Annual Report 2013

BANK OF ENGLAND

Bank of England Annual Report 2013

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

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BANK OF ENGLAND

The Bank's Core Purposes are determined by Court as part of its role in setting the Bank's objectives and strategy. The statement on page 1 was endorsed by Court in May 2013.

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The Bank's Financial Statements

The Bank's core purposes

The Bank of England exists to ensure monetary stability and to protect and enhance the stability of the financial system.

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

Core Purpose 2 **Financial Stability**
Financial stability entails maintaining an efficient flow of funds within the economy and confidence in financial intermediaries. This is pursued through: the Bank's financial operations, including as lender of last resort; the decisions of the Financial Policy Committee; the PRA's[1] prudential regulation of financial institutions; the Bank's role as resolution authority; and Bank oversight and regulation of key payment, clearing and settlement infrastructure.

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

- Other central banks and international organisations to improve the international monetary and financial system.
- HM Treasury and the Financial Conduct Authority.

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

(1) Prudential Regulation Authority.

Foreword by the Chairman of Court

Sir David Lees Chairman

The role of the Non-executive Directors — on the Bank's Court as on any other Board — is to provide challenge and informed criticism, and where necessary to ensure that lessons are learned and acted upon. It is also our role to recognise success, and the completion of the series of projects to prepare the Bank for its new responsibilities, culminating in the transition of 1,185 staff into a newly fitted out building close to the Bank, was a signal achievement. The Bank's new Prudential Regulation Authority (PRA) started work on 1 April in an almost seamless transition from the Financial Services Authority (FSA). At the same time the Bank acquired new responsibilities for financial infrastructure, and the Financial Policy Committee (FPC) was established as a statutory committee of Court. All those involved in managing and supporting this transition — at the Bank and at the FSA — deserve our thanks.

Putting the pieces together is of course just the start. The new macro and micro regulators now have to meet the high expectations of the new framework, and Court's role is to ensure that they do so. Court itself is changed by the 2012 legislation. Its new Oversight Committee, which replaces NedCo, the former Committee of Non-executive Directors, has a broad responsibility for keeping under review the Bank and its major policy committees, and has powers to do so. Like the former Committee, it is required to keep under review the Bank's performance as an organisation — its strategy, budgets, risk and controls — but unlike NedCo, it is concerned not just with the process and procedures of policy but also with the outcomes. Members of the Oversight Committee will be able to attend any of the policy committees as observers and may commission *ex-post* reviews of policy outcomes. This is a major change, and the new Committee has already started to plan the way forward.

During the year, the Court commissioned reviews of three key functions of the Bank that were tested in the financial crisis: macroeconomic forecasting, the provision of liquidity and liquidity assurance to the banking system as a whole, and the provision of emergency support to individual institutions. The reviews made a large number of recommendations, the vast majority of which the Bank accepted. The Oversight Committee will continue to review implementation.

Also in preparation for the legislative changes, Court reviewed in detail the way in which it delegates functions to the executive of the Bank and to its own sub-committees. The result is contained in a statement of 'Matters reserved to Court', which serves as a comprehensive guide to the Bank's new governance arrangements and which has been published on the Bank's website.

The executive of the Bank has also adapted the way it operates: as documented elsewhere in this *Report*, a number of new Committees have been formed under the Deputy Governors to oversee key aspects of the Bank's work. This was an essential change given the scale of the new responsibilities of the Bank as a whole and the Governor in particular. In addition to the Monetary Policy Committee (MPC) and the FPC, the Governor now chairs the PRA Board which meets typically twice a month and which, as well as overseeing regulatory policy, will be responsible for all major microprudential decisions. Another significant change is the decision to appoint a Chief Operating Officer of the Bank, to draw together all internal management issues.

Like any Board, Court must monitor its own effectiveness, and does so each year. This year's review was completed in March and included five priority actions for Court going forward. I have been grateful for the support of all my colleagues on Court over the year, which has required the formation of several new Committees and working parties in addition to the established audit and remuneration committees. During the year Harrison Young, Mark Tucker and Brendan Barber left the Court — the latter after nine years of service; and they were replaced by Bradley Fried, Tim Frost and Dave Prentis. One of the changes in the new Act was to appoint members for renewable terms of up to four years, a change that I greatly welcome as providing greater continuity.

I very much welcome Mark Carney's appointment as Governor. He has an outstanding reputation as a central bank Governor, and internationally as chairman of the G20 Financial Stability Board. The Bank is fortunate to have him as successor to Mervyn King, who leaves the Bank in June after 23 years' service, the last ten as Governor. Mervyn's contribution to the Bank has been immense: he was the architect of the present monetary arrangements, the first author of the *Inflation Report*, a founding member of the MPC and the progenitor of the FPC. His vision and analytical rigour has been applied to every aspect of the Bank's work, from monetary policy through crisis management to prudential regulation. His has been a job well done and we wish him every success and happiness in whatever lies ahead.

28 May 2013

Foreword by the Governor

Sir Mervyn King Governor

It has been a year of profound change for the Bank. 1,405 people have joined the organisation as we took on our new regulatory responsibilities. At the same time, we have continued, in the aftermath of the financial crisis, to promote price stability, build a resilient financial system and deliver a sustainable recovery in the UK economy.

The MPC has had to strike a delicate balance. Inflation has fallen from its 2011 peak, but remains above our 2% target. That reflects increases in administered and regulated prices, including electricity and gas, rail fares and university tuition fees. Market-generated inflation pressures and wage growth have remained subdued, encouraging the Committee to look through the impact of administered prices. Meanwhile economic growth has been much weaker than most commentators had expected, held back by the crisis in the euro area, as well as the protracted squeeze on the level of real take-home pay.

The MPC has already done a great deal to stimulate economic activity. Bank Rate has been held at near zero for over four years and markets expect it to remain there for many years to come. And an enormous amount of new money has been injected into the economy via our purchases of gilts, which amount to about 25% of GDP. The Funding for Lending Scheme — a joint initiative with HM Treasury — provides long-term funding for banks linked to their lending to UK households and businesses. The Scheme has contributed to a sharp reduction in funding costs for UK banks and building societies since the middle of 2012, leading to a reduction in borrowing costs and an increase in the availability of credit.

The scale of the stimulus provided by the Bank means that there are now good reasons to suppose that a gentle recovery is under way. But to support an improvement in credit conditions and ensure that recovery, confidence in our financial system must be restored. For that, our banks must be adequately capitalised. That is why the Bank's FPC, which was given statutory powers in April as the Financial Services Act came into force, has recommended that Britain's banks take action to deal with a significant, but manageable, shortfall in their overall capital position.

The greatest change at the Bank this year has been the creation, on 1 April, of the PRA, responsible for supervising the prudential aspects of banks, building societies, insurance companies and investment firms. The PRA's new judgement-led and forward-looking approach to supervision is now established and the PRA — under the guidance of the new PRA Board — is overseeing banks' plans to address the shortfall in capital identified by the FPC.

The creation of the PRA has involved moving 1,185 people into a new building at 20 Moorgate. It is a testament to the careful planning of the move that delicate supervisory work arising from problems in Cyprus continued seamlessly throughout the final weekend of the transition. I am proud that, in only a short period of time, the PRA and the Bank of 2012 have already become one as a new, expanded, Bank of England.

Andrew Bailey has been appointed as the Chief Executive of the PRA and a Deputy Governor of the Bank. He is the right person to lead the PRA into a new era of judgement-led supervision. Iain Cornish, Rosalind Gilmore and Charles Randell have joined the PRA Board as independent directors and will bring a wealth of experience to bear on key regulatory decisions.

With increased responsibilities for the Bank have come changes to its governance. The new legislation creates a powerful Oversight Committee of Court, made up of Non-executive Directors, which will keep under review the performance of the Bank in relation to its objectives and strategy. It will be expected to commission independent reviews from outside experts. In 2012, before the Oversight Committee formally came into being, three external reviews were carried out into aspects of the Bank's work. I am grateful to David Stockton, Ian Plenderleith and Bill Winters for their thorough and thoughtful reviews. The Bank has implemented many of their recommendations already and others are being taken forward for future implementation.

This year we have said goodbye to four members of our policy committees: Alastair Clark, Bob Jenkins, Adam Posen and Michael Cohrs (who remains a member of Court). In their place, we have welcomed Ian McCafferty to the MPC and Clara Furse, Richard Sharp and Martin Taylor to the FPC. Brendan Barber, Mark Tucker, Adair Turner and Harrison Young have left Court and Bradley Fried, Tim Frost and Dave Prentis have been appointed. I would like to thank all those who have left for their valuable service to the Bank and wish them well in their new roles.

This is my last Foreword to a Bank of England *Annual Report*. My proudest achievement has been to attract the best and the brightest to embrace public service here at the Bank. In return, I have had the extraordinary privilege of working with them over more than two decades. My final task is to welcome Mark Carney as the new Governor. He will bring great qualities and his own approach. I wish him every success and I know I am leaving the Bank in safe hands.

28 May 2013

The Role of Court, its Committees and the MPC

The framework for governance and accountability is set by the Bank of England Act 1998. Court acts as a unitary board of directors with executive and non-executive members; but the Non-executive Directors also meet separately, as an Oversight Committee, to keep the Bank's performance under review. As described below, amendments made by the Financial Services Act 2012 (the '2012 Act'), which came largely into force on 1 April 2013, have led to significant changes in the organisation of Court and expanded the role of the non-executive members.

The Court of Directors

The Court of Directors is responsible for managing the affairs of the Bank, other than the formulation of monetary policy. Court's statutory responsibilities include determining the Bank's objectives and strategy, and ensuring the effective discharge of the Bank's functions and the most efficient use of its resources.

Members of Court are appointed by the Crown, for periods of eight years in the case of the Governor, five years for the Deputy Governors, and up to four years for the Directors. One of the Directors is designated by the Chancellor of the Exchequer to chair Court. Details of the Court as at 28 February 2013 are shown on pages 8–9. On the coming into force of the 2012 Act, an additional Deputy Governor was appointed, to cover prudential regulation and to be Chief Executive of the PRA.

Court delegates the day-to-day management of the Bank to the Governor and through him to other members of the executive. But it reserves the right to approve a number of key decisions itself, including:

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

These 'matters reserved to Court' are reviewed annually and are published on the Bank's website.[1] Court minutes since April 2013 have been published.

In relation to the PRA, which is a wholly-owned subsidiary with its own separate Board of Directors, Court has reserved the right to conduct reviews of performance, and has delegated that function to the Oversight Committee (see below).

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

Oversight Committee

The Chairman of Court is also chairman of a new Committee of Court established under the 2012 Act, consisting of all the Non-executive Directors. In the 2012 Act this Committee, formerly known as 'NedCo', was reconstituted as the 'Oversight Committee', and its functions and powers were considerably extended. The Oversight Committee's responsibilities include monitoring the Bank's performance against all its objectives — the statutory objectives for monetary policy and financial stability (including the responsibilities of the FPC), and objectives set by Court itself — and also keeping under review the achievement of the Bank's financial management objectives, the Bank's internal controls, and the procedures of the MPC and the FPC. Members of the Committee may attend meetings of the MPC and the FPC and have access to their briefing papers. The Committee may commission external reviews to inform its work: and subject to confidentiality restrictions, these must be published. Under the 2012 Act the Committee must publish a Report as part of the Bank's *Annual Report*. The final Annual Report of NedCo is on pages 47–49.

(1) See www.bankofengland.co.uk/about/Documents/matters042013.pdf.

Remuneration Committee

Court's Remuneration Committee advises on the remuneration of the Bank's most senior executives, including the Governors, the Executive Directors (who are not members of Court), the Advisers to the Governors, the external members of the MPC and the FPC and the appointed members of the PRA Board. Final decisions on remuneration are made by the Oversight Committee (for Governors, MPC, FPC and PRA Board members) and by Court (for other members of the executive).

The members of the Remuneration Committee are Sir Roger Carr (Chairman), Michael Cohrs, Sir David Lees and Dave Prentis. The Committee's Report on Remuneration is on pages 44–46.

Audit and Risk Committee (ARCo)

The functions of the Audit and Risk Committee are to assist Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management; and to assist the Oversight Committee in discharging its responsibilities under the Bank of England Act 1998 for 'keeping under review the internal financial controls of the Bank with a view to securing the proper conduct of its financial affairs'. The Committee is responsible for providing independent assurance to Court that the Bank's risk and control procedures are adequate. The Committee, which meets regularly, has detailed terms of reference that include: receiving reports from, and reviewing the work of, the internal and external auditors; reviewing the annual financial statements prior to their submission to Court; considering the appropriateness of the accounting policies and procedures adopted; making recommendations on the appointment of the external auditors, their independence and their fees; and reviewing the Bank's risk matrix and specific business controls.

The members of the Committee are Lady Rice (Chairman), Bradley Fried, Tim Frost and John Stewart. Sir David Lees, the Deputy Governors, the Executive Director for Markets, the Finance Director, the Bank's Secretary, the Executive Director for Human Resources, the Head of Internal Audit and the external auditors normally attend the meetings of the Committee.

Financial Stability Committee
Financial System Advisory Committee (FSAC)

The Financial Stability Committee was created by the Banking Act 2009, and its statutory terms of reference related mainly to the powers given to the Bank by that Act — for bank resolution and payment system oversight. It also played a role in recommending to Court the Bank's Financial Stability Strategy. The 2012 Act abolished this Committee, so that its functions reverted to the Court of Directors. The Court in turn formed the FSAC in its place, from 1 April 2013, to advise on and monitor the performance of the Bank's financial stability functions which are not within the remit of the FPC. These include payment system oversight, the regulation of central counterparties (CCPs) and settlement systems, the Bank's role in relation to the Special Resolution Regime and emergency liquidity assistance (ELA). It consists of the Deputy Governor Financial Stability, the Chairman of Court and three other members of Court — Bradley Fried, Tim Frost and John Stewart.

Financial Policy Committee (FPC)

The FPC is a statutory sub-committee of Court. It consists of the Governor (Chairman), the three Deputy Governors, the Chief Executive of the Financial Conduct Authority (FCA), the Executive Director responsible for Financial Stability, four external members appointed by the Chancellor of the Exchequer[1] and a non-voting representative of HM Treasury. The FPC contributes to the achievement by the Bank of its Financial Stability Objective by identifying, monitoring and taking action to reduce risks to the financial system: subject to that, it is required to support the Government's economic policy, including its objectives for growth and employment. The Committee may give directions to the PRA and the FCA in relation to macroprudential measures prescribed by secondary legislation under the Bank of England Act 1998.

Monetary Policy Committee (MPC)

The Bank of England Act 1998 establishes the MPC as a Committee of the Bank and sets a framework for its operations. Under the Bank of England Act 1998, the Bank's objectives in relation to monetary policy are to maintain price stability and, subject to that, to support the Government's economic policies, including its objectives for growth and employment. At least once a year, the Government specifies the price stability target and its growth and employment objectives. The MPC must meet at least monthly; its members comprise the Governor, the Deputy Governor Monetary Policy and the Deputy Governor Financial Stability, two of the Bank's Executive

(1) Dame Clara Furse, Donald Kohn, Richard Sharp and Martin Taylor.

The Role of Court, its Committees and the MPC

Directors,[1] and four members appointed by the Chancellor of the Exchequer.[2] Membership of the MPC is given on page 13.

The MPC's decisions are announced after each monthly meeting and minutes of their meetings are published two weeks later. The quarterly *Inflation Report* includes the MPC's projections of inflation and output. The Chairman of Court meets each member of the MPC on a one-to-one basis each year to ensure that they are receiving sufficient support from the Bank to enable them to carry out their responsibilities, and to ensure that any particular issues needing attention are surfaced. A report is made to Court summarising the results of those meetings.

(1) The Executive Director for Monetary Analysis and Statistics, and the Executive Director for Markets.
(2) Ben Broadbent, Ian McCafferty, David Miles and Martin Weale.

The Court of Directors as at 28 February 2013


Sir Mervyn King Governor


Charlie Bean Deputy Governor


Paul Tucker Deputy Governor


Sir David Lees Chairman of Court


Sir Roger Carr


Michael Cohrs


Bradley Fried


Tim Frost


Dave Prentis


Lady (Susan) Rice, CBE


John Stewart


Lord (Adair) Turner

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

- Member of the Panel on Takeovers and Mergers
- Director, Royal Opera House Enterprises Limited
- Trustee, Royal Opera House Endowment Fund
- Governor, Royal Ballet School
- Governor, Shrewsbury International School in Bangkok

Sir Roger Carr
Deputy Chairman of Court and Senior Independent Non-executive Director
Appointed 1 June 2007.
Term expires on 31 May 2014.

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

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

- Advisor, EQT
- Advisory Board, British Airways
- Fellow, Cambridge University
- Non-executive Director, SurfCast Inc

Bradley Fried
Appointed 1 June 2012.
Term expires on 31 May 2015.

- Managing Partner, Grovepoint Capital LLP
- Non-executive Director, Investec plc and Investec Limited
- CEO in Residence and Fellow in Finance at Cambridge University's Judge Business School
- Fellow of Magdalene College, Cambridge

Tim Frost
Appointed 1 June 2012.
Term expires on 31 May 2014.

- Non-executive Director, Cairn Capital
- Member of Court and Council, London School of Economics
- Non-executive Director, LSE Enterprise
- Non-executive Director, Markit

Dave Prentis
Appointed 1 June 2012.
Term expires on 31 May 2015.

- General Secretary of UNISON
- Member of the Trades Union Congress Executive Council
- Member of the Labour Party Joint Policy Committee
- Vice-President of the European Public Services Union
- President of Public Services International
- Commissioner of UK Commission for Employment and Skills
- President of Unity Trust Bank

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

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

John Stewart
Appointed 1 December 2009.
Term expires on 30 November 2015.

