerances and detailed parameters and controls to minimise the foreign currency liquidity risk that arises. These include limits over cash flow and maturity mismatches, and for bond holdings, minimum issue size and concentrations limits are set as well as reporting requirements for key risk indicators. The following tables analyse the Bank's foreign currency financial assets and liabilities at the balance sheet dates into relevant maturity groupings based on the remaining period to the contractual maturity date.

Foreign currency liquidity risk
As at 29 February 2012

	Up to 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m	Total £m
Assets						
Cash and balances with other central banks	372	–	–	–	–	372
Loans and advances to banks and other financial institutions	4,687	3,544	5,252	–	–	13,483
Securities held at fair value through profit and loss	530	502	272	3,501	–	4,805
Derivative financial instruments						
Cash inflow	2,446	1,058	2,962	2,304	–	8,770
Cash outflow	(2,759)	(1,694)	(4,024)	(2,233)	–	(10,710)
Other assets	1,246	–	–	–	–	1,246
Total assets	**6,522**	**3,410**	**4,462**	**3,572**	**–**	**17,966**
Liabilities						
Deposits from central banks	3,279	1,883	3,702	–	–	8,864
Deposits from banks and other financial institutions	519	–	–	–	–	519
Other deposits	414	–	–	–	–	414
Foreign currency bonds in issue	1,310	–	12	3,818	–	5,140
Derivative financial instruments						
Cash inflow	(3,777)	(915)	(864)	(371)	–	(5,927)
Cash outflow	3,927	1,910	1,359	418	–	7,614
Other liabilities	1,334	–	–	–	–	1,334
Total liabilities	**7,006**	**2,878**	**4,209**	**3,865**	**–**	**17,958**
Net liquidity gap	**(484)**	**532**	**253**	**(293)**	**–**	**8**
Cumulative gap	**(484)**	**48**	**301**	**8**	**8**	

Notes to the Banking Department Financial Statements continued

28 Financial risk management continued

As at 28 February 2011

	Up to 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m	Total £m
Assets						
Cash and balances with other central banks	326	–	–	–	–	326
Loans and advances to banks and other financial institutions	4,610	2,380	5,842	–	–	12,832
Securities held at fair value through profit and loss	643	472	423	3,317	–	4,855
Derivative financial instruments						
Cash inflow	2,222	280	3,108	806	–	6,416
Cash outflow	(2,310)	(478)	(3,742)	(788)	–	(7,318)
Other assets	1,366	–	–	–	–	1,366
Total assets	**6,857**	**2,654**	**5,631**	**3,335**	**–**	**18,477**
Liabilities						
Deposits from central banks	3,846	1,302	3,509	–	–	8,657
Deposits from banks and other financial institutions	370	117	84	–	–	571
Other deposits	409	–	–	–	–	409
Foreign currency bonds in issue	1,310	–	8	3,800	–	5,118
Derivative financial instruments						
Cash inflow	(2,815)	(1,375)	(472)	(1,844)	–	(6,506)
Cash outflow	2,847	2,223	2,182	1,988	–	9,240
Other liabilities	992	–	–	–	–	992
Total liabilities	**6,959**	**2,267**	**5,311**	**3,944**	**–**	**18,481**
Net liquidity gap	**(102)**	**387**	**320**	**(609)**	**–**	**(4)**
Cumulative gap	**(102)**	**285**	**605**	**(4)**	**(4)**	

d Fair value of financial assets and liabilities

The table below shows the financial instruments carried at fair value by valuation method:

As at 29 February 2012

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Loans and advances to banks and other financial institutions	–	12,984	–	12,984
Securities held at fair value through profit or loss	4,653	129	–	4,782
Derivative financial instruments	–	461	–	461
Available for sale securities	4,852	–	488	5,340
	9,505	**13,574**	**488**	**23,567**
Liabilities				
Deposits from central banks	–	13,590	–	13,590
Foreign currency bonds in issue	5,104	–	–	5,104
Derivative financial instruments	–	232	–	232
	5,104	**13,822**	**–**	**18,926**