- Chairman, Legal and General Group plc
- Chairman, The Guide Dogs for the Blind Association
- Chairman, Southern Cross Stud

Lord (Adair) Turner**
Appointed 20 September 2008.
Resigned 31 March 2013.

- Chairman, The Financial Services Authority
- Member of the Council, Overseas Development Institute
- Fellow of the Royal Society of Edinburgh
- Trustee of the British Museum

* Sir David Lees has indicated that he will retire from Court in December 2013.
** Andrew Bailey joined the Court on his appointment as Deputy Governor for Prudential Regulation on 1 April 2013. At the same time Adair Turner left the Court as his term as Chairman of the FSA came to an end.

The Executive Team

Mervyn King Governor

Charlie Bean Deputy Governor
Monetary Policy

Paul Tucker Deputy Governor
Financial Stability

Andrew Bailey Deputy Governor
Prudential Regulation and
CEO Prudential Regulation Authority

Julian Adams Executive Director
Insurance Regulation

Nils Blythe Executive Director
Communications

Catherine Brown Executive Director
HR

Spencer Dale Executive Director
Monetary Analysis and Statistics

Paul Fisher Executive Director
Markets

John Footman Secretary of the
Bank

Andy Haldane Executive Director
Financial Stability

Warwick Jones Finance Director

Graham Nicholson Chief Legal
Adviser

Chris Salmon Executive Director
Banking Services and Chief Cashier

Paul Sharma Executive Director
Regulatory Policy

The organisation chart on the following page shows how responsibility for individual functions is delegated within the Bank, including the PRA from 1 April 2013. Each major function is headed by a member of the Executive Team. The Executive Team meets regularly, and other Bank officials join the meetings when matters within their areas of responsibility are discussed.

Management structure

- **Mervyn King**
  Governor
  - **Charlie Bean**
    Deputy Governor
    Monetary Policy
    - **Spencer Dale**
      Executive Director Monetary Analysis and Statistics
    - **Paul Fisher**
      Executive Director Markets
  - **Nils Blythe**
    Executive Director Communications
  - **Warwick Jones**
    Finance Director
  - **John Footman**
    Secretary of the Bank
  - **Catherine Brown**
    Executive Director HR
  - **Graham Nicholson**
    Chief Legal Adviser
  - **Paul Tucker**
    Deputy Governor
    Financial Stability
    - **Chris Salmon**
      Executive Director Banking Services Chief Cashier
    - **Andy Haldane**
      Executive Director Financial Stability
  - **Andrew Bailey**
    Deputy Governor
    Prudential Regulation
    CEO Prudential Regulation Authority
    - **Julian Adams**
      Executive Director Insurance Regulation
    - **Paul Sharma**
      Executive Director Regulatory Policy

Review of 2012/13

During the year the Bank completed its preparations for the new regulatory regime provided for in the 2012 Act: on 1 April 2013 the statutory FPC came into being and the PRA started operating as a part of the Bank.

In the area of monetary policy, further asset purchases were announced and the Funding for Lending Scheme (FLS) was launched.

1 – Monetary stability

The Government's inflation target remains 2%, measured by the twelve-month increase in the consumer prices index (CPI). CPI inflation fell from 3.5% at the start of the year to only a little above target by September, as upward pressures on the twelve-month rate from past increases in the prices of commodities and other imported goods and services eased. But inflation picked up again over the second half of the year. In large part this reflected increases in university tuition fees and retail utility bills. These prices are particularly sensitive to administrative and regulatory decisions, and less so to the balance of domestic supply and demand. The impact from these administered prices is thought likely to persist for the next two years or so. Domestic cost pressures were more subdued, and remained consistent with inflation being much closer to target were it not for these administrative price effects. As such, in February 2013 the MPC stated their preference for bringing inflation back to target relatively slowly, in light of these administrative effects, rather than risk derailing the recovery by attempting to return inflation to target sooner.

Quarterly movements in GDP growth were volatile over the course of the year, being affected by one-off events such as the Diamond Jubilee and the Olympics. Looking through the influence of temporary factors, output was broadly flat. In contrast employment increased by almost half a million between 2012 Q1 and the 2012 Q4. Labour productivity therefore fell, putting upward pressure on the growth of companies' costs. Although unemployment fell further to 7.8% on the Labour Force Survey measure in 2012 Q4, there remained a sizable margin of slack in the economy.

Headwinds from tight credit conditions and the fiscal consolidation continued to weigh on the outlook for growth during the year and the United Kingdom's economic prospects remained particularly sensitive to developments in its external environment.

In the early summer of 2012, the MPC became increasingly concerned that developments in the United Kingdom's external environment, and in the euro area in particular, would lead to adverse movements in UK net trade, financial market prices and the confidence of UK households and companies. There remained a risk, however, that having been above target for so long inflation would fall back more slowly than the MPC anticipated.

Against this backdrop, the MPC voted in July that an increase of £50 billion in the stock of asset purchases financed by the issuance of central bank reserves, to a total of £375 billion, was warranted in order to meet the 2% CPI inflation target. Bank Rate has been left unchanged at 0.5% since March 2009.

Concerns about actual and prospective increases in the costs of funding for UK banks, and the impact this might have on lending to households and companies, led the MPC to support the FLS, which was launched jointly by the Bank and HM Treasury on 13 July 2012. The FLS was designed to provide funding at below market rates to participating banks and building societies in a manner which incentivised them to lend to the UK real economy.

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

Foreign exchange reserves

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

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

Support for the Monetary Policy Committee (including the Stockton Review)

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

Progress has continued on reaping the gains associated with introducing a new central economic forecasting platform. The greater simplicity of the central organising model has helped facilitate discussions of underlying economic drivers, as well as allowing more staff time to be spent considering them. Some progress has also been made in incorporating insights from a 'suite' of supporting models. Developing further expertise in this regard remains a priority for next year.

The Bank has continued to encourage staff involved in supporting the MPC to demonstrate intellectual assertiveness when briefing the Committee and to challenge both the MPC's forecast judgements and the received wisdom on key issues more generally. This is essential to ensure that a well-rounded view of the issues facing monetary policy is presented to the MPC. It is also consistent with the emphasis placed on providing challenge to key MPC judgements by the Stockton Review recently commissioned by Court on the MPC's forecasting capability.

Other key themes emerging from the Stockton Review were the desirability of enhancing the role of monetary policy analysis within the MPC's forecast process and of providing greater transparency about the MPC's forecasts. There is considerable enthusiasm to take forward a number of specific options intended to promote such

Members of the Monetary Policy Committee


Mervyn King Governor

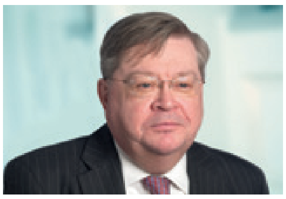

Charlie Bean Deputy Governor Monetary Policy


Paul Tucker Deputy Governor Financial Stability


Ben Broadbent


Spencer Dale


Paul Fisher


Ian McCafferty(1)


David Miles


Martin Weale

(1) Ian McCafferty began his term on 1 September 2012, replacing Adam Posen.

Review of 2012/13 continued

improvements, and support to the MPC is evolving accordingly. Details can be found in the Bank's response to the Court reviews, published in March 2013.(1)

During the year, the Bank's analytical support for the MPC focused particularly on: further research into the impact of quantitative easing (including into its distributional consequences, on which the Bank published a paper in August);(2) monitoring the impact of the FLS and assessing prospects for net lending to the real economy more generally; the United Kingdom's external environment, including the transmission of events abroad to the UK economy via financial markets; the impact of the recession on the supply capacity of the economy, including the weakness of productivity; prospects for household spending; and risks to inflation expectations.

In 2013/14 the Bank's analytical support for the MPC will remain focused on ensuring that the Committee has the information it needs to make decisions about monetary policy. Work is under way to strengthen the Bank's ability to analyse and model medium-term influences on inflation, including the productive capacity of the economy, shifts in the pattern of demand and production, global price pressures and inflation expectations.

The Bank will also continue to analyse the impacts both of quantitative easing and of the FLS.

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

2 – Market operations

The Bank's operations in the sterling money markets have two objectives stemming from its monetary policy and financial stability responsibilities — to implement the MPC's decisions in order to meet the inflation target; and to reduce the cost of disruption to the liquidity and payment services supplied by banks to the UK economy. The Bank's Asset Purchase Facility (APF) provides the MPC with an additional tool of monetary policy, by targeting the level of asset purchases financed by the creation of central bank reserves. The framework for the Bank's operations in the sterling money markets, known as the Sterling Monetary Framework, is set out in the Bank's 'Red Book'.(3)

Asset Purchase Facility

Since its creation in January 2009, the APF has served two functions. Its first function is to provide a means for the MPC to relax monetary policy by purchasing assets financed by the creation of central bank reserves and hence injecting liquidity directly into the economy.

Although the MPC has maintained the level of Bank Rate at 0.5% since March 2009, in 2012 it announced two extensions to its asset purchase programme. On 9 February 2012, the MPC announced that the APF would purchase an additional £50 billion of gilts; the purchases were completed in May 2012. On 5 July 2012, the MPC announced that the APF would purchase an additional £50 billion; that programme was completed on 31 October 2012. The stock of asset purchases financed by the issuance of central bank reserves was £375 billion at the end of the 2012/13 financial year. At its February 2013 meeting, the MPC noted that the APF's holdings of the March 2013 gilt would mature in early March and agreed to reinvest the cash flows of £6.6 billion associated with this redemption.

The second purpose of the APF is to improve liquidity in selected secondary private credit markets, by acting as a backstop provider of liquidity. The various schemes largely achieved their objectives during 2009 and 2010. By the end of February 2013, the corporate bond portfolio stood at around £23 million, down from its peak of £1.6 billion in June 2010. The secured commercial paper facility was not used during 2012 but it remains open should any new programmes be submitted for eligibility. The quarterly reports of the APF contain further details of all the transactions made.(4)

On 9 November 2012, HM Treasury announced arrangements to transfer gilt coupon payments received by the APF, net of interest costs and other expenses, to the Exchequer as partial settlement of the indemnity to HM Treasury over a nine-month period. As purchases of the APF had reached £375 billion, this Facility had expected to accumulate a large cash balance: around £31.6 billion by the end of the financial year 2012/13. At the end of February 2013, £7.5 billion of that had been

(1) See www.bankofengland.co.uk/publications/Pages/news/2013/051.aspx.
(2) See www.bankofengland.co.uk/publications/Pages/news/2012/073.aspx.
(3) Available at www.bankofengland.co.uk/markets/Documents/money/publications/redbookjune2012.pdf.
(4) Available at www.bankofengland.co.uk/publications/Pages/other/markets/apf/quarterlyreport.aspx.

transferred to HM Treasury and the remainder will be transferred during 2013/14. These arrangements are detailed in an exchange of letters between the Chancellor of the Exchequer and the Governor.(1)

Funding for Lending Scheme

As described above, the FLS was launched on 13 July 2012. For a fee, banks and building societies can borrow UK Treasury bills from the Bank for a period of up to four years against a wide range of collateral. The fee depends on the amount of net lending during the period between 30 June 2012 and 31 December 2013. The FLS opened on 1 August 2012. At the end of February 2013, 39 firms had signed up to the Scheme and had drawn £15.2 billion.(2)

On 24 April 2013 an extension was announced to the FLS. Additional drawings will be allowed until the end of January 2015 based on net lending from 1 January 2014, with an initial allowance based on lending from 1 April–31 December 2013. Within these periods extra weight will be placed on lending to small and medium-sized enterprises (SMEs). The FLS will also be expanded to include lending by banking groups involving financial leasing corporations and factoring corporations, and certain non-bank mortgage lenders.

Sterling Monetary Framework

The Bank's Sterling Monetary Framework (SMF) is designed to allow it to meet its objectives of implementing the MPC's decisions on Bank Rate, and providing liquidity insurance to the banking system.

The system of reserves averaging, whereby commercial banks set their own target levels for holdings of central bank reserves in the period between one MPC decision date and the next, was suspended in March 2009. Since then, all reserves balances have been remunerated at Bank Rate. The Bank is prepared to reintroduce the reserves averaging framework if required. Those elements of the SMF designed to provide liquidity insurance to the banking system have remained in operation throughout.

The Bank offers a range of liquidity insurance facilities. The monthly indexed long-term repo operations offer eligible counterparties three-month or six-month cash, via a competitive auction mechanism, against either the Bank's 'narrow' or 'wider' collateral sets.(3) As the degree of financial stress in the system increases, the auction permits allocation of a higher proportion of the funds against the wider collateral set.(4)

The Bank also stands ready to provide liquidity insurance on a bilateral basis via its Discount Window Facility (DWF). The pool of DWF-eligible collateral is broader than the 'wider' collateral set, and includes own-name securities, covered bonds and portfolios of unsecuritised 'raw' loans. From its introduction in 2008, the Bank has been encouraging eligible counterparties to pre-position collateral in the DWF, to ensure that they are capable of drawing on the facility at short notice, if required, and since mid-2012 to collateralise their use of the FLS.

The Bank launched the Extended Collateral Term Repo (ECTR) Facility in December 2011. The ECTR Facility is a contingent facility that is a permanent addition to the Bank's SMF, which enables the Bank to provide liquidity to the banking system as a whole against pre-positioned DWF collateral. On 15 June 2012, given current and prospective market conditions, the Bank announced that it would run regular monthly ECTR auctions, offering six-month sterling liquidity against collateral pre-positioned for use in the Bank's DWF.(5) The ECTR auctions in November and December 2012 received no bids and so the auctions were suspended. The ECTR Facility remains activated and the Bank will hold further auctions if it judges there is sufficient demand. That will remain the position until the Bank has concluded its response to the Winters Review, which was commissioned by Court and contained recommendations related to the future of these operations.

Winters Review

Bill Winters assessed the SMF and how it had functioned and developed during the crisis. The Winters Review concluded that the SMF had been improved throughout the financial crisis and that it was robust and broadly fit for purpose. The Review identified several options for improving the SMF further. Some of these options

(1) Available at www.bankofengland.co.uk/publications/Pages/news/2012/104.aspx.
(2) For more information, see www.bankofengland.co.uk/markets/Pages/FLS/default.aspx.
(3) The 'narrow' collateral set includes those securities issued in the deepest and most liquid markets which, in the Bank's view, are likely to remain liquid in all but the most extreme circumstances. The 'wider' collateral set comprises high-quality securities which would normally be expected to trade in liquid markets, and which satisfy the Bank's criteria for the suitability of assets as wider collateral.
(4) For more information, see Fisher (2011), 'Recent developments in the sterling monetary framework', available at www.bankofengland.co.uk/publications/Documents/speeches/2011/speech487.pdf.
(5) See www.bankofengland.co.uk/publications/Pages/news/2012/060.aspx for more details.

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included trying to address the 'stigma' attached to some facilities like the DWF and also governance arrangements for the SMF, including the roles of the MPC and the FPC. Work is under way to address the recommendations from the Review, many of which will be concluded in the first half of 2013.

Foreign currency liquidity insurance

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

On 13 December 2012, the Bank, in conjunction with the Bank of Canada, the European Central Bank (ECB), the US Federal Reserve and the Swiss National Bank announced an extension of the existing temporary US dollar liquidity swap arrangements by one year, to 1 February 2014. Reintroduced in May 2010, the swap lines provide a backstop for US dollar funding to UK banks and building societies should they require it. As at the end of February 2013, there had been no usage of the reinstated facility in the United Kingdom since its reintroduction. In addition, the five central banks and the Bank of Japan agreed to extend the network of bilateral reciprocal swap lines for a further year to 1 February 2014. This would allow any one central bank to provide liquidity to its banking system in any of the other currencies, if required.(1)

Since December 2010, the Bank has also maintained a temporary swap agreement with the ECB, to enable the provision of sterling liquidity to ECB counterparties if required, subject to a limit of £10 billion. During the year, the term of the agreement was extended until 30 September 2013.(2) At the end of February 2013, there were no outstanding transactions under this facility.

On 22 February 2013 the Bank announced that it was in discussions with the People's Bank of China on the establishment of a reciprocal three-year renminbi-sterling swap arrangement. The arrangement would be used to finance trade and direct investment between the two countries and to support domestic financial stability should market conditions warrant.(3)

Managing risk on the balance sheet

In November 2010, the Bank announced a new initiative which required greater transparency regarding asset-backed securities.(4) Most newly issued UK residential mortgage-backed securities and covered bonds now comply with the Bank's new criteria. This means that new UK transactions will be accompanied by loan-level data, transaction documents and cash-flow models, which will allow the Bank and market participants to conduct more detailed analysis of these transactions.

Similar requirements have been applied to transactions backed by commercial mortgages, SME loans and asset-backed commercial paper and came into effect on 1 January 2013.(5) In December 2012, the Bank published similar requirements for transactions backed by consumer loans, auto loans and leases. These transparency requirements will come into effect on 1 January 2014.(6)

The Bank is also progressing work on the system which will be used to implement the Single Collateral Pool (SCP) model. The model will simplify the process for managing the collateral provided in the Bank's operations, with the aim of enhancing operational efficiency and reducing operational risk. At present many of the Bank's operations are 'repo' transactions where individual securities are held as collateral against the Bank's exposures to that participant. The proposed SCP model will aggregate a participant's collateral position, and lead to a significant reduction in the number of transactions needed to provide collateral to the Bank. The SCP is expected to be operational in late 2013.