As at 28 February 2011

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Loans and advances to banks and other financial institutions	–	12,536	–	12,536
Securities held at fair value through profit or loss	4,367	385	–	4,752
Derivative financial instruments	–	314	–	314
Available for sale securities	4,524	–	417	4,941
	8,891	**13,235**	**417**	**22,543**
Liabilities				
Deposits from central banks	–	12,967	–	12,967
Foreign currency bonds in issue	5,037	–	–	5,037
Derivative financial instruments	–	366	–	366
	5,037	**13,333**	**–**	**18,370**

There have been no transfers between levels in the year.

Level 1 Valued using unadjusted quoted prices in active markets for identical financial instruments.

Level 2 Valued using techniques that rely upon relevant observable market data curves. This category of instruments comprised derivatives, repurchase transactions, commercial paper and deposits.

Level 3 Valued using techniques where at least one input that could have a significant impact on the valuation is not based on observable market data. During the year this category consisted primarily of the Bank's investment in the Bank for International Settlements (note 14).

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

Notes to the Banking Department Financial Statements continued

29 Contingent liabilities and commitments

a Contingent liabilities

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

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

Since 1930 there has also been a contingent liability in respect of uncalled capital on the Bank's investment in the Bank for International Settlements, now denominated in Special Drawing Rights (SDR). The sterling equivalent of this liability based on the SDR price at the balance sheet date was £175 million (2011: £173 million).

The Bank has been required to subscribe to the share capital of the European Central Bank (ECB) since its establishment in 1998. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the European System of Central Banks (ESCB) Statute and which must be adjusted every five years and on the accession of new states to the European Union. The next quinquennial adjustment is due in 2014.

In accordance with the Treaty on the Functioning of the European Union, and in line with other non euro area national central banks, the Bank is only required to pay a 'minimal percentage' of its subscribed share capital, currently 3.75% amounting to €59 million (2011: 3.75% amounting to €59 million) by way of contribution to the operational costs of the ECB. The 'minimal percentage' can be varied by the General Council of the ECB. The Bank has not been notified of any intentions to change the 'minimal percentage'.

b Capital commitments

Capital commitments outstanding at 29 February 2012 amounted to £4 million (2011: £6 million).

In addition the Bank had contingent capital commitments outstanding at 29 February 2012 of £6 million (2011: £nil).

c Operating lease commitments — minimum lease payments

	2012		2011	
	Land and buildings £000	**Computer and other equipment £000**	Land and buildings £000	Computer and other equipment £000
At the year end, minimum lease payments under non-cancellable operating leases were:				
Expiring within one year	59	109	51	4
Between one and five years	829	90	1,506	–
Expiring in five years or more	820	–	792	–
	1,708	**199**	**2,349**	**4**

The Bank leases the premises occupied by its Agencies.

30 Related parties

Transactions with those commercial banks which are related parties but not wholly-owned by HM Treasury have not been disclosed as the Bank does not believe such disclosures to be appropriate having regard to its functions.

a HM Government

The Bank provides a range of activities to its shareholder, HM Treasury, and to other Government departments and bodies:

- Provision of banking services, including holding the principal accounts of Government.
- Management of the Exchange Equalisation Account.
- Management of the note issue.

The Bank also engaged in transactions with the Financial Services Compensation Scheme and other related parties.

The aggregate balances on HM Treasury and other public sector accounts are included within note 22 as public deposits. The total charges made to the Government are disclosed in note 4.

Debt Management Office

The Bank has entered into agreements with the United Kingdom Debt Management Office (DMO) whereby the DMO lends UK government securities to the Bank with the simultaneous agreement that the Bank would deliver equivalent securities to the DMO on termination of those agreements.

At 29 February 2012 the Bank had borrowed Treasury bills with a face value of £nil (2011: £91 billion) under the Bank's Special Liquidity Scheme.