Market intelligence

The Bank runs a market intelligence (MI) programme to support its core purposes of maintaining monetary stability and ensuring the resilience of the financial system. It provides an insight into the behavioural drivers underlying movements in financial market prices, can help fill in data gaps where reliable statistical information does not exist, and can provide an immediate read on emerging themes and risks. The Bank's MI programme is an important contributor to the Bank's monetary and financial stability objectives. The scope of input into the financial stability objective increased following the appointment of the interim FPC, which was charged with identifying, monitoring and taking action to reduce

(1) See www.bankofengland.co.uk/publications/Pages/news/2012/159.aspx.
(2) See www.bankofengland.co.uk/publications/Pages/news/2012/083.aspx.
(3) See www.bankofengland.co.uk/publications/Pages/news/2013/033.aspx.
(4) See www.bankofengland.co.uk/markets/Documents/marketnotice101130abs.pdf.
(5) See www.bankofengland.co.uk/markets/Documents/marketnotice111220.pdf.
(6) See www.bankofengland.co.uk/markets/Documents/marketnotice121217.pdf.

systemic risks, and prospectively with the arrival of the PRA into the Bank.

MI is gathered through a continuous series of meetings and conversations between Bank staff and external contacts, to gather and analyse information from market participants. These discussions do not focus on the activities of the individual firms spoken to, but are used to gain contacts' insight on financial markets from their own perspectives. The Bank is uniquely positioned to run such a programme, given its public policy objectives, its own sterling and foreign currency operations, and its location within one of the world's foremost international financial centres. The Bank's external contact base is extensive, internationally diverse, and covers a wide range of markets.

Over the past year, the Bank's MI function has focused on a wide range of issues. That list includes: the financial market impact of the euro-area sovereign debt crisis and macrofinancial developments globally; developments in bank capital and funding markets; the impact of the MPC's programme of asset purchases, on the gilt market and other asset markets more generally; the impact of official sector policy innovations, including the FLS; the impact of the low-yield environment and the search for yield; the degree of banking sector dis-intermediation, including corporate access to the capital markets; and the impact of regulation (for example on over-the-counter (OTC) derivatives markets). The resulting insights have provided valuable information for both the MPC and the interim FPC in their policy deliberations.

3 – Banknotes and banking

Note circulation

The Bank is responsible for maintaining confidence in the currency, by meeting demand with good-quality genuine banknotes that the public can use with confidence. The average value of notes in circulation over the past year was £53.4 billion. Last year the Bank issued 760 million new notes and, at the year end, the number of Bank of England notes in circulation was 2.99 billion.

The Bank of England's direct involvement in wholesale processing and distribution is limited to the issue of new notes, withdrawing notes superseded by new designs, and the authentication and destruction of notes that are no longer fit for circulation. The wholesale distribution and circulation of Bank of England banknotes is managed under the Note Circulation Scheme (NCS) which promotes the processing and distribution of notes by the commercial sector. To make this arrangement economically viable, the NCS allows its members (commercial banks, cash-in-transit companies and the Post Office) to hold notes in custody for the Bank within their network of cash centres. The rules of the NCS are framed to minimise the risks to the Bank that arise by virtue of allowing the custody of its notes to be held in this way by commercial organisations, and to promote efficiency in the distribution and processing of notes in a way that meets the demands of cash users.

During the past year, the main ATM operators increased the outflow of £5 notes, with £5s accounting for 1.69% of notes dispensed from ATMs — exceeding the Bank's target of 1.2%. The London Olympics and Paralympics led to an increase in demand for Bank of England notes. The Bank worked closely with the cash industry to ensure that there were sufficient notes to meet demand and that cash deliveries were able to take place as required despite more difficult traffic conditions. The considerable planning, supported by robust contingency plans, resulted in a smooth distribution of cash during this important time.

Banknote production

In November 2012, the Bank issued a Contract Notice in the Official Journal of the European Union seeking expressions of interest to bid for the contract to print Bank of England banknotes. Printing of the Bank's notes was outsourced to De La Rue in 2003: the minimum term of the contract expires in early 2015 so the Bank is holding an open and competitive tender. The Contract Notice explained that the notes should continue to be printed at the Bank's premises in Debden, Essex.

Counterfeits

During calendar-year 2012, 719,000 counterfeit Bank of England notes were taken out of circulation with a face value of £13.1 million. About 90% of these were taken out of circulation during machine sorting of notes by the members of the Bank's NCS. In 2012 around 13.4 billion banknotes were machine sorted in the NCS, so the total number of counterfeit notes taken out of circulation as a share of the total number processed was 0.0054%. The equivalent figures for the previous three years were 0.0028% (2011), 0.0024% (2010) and 0.0047% (2009). The Bank continues to work closely with law enforcement agencies to detect and stop counterfeiting. Organised

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criminal gangs are behind the vast majority of all counterfeits detected. The police and the Serious Organised Crime Agency continue to seek to prevent and disrupt counterfeiting. It is important that counterfeiters are stopped as rapidly as possible.

In February 2013 the Strategic Cash Group launched a Consultation on a Code of Conduct for the Authentication of Machine Dispensed Banknotes. The Code, when it is implemented, will promote robust banknote authentication with machine-dispensed notes being first authenticated by a machine that has passed the Bank's framework for the Testing of Automatic Banknote Handling Machines. Model names of machines that pass our tests are published on the Bank's website. Businesses are encouraged to use only machines that have been proven to work against the latest counterfeit threats.

The Bank develops and circulates, free of charge, to police, retailers, banks and the public, a range of educational and training materials to help identify genuine banknotes. Information is also provided on the Bank's website, in leaflets and posters, in a short film and via computer-based training. In 2012 the Bank also used a number of social media sources to promote its education message. Targeted training sessions continued to be held, for example, for retailers and police forces, with a particular focus in 2012 on the areas close to the Olympic sites.

Scottish and Northern Ireland notes

The Bank has responsibility for regulating the note issuance of the seven commercial note-issuing banks in Scotland and Northern Ireland. The primary purpose of the regime is to provide enhanced protection for noteholders while ensuring that local banknote issuance can continue in accordance with long-standing tradition.

The banks are required to back their note issue at all times through a combination of Bank of England notes, UK coin and an interest-bearing account held at the Bank. The Bank may impose financial penalties on institutions that do not comply with Regulations or the Rules.

Under the Regulations, the Bank is required to publish at least annually a report on the discharge of its functions. This report and other information about the Regulations are available on the Bank's website.(1)

RTGS

The Bank's Real Time Gross Settlement (RTGS) platform was available for 100% of operating hours in 2012, as also achieved in 2011. The average daily payments values in the two main payment and settlement systems which use the RTGS platform — the CHAPS high-value sterling payment system and the CREST delivery-versus-payment system — were £270 billion and £293 billion respectively. The RTGS platform is also used for the settlement of a range of deferred net settlement systems — Bacs, Cheque & Credit Clearing, Faster Payments and LINK — with an aggregate daily settled value of £4.2 billion.

RTGS's principal purpose is to eliminate interbank credit risk in the sterling payment and securities markets. On 15 April 2013, the Bank introduced a Liquidity Saving Mechanism into RTGS. This reduces the liquidity that is required by CHAPS settlement banks to settle high-value payments through RTGS.

Notwithstanding the strong track record of system availability, the Bank has been considering means to enhance its resilience further. In July 2011, the Bank entered an agreement with SWIFT to develop an additional contingency facility which would operate in the event that the Bank's existing facilities simultaneously failed. The new facility is planned to be available in early 2014.

Banking operations

The Bank's customer banking strategy focuses on those banking activities that enable the Bank to fulfil its responsibilities as the central bank of the United Kingdom. That involves providing wholesale banking services to UK Government, other central banks, and, where there are financial stability reasons to do so, certain other financial sector firms.

As part of this strategy the Bank also provides custodial services for a range of customers. As of 28 February 2013, total assets held by the Bank as custodian were £699 billion,(2) of which £210 billion were holdings of gold.

Plenderleith Review

In May 2012, Ian Plenderleith was commissioned by Court to review the Bank's provision of Emergency Liquidity

(1) See www.bankofengland.co.uk/banknotes/Pages/about/s_ni_legislationandreports.aspx.
(2) This value excludes assets held under custody for Bank of England Asset Purchase Facility Fund Ltd (BEAPFF).

Assistance (ELA) in 2008/09. The Plenderleith Review highlighted lessons designed to ensure that all future ELA operations are as effective as that carried out in 2008/09, which the Review concludes 'can be judged to have achieved its purpose effectively'. The principal objective of many of the 28 recommendations raised in the Review is to build on that experience to maximise the Bank's readiness for any future ELA, in identifying problems early, in the conduct of operations and in the range of counterparties to which ELA might be extended. Work is in progress to ensure that the vast majority of these recommendations will be implemented by the end of 2013.

4 – Financial stability

Financial Policy Committee

During the year the Financial Services Act 2012 received Royal Assent, and provisions relating to the FPC came largely into force on 1 April 2013.

The objectives of the FPC are:

- to contribute to the achievement by the Bank of its Financial Stability Objective[1] which is to be achieved primarily by the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system, and
- subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment.

HM Treasury must make recommendations at least once a year to the FPC about the FPC's responsibilities in respect of the Financial Stability Objective and of the Government's objectives for growth and employment; and the FPC must formally respond, providing its reasons if it proposes not to follow the recommendations. HM Treasury recommendations were received on 30 April 2013.

The FPC has powers to make recommendations (to anyone) and to give directions to the regulators (the FCA and the PRA). Directions may only be given in respect of macroprudential tools specified by HM Treasury order. The FPC must issue an explanatory statement when exercising its powers of direction and recommendation, and also to keep any open action under regular review. Such summaries and reviews are to be published in the *Financial Stability Report* (*FSR*).

The interim FPC, established by the Bank's Court in anticipation of the statutory FPC, held four policy meetings in 2012/13. It issued recommendations, including on UK bank capital levels, liquid asset buffers, balance sheet management and disclosure. These are published in the Record of its policy meetings and in the *FSR*, as discussed on page 23.

An important task for the interim FPC was to undertake preparatory work and analysis to identify the macroprudential tools for which its direction powers would apply. In March 2012, it issued advice to HM Treasury on the tools over which it thought the statutory FPC should have powers of direction, as well as tools that merited further consideration in the future. In September, HM Treasury issued a consultation document suggesting that the FPC should initially have powers of direction over: (i) the countercyclical capital buffer, which would act as a time-varying buffer over and above minimum bank capital requirements; and (ii) sectoral capital requirements, through which financial institutions' capital against exposures to specific sectors could be varied over time. In addition, the Government intends to provide the FPC with direction powers over a time-varying leverage ratio tool, but no earlier than 2018. As requested by the Government, in January 2013, the interim FPC published a Draft Policy Statement explaining how the FPC might use the countercyclical capital buffer and sectoral capital requirements.[2] The FPC has now been given the statutory power to direct sectoral capital requirements with effect from 1 April and will be given responsibility for countercyclical capital buffers as part of the implementation of the Capital Requirements Directive.

Prudential risks and policies

Sovereign and banking risks arising from the euro area continued to be the most significant and immediate threats to UK financial stability in 2012. While market concerns about severe near-term stresses reduced significantly in the second half of the year, concerns about the possibility of disorderly outcomes, which could have major implications for UK financial stability, persisted. Surveillance of risks has therefore included detailed market intelligence and analysis of market developments in the euro area and the potential impact on the UK financial system.

(1) The Bank's Financial Stability Objective is to 'protect and enhance the stability of the financial system of the United Kingdom'.
(2) See www.bankofengland.co.uk/financialstability/Pages/fpc/coreindicators.aspx.

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While UK banks have reduced their direct exposures to sovereigns and banks in vulnerable euro-area economies, exposures to non-bank private sectors in these countries have remained significant and interconnected EU financial markets create potential for large indirect losses. In addition, while UK banks have built resilience through higher capital levels and stronger funding structures, bank profitability and so capital generation has declined and investor confidence in banks has remained low. UK credit growth has remained weak throughout 2012, though there were some signs of improvement in credit conditions looking ahead, with reduced funding costs — in part due to the introduction of the FLS — being partially passed through to some lending rates.

The Bank has continued to influence global prudential standards and European and UK legislation relating to mitigating systemic risk. Together with the FSA, the Bank has supported HM Treasury in EU negotiations on implementing the Basel III Agreement via a new EU Capital Requirements Directive and Regulation (CRD/CRR). Ensuring sufficient flexibility in CRD/CRR for the FPC to undertake macroprudential policies has been a key priority for the Bank. In line with this, the Bank also contributed to Recommendations issued by the European Systemic Risk Board (ESRB) on a toolkit of national macroprudential instruments.

The need to strengthen banks' liquidity and funding strategies was a key lesson from the crisis. Early 2013 saw the endorsement by Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision (BCBS), of a package of amendments to the Liquidity Coverage Ratio (LCR) and reaffirmation of the standard as an essential part of the Basel III reforms. The Bank contributed to work in 2012 to develop agreement on the LCR, which seeks to ensure that banks hold sufficient liquid assets to prevent central banks becoming the 'lender of first resort'. And, at EU level, the Bank has input to the development by the ESRB of Recommendations aimed at addressing vulnerabilities relating to bank funding and asset encumbrance.

The Bank has been involved in other BCBS work to strengthen prudential requirements for banks. These include reforms to capital requirements for assets held in bank 'trading books' and development of an international regime for limits on large exposures between banks and other counterparties.

A key objective in strengthening UK and global system resilience is to improve 'loss-absorbing capacity' for bank and non-bank systemically important financial institutions. A key achievement during 2012 was BCBS agreement, with significant Bank input, on an international framework for domestic systemically important banks, complementing that for global systemically important banks.

Work to identify globally systemically important non-banks continues at the Financial Stability Board (FSB) as part of a broader policy reform agenda which includes prospective shadow banking reforms. The Bank is actively engaged in this work, particularly through its participation in workstreams related to securities lending and repo markets and 'other' shadow banks. Reforms to improve the resilience of money market funds have been proposed internationally and at EU level, and the Bank has input to recommendations issued by the ESRB.

Infrastructure policy and payment system oversight

The Bank has been closely involved in the significant international work programme to reform derivatives markets, improve the robustness of CCPs and other financial market infrastructures (FMIs), and to design appropriate resolution arrangements for them. In particular, the Bank has contributed to the preparation of prudential technical standards for EU CCPs by the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) following the finalisation of the EU Regulation on OTC derivatives, CCPs and trade repositories of 4 July 2012, commonly known as the European Market Infrastructure Regulation (EMIR). This creates a new EU regime for the prudential supervision of CCPs, following the global Principles for Financial Market Infrastructures published in April 2012 by the Basel central bank Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO). EMIR also implements the 2009 G20 commitment to mandate central clearing for standardised OTC derivatives, and require reporting to trade repositories for all OTC derivatives. The Bank has participated in CPSS-IOSCO work aimed at formulating clear and consistent international guidelines for access to data held by trade repositories. Domestically, the Bank has worked with HM Treasury on the extension of the UK Special Resolution Regime to CCPs, and on the introduction of a new 'Recognition Requirement' for UK

CCPs requiring them to have rules to allocate losses that exceed their standard resources. The Bank has also contributed to BCBS-IOSCO proposals on margin requirements for non-cleared derivative transactions and to CPSS-IOSCO work on recovery and resolution arrangements for FMIs.

In March 2013, the Bank published its *Payment Systems Oversight Report 2012*.[1] The *Report* outlined the Bank's oversight of systemically important payment systems and the structural changes to the regime that will follow implementation of the 2012 Act. The *Report* also described the significant risk-reducing changes implemented by the payment systems in the previous year in response to the Bank's oversight priorities. These changes have contributed to: a reduction in tiering in the CHAPS system, with one additional bank joining in 2012 and several more confirming their intention to join; a reduction in UK CCPs' intraday exposures to their payment banks; more robust default arrangements for Bacs and FPS; and improvements in CHAPS, Bacs and FPS governance, including the commitment to recruit independent Board chairs and directors (this recruitment is under way). The *Report* also described the further work necessary in the period ahead, with the Bank placing particular emphasis on operational risk in 2013.

Special Resolution Regime

A key objective for the year has been further development of the UK resolution regime through statutory changes and resolution planning.

The Special Resolution Unit (SRU) was established in February 2009 for the Bank to fulfil its responsibilities for resolving distressed UK banks and building societies under the Special Resolution Regime (SRR), which was introduced through the Banking Act 2009. Subsequently, the Investment Bank Special Administration Regime Regulations (2011) established specialised insolvency arrangements for investment firms, operated primarily by the FCA. Over the past year, the SRU has worked closely with HM Treasury, the FSA and the Financial Services Compensation Scheme on enhancements to the UK resolution regime and on contingency planning for specific institutions.

The SRU has been involved in the development of legislative proposals to strengthen the SRR, including widening the scope of the regime beyond deposit-takers and augmenting its toolkit, in particular with the addition of a bail-in tool (which would allow a going-concern restructuring of a failing bank with shareholders and uninsured creditors exposed to losses). The Financial Services Act 2012 extends the scope of the SRR beyond banks to investment firms, clearing houses and their parent undertakings. The forthcoming EU Directive on recovery and resolution is expected to be agreed in 2013. Its implementation into domestic law in the United Kingdom will introduce a bail-in tool, and, along with other enhancements to the regime, improve UK compliance with the FSB's Key Attributes for Effective Resolution Regimes.

As part of that compliance, the SRU has worked with resolution authorities in other countries towards the preparation of resolution plans, co-operation agreements and resolvability assessments for the 28 globally systemically important financial institutions (G-SIFIs) identified by FSB. This has supplemented work domestically with the FSA on resolution planning for the firms subject to SRR on the basis of recovery and resolutions plans submitted to the FSA under the Financial Services Act 2010.