In the year to 29 February 2012 the Bank paid the DMO loan fees for Treasury bills borrowed of £26 million (2011: £93 million).

At 29 February 2012 the Bank had a loan from the DMO of £508 million (2011: £508 million) in relation to the provision of funding to the Bank of England Asset Purchase Facility Fund Ltd.

In addition, the DMO placed interest bearing deposits with the Bank during the year which are included within note 22 as public deposits.

HM Treasury

HM Treasury indemnified the Bank against any losses it may have incurred in connection with the Special Liquidity Scheme and continues to indemnify the activities of the Bank of England Asset Purchase Facility Fund Ltd during the year.

The Bank has requested HM Treasury to require the Financial Services Compensation Scheme (FSCS) to make a payment reimbursing the sum of £2.9 million in respect of expenses incurred by the Bank in connection with the resolution of Dunfermline Building Society in accordance with the Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2009.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the United Kingdom's statutory fund of last resort for customers of authorised financial services firms set up under the Financial Services and Markets Act 2000 (FSMA). The FSCS is independent from the Financial Services Authority, although accountable to it and ultimately to the Treasury.

The FSCS placed interest bearing deposits with the Bank during the year which are included within note 22 as public deposits.

Notes to the Banking Department Financial Statements continued

30 Related parties continued

Bradford & Bingley plc and Northern Rock (Asset Management) plc

Bradford & Bingley plc and Northern Rock (Asset Management) plc are wholly-owned by HM Treasury through the holding company UK Asset Resolution Ltd and placed interest bearing deposits with the Bank during the year that are included within note 21.

Northern Rock plc

Northern Rock plc was wholly-owned by HM Treasury through the holding company UK Asset Resolution Ltd until it was acquired by Virgin Money on 1 January 2012.

During the period to 31 December 2011, Northern Rock plc held interest bearing deposits with the Bank.

b Subsidiaries

Full details of the subsidiaries of the Bank are disclosed in note 15.

Bank of England Asset Purchase Facility Fund Ltd (BEAPFF)

BEAPFF is a wholly-owned subsidiary of the Bank. It was established on 30 January 2009 in order to fulfil the remit of the Chancellor of the Exchequer given to the Bank on 19 January 2009. This remit was subsequently expanded to enable the Fund to be used as a monetary policy tool at the request of the Monetary Policy Committee.

The financial statements of BEAPFF have not been consolidated as the Bank has no economic interest in its activities. BEAPFF's operations are fully indemnified for loss by HM Treasury and any surplus for these operations is due to HM Treasury.

Purchases of assets by BEAPFF are financed via a loan from the Bank. From 6 March 2009 to 4 February 2010 and from 7 October 2011 advances on this loan were financed by the issuance of central bank reserves. Prior to 6 March 2009 and from 4 February 2010 to 6 October 2011 advances on this loan were financed by a loan from the DMO.

At 29 February 2012 the loan from the Bank to BEAPFF was £286.6 billion (2011: £199.8 billion). Interest on this loan is receivable at Bank Rate and amounted to £1.1 billion for the year ending 29 February 2012 (2011: £1.0 billion).

At the year end BEAPFF held a deposit at the Bank of £20.7 billion (2011: £11.8 billion), which is included in other deposits (note 22). Interest on this deposit is payable at Bank Rate and totalled £85 million for the year ending 29 February 2012 (2011: £44 million).

c Key management personnel

Members of Court are covered by an indemnity from the Bank, granted in 2000 (see page 4).

The following information is presented only in respect of those employees of the Bank who would be considered as key management personnel, as defined under IAS 24 (Related Party Disclosures). This comprised the Governors, members of the Executive Team and Non-executive Directors. At 29 February 2012, the number of key management personnel was 22 (2011: 21).

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

	2012 £000	2011 £000
Loans		
Balance brought forward	44	24
Loans made during year	12	34
Loans repaid during year	(24)	(14)
	32	**44**
Interest income earned	1	1
Number of key management personnel with loans at 29 February	3	3

No provisions have been recognised in respect of loans given to related parties (2011: £nil).