5 – The new regulatory regime

Prudential Regulation Authority

The 2012 Act transferred regulatory powers under the Financial Services and Markets Act 2000 (FSMA) to the PRA and the FCA. The PRA is a new subsidiary of the Bank.

During the year the Bank published several documents setting out the approach the PRA would take to banking supervision and insurance supervision against the background of the objectives set out in the Act.

The documents stressed that a key principle underlying the PRA's approach to supervision is that it would not seek to operate a 'zero-failure' regime. Rather, it would seek to ensure that any financial firms which failed did so in a way that avoided significant disruption to the supply of critical financial services.

The documents also emphasised the statutory requirements — Threshold Conditions — that firms must meet, and continue to meet to be permitted to engage in

(1) www.bankofengland.co.uk/publications/Pages/news/2013/056.aspx.

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activities regulated by the PRA. The Threshold Conditions require, for example, firms to maintain appropriate capital and liquidity, and to have suitable management. Given that the Threshold Conditions promote the safety and soundness of firms and policyholder protection, they are crucial for helping the PRA to meet its objectives.

The PRA's approach to regulation and supervision was described as having three defining characteristics:

- A judgement-based approach. The PRA would use judgement in determining whether financial firms are safe and sound, whether insurers provide appropriate protection for policyholders, and whether firms meet, and are likely to continue to meet, the Threshold Conditions. Judgements will be based on evidence and analysis, and will not be constrained by a narrow interpretation of either domestic or EU rules.

- A forward-looking approach. The PRA would assess firms not just against current risks, but also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it will generally aim to do so at an early stage.

- A focused approach. The PRA would focus on those issues and firms that posed the greatest risk to the stability of the UK financial system and to policyholders. The frequency and intensity of supervision applied to a particular firm would therefore increase in line with the risk it poses to the PRA's objectives.

CCPs and Securities Settlement Systems (SSSs)

The Bank worked closely with the FSA to prepare for the transfer of responsibility for the supervision of CCPs and SSSs from the FSA to the Bank on 1 April 2013. This function will be undertaken alongside the Bank's existing statutory responsibility for the oversight of payment systems so that all systemically significant post-trade infrastructures are now supervised by the Bank. In December 2012 the Bank published a paper on its proposed approach to the supervision of FMIs.[1]

6 – Communication

Effective communication is essential to build understanding and trust in the roles and functions of the Bank, in its policy frameworks, and in the Bank's own effectiveness. Throughout the year members of the MPC and the interim FPC, led by the Governor, made speeches and gave media interviews to explain the Bank's policy decisions. These were complemented by contributions from other senior members of staff on the Bank's wider responsibilities.

The MPC has continued to publish the minutes of its monthly policy meetings. Its quarterly *Inflation Reports* are accompanied by press conferences, which allow the MPC's decisions and judgements about the outlook for the economy and inflation to be explained in more detail. The February 2013 *Report*, the first following the publication of the Stockton Review into the MPC's forecasting capability, contained more information on key forecast judgements.

The launch of the FLS by the Bank and HM Treasury on 13 July 2012 was accompanied by a public exchange of letters between the Governor and the Chancellor of the Exchequer; an explanatory note that described the design of the Scheme and how it will support the economy; a syndicated television interview featuring Paul Fisher; and extensive print media briefing. The November 2012 *Inflation Report* described the indicators by which the Bank will monitor the transmission of the FLS, and the February 2013 *Report* summarised developments against those indicators, and what the indicators are expected to show as 2013 progresses. The Bank also publishes on a quarterly basis, for each group participating in the FLS, the amount borrowed from the Bank as part of the Scheme, and the net flows of lending to UK households and firms.[2]

During the visit by the MPC to Wales in October 2012, the fifth such annual regional visit by the Committee as a whole, the Governor and several other MPC members gave speeches and media interviews. MPC members have also undertaken a total of 52 visits outside Greater London in 2012/13, meeting with the Bank's Agents' business contacts and other organisations to explain monetary policy and to gather intelligence regarding regional business conditions. The Bank's Agents play an important role both in gathering economic intelligence and communicating monetary policy across the United Kingdom. In addition, during 2012/13, two further 'Monetary Policy Roundtable' conferences were held with economists from a range of private sector institutions, academia and public sector bodies, with summaries of

(1) See www.bankofengland.co.uk/publications/Documents/news/2012/nr161.pdf.
(2) See www.bankofengland.co.uk/markets/Pages/FLS/default.aspx.

discussions published on the Bank's website and in the *Quarterly Bulletin*.

The *FSR* was published twice during 2012/13. These *Reports*, published under the guidance of the interim FPC, set out the Committee's assessment of the outlook for the stability and resilience of the financial sector, as well as the policy actions it advised to reduce and mitigate risks to financial stability. The publication of each of these *Reports* was accompanied by a press conference. Alongside the *FSR*, the Committee also published Records of each of its quarterly policy meetings. In quarters in which there was no *FSR*, the interim FPC issued a press statement outlining the decisions it had taken.

In January 2013, the interim FPC published a Draft Policy Statement explaining how the FPC would use its proposed new macroprudential powers to set the countercyclical capital buffer and sectoral capital requirements. The Policy Statement described these tools, the likely impact of using them on financial stability and growth, and the circumstances in which the FPC might expect to use each tool. It also described the core indicators the FPC will routinely review to help inform its judgement.

Interim FPC members made visits to eight financial centres outside Greater London in 2012/13 (including Birmingham, Edinburgh, Glasgow, Leeds, Manchester) to discuss financial stability issues with the Bank's Agents' business contacts and other organisations, and to explain the new arrangements for macroprudential regulation. The Bank has continued to publish the results of the *Systemic Risk Survey*,[1] which seeks to quantify and track, on a biannual basis, market participants' perceptions of systemic risks.

Agents


Peter Andrews
Greater London


Neil Ashbridge
Wales


Graeme Chaplin
West Midlands & Oxfordshire


Stephen Collins
South West


Alastair Cunningham
East Midlands


William Dowson
Scotland


Phil Eckersley
South East & East Anglia


Juliette Healey
Yorkshire & The Humber


Frances Hill
Northern Ireland


Chris Piper
Central Southern England


Rosie Smith
North East


John Young
North West

(1) See www.bankofengland.co.uk/publications/Pages/other/srs/default.aspx.

Review of 2012/13 continued

The Bank also issued during the year a series of papers setting out its proposed approach to the regulation of banks and insurance companies through the PRA, and its proposed approach to the supervision of CCPs and SSSs.

A key mechanism for transparency and accountability is parliamentary hearings. Bank witnesses gave evidence at fifteen parliamentary hearings during the year. Of those, ten hearings were in front of the Treasury Committee of the House of Commons. These included three hearings on the Bank's *Inflation Report*, an appointment hearing for an external MPC member, and two hearings on the *FSR*. In addition, there was an appointment hearing with Mark Carney, one hearing at the request of the Deputy Governor for Financial Stability, and hearings with two of the authors of the Court reviews, Bill Winters and Ian Plenderleith. The Bank was represented at four hearings of the Parliamentary Commission on Banking Standards, and gave evidence at one hearing of the Economic Affairs Committee of the House of Lords.

Enhancing public understanding of the Bank's role across all its functions remained a key priority throughout 2012/13. The Bank continued to extend its use of social media channels, such as Twitter and YouTube. In addition, the Bank continues to provide information and learning resources through its museum, website and schools' programme. The Bank's museum attracted over 119,000 visitors in 2012/13, a record number since it opened in 1988. The Bank's annual economics competition for schools and colleges, Target Two Point Zero, reached its thirteenth year in 2012/13 with 284 schools and colleges taking part. Consistent with the Bank's commitments under the Welsh Language Act, the Bank extended its range of Welsh language information and educational materials.

7 – Organisational capacity

During the year, the Bank has focused on ensuring it has the staff and capability required to perform its expanded statutory functions from 2013, and that existing business areas have people with the technical expertise and management skills to carry out the Bank's core purposes effectively. To achieve this, four areas have received particular attention: the creation of the PRA and the transfer of FSA staff into it; expanding central services to support the larger Bank; recruitment; and talent management.

Practical preparations to create the PRA and enable it to operate as part of the Bank are now complete. The PRA is based at 20 Moorgate in the City of London. Moorgate was selected following a review by Court which considered the cost and benefits of locating the PRA in the City and the importance of the physical proximity of the PRA to the Bank. This proximity will facilitate the integration of the PRA to the Bank's policy functions and ensure that the PRA can draw on the Bank's central services in an efficient and effective manner.

In early 2013, staff transferred to the PRA and the Bank from FSA offices in Canary Wharf. Over a three-month period, 1,185 people were moved with minimal disruption to 'business as usual' at either the FSA or the Bank. As part of this process, transferring staff received induction and training into Bank policies, processes and systems to support their integration into the Bank. The PRA went live on 1 April 2013.

In 2013/14, work will continue to fully embed the changes to the regulatory processes, IT infrastructure and data collection management. These will facilitate the transformation of the PRA as originally envisaged in the Government's reforms of the UK financial regulation system.

PRA staff have access to all relevant Bank infrastructure, in particular to the Bank's Banking Sector Monitoring tool, which allows high-frequency regulatory data on banks to be easily viewed and analysed, using both standard and bespoke analytical reports.

During 2012/13, the Bank's central services functions were expanded and reorganised in preparation for the integration of the PRA. Changes have been made to responsibilities and reporting lines to give greater clarity of responsibility and to make it easier for new staff to find the services and resources they require.

The Bank made 275 new permanent hires in 2012/13 to support the expansion of its operational capability and bring considerable expertise across its central functions. The Bank took responsibility for recruitment for the PRA in early 2013, ahead of legal cutover. The Bank has used the opportunity to make diversity gains.(1)

(1) See Employees section, page 42.

During the year the Bank undertook comprehensive talent and succession planning across all areas. The Bank has worked closely with the FSA to provide staff transferring to the PRA with the training and support required to work effectively within the new supervisory approach.

The Finance Directorate, in addition to maintaining financial control, has continued to lead Bank-wide initiatives to improve the Bank's approach to organisational performance measurement, the reporting and management of operational risk, and to strengthen project management. Each Directorate has a framework setting out that area's objectives and plans and linking them to those of the organisation as a whole, and then tracking performance over time. Centralised risk systems support reporting to the Executive Team, the Audit and Risk Committee, and Court.

The Bank's strategic priorities in 2013/14

The strategic priorities endorsed by Court for 2013/14 are:

Core Purpose 1 — Monetary Stability

Strategic Priority 1 **Keep inflation on track to meet the Government's 2% target.**
Maintain price stability, and, subject to that, support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

- Respond effectively and decisively to the continuing risks posed by the European debt crisis in order to ensure that inflation remains on track to meet the inflation target.
- Advance the Bank's understanding of the evolving macroeconomic environment.
- Consider the impact of unconventional monetary policies.
- Understand and communicate the interface between monetary and macroprudential policies.
- Respond to the Stockton Review of the MPC's forecasting capability.

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

- Implement further asset purchases as required by the MPC.
- Keep under review the plan for the unwinding of the APF.
- Be prepared to reintroduce reserves averaging framework if required.
- Meet demand for the required volume and denomination of banknotes efficiently and effectively. Progress the banknote supplier re-tender process.
- Develop a strategic plan for future note issuance.

Core Purpose 2 — Financial Stability

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

- Influence domestic and international reform, co-ordinated across the Bank and the PRA.
- Continue to develop the EU and UK resolution regimes, including through a bail-in tool and, with the PRA, through financial institutions' recovery and resolution plans.
- Implement the operational framework for the oversight in the Bank of CCPs and SSSs.
- Embed and continue to develop the contribution of market intelligence to policy debates.
- Further develop the Bank's contribution to financial system business continuity planning.
- Respond to the Plenderleith Review of the provision of Emergency Liquidity Assistance in 2008/09; and to the Winters Review of the Bank's framework for providing liquidity to the banking system as a whole.

Strategic Priority 4 **Deliver macroprudential policy, operating through the Financial Policy Committee.**
The FPC is to exercise its functions to contribute to achieving the Bank's Financial Stability Objective, and subject to that, support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

- With HM Treasury and the PRA, influence the international framework for macroprudential regulation, including through the European Systemic Risk Board.
- Continue developing analytical support to the FPC, including on the non-bank financial sector, and on the impacts of decisions on FPC instruments.
- Continue to develop an effective interface between macro and microprudential regulation, including the use by the FPC of recommendations and directions to the PRA and the FCA.

Strategic Priority 5 **Integrate microprudential supervision into the Bank.**

- Deliver a forward-looking, judgement-based supervisory approach and affirm the PRA's authority with PRA-authorised firms.
- Maintain effective co-operation with the FCA.

Strategic Priority 6 **Influence and implement policy to advance the PRA objectives.**

- Ensure the implementation of the new regulatory regime and other changes to domestic, European and international law governing regulation.
- Lead and shape the development and implementation of domestic and international policy to advance the PRA objectives.

Supporting Core Purposes 1 and 2:

Strategic Priority 7 **Build and sustain public support for the Bank's governance and for its monetary policy, macro and microprudential frameworks.**

- Establish the role and public understanding of new accountability mechanisms for the Bank, with clear roles for Court and its sub-committees, including the new Oversight Committee.
- Actively explain the Bank's governance and activities.
- Continue to make the case for inflation targeting and the monetary policy framework, including through new media.
- Influence the international debate on monetary policy, and the international monetary system.
- Continue to develop a constituency that supports financial stability and the aims of macro and microprudential regulation.
- Increase public understanding of the role of the FPC and the PRA.
- Review the Bank's communications protocol annually and ensure adherence to it.

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

Create one Bank with a unified commitment to all aspects of its core purposes, and a culture of inclusiveness and excellence.

Successfully integrate the Bank's new statutory functions while maintaining the effectiveness of existing functions.

- Complete a seamless transition of prudential supervision and staff to the Bank without interruption to the supervision of firms.
- Ensure staff involved in the Bank's new functions have the experience and access to training required to work effectively.
- Continue fostering a culture of inclusiveness, creativity and challenge.

Ensure that leadership and governance structures can operate effectively in carrying out the core purposes during a period of transition.

- Ensure the Bank has governance structures to oversee its expanded remit.
- Provide practical support to facilitate a smooth transition to the new team of Governors.
- Identify areas where Heads of Division and other senior Bank staff can assume more responsibility, and delegated authority, from the Bank Governors and Directors.

Provide organisational support, systems and processes necessary for the delivery of the expanded core purposes.

- Complete the practical integration of the PRA into the Bank at 'Day 1', including the IT and data collection infrastructure, and continue work on steady-state preparations.
- Revise the Bank's career model to incorporate supervision and ensure sufficient depth of expertise to deliver all core functions effectively.
- Embed talent management and career development paths for all staff in the Bank.

Continue to **manage the Bank's resources efficiently.**

- Ensure a satisfactory conclusion to the CRD Review, and produce the budget and business plan for the PRA and the 2013/14 fees consultation.
- Increase the efficiency of the Bank's central services by realising synergies arising from the integration of the PRA.
- Review the efficiency of ISTD and implement findings.
- Improve resilience of IT system security.
- Maintain the highest level of risk management across all the Bank's activities.
- Exercise financial control to keep expenditure within budget.
- Carry out specific value for money projects each year.

The strategy for the Bank's monetary stability mission

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

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

Public confidence in the currency also requires stability in its value. That is the task of monetary policy. The Bank of England Act 1998 delegates to the Bank's MPC the task of setting the Bank's policy rate — and other monetary instruments, such as asset purchases — in order to:

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

The exact definition of price stability is laid out annually by the Chancellor of the Exchequer in the annual *Budget* statement; presently it is to achieve a CPI inflation rate of 2%. The framework recognises, however, that inflation will depart from the target because of shocks and disturbances and that in such circumstances attempts to hold it there would lead to undesirable volatility in output. The MPC's aim is therefore to set policy so that inflation is brought back to the target within a reasonable time period but without creating undue instability in output. The Act also commits the Bank to operating an open and accountable policymaking regime, to explaining the decisions of the MPC transparently and to implementing them effectively in the money markets.

Inflation remains elevated above the Government's target and is likely to remain so over the next year or so, in part reflecting an unusually large contribution from administered and regulated prices. Moreover, output has been broadly flat for the past two years and, although there have been signs that growth picked up in early 2013, some margin of spare capacity is likely to persist. In response, the Bank and HM Treasury have introduced the FLS with the aim of boosting the supply of credit, while the MPC has expanded its stock of assets purchased through the issuance of central bank reserves to £375 billion. The Government has also asked the MPC to explore the scope to provide further monetary stimulus when Bank Rate is close to its effective lower bound through the use of forward guidance and thresholds. Judging, executing and explaining the appropriate stance of monetary policy over 2013/14 against that background represents a particular challenge. The business plan below reflects that challenge.

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

The following business plan will drive the Bank's efforts — over the coming year and beyond — to maintain price stability and, subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment:

Banknote issuance

- Continue to ensure the integrity and availability of banknotes.
- Progress the re-tender of banknote printing, including publishing an Invitation to Tender.
- Work with the industry to prepare for the withdrawal of the Houblon note.
- Identify denomination and provisional timetable for issuance of the next new note.
- Undertake analysis of the long-term demand for, and distribution of, cash.
- In consultation with the cash industry and the Payments Council, develop, consult and implement a code of practice for the recirculation of Bank of England notes outside the specialist cash handling industry.

Analytical support to MPC decisions

- Maintain the high-quality support already provided through key outputs such as pre-MPC, the forecast round and

analytical notes, ensuring that it is well targeted at the needs of MPC members.
- Respond to the findings of the Stockton Review of the MPC's forecasting capability.
- Deepen analysis of the effects of asset purchases, the FLS and other unconventional monetary policies, including the use of forward guidance and thresholds.
- Further exploit the 'suite' of economic models in forecasting and policy analysis.
- Establish a platform for understanding the interface between monetary and macroprudential policies, including incorporating the impact of the latter into the forecast.
- Enhance capacity to service future MPC needs through an appropriate research programme, and through the development and maintenance of key skills.
- Guard against 'group think' by increasing engagement with external contacts and fostering a culture of creativity and challenge.

Implementation of monetary policy
- Implement further asset purchases as instructed by the MPC.
- Keep under review the plan for the unwinding of the APF.
- Respond to the recommendations of the Winters Review of the SMF insofar as it affects the implementation of monetary policy.
- Look for potential cost savings in the management of the Exchange Equalisation Account (EEA).
- Continue to rationalise and improve systems and processes supporting market operations, especially those related to new initiatives.

External engagement
- Continue advocacy of an inflation target and communication of the framework for monetary policy, including the use of unconventional policy instruments.
- Enhance the explanation of the Bank's framework for implementing monetary policy.
- Influence the external debate on monetary policy and the reform of the international monetary system.

Risks to delivery
Key risks are:
- The reputational consequences of inflated public expectations of what monetary policy can and should achieve within an inflation-targeting framework in the face of a continuing adverse economic environment.
- An inability, particularly as a result of pay constraints, to recruit and retain sufficiently experienced staff able to exercise the necessary critical judgement in providing analytical support to the MPC and implementing monetary policy.
- Incorporation of the Bank's new supervisory and macroprudential responsibilities distracts attention from the pursuit of monetary stability.
- The reputational consequences of ineffective implementation of monetary policy and/or poor management of the associated risks to the Bank's balance sheet.
- Unexpected legal and commercial complexities arising from the banknote re-tender.

The MPC and Court
The Court of Directors of the Bank has no locus of responsibility in regard to the monetary policy decisions of the MPC. Under the Financial Services Act 2012, the Court's Oversight Committee has responsibility: for keeping the procedures followed by the MPC under review; for commissioning backward-looking reviews on policy outcomes; for ensuring that the MPC collects the regional, sectoral and other information necessary to formulate monetary policy; and for ensuring that the Bank devotes appropriate resources in support of the MPC. To that end:

- The Bank's executive, liaising with the MPC when necessary, will review the content of the strategy periodically, including plans for delivery and resources.
- As part of its quarterly review of strategy, Court will monitor the delivery of these particular strategic objectives.
- Annually, the Executive Director for Monetary Analysis and Statistics, after consultation with the rest of the MPC, will provide a report to Court on the adequacy of the support provided to the MPC by the Bank.
- On behalf of the Oversight Committee, the Chairman of Court will meet annually with each of the members of the MPC individually in order to identify any failings in the support provided or in the MPC's processes.
- The Oversight Committee will decide from time to time what, if any, reviews should be commissioned to look into policy outcomes.

The Bank's monetary stability strategy is published and delivery of its strategic objectives will be monitored quarterly and concurrently by Court and the Oversight Committee.

The strategy for the Bank's financial stability mission

This plan was drawn up under the provisions of the Bank of England Act in force prior to April 2013, which required Court to determine the Bank's strategy in relation to its Financial Stability Objective on the advice of the former Financial Stability Committee. The Court will, later this year, adopt a Financial Stability Strategy under the new legislation, acting on the advice of the FPC.

Under the Bank's Core Purposes, the Bank of England, as the central bank of the United Kingdom, is committed to doing everything within its powers to sustain financial stability. The purpose of preserving stability is to maintain the three vital functions which the financial system performs in our economy:

- Providing the main mechanism for paying for goods, services and financial assets.
- Intermediating between savers and borrowers, and channelling savings into investment, via debt and equity instruments.
- Insuring against and dispersing risk.

The Government reforms of the UK regulatory regime, which came into effect during the spring of 2013, will significantly increase and broaden the Bank's role and responsibilities for financial stability:

- The Bank's statutory objective will be to protect and enhance the stability of the financial system of the United Kingdom.
- The FPC will be established under statute as the macroprudential policy body.
- The PRA will become part of the Bank, responsible under statute for prudential supervision of individual deposit-takers, insurers and certain investment firms.
- The Bank will be responsible for oversight of clearing and settlement systems.

Those add to the Bank's previous responsibilities:

- Provision of the final settlements service in sterling and of liquidity insurance.
- Statutory oversight of payment systems.
- Operating the Special Resolution Regime.

The statutory objective of the FPC is to contribute to the achievement of the Bank's Financial Stability Objective and, subject to that, to support the economic policy of the Government, including its objectives for growth and employment. The FPC will have powers to make recommendations to the PRA, the FCA and others; it will be able to give directions on specific matters to the PRA and the FCA; and it will be able to make recommendations to HM Treasury on the perimeter of the microregulatory regime.

The statutory objective of the PRA is to promote the safety and soundness of PRA-authorised firms; and, in the case of insurance companies, also to contribute to securing an appropriate degree of protection for policyholders. The PRA's objective is consistent with the Bank's overall stability mandate.

It is vital that the Bank works as one to pursue stability. A number of areas were already actively involved, especially Banking Services, Financial Stability, Markets and the Special Resolution Unit. They have been joined, following the legislative changes, by the PRA. The Bank also needs to work closely with the FCA, which will be the supervisor of funds and trading platforms. And, working with its overseas peers, the Bank needs to ensure that it actively shapes and contributes to the extensive programme of international reforms.

The business plans for 2013/14 are set out in two parts: for the Bank's broad financial stability mission, and for the PRA's microprudential supervision.

Architecture

- Working with HM Treasury and the FPC, introduce Directive Powers for the FPC's macroprudential mandate.
- Work with HM Treasury on design of Banking Reform Bill regime for ring-fencing banks.
- Work with HM Treasury on Banking Union (BU), and forge even closer relationships with the ECB as the BU's single prudential supervisor.
- Enhance links with EU decision-taking bodies, the ECB and the ESRB.
- Review the structure and governance of the Bank's financial stability functions in the light of the reforms.

Surveillance of threats to stability and analytical support for the FPC

- Develop top-down stress testing as a key input to FPC assessments of system resilience.
- Identify systemic risks and fault lines, including from financial infrastructure, regulatory policies and overseas systems. Pursue internationally through the FSB and ESRB.
- Develop assessments of the functioning and regulation of the non-bank financial sector and markets, including advice to the FPC on 'regulatory perimeter' issues.
- Maintain the contribution of market intelligence to policy debates.

Prudential policy

- Enhance processes for turning FPC conclusions into implementable policies by the PRA, the FCA etc; and indicators to explain FPC decisions.
- With the BCBS and FSB, contribute to implementing policy on 'greater loss-absorbing capacity' for non-bank and domestic bank systemically important financial institutions.
- Contribute actively to the fundamental review of Basel Accord

capital requirements for banks' trading books; and on simplifying the Capital Accord, including through transparency and floors on internal-model risk weights.
- Help to deliver the FSB's policy framework on shadow banking.
- Develop framework for advising the FPC on accounting and disclosure policies relevant to stability, in particular provisioning; and maintain liaison with the Financial Reporting Council (FRC).
- Examine the regulatory regimes for insurance and pension funds from a stability perspective.

Financial infrastructure and capital markets
- Implement the new framework for Bank oversight of CCPs and SSSs.
- Enhance resilience of payment systems, especially through reduced risks from tiering in the wholesale payment systems; mutualised default funds in retail schemes; strengthened core Bank RTGS systems; and 'Term Delivery By Value' instruments in CREST and LCH.Clearnet.
- Promote practices in key capital markets that underpin system stability.
- Enhance Bank co-operation with the FCA.

Liquidity insurance and crisis management
- Review and implement, as appropriate, the Plenderleith Review on emergency liquidity assistance.
- Review and implement, as appropriate, the Winters Review on liquidity insurance to the system.
- Work with HM Treasury to implement the FSB Key Attributes for resolution regimes and the EU Recovery and Resolution Directive, including through legislation for a bail-in tool.
- With FSB and CPSS/IOSCO, develop a resolution regime for CCPs and other FMI.
- Work with home and host authorities to produce realistic resolution plans for banks domiciled or active in the United Kingdom.
- Maintain efforts on developing funding arrangements for deposit insurance that enhance stability and reduce moral hazard.
- Implement arrangements for providing banking services and remove any technical obstacles to providing liquidity assistance to CCPs.
- Strengthen contingency arrangements for financial sector resilience to a major operational disruption around different kinds of threat, including cyber attacks. Involve the FPC on key threats.

Communication and stakeholders
- Contribute actively to public accountability, including identifying metrics of system resilience.
- Engage with the various key stakeholders for the FPC.
- Promote public understanding of the Bank's stability role and mandate, including through the Agents.

Risks to delivery
There are risks to the delivery of this plan. External risks will be discussed in the Bank's regular FSRs. Three immediate internal ones are:

- Not having sufficient senior, experienced staff with the necessary expertise and knowledge of the financial system and the capacity to engage effectively in international policy debates and to design the implementation of FPC decisions.
- Not having sufficient resources immediately available in the event of a sudden worsening of the crisis.
- Not having enough resources dedicated to non-bank policy issues.

Sub-committee and Court
The Financial Stability Committee (FSC), which under the 2009 Banking Act is a sub-committee of the Court of Directors of the Bank, has agreed this strategy.

Following enactment of the Financial Services Bill, the Oversight Committee of Court will be responsible for keeping under review the delivery of the Bank's objectives. It will also seek to identify any failing in the support provided to the FPC or in its processes. The Committee will commission reports on the performance on the Bank's policy functions from external experts and the Bank executive.

Also, Court has decided that, following enactment of the Financial Services Bill, the FSC will be succeeded by a new, non-statutory committee of Court, to be known as the Financial Services Advisory Committee, which will advise on and monitor the performance of the Bank's financial stability activities that do not fall to the FPC or the PRA. This will cover non-supervisory actions in relation to specific institutions, and the Bank's functions as provider of liquidity insurance, resolution authority, and overseer of financial infrastructure.

- After the new legislation is in place, this Committee of Court will review the content of the strategy periodically, including plans for delivery and resources.
- As part of its quarterly review of strategy, Court and the Oversight Committee concurrently will monitor the delivery of these particular strategic objectives.

Prudential regulation

The following section was approved by the PRA Board on 22 March 2013.

From April 2013, the PRA — as part of the Bank of England — becomes the United Kingdom's prudential regulator for deposit-takers, insurance companies and major investment firms, under the 2012 Act. The PRA needs to fulfil two statutory objectives:

- To promote the safety and soundness of all the firms it supervises — that is to seek to ensure all firms have resilience against failure and avoid disruption to the continuity of financial services. In promoting safety and soundness, the PRA is required to focus primarily on the harm that firms can cause to the stability of the UK financial system.
- And specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are, or may become, policyholders.

Both of these objectives are underpinned by the principle that a stable financial system, which is resilient in providing the critical financial services the economy needs, is a necessary condition for a healthy and successful economy — and that firms can affect the stability of the financial system either through the way they carry on their business or by failing.

It is not, however, the PRA's role to ensure that no firm fails. Indeed, a key principle underlying the PRA's approach is that it does not seek to operate a 'zero-failure' regime. Rather, the PRA seeks to ensure that any firms that fail do so in a way that avoids significant disruption to the supply of critical financial services. The PRA expects all firms to meet, and continue to meet, the statutory 'Threshold Conditions', which are the minimum requirements that firms must meet to engage in regulated activities. The PRA's approach to supervision[1] has three defining characteristics:

- *Judgement-based.* The PRA will use judgement in determining if firms pose risks to its objectives and are likely to continue to meet the Threshold Conditions.
- *Forward-looking*. The PRA will assess firms not just against current risks but also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it will seek to do so at an early stage.
- *Focused*. The PRA will focus on those issues and those firms that pose the greatest risk to its objectives.

The following business plan drives the work to establish the PRA and implement the new regime over the coming year and beyond:

PRA strategic priorities

For 2013/14, the PRA has four strategic priorities which cut across the whole organisation and cover the main areas of change on the transition to steady state:

- Ensure the implementation of the new regulatory regime and other changes to domestic, European and international law governing regulation.
- Deliver a forward-looking, judgement-based supervisory approach and affirm the PRA's authority with PRA-authorised firms.
- Lead and shape the development and implementation of domestic and international policy to advance the PRA objectives.
- Ensure the PRA has the right people and processes to carry out its statutory objectives and operates as an effective part of the Bank.

Business aims

To support the achievement of these strategic priorities, the PRA has five major business aims, each with associated initiatives and deliverables:

- Deliver effective banking supervision and work with other supervisory authorities in the United Kingdom and overseas (eg the FCA), including by:
  - Embedding the new PRA approach for supervision of banks.
  - Working with the FPC, including providing analysis and acting on relevant recommendations.
  - Engaging with and influencing overseas regulators, as well as implementing further work on recovery and resolution planning for individual firms.
- Deliver effective insurance supervision and work with other regulatory bodies (eg the FCA) to advance the fulfilment of the PRA's general objective and policyholder protection objective, including by:
  - Embedding the new PRA approach for supervision of insurance firms.
  - Engaging with and influencing overseas regulators.
- Influence and implement policy to advance the fulfilment of the PRA regulatory agenda, including in relation to:
  - Solvency II and Capital Requirements Regulation/Capital Requirements Directive IV (CRR/CRD IV).
  - The Independent Commission on Banking (ICB).
  - The European Banking Union.
  - The Basel Committee, FSB and International Association of Insurance Supervisors.
  - The new Building Societies Act and Credit Unions Act.
- Equip the PRA to anticipate risks in the firms it regulates and in the environment in which they operate in, to enable the PRA to deliver its objectives and contribute to the FPC's macroprudential objectives, including by:
  - Investment in analytics (through the Business Transformation Programme — see below) that enable the PRA's technical specialist resource to provide

(1) As set out in *The PRA's approach to banking supervision* and *The PRA's approach to insurance supervision* April 2013. See www.bankofengland.co.uk/pra/Pages/supervision/default.aspx.

effective support to supervisors to enable them to make forward-looking, judgement-based decisions.
- Establish the PRA with the desired culture and the right people, supported by appropriate and effective processes, including by:
  - Recruitment, retention and development of staff to enable the organisation to fulfil its statutory objectives.
  - Delivery of a data strategy and associated IT changes required to support the new regulatory approach under the Business Transformation Programme.

The Business Transformation Programme

The Business Transformation Programme builds on the work done leading up to the creation of the PRA and to make the PRA work as an effective prudential regulator as part of the Bank. To achieve this, the programme will:

- Complete the transition to the new supervision, policy and authorisation processes.
- Deliver the data strategy and IT changes that support the new regulatory approach.
- Improve working methods and approach so that the PRA can:
  - Achieve a forward-looking, judgement-based approach to analysis and decision-making.
  - Integrate into, and contribute to, the wider Bank.

Risks

The major risks to delivery are:

- The operational effectiveness of decoupling of prudential and conduct regulation can only be truly tested when full separation of the FSA occurs.
- To implement the new approach, the PRA needs to be able to recruit and retain high-quality people in a range of disciplines and technical expertise, and to provide sufficient development opportunities to retain staff.
- Operational transition to working within the Bank could raise unforeseen issues that affect support to supervision and delay the fulfilment of PRA objectives.
- Micro and/or macroprudential risks within a firm or the system could increase significantly (eg because of an intensification of the euro-area crisis) requiring the PRA to reprioritise resources.
- Legislative and policy delay and uncertainty could obstruct delivery of the business plan, and make it harder for the PRA to deliver its desired supervisory approach. Risks include delay and uncertainty in:
  - The final outcome of Solvency II, CRR/CRD IV and Common Reporting legislation.
  - The legislation enacting the recommendations of the ICB; plans for a Banking Union in the EU; and the final rules resulting from the implementation of the Dodd-Frank Act in the United States.

Value for money considerations

The PRA adheres to the principles of good regulation as laid out in the Approach documents, including the efficient and effective use of resources. To help ensure that the cost of regulation does not exceed that of the old regime, supervisory and policy resources are focused on those risks and issues most material to the PRA's objectives. In addition, the National Audit Office, as the PRA's auditors, are able to instigate value for money reviews into different aspects of the PRA's operations.

Court and the PRA

Responsibility for supervisory decisions about individual firms and PRA policymaking rests with the Board of the PRA rather than the Court of Directors of the Bank. The Bank is required to approve the PRA's budget, however. The PRA is also required to consult the Bank on its strategy. Processes are in place to allow the Court to appropriately monitor the delivery of these requirements.

The Bank has a responsibility for the PRA. The Oversight Committee ensures, like other Bank committees, that the PRA Board is properly resourced and has adequate information. They are in a position to review regularly the way the PRA Board is operating. And they can look at the success with which the PRA has delivered its strategy.

Financial review

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

- First, that the Bank will set a budget for spending on policy functions — monetary policy and financial stability — having regard to the figure given in the five-yearly review of the Cash Ratio Deposit (CRD) scheme. Under the CRD regime, banks and building societies are required to place a percentage of their deposit base, above a minimum threshold, at the Bank interest-free. The Bank then invests those deposits in interest-yielding assets, generating income to fund its policy functions.

- Second, that the other, remunerated, activities of the Bank will be expected to break even over the medium term. In these areas the focus will be on net spending, although the Bank will remain committed to providing value for money, without running undue risks. Any losses or gains from these activities will not flow through to the CRD-payer, but instead affect the Bank's capital.

- Third, that if spending on policy functions is in line with CRD income and other functions break even, the profit of the Bank is broadly equivalent to the return on the assets in which its capital and reserves are invested — largely gilts and AAA-rated sterling-denominated bonds. The Bank's post-tax profit is shared 50:50 with HM Treasury unless otherwise agreed.