	2012 £000	2011 £000
Deposits		
Governors and Executive Directors		
Balance brought forward	849	464
Deposits taken during year	683	1,082
Deposits repaid during year	(787)	(697)
	745	**849**
Non-executive Directors		
Balance brought forward	4,538	4,534
Deposits taken during year	1,010	2,004
Deposits repaid during year	–	(2,000)
	5,548	**4,538**
Interest expense on above deposits	15	13
Number of key management personnel with deposits at 29 February	7	6

Loans and deposits repaid during the year include movements due to changes in key management personnel.

There were no other transactions that would be required to be shown under the provisions of the Companies Act 2006. None of the key management personnel had a material interest, directly or indirectly, at any time during the year in any other significant transaction or arrangement with the Bank or any of its subsidiaries.

All employees, excluding the Governor, Deputy Governors, the Legal Adviser to the Governor and external MPC members, are entitled to season ticket loans (repayable monthly over five to twelve months) and may choose to take personal loans (for periods of up to five years and at a variable interest rate equal to HMRC's Official Rate of Interest currently 4%) as part of their remuneration package.

Notes to the Banking Department Financial Statements continued

30 Related parties continued

Staff, including Governors and Executive Directors, holding current and interest-bearing deposit accounts at the Bank of England receive interest at commercial rates. With effect from 1 June 2009, newly appointed Non-executive Directors may not open accounts at the Bank of England.

Key management remuneration

	2012 £000	2011 £000
Salaries and short-term benefits	3,372	2,712
Post-employment benefits	330	690
	3,702	**3,402**

Post-employment benefits have been calculated on a funding valuation basis.

Full information on the remuneration (including pension arrangements) of the Members of Court is given in the Remuneration report on pages 44 to 46.

d The Bank's pension scheme

The Bank provides the secretariat, accounting services and some banking and custodial services to the Bank's funded pension scheme. In the year to 29 February 2012 no charge was made for these services (2011: £nil). These activities are undertaken on behalf of, and under the supervision of, the Trustee of the Pension Fund. The contribution paid to the scheme during the year was £67 million (2011: £67 million). There were no other material transactions between the Bank and the pension scheme during the year to 29 February 2012. At 29 February 2012 the balances on accounts held with the Bank were £19 million (2011: £18 million).

e Other entities with links to the Bank

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

31 Post Balance Sheet Events

The Bank has undertaken to bear the costs arising from certain leased property at Canada Square currently occupied by the Financial Services Authority which will be vacated from the commencement of the new regulatory regime.

This obligation crystallised when the Bank agreed to lease a property at 20 Moorgate from which to operate the Prudential Regulation Authority on 27 April 2012.

The vacated property will not be occupied by the Bank but it is anticipated that it will in whole or in part be sublet. The current best estimate of the net liability to be recognised in the accounts to February 2013 is between £10 million and £30 million.

A sub-committee of Court reviewed the relative costs and benefits of locating the Prudential Regulation Authority in Canada Square as set out in the Report of the Non-executive Directors on page 48 of the Annual Report. The potential costs of any unlet space formed part of that review.

32 Date of approval

The Members of Court approved the financial statements on pages 52 to 96 on 20 June 2012.

Issue Department

Account: for the period ended 29 February 2012

	Note	2012 £m	2011 £m
Income and profits			
Securities of, or guaranteed by, the British Government		664	292
Other securities and assets		258	255
		922	547
Expenses	2		
Cost of production of Bank notes		36	40
Cost of issue, custody and payment of Bank notes		26	23
Other expenses		9	9
		71	72
Payable to HM Treasury		851	475

Statement of Balances: 29 February 2012

	Note	2012 £m	2011 £m
Assets			
Securities of, or guaranteed by, the British Government	3	5,749	5,687
Other securities and assets including those acquired under reverse repurchase agreements	4	49,172	46,507
Total assets		54,921	52,194
Liabilities			
Notes issued:			
In circulation	5	54,921	52,194
Total liabilities		54,921	52,194

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

Sir Mervyn King Governor
Mr C R Bean Deputy Governor
Sir David Lees Chairman of Court
Mr W R Jones Finance Director

The notes on pages 98 and 99 are an integral part of these statements of accounts.