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

Financial results in 2012/13

Net expenditure on the Bank's policy functions in 2012/13 was £129.9 million, £4.0 million below the budgeted amount. That reflected a combination of lower-than-budgeted staff costs and some deferrals in project spending. This was partly offset by the unbudgeted costs associated with the three Reviews commissioned by Court. Staff numbers have increased steadily, to end the year broadly in line with budgeted numbers. The Bank has maintained its resources required to support the interim FPC, in line with the Bank's new responsibilities as the macroprudential authority.

On a management accounts basis, remunerated functions generated net income of £28.2 million, £22.7 million above the forecast surplus position in the budget for 2012/13. That reflected the income generated from the operation of the FLS net of expenses, which was unbudgeted, and higher income from banking services.

As in 2011/12, spending on the Bank's policy functions was higher than CRD income. The level of CRD income was £93.0 million in 2012/13, compared to a budget of £90.2 million. For a number of years prior to 2009/10, CRD income was in excess of policy spending. However, over the period 2008-13, to which the current CRD scheme settlement applies, CRD income was below the Bank's policy function spending due to lower-than-expected growth in deposits and declining returns on gilts.

The Bank will recover the transition costs incurred for the creation of the PRA for the year 2012/13 as well as those expensed in previous years' income statements.

Bank expenditure by function(1)

£ millions

	2011/12 Actual	2012/13 **Actual**	2012/13 Budget	2013/14 Budget
Policy functions				
Monetary policy	66.5	68.0	69.8	63.8
Financial stability	54.1	61.9	63.1	63.1
Contingency reserve	–	–	1.0	1.6
Expenditure on policy functions	**120.6**	**129.9**	**133.9**	**128.5**
Remunerated functions				
Note issue	71.0	76.6	80.4	72.8
Government agency services	8.0	8.7	8.6	8.1
Payment and settlement	10.3	11.4	11.7	12.0
Banking services	26.9	29.3	29.9	26.5
Other functions	18.3	15.7	11.7	20.1
Expenditure on remunerated functions	**134.5**	**141.7**	**142.3**	**139.5**
PRA(2)	–	–	–	**209.4**
Legacy costs(3)	**7.7**	**8.6**	**9.0**	**13.3**
Total expenditure(4), (5)	**262.8**	**280.2**	**285.2**	**490.7**

(1) From the Bank's management accounts, net of recoveries; figures contain reporting differences to the statutory financial accounts, such as the inclusion of notional interest charges and the treatment of pensions. The onerous lease provision of £19.1m is not included.
(2) Eleven months from 1 April 2013.
(3) Mainly pensioner benefits and interest on severance provisions.
(4) In addition to the amount above the Bank incurred non-capital expenditure of £48.5m (2012: £14.7m) relating to the PRA transition which is recoverable from the PRA.
(5) In addition the Bank has incurred costs of £1.6m (2012: £2.2m) relating to the APF which are recoverable from the Bank of England Asset Purchase Facility Fund Ltd.

Financial review continued

Budget for 2013/14

The following budget commentary includes reference to the Prudential Regulation Authority.

The budgeted expenditure for the Bank's policy functions in 2013/14 is £128.5 million, 26% of the total expenditure by function (46% excluding the PRA).

The 2013/14 policy budget is in line with prior year plans after being adjusted for the sharing of corporate services costs with the PRA, additional costs of the new CCP/SSS oversight responsibilities and accounting changes. After 2013/14, nominal spending growth of 2% per year, in line with the CPI inflation target, is assumed such that the cost of the Bank's policy functions remains flat in real terms. This is in line with Court's policy to set budgets that over time imply no real increase in the Bank's policy costs, subject to any increase in responsibilities.

The forecast for CRD income contained in the budget for 2013/14 is consistent with the new settlement expected to come into force in early June. Income forecasts remain sensitive to the future path of interest rates and growth in the level of CRDs.

The 2013/14 budget was developed against the backdrop of the five-yearly CRD review announced by the Chief Secretary to the Treasury on 18 September 2012. The review was led by a Steering Group of senior representatives from the Bank and HM Treasury. The review reached the following conclusions:

- The CRD scheme continues to be a suitable method of funding the Bank of England's monetary policy and financial stability operations.
- The CRD ratio should be changed to 0.18% from 0.11%.
- The minimum deposits threshold should be raised to £600 million, from £500 million.

This was agreed by the Chief Secretary to the Treasury. Subject to parliamentary approval the revised ratio will come into effect on 3 June 2013.

Scope for additional efficiency savings has been identified in corporate services areas, which will be implemented during the next five-year period. HM Treasury will review efficiency savings identified by the Bank once the PRA shared corporate services model has been established. HM Treasury will consider the implications of identified efficiency savings for the Bank's monetary policy and financial stability funding requirements through the CRD scheme.

The projection for the Bank's remunerated functions in 2013/14 is for a surplus consistent with the Bank's objective for these activities to be broadly self-financing over the medium term.

The budget for 2013/14 includes proposals for £64.9 million of project-related expenditure, of which £37.6 million relates to additions to the Bank's fixed or intangible assets. A significant portion supports the Bank's policy functions, such as the development of new economic models and data tools, including in relation to the Bank's new macroprudential responsibilities, or systems and processes for current and future requirements in implementing the Bank's policy operations. The budget includes the PRA project portfolio, principally post legal cutover work to de-couple from legacy FSA IT systems and processes and the implementation of the Solvency II directive. The remainder of the investment plan is mainly on IT systems and processes, and property and banking services.

The PRA commenced operations on 1 April 2013. £87.5 million of costs relating to the set-up of the PRA, including £22.8 million of capital expenditure, had been incurred to the end of the 2012/13 financial year. Costs for the remainder of the project are expected to be £9.3 million. The total costs to the Bank of PRA transition are expected to be around £96.8 million to completion in line with estimates presented to HM Treasury. These costs will be recovered from the PRA. Support services will be based on an integrated model across the Bank and the PRA, with the Bank's existing support functions expanded to support the front-line operations of the PRA. The Bank's intention is that the PRA will operate at lower cost than the equivalent part of the FSA would have done.

Proposals for major projects supporting the strategic priorities in 2013/14 include:

Strategic priority	Project	2013/14 budget £m	Total cost £m	Project completion
2. Policies, tools and infrastructure for monetary policy and banknotes	Design and Production of the Next Banknote	2.2	4.8	2016/17
	Loan Collateral Risk Monitoring	0.8	2.1	2014/15
3. Resilience of the financial system	RTGS Resilience Enhancement	0.8	4.4	2014/15
4. Macroprudential policy	Model Management	0.8	2.4	2015/16
	FPC Data Requirements	0.3	1.1	2014/15
5. Integrate microprudential supervision into the Bank	PRA Business Transformation Programme	10.0	32.5	2016/17
6. Influence and implement policy to advance PRA objectives	Solvency II	11.6	37.6	2016/17
	CRD IV	2.4	3.5	2015/16
8. Right people and processes	Desktop Replacement Project	10.4	13.1	2013/14
	Network Infrastructure Replacement Programme	4.6	9.6	2016/17
	New Collateral Operations	1.2	9.5	2013/14
	Information Assurance	1.4	6.7	2013/14

Financial statements

The Banking Department's financial statements for the year ended 28 February 2013 are given on pages 52–98 and show a profit before tax of £125 million (2011/12: £100 million after a restatement of £18 million resulting from the adoption of the revised accounting treatment for pension charges). After a tax charge of £15 million (2011/12: £15 million), the profit transferred to reserves amounts to £55 million (2011/12: £49 million). The amount payable in lieu of dividend amounts to the remaining £55 million (2011/12: £2,298 million which included £2,262 million in relation to the surplus from the Special Liquidity Scheme (SLS)).

The statements of account for the Issue Department (which are given on pages 99–101) show that the profits of the note issue were £517 million (2011/12: £853 million). The level of Bank Rate is the main driver of the profits of the Issue Department. In addition, in 2012/13 there was a significant net decrease of £113 million in the market value of gilts held on Issue Department, which was settled by transfers from the National Loans Fund. This partially reversed last year's net gains of £394 million, which were taken through income. The profits of the Issue Department are payable in full to HM Treasury.

Profit before tax

£ millions	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	**2012/13**
Banking Department	106	99	191	197	995	231	132	100	**125**
Issue Department	1,618	1,698	1,653	2,327	2,188	491	475	853	**517**

Financial review continued

Banking Department balance sheet

The balance sheet of the Banking Department increased during the year, from £315.5 billion at 29 February 2012 to £397.7 billion as at 28 February 2013.

The main change in the components of Banking Department assets was an increase in 'other loans and advances', from £286.6 billion at 29 February 2012 to £375.2 billion at 28 February 2013, principally the advance to BEAPFF for asset purchases on behalf of the MPC, which increased by £88.6 billion in the year.

On the liabilities side, deposits from banks and other financial institutions, mainly reserves balances, increased by £79.5 billion to £297.1 billion at 28 February 2013. Other deposits also increased to £78.1 billion (2011/12: £70.2 billion), reflecting deposits from other central banks, deposits from BEAPFF (mainly gilt coupon receipts) and from the Issue Department. The latter nets out in the combined balance sheet.

At 28 February 2013, the Banking Department balance sheet contained £4.0 billion of liabilities associated with the management of the Bank's foreign exchange reserves (2012/13: £5.1 billion) as the latest Bank of England bond was issued on 11 March 2013.

The level of CRDs remained at £2.4 billion at 28 February 2013 (2011/12: £2.4 billion), and capital and reserves remained at £3.4 billion (2011/12: £3.4 billion).

Capital and reserves together with CRDs are predominantly invested in gilts and supranational sterling bonds. The Banking Department's holdings of gilt securities were £4.3 billion at 28 February 2013 (2011/12: £4.4 billion) and holdings of other supranational sterling bonds were £435 million (2011/12: £446 million).

Issue Department balance sheet

Banknote liabilities continued to increase year on year, and were £58.0 billion on 28 February 2013 (2011/12: £54.9 billion). Gilt purchases for Issue Department, introduced in January 2008, remained on hold during the year while BEAPFF undertook gilt purchase operations. The market valuation of gilts on Issue Department was £4.9 billion at 28 February 2013 (2011/12: £5.4 billion). The Ways and Means advance to HM Treasury remained at £370 million during 2012/13.

Reverse repos outstanding at 28 February 2013 were £15 million (2011/12: £1.6 billion), and the Issue Department's deposit with the Banking Department, netted out in the combined balance sheet, was £52.7 billion (2011/12: £47.6 billion).

Summary combined balance sheet

	2013 £m	2012 £m
Assets		
Ways and Means advance	370	370
Loans and advances	387,717	303,721
Securities held at fair value through profit or loss	3,573	4,782
Derivative financial instruments	334	461
Available for sale securities	10,072	10,719
Other assets	937	2,778
Total assets	**403,003**	**322,831**
Liabilities		
Notes in circulation	58,022	54,921
Deposits	336,814	255,030
Foreign currency bonds in issue	4,007	5,104
Derivative financial instruments	229	232
Other liabilities	579	4,157
Capital and reserves	3,352	3,387
Total equity and liabilities	**403,003**	**322,831**

Combined balance sheet

The separation of Banking from Issue in the Accounts is required by statute. A summary combined Bank balance sheet as at 28 February 2013, is set out on the previous page. It is provided for information purposes only, to assist comparison with other central banks.

In summary, the combined balance sheet increased by £80.2 billion. The largest movement in assets was an increase in 'loans and advances' by £84.0 billion, with small increases across other balance sheet categories. On the liabilities side, 'deposits' increased by £81.8 billion, while 'notes in circulation' increased by £3.1 billion and other liabilities decreased by £3.6 billion as last year's balance was increased by the SLS payment in lieu of dividend liability of £2.3 billion and the Bank of England bond issuance and related assets of £1.3 billion which were in the course of settlement as at 29 February 2012.

Payment in lieu of dividend to HM Treasury

The Bank of England Act 1946, as amended by the Bank of England Act 1998, requires the Bank to pay to HM Treasury, in lieu of dividend on the Bank's capital, on the fifth day of April and October (or prior working day), a sum equal to 25% of the Bank's post-tax profit for the previous financial year or such other sum as the Bank and HM Treasury may agree. The overall effect is that the Bank and HM Treasury will normally share post-tax profits equally. In 2011/12 the surplus of the SLS was also included within the payment in lieu of dividend to HM Treasury.

On 5 April 2013, the Bank paid the first instalment of £25 million in respect of the financial year ended 28 February 2013 based on provisional full-year figures. The balance of £30 million will be paid on 4 October 2013.

In respect of the year to 29 February 2012, the Bank paid £2,279 million in April 2012 and £19 million in October 2012.

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

The Court of Directors is responsible for ensuring that the financial statements of the Banking Department are properly prepared on the basis set out therein, as at 28 February 2013 and for the year to that date. The statements of account of the Issue Department are prepared in accordance with provisions agreed between the Bank and HM Treasury to implement the requirements of the Currency and Bank Notes Acts 1928 and 1954, the National Loans Act 1968 and the Currency Act 1983. The Court of Directors is responsible for ensuring that the statements of account are prepared in accordance with these requirements as at 28 February 2013 and for the year to that date.

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

The Court of Directors confirms that suitable accounting policies, consistently applied and supported by reasonable and prudent judgement and estimates, have been used in the preparation of the financial statements of the Banking Department. The accounting framework adopted is set out on pages 57–65.

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

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

Risk management and business practices

Risk management

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

In accordance with the FRC's Revised Guidance for Directors on the UK Corporate Governance Code, Court has reviewed the effectiveness of the risk management and internal control systems. Court confirms that an ongoing process of identifying, evaluating and managing the Bank's risks has operated throughout the year covered in this *Annual Report* and up to the date of its approval. To facilitate Court's review and confirmation, the Executive Directors and Directors have certified compliance with the Bank's risk management and internal control requirements by the areas for which they are responsible. This attestation included a review of the risk and control issues identified and reported during the year.

The Bank's risk framework

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

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

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

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

Risk policies

The Bank's approach to managing strategic risk is described in a strategic risk statement, reviewed by the Business Risk Committee (BRC) and approved by the Governors. For operational risk the Bank's risk policy and appetite is articulated in an overarching operational risk policy document, which is supported by a set of seven operational risk standards. In addition, there are three financial risk standards, which describe the Bank's policy and appetite for market, credit and liquidity risk. The management of financial risk is discussed in note 28 to the Financial Statements.

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

Risk governance

The development and implementation of the Bank's risk framework is overseen by the BRC. This includes reviewing the Bank's risk policies set out in the risk standards (see above) before their approval by the Governors. The BRC also reviews the Bank's operational risk profile and alerts the Executive Team, Audit and Risk Committee (ARCo) and Court to any significant out-of-tolerance operational risk issues, and actions that are required to mitigate risks. The BRC is supported in these activities by the Risk Oversight Unit (ROU).

The Assets and Liabilities Advisory Committee (ALCo) supports the Executive Director for Markets (ED Markets) in reviewing the financial risk profile of the Bank.

ED Markets reports to the Governors quarterly on risk issues, and notifies the Governors of any significant breaches of risk tolerance as they arise. Reports on financial risk are also provided to the BRC for information.

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

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

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

The Audit and Risk Committee (ARCo): ARCo assists Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management. It has responsibility for reviewing the findings of internal and external auditors and monitoring outstanding actions for timely completion. It is supported by the Bank's Internal Audit function. As part of its continuing activities, the Committee receives reports on the Bank's risk profile, the operation of the risk framework and the risk management processes and systems in place in the Bank.

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

The Executive Team (ET): ET members are responsible for managing the risks within their Directorates (and for risk standards where applicable). ET reviews quarterly reports on strategic, policy implementation, operational and financial risks, prior to their discussion at ARCo and Court.

The PRA Board: The Board's responsibilities include approving the PRA's overall strategy; considering the most significant supervisory decisions; and a number of legislative functions such as rule making. Specifically, the Board takes responsibility for approval of the risk management policies adopted by the PRA, and ensuring that those policies are maintained. The management of operational risk has been delegated to the PRA Executive Committee (ExCo) and the management of risks relating to supervision to the Supervision, Risk and Policy Committee (SRPC). The SRPC is responsible for considering a wide range of regulatory issues, including firm-specific decisions, exercising oversight of the supervisory risk portfolio, and discussing and approving policy proposals.

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

The Business Risk Committee (BRC): The BRC ensures that the risk framework provides the operational risk information required by the Bank's senior management to manage the Bank's risk profile. Responsibilities can be summarised in three areas:

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

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

Assets and Liabilities Advisory Committee (ALCo): ALCo supports and advises ED Markets on the management of the Bank's balance sheet under the terms of the annual Balance Sheet Remit from the Governor. In the context of the Remit and risk framework, it monitors the financial

Risk management and business practices continued

performance and risk profile of the Bank's main financial activities, and of the balance sheet as a whole.

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

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

Internal Audit Division: Internal Audit reports jointly to the Chair of ARCo and to the Governor. Internal Audit assists the Court of Directors and ET in protecting the Bank, and its reputation, by independently and objectively evaluating the effectiveness of internal controls, risk management and governance processes.

Governance of risk management within Directorates

Each Bank Directorate has staff that are given responsibility for co-ordinating risk management activities for that business area. In the case of Banking Services and Markets, there are dedicated organisational units set up to deliver the risk framework locally. For Markets, this responsibility lies with MSROD. In Banking Services, the Banking Risk Unit (BRU) is responsible for developing and implementing a framework to ensure that risks are effectively managed.

Other risk management committees

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

Exchange Equalisation Account (EEA)

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

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

Employees

At the end of February 2013 the Bank employed 2,029 full-time staff and 278 part-time staff, ie 2,307 staff in total; 2,092 of these staff were on permanent contracts, up from 1,898 as at 29 February 2012 and 215 were on temporary contracts, up from 147 as at 29 February 2012. During the year, including temporary staff, 504 individuals joined the Bank and 242 left. The Bank is continuing to take steps to address its staffing requirements, in particular in respect of its new responsibilities, including those necessary to support the PRA. The Bank maintains its arrangements for consulting staff on matters affecting their interests, including with representatives of the recognised trade union, Unite.

During 2012 the Bank had considerable success in the recruitment and progression of women. 44% of graduate recruits were women, a significant increase from a long-term average of around 29%. For the first time, the Bank surpassed its progression target of 30% female representation in management roles, with women now holding 32% of such roles. During the year to 28 February 2013, women were appointed to three of seven vacant Head of Division roles, bringing representation at this level to 22%. The Bank has specific development initiatives to support women in achieving their potential, including mentoring from chairmen of FTSE 100 boards. Flexible working has become an integral part of the Bank's working practices, meaning that all employees can choose roles to suit different stages of life while still advancing their careers. In February the Bank won the public sector category of the Financial Mail's

Breaking the Mould awards, which are designed to celebrate firms doing most to encourage women.

Considerable effort has also been channelled into expanding the representation of ethnic minorities, and progress is now being made. The representation of Black, Asian and Minority Ethnic (BAME) staff has increased, and is at a historic high of 11%. The Bank has had notable successes in graduate recruitment, with 15% of BAME heritage, and initial entrants (A levels) with 17%. As part of an extensive recruitment programme for technical IT staff, 35% of successful recruits declared BAME heritage.

In 2013 the Bank created the Equality and Diversity Committee, sponsored by the Court of Directors. The Committee's role is to provide high-level support to the Bank's diversity and inclusion agenda. The Committee is chaired by Spencer Dale (the Bank's Diversity and Inclusion Sponsor) and comprises four non-executive members of Court and three EDs. The inaugural meeting was held on 12 March 2013.

Health and safety

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

The environment

The SHE Committee also monitors the impact of the Bank's operations on the environment. The Bank tries to minimise that impact through better power efficiency and improved waste management. Completion of projects to replace end-of-life heating and cooling plant at Head Office and its site at Debden is expected to improve efficiency and reduce the Bank's environmental impact.

More than 98% of waste, or 1,351 tonnes, generated by the Bank at its two main sites in London and Essex is recycled or reused. One fifth of this waste is utilised in the production of power through the burning of the waste material at an award winning 'Energy from Waste' facility.

The Bank's publications, including this *Report*, are printed on paper which contains 50% recovered waste and 50% virgin fibre and is certified as a Forest Stewardship Council mixed sources product.

Political and charitable donations

The Bank continued to play an active role in community initiatives. During 2012/13 the Bank contributed an estimated total of £615,000 in support of its community programme (2011/12: £688,000). Cash donations totalled £348,000 (2011/12: £449,000), including:

- £60,000 to community organisations via the Staff Volunteering Award Scheme;
- £60,000 to charities supported by the Bank's regional Agencies;
- £25,000 to match staff fundraising for the staff charities of the year;
- £32,000 matched funding under the Payroll Giving Scheme;
- £15,000 via the Bank of England Court Awards through which donations are made to community organisations in recognition of outstanding volunteering contributions by members of staff;
- £64,000 made to charitable and other organisations;
- £5,000 for the David Sharp School Governor Awards; and
- £87,000 in donations to support academic research (2011/12: £95,000).

The Bank may grant staff paid leave to perform voluntary duties in the community, or to undertake public and civic duties. The Bank estimates the total value of non-cash community contribution, including time spent by staff on community involvement, travel costs for volunteers and the costs of hosting charitable events at the Bank, to be £152,000 in 2012/13 (2011/12: £239,000), of which £129,000 was for staff time involved in volunteering and civic duties.

No donation was made for any political purpose in 2012/13 (2011/12: nil). No paid leave was granted to staff for political purposes in 2012/13 (2011/12: nil).

Policy on payment of suppliers

The Bank is an approved signatory to The Prompt Payment Code.(1) Standard payment terms are 30 days but the Bank aims to pay invoices as quickly as possible. Measured in terms of the number of working days between receipt of an invoice and payment by the Bank, average trade creditor payment days were estimated to be 13.3 in 2012/13 (2011/12: 12.2). The average amount of invoices processed per month in 2012/13 was 1,650 (2011/12: 1,450).

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

Remuneration of Governors, Directors, MPC and interim FPC members

Court determines the remuneration of the Bank's most senior executives, including the Executive Directors and Advisers to the Governors and annual pay awards to Governors (but not initial pay awards on appointment). Court is advised by the Remuneration Committee, the composition of which is shown on page 5. Although no executive member of Court sits on the Remuneration Committee, the Governor may be invited to attend meetings.

Remuneration policy

The Remuneration Committee's approach has been to carry out reviews of senior Bank remuneration every five years in order to set appropriate pay, benefits and conditions of service. The Committee takes account of supply and demand, including external salary comparisons insofar as these might affect the availability of good candidates, while bearing in mind the Bank's position within the public sector. Where relevant, the Committee makes use of external advice. The five-yearly reviews set the rate for each job and the policy by which salaries will be increased each year and by which bonuses will operate for Executive Directors. The last review was carried out in 2006 with the assistance of Towers Perrin: its conclusions, and the actions flowing from them, have been summarised in previous *Annual Reports*.

Although a further review would have been expected in 2011, in July 2010 the Governor informed the Committee that he wished to freeze his salary for two years. In May 2012, the Governor requested that his salary remain frozen until the end of his term. Subsequent to the Governor's salary being frozen in 2010, and in line with Government policy for the public sector, Court decided that for the remainder of the executive group, and indeed the whole of the Bank, pay should be frozen for two years from 1 March 2011 to 28 February 2013. The annual pay review for all staff for the year commencing 1 March 2013 has been completed, although the Governor and Deputy Governors have chosen to continue having their pay frozen for 2013/14. The next five-yearly review for senior Bank remuneration will be undertaken during 2013, and decisions on implementation will be taken later in the year.

The Governor and the two Deputy Governors currently receive less pay than was recommended in the 2006 review: this proposed a rate of £375,000 to £400,000 for the Governor and £315,000 for the Deputy Governors, in all cases with smaller pension benefits. When the Governor was appointed for a second term, from July 2008, he chose not to accept the new package, and to remain on his previous salary. He receives no pension benefit, his Bank pension having been fully accrued at the end of his first term. Mr Bean chose to retain his existing pension terms on his appointment to Deputy Governor, Monetary Policy on 1 July 2008 as did Mr Tucker on his appointment to Deputy Governor, Financial Stability on 1 March 2009. They receive benefits in the Bank's Court pension scheme. That scheme, along with the Bank's final salary scheme for staff, is now closed to new members. Unless already a member of one of these schemes, any new member of the Executive Team is now appointed on the basis of joining the Career Average section of the Bank Pension Fund or receiving a salary supplement of 30% in lieu of pension.

Remuneration structure of the Governors

The remuneration arrangements for the Governor and Deputy Governors are set out below. The remuneration of the next Governor is set out in the Report by the Non-executive Directors on page 48.

Service contracts

The Governor and Deputy Governors are each appointed by the Crown for five-year terms.(1) The Governors have no termination provisions at the end of their appointments, other than a period of three months' continued employment by the Bank when they cease to be members of the MPC.

Under the Bank of England Act 1998, Governors are required to provide remunerated services to the Bank only. With Court's approval other directorships relevant to the Bank's work may be accepted, but any fees must be paid to the Bank. The only such directorship held during the past year has been the appointment to the FSA Board held by Paul Tucker.

Base salaries

On 1 March 2010, the salaries of the Deputy Governors were increased by 2.5% from £252,497 to £258,809: they were then frozen for two years. With effect from 1 March 2013 a 1% increase in salary was offered to the Deputy Governors but they chose not to accept the increase. However, the reference salary for the Deputy Governor role has increased to £261,397.

The review for the Governor's salary was due on 1 July 2010; as noted above he chose to accept no increase.

(1) From April 2013, a Governor's term will be eight years.

The Governor and the Deputy Governors do not receive bonuses.

Pensions

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

Pension benefits for the current Deputy Governors are provided through the Court section of the Pension Fund, which allows members to achieve a maximum pension of two thirds at a normal pension age of 60 after 20 years of service. This is supplemented in one instance by an unfunded scheme as described below. For executives joining the Court Pension Scheme before 2005 who were subject to the pension earnings cap introduced in the Finance Act 1989, the Bank contracted to provide additional unfunded pensions so that their total pensions broadly matched what would have been provided by the Scheme in the absence of the cap. During the year ended 28 February 2013, unfunded entitlements were provided to Mr Bean. Provision for these unfunded benefits is made in the Bank's financial statements. Court decided not to grant unfunded benefits to members joining after 2005.

Remuneration of members of Court

	Salary £	Benefits[1] £	Total 2012/13 £	Total 2011/12 £
Governor				
Sir Mervyn King[2]	305,368	2,382	307,750	307,792
Deputy Governors				
Mr C R Bean[2]	258,809	1,586	260,395	260,401
Mr P M W Tucker[2]	258,809	4,411	263,220	263,020
Non-executive Directors[3] [4]	150,000	17,356	167,356	162,813
Total	**972,986**	**25,735**	**998,721**	**994,026**

(1) Includes the provision of facilities which give rise to a tax liability.
(2) The table excludes business-related travel expenses taxable under HMRC rules of £1,666 (including tax).
(3) Lord Turner sat on Court as Chairman of the Financial Services Authority, and Paul Tucker, as Deputy Governor for Financial Stability, was a director of the FSA. Lord Turner waived remuneration from the Bank of £15,000 in 2012/13 and Paul Tucker waived remuneration from the FSA of £35,000.
(4) Does not include Mr Cohrs's remuneration as a member of the interim FPC, reported on page 46.

Pension entitlements and accruals (including unfunded entitlements)

	Cash equivalent as at 29.2.12 £	Cash equivalent as at 28.2.13 £	Increase in cash equivalent £	Accrued pension as at 29.2.12 £pa	Accrued pension as at 28.2.13 £pa	Increase in accrued pension £pa	Cash equivalent of additional pension earned during year ended 28.2.13 £
Mr C R Bean	3,555,600	3,960,800	405,200	101,900	110,900	9,000	321,400
Mr P M W Tucker	5,006,600	5,708,700	702,100	142,000	157,700	15,700	568,300

The cash equivalent for additional pension earned during the year ended 28 February 2013 is calculated using the assumptions adopted for the 2011 Pension Fund valuation, under which scheme liabilities were valued on an index-linked gilts yield discount rate and no credit is taken in advance for the possibility that returns on investments held by the Fund would exceed the long-term interest rate. This differs from the IAS 19 measure of pension liabilities where the discount rate assumption reflects the investment return on high-quality corporate bonds at the balance sheet date; had this been used the cash-equivalent values above would be lower. Further details of the valuation of pension benefits are provided in Note 18 to the Banking Department Financial Statements (pages 76–83).

Other benefits

The Remuneration Committee also keeps under review other benefits available to the Governors. Medical insurances and health checks were the principal non-salary benefits received during the year to 28 February 2013.

Remuneration of Non-executive Directors

The Bank of England Act 1998 provides for the remuneration of the Non-executive Directors to be determined by the Bank with the approval of the Chancellor of the Exchequer.[1]

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

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

With effect from 1 June 2009, these rates were set at £15,000 per annum for Directors, £20,000 for Committee Chairmen, £25,000 for the Senior Independent Director and £30,000 for the Chairman of Court. Non-executive Directors do not receive any post-retirement or medical benefits from the Bank or any additional fees for serving on Committees. The Bank meets appropriate travel and subsistence expenses.

Remuneration of external MPC and interim FPC members

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

The external members of the MPC were each paid £101,362 in 2012/13. They do not earn bonuses. They were also paid a supplement of 30% of salary in lieu of membership of the Bank's pension fund. They are entitled to cover under the Bank's group medical insurance scheme.

The external members of the interim FPC were paid at the rate of £55,000 per annum. They received no other benefits. The interim FPC ceased on 31 March 2013, replaced by the statutory FPC from 1 April 2013.

On leaving the Bank external members are paid their salary for a period of three months, during which period the Bank has the right to veto any employment that would conflict with their former interim FPC or MPC responsibilities, and to require continued adherence to the interim FPC or MPC guidelines, which sets rules for public speaking and media contacts. For MPC members, to the extent that they receive income from employment that does not conflict with their former MPC responsibilities, their income from the Bank is reduced.

Executive Directors' salaries and benefits

The table below shows the basic salaries and taxable benefits of the Executive Directors as at 28 February 2013.

	£
Andrew Bailey	202,429
Nils Blythe	166,642
Catherine Brown	209,133
Spencer Dale	187,733
Paul Fisher	187,733
John Footman	195,014
Andy Haldane	187,733
Warwick Jones	209,967
Graham Nicholson	179,375
Chris Salmon	175,963

The figures above exclude any entitlement to bonus.

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

Other senior executives' salaries and benefits

The table below shows the remuneration ranges for all staff with remuneration in excess of £80,000, apart from those disclosed above and individuals seconded to the FMLC.(1) Consistent with recent disclosures in the public sector, the figures relate to 2012/13 and show the full-time equivalent salary and include base pay and any taxable benefit allowances, but exclude bonus and pension contribution.

Remuneration range (£)	Number in range
160,000 – 169,999	1
150,000 – 159,999	2
140,000 – 149,999	0
130,000 – 139,999	6
120,000 – 129,999	19
110,000 – 119,999	10
100,000 – 109,999	25
90,000 – 99,999	42
80,000 – 89,999	73
Total	**178**

Bonuses

In line with previous years, 2012/13 bonus payments were made to Executive Directors, other senior executives and staff on an individual performance-related basis. Bonus payments were made from a pool of 6% of the total salaries of all employees, excluding Governors, at 31 December 2012.

(1) Financial Markets Law Committee, an independent committee of legal experts whose work is sponsored by the Bank and industry organisations.

Report by the Non-executive Directors

Since 1998, and for all of the year under review, the Non-executive Directors of the Bank made up a statutory sub-committee to keep under review the Bank's performance, finances and controls. On the coming into force of the 2012 Financial Services Act, on 1 April 2013, this Committee was reconstituted as the Oversight Committee, with a broader remit and wider powers. This section is consequently the last Report of the Committee of Non-executive Directors under Section 4(2)(a) of the Bank of England Act 1998. The Oversight Committee will issue a Report in future.

During the year under review, NedCo was responsible for keeping under review the Bank's performance in relation to its strategy and objectives; for monitoring achievement of its financial management objectives; for keeping internal financial controls under review; for reviewing the procedures of the MPC, and for determining the remuneration of the executive members of Court and other MPC and interim FPC members.

In part the Committee exercised its reviewing function through meetings of the full Court, where the Non-executive Directors provide an independent, informed and critical challenge to the Bank executive. Scrutiny of executive pay and internal controls are conducted respectively by the Remuneration Committee and the ARCo. Members of NedCo held regular informal meetings with the external members of the MPC and of the interim FPC, and with the Executive Directors. The Committee itself met four times during the year. During these meetings the Committee set and reviewed the Governor's objectives; reviewed the procedures of the MPC; discussed the commissioning of the Court Reviews (see below); agreed the remuneration arrangements for the next Governor; discussed the operation of the new Oversight Committee; and agreed its own report.

Reviewing performance

Directors received comprehensive quarterly reports on the implementation of the Bank's strategy, the management of major projects and any risks to delivery. These provide a sound basis for discussion with executive management. Reports on the development of the PRA transition programme, which was by far the largest project the Bank has undertaken in recent years, were discussed at every meeting of Court during the year, and in more detail at every ARCo. The Bank's performance in relation to its strategy and objectives is reviewed on pages 12–25 of this *Annual Report*. In NedCo's opinion this evaluation is a fair statement of the Bank's performance against its objectives and strategy for 2012/13.

Reviewing financial management

The Bank's budget for 2013/14, and the outcome for the previous year, is discussed on pages 34–39. Despite the pressures of new responsibilities, the Bank has remained successful in controlling its costs over the past decade, and Court's general objective remains to set budgets that imply no increase in real terms in the Bank's policy costs. This is reflected in the outcome of the Cash Ratio Deposit (CRD) review, as set out on page 36. It is the CRD income that funds the Bank's policy costs. For the PRA, which is funded by a levy, Court's plan is that it should operate at less cost than the equivalent function would have done at the FSA.

Value for money

In 2011 NedCo decided to commission one value for money (VFM) review each year. The first reported in February 2012, and looked at the scope for savings in the delivery of payment and settlement services. Additional potential savings in relation to renewal of IT contracts were identified. The second, completed in February 2013, reported on the effectiveness and efficiency of the Bank's Security Division. A further VFM study is planned for 2013/14, focusing on IT costs across the Bank including the PRA. The Bank's biggest single contract is for the printing of banknotes, and the present contract expires in 2015. A Committee of Directors has been formed to monitor the Bank's approach to contract renewal.

Audit and Risk

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

Report by the Non-executive Directors continued

Premises for the PRA

As noted in last year's report, a sub-committee of Directors recommended to Court the acquisition by the Bank of a leasehold interest in 20 Moorgate as accommodation for the PRA. The Bank took possession of 20 Moorgate in June 2012 and fit-out was completed in good time for the PRA staff to move from Canary Wharf, in stages, over the early months of 2013, ahead of legal cutover on 1 April. The close proximity of the new premises to the Bank will play an important part in the cultural and structural integration of the PRA into the Bank of England.