Notes to the Issue Department Statements of Account

1 Bases of preparation

The statements of account are prepared in accordance with the requirements of the Currency and Bank Notes Acts 1928 and 1954, the National Loans Act 1968 and the Currency Act 1983. All profits of the note issue are payable to the National Loans Fund.

- The statements of account are prepared on the basis of amounts received and paid as modified by the effects of a revaluation of securities.
- All securities are revalued quarterly at their clean mid-market price and are stated, with purchased accrued interest, in the balance sheet at this valuation. The last valuation was made as at 28 February 2012.
- If a revaluation of securities shows a net gain this is included in income. A deficit is not taken against income but is settled by a transfer from the National Loans Fund. Total such gains in the year to 29 February 2012 amounted to £394 million (2011: net gain £8 million).
- Notes in circulation exclude old series notes which have been written off. The value of the note is still given by the Bank on presentation. The Bank is reimbursed by HM Treasury in these instances.

2 Expenses

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

On an accruals basis, the cost of note issue for the year to 29 February 2012 was £72 million (2011: £74 million).

3 Securities of, or guaranteed by, the British Government

	2012 £m	2011 £m
British Government Stocks	5,379	5,317
Ways and Means advance to the National Loans Fund	370	370
	5,749	**5,687**

The Ways and Means advance earns interest at Bank Rate.

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

	2012 £m	2011 £m
Deposit with Banking Department	47,562	36,284
Reverse repurchase agreements	1,610	10,223
	49,172	**46,507**

5 Notes in circulation

	2012 £m	2011 £m
£5	1,477	1,355
£10	6,841	6,493
£20	33,129	30,973
£50	9,899	9,940
Other notes*	3,575	3,433
	54,921	**52,194**

*Includes higher value notes used as cover for the note issues of banks in Scotland and Northern Ireland.

6 Assets and liabilities

a Interest rate exposure

As the liabilities of the Issue Department are interest free, the income of the Issue Department is directly exposed to movements in interest rates. As at the year end 29 February 2012, the assets of the Issue Department had the following repricing period profile; repricing in up to one month £49.5 billion (2011: £46.5 billion), repricing in greater than one but less than three months £nil (2011: £0.4 billion), repricing in greater than three but less than six months £0.4 billion (2011: £0.3 billion), repricing in greater than six but less than twelve months £nil (2011: £nil) and repricing greater than one year £5.0 billion (2011: £5.0 billion). Prior year figures have been restated to reflect that index linked long-term reverse repurchase agreements are considered to be repriced within 1 month.

b Currency exposure

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

c Credit risk

Credit risk is the risk of loss arising from the failure of a borrower, issuer, counterparty or customer to meet its financial obligations to the Bank. The Bank is exposed to credit risk both through direct exposures and through contingent exposures, such as via collateral. The source of credit risk arises as a result of the Bank providing liquidity to financial institutions via open market operations.

In providing liquidity via routine open market operations, and, intraday, via the Bank's operation of wholesale payment systems, credit risk is managed by ensuring that exposures are fully collateralised (with appropriate margin) by internally rated as equivalent to investment-grade securities.

Credit risk on the securities held by the Bank is managed by holding only internally rated as equivalent to investment-grade securities in routine circumstances, issued chiefly by governments and central banks.

7 Accrued interest

At 29 February 2012 the unrecognised accrued interest on the assets held on the Issue Department Statement of Balances was £86 million (2011: £101 million).

8 Date of approval

The Members of Court approved the statements of account on pages 97 to 99 on 20 June 2012.

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Enquiries relating to the Bank of England *Quarterly Bulletin* and *Inflation Report* may be made on 020 7601 4030 and *Financial Stability Report* on 020 7601 4314.

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