As part of the decision to move PRA staff from Canary Wharf to the City, the Bank undertook to bear the cost of managing the space that they might have occupied had they remained with the FSA. In the event nearly half the space was needed by the FCA. The property sub-committee has been closely monitoring the reletting of the remainder, which at the end of the year accounted for an empty property provision of £19.1 million in the Bank's books on the conservative assumption that no further reletting takes place.

MPC procedures

NedCo has been responsible for keeping the procedures followed by the MPC under review, and to ensure that the MPC has adequate resources to support its work. This includes reviewing the regional, sectoral and other information used by the MPC for the purposes of formulating monetary policy. Support for the MPC is covered on pages 13–14 of this *Report*. Directors receive a written monthly report from the MPC, and every three months, following publication of the *Inflation Report*, individual MPC members are invited to attend Court to discuss both the *Inflation Report* and MPC procedures. Directors periodically attend pre-MPC meetings as part of their review. A formal questionnaire is completed each year by each MPC member, and the results are reviewed by Court. The Chairman of Court holds individual discussions with MPC members and these too are reported to Court.

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

Remuneration

The Remuneration Committee assesses the remuneration of the executive members of Court, the Bank's Executive Directors and other senior executives. It also recommends to Court the terms and conditions of the members of the MPC and the FPC. The report of the Remuneration Committee is set out on pages 44–46 and so far as appropriate forms part of this *Report*. Last December NedCo confirmed their agreement to the remuneration of the next Governor effective from 1 July 2013, comprising a salary of £480,000 per annum, a cash allowance in lieu of pension of 30% of salary and an annual accommodation allowance of £250,000. These will be subject to tax and such social security contributions that the Bank may be required to deduct.

Preparing for a larger Bank

The changes to the Bank's responsibilities, and in particular the advent of the PRA, represent a set of management as well as policy challenges. There are three major policy Committees rather than one, so the senior executive is more stretched. Following legal cutover at 1 April 2013, and including the PRA, the Bank had 3,505 staff, an increase of 1,601 over the past three years. Parliament has recognised this in legislating for changes in governance, in particular the third Deputy Governor (for prudential regulation) and the Oversight Committee. At the senior management levels there have already been changes. The Governor has delegated authority to Committees chaired by Deputy Governors in the areas of money market operations, resolution, banknotes and the regulation of FMIs; and there are similar delegations from the Board of the PRA to the executive. The Non-executive Directors have welcomed these moves, and also the decision to appoint a Chief Operating Officer for the whole Bank. Reflecting its wider responsibilities Court approved in March 2013 a revised delegation document, known as 'Matters reserved to Court', which has now been published on the Bank's website.(1)

The Court Reviews

In May 2012 Court commissioned external reviews focused on three areas of the Bank's performance and capabilities that had been tested in the financial crisis: the arrangements for providing emergency liquidity support to an institution; the framework for providing liquidity to the banking system as a whole; and the MPC's forecasting

(1) See www.bankofengland.co.uk/about/Documents/matters042013.pdf.

capability. Each review was conducted by an internationally respected expert, with support from Bank staff, and made a number of recommendations. The Bank's responses to the recommendations were published in March 2013. Implementation of the responses will be monitored by the Oversight Committee.

Preparing for the Oversight Committee

The Committee followed closely the development of the Financial Services Bill, and in particular the amendments to create the Oversight Committee. These extend the scope of the Committee's reviewing functions to all the objectives of the Bank, including its statutory objectives for monetary and financial stability, and give Committee members the right to attend policy committee meetings as observers, and to have access to all documents provided to the Committee. The Committee is explicitly empowered to commission external reviews of the kind that were conducted in 2012, either from outside experts or, with the Governor's consent, from Bank staff.

Attendance

The table below sets out attendance by the Bank's Non-executive Directors at meetings of Court, NedCo, the Financial Stability Committee, the Audit and Risk Committee and the Remuneration Committee.

Attendance by other Court members is also listed.

Attendance (number of meetings)	Court (10)	NedCo (4)	FSC (6)	Audit & Risk (6)	RemCo (5)	Nominations (1)
Sir David Lees	10	4	6	6**	5	1
Mr Barber#	2 of 2	0 of 1	–	–	–	–
Sir Roger Carr	9 of 10	4	–	–	5	1
Lady Rice	10	4	–	6	–	1
Lord Turner	10	4	–	–	–	–
Mr M Tucker#	0 of 2	0 of 1	0 of 2	0 of 2	–	–
Mr Stewart	10	4	6	6	–	–
Mr Young#	2 of 2	1 of 1	2 of 2	–	–	–
Mr Cohrs	10	4	–	–	3 of 5	–
Mr Fried*	8 of 8	2 of 3	4 of 4	3 of 3	–	–
Mr Frost*	8 of 8	3 of 3	4 of 4	2 of 3	–	–
Mr Prentis*	5 of 8	2 of 3	–	–	3 of 4	–
Sir Mervyn King	10	–	1	–	4 of 4	1
Mr Bean	8 of 10	–	4 of 6	4 of 6**	–	–
Mr P Tucker	9 of 10	–	5 of 6	3 of 6**	–	–

\# Resigned 31 May 2012.
* Appointed 1 June 2012.
** Sir David Lees, Mr Bean and Mr P Tucker are in attendance.

Report of the Independent Auditor

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

We have audited the financial statements of the Banking Department ('financial statements') for the year ended 28 February 2013, set out on pages 52 to 98, and the statements of account of the Issue Department ('statements of account') for the year ended 28 February 2013, set out on pages 99 to 101. 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 out 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 100 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 98 for the year ended 28 February 2013 have been properly prepared, in all material respects, in accordance with the bases of preparation set out in note 2 on pages 57 to 65.

- the statements of account of the Issue Department on pages 99 to 101 for the year ended 28 February 2013 have been properly prepared, in all material respects, in accordance with the bases of preparation set out in note 1 on page 100.

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

28 May 2013

Banking Department

Income Statement for the year to 28 February 2013

	Note	2013 £m	2012* £m
Profit before tax	4	125	100
Corporation tax net of tax relief on payment to HM Treasury	7	(15)	(15)
Profit for the year attributable to shareholder		**110**	**85**

* The prior year has been restated. See note 2b for details.

The notes on pages 57 to 98 are an integral part of these financial statements.

Statement of Comprehensive Income
for the year to 28 February 2013

	Note	**2013 £m**	2012* £m
Profit for the year attributable to shareholder		110	85
Other comprehensive income:			
Revaluation of available for sale securities	14	(44)	382
Revaluation of properties	16	–	(5)
Remeasurements on retirement benefits	18	(95)	306
Corporation tax relating to components of other comprehensive income	7	49	(166)
Other comprehensive income for the year, net of tax		(90)	517
Total comprehensive income for the year		**20**	**602**

* The prior year has been restated. See note 2b for details.

The notes on pages 57 to 98 are an integral part of these financial statements.

Balance Sheet as at 28 February 2013

	Note	2013 £m	2012 £m
Assets			
Cash and balances with other central banks	9	787	372
Loans and advances to banks and other financial institutions	10	11,719	15,157
Other loans and advances	11	375,196	286,582
Securities held at fair value through profit and loss	12	3,573	4,782
Derivative financial instruments	13	334	461
Current tax assets		12	–
Available for sale securities	14	5,179	5,340
Investments in subsidiaries	15	–	–
Property, plant and equipment	16	243	218
Intangible assets	17	11	10
Retirement benefit assets	18	460	564
Other assets	19	211	1,986
Total assets		**397,725**	**315,472**
Liabilities			
Deposits from central banks	20	14,371	14,806
Deposits from banks and other financial institutions	21	297,124	217,623
Other deposits	22	78,063	70,163
Foreign currency bonds in issue	23	4,007	5,104
Derivative financial instruments	13	229	232
Current tax liabilities		–	44
Deferred tax liabilities	24	166	201
Retirement benefit liabilities	18	202	252
Other liabilities	25	211	3,660
Total liabilities		**394,373**	**312,085**
Equity			
Capital	26	15	15
Retained earnings		2,465	2,477
Other reserves		872	895
Total equity attributable to shareholder		**3,352**	**3,387**
		397,725	**315,472**

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 98 are an integral part of these financial statements.

Statement of Changes in Equity
for the year to 28 February 2013

		Attributable to equity shareholder				
	Note	Share capital £m	Available for sale reserve £m	Property revaluation reserve £m	Retained earnings £m	Total £m
Balance at 1 March 2011		15	458	150	3,800	4,423
Post-tax 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*	8	–	–	–	(2,298)	(2,298)
Balance at 29 February 2012		**15**	**750**	**145**	**2,477**	**3,387**
Post-tax comprehensive income for the period		–	(23)	–	43	20
Payable to HM Treasury in lieu of dividend	8	–	–	–	(55)	(55)
Balance at 28 February 2013		**15**	**727**	**145**	**2,465**	**3,352**

* 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 98 are an integral part of these financial statements.

Statement of Cash Flows for the year to 28 February 2013

	Note	2013 £m	2012* £m
Cash flows from operating activities			
Profit before taxation		125	100
Adjustments for:			
Amortisation of intangibles	17	4	3
Depreciation of property, plant and equipment	16	11	10
Dividends received	4	(14)	(14)
Net movement in accrued interest and provisions, including pensions		125	65
Changes in operating assets and liabilities:			
Increase in loan advanced to the Bank of England Asset Purchase Facility Fund Ltd	11	(88,614)	(86,775)
Net decrease in other advances		1,120	681
Net increase in securities held at fair value through profit or loss		(214)	(39)
Net increase in deposits		87,035	84,457
Net increase/(decrease) in foreign currency bonds in issue		7	(10)
Net decrease/(increase) in financial derivatives	13	124	(281)
Net increase in other accounts		(54)	–
Corporation tax paid		(56)	(42)
Net cash outflow from operating activities		**(401)**	**(1,845)**
Cash flows from investing activities			
Purchase of available for sale securities	14	(235)	(323)
Proceeds from redemption of available for sale securities	14	297	257
Dividends received	4	14	14
Purchase of intangible assets	17	(5)	(3)
Purchase of property, plant and equipment	16	(37)	(17)
Net cash inflow/(outflow) from investing activities		**34**	**(72)**
Cash flows from financing activities			
Cash generated from indemnified operations		–	53
Tax on financing activities		633	(15)
Payment to HM Treasury under Section 1 (4) of the Bank of England Act 1946		(2,298)	(64)
Net cash outflow from financing activities		**(1,665)**	**(26)**
Net decrease in cash and cash equivalents		**(2,032)**	**(1,943)**
Cash and cash equivalents at 1 March	27	6,172	8,115
Cash and cash equivalents at 28 February	**27**	**4,140**	**6,172**

* The prior year has been restated. See note 2b for details.

The notes on pages 57 to 98 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 Acts of 1694 and 1844, the Bank of England Acts 1946 and 1998, the Banking Act 2009 and the Financial Services Act 2012. 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 99 to 101, 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. Securities held on Issue Department are revalued quarterly at their clean market price. 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. 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 adopted 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.
- Fair value of collateral pledged and held.
- Related party disclosure.

b New and amended accounting standards

The following revised standard has been applied in 2012/13:

Amended IAS 19 (Employee benefits)

The amendments to IAS 19 effective for periods starting on or after 1 January 2012 have been applied for the first time. The Bank has opted to adopt this standard ahead of the EU deadline. 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 is to reduce the net expense to £16 million from £65 million. All changes have been made retrospectively in line with IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors), with the prior year expense restated from £48 million to £30 million and the corresponding impact effected in the Statement of Comprehensive Income.

In addition the Bank has considered the potential effect of forthcoming EU endorsed standards which have not been adopted in the financial statements; none of these is expected to materially impact the Bank.

c Consolidation

The financial statements of Bank's subsidiaries, including the Bank of England Asset Purchase Facility Fund Ltd and the Prudential Regulation Authority, have not been consolidated. Under the Bank of England Act 1998 the financial statements are prepared on a non-consolidated basis. 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.

Derivatives must be held at fair value through profit or loss. 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. The policy for establishing fair values of securities in non-active markets is described in note 3 'Significant accounting estimates and judgements in applying accounting policies' on page 65.

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 (i.e. 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.

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
Leasehold improvements	over the estimated remaining life of the lease
Plant within buildings	over periods ranging from five to twenty years
IT equipment	over periods ranging from three to seven 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 directly associated with the internal production of unique and separately identifiable software products, which are controlled by the Bank and which will 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:

- Three 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 obligation to pay cash flows relating to the financial liabilities has 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. The Bank is entitled to tax relief on the amount due to HM Treasury as a payment in lieu of a dividend in accordance with section 1 (4) Bank of England Act 1946. Tax relief on amount due to HM Treasury is credited directly to the income statement in accordance with paragraph 52B of IAS 12.

The Bank was granted corporation tax credit in relation to the Special Liquidity Scheme surplus payment 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 re-measurement of available for sale securities and actuarial gains and losses on retirement benefit obligations is 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. Remeasurements on retirement benefits 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. Remeasurements on retirement benefits 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 to redundancy provisions and healthcare for certain pensioners, which are accounted for on a similar basis to the accounting 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. Where the level of fee is contingent on a particular outcome, the Bank only recognises the fee that is known to be recoverable.

q Provisions

Provisions are recognised in respect of restructuring, redundancy, onerous leases 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, without charge, from loss by HM Treasury. Surpluses from such indemnified operations, after the deduction of fees, operating costs and tax, are 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 loaned 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 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

The Bank's accounting policy for the valuation of financial instruments is described in note 2 (e) and (k). The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. Details of valuation techniques for the different classifications are given in note 28. Fair values of equity investments classified for accounting purposes as available for sale rely to a greater extent on unobservable inputs and therefore require a greater level of management judgement to calculate a fair value than those based on wholly observable inputs. These equity investments, disclosed in note 14, are held by the Bank for the long term as part of its central banking activities and may not be readily saleable. The values 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.

d Onerous lease provision

The Bank has recognised an onerous lease provision in respect to certain leased property previously occupied by the FSA and which was vacated on the commencement of the new regulatory regime.

In determining the provision Management has made certain judgements in respect of; the likelihood of sub-letting space, the anticipated income receivable and an appropriate discount rate. The provision is included within note 25.

Notes to the Banking Department Financial Statements continued

4 Profit before tax

	Note	2013 £m	2012* £m
Income includes			
Charges for services to HM Government (including charges to the Issue Department in respect of the Note Issue)		88	82
Banking charges and tariff income		21	19
Dividend income		14	14
Expenses include			
Staff costs	5	132	137
Legal fees		2	2
Amortisation of intangible assets	17	4	3
Depreciation of property, plant and equipment	16	11	10
Software expenditure		9	6
Operating lease rentals — property		1	1
— other		–	–
Onerous lease provision		19	–
Other administrative expenses		99	108

* The prior year has been restated. See note 2b for details.

The Bank incurred £48.5 million of costs relating to the set up of the PRA during the year (2012: £14.7 million, 2011: £1.5 million) and has charged the current and previous years' transition costs to the PRA. A receivable has been recognised on the balance sheet. The PRA Board has agreed to recover these costs from fee-payers over a period of five years.

5 Staff costs

	Note	2013 £m	2012* £m
Wages and salaries		105	97
Social security costs		11	10
Pension and other post-retirement costs	18	16	30
		132	**137**

* The prior year has been restated. See note 2b for details.

Wages and salaries include £7 million (2012: £4 million) to be recovered from the PRA and £2 million of costs capitalised as intangible assets (2012: £2 million).

Average number of employees

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

	2013	2012
Governors and other members of Executive Team	13	14
Managers and analysts	855	790
Other staff	1,305	1,151
	2,173	**1,955**

The number of persons employed by the Bank at the end of February 2013 was 2,307, of which 2,029 were full-time and 278 were part-time (2012: 2,045; of which 1,791 full-time and 254 part-time).

6 Auditor's remuneration

	2013 £000	2012 £000
Audit fees for the Bank's audit:		
— Fees relating to current year	260	260
— Fees relating to prior year	–	(5)
Fees payable to the Auditor for services provided to the Bank:		
— Audited-related assurance services	43	65
— Taxation advisory services	38	27
— All other non-audit services	70	21
	411	**368**

In addition, fees of £30,000 for audit services and £9,000 for other services in relation to Bank of England Asset Purchase Facility Fund Ltd paid by the Bank were recovered via a management fee (2012: £30,000 and £nil respectively). Audit-related assurance services include £25,000 for providing assurance to HM Treasury on the allocation of costs (2012: £30,000) and £18,000 for the review of the Whole of Government Accounts submissions (2012: £35,000).

The Bank will be recovering £32,938 (2012: £21,910) of costs associated with the PRA transition from the PRA.

7 Taxation

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

	2013 £m	2012* £m
Current year corporation tax	6	1
Prior year corporation tax	–	–
Deferred tax — current year	9	14
Tax charge on profit	**15**	**15**

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:

	2013 £m	2012* £m
Profit before tax	125	100
Tax calculated at rate of 24.17% (2012: 26.17%)	30	26
Tax relief on payment to HM Treasury	(13)	(9)
Non-deductible expenses	1	–
Dividend not subject to corporation tax	(3)	(4)
Movement in unrecognised deferred tax on properties	–	1
Change in tax rate to 23% (2012: 25%)	–	1
Total tax charge for the period	**15**	**15**

* The prior year has been restated. See note 2b for details.

Notes to the Banking Department Financial Statements continued

7 Taxation continued

Tax (credited)/charged to equity comprises:

	2013 £m	2012* £m
The tax (credited)/charged to equity through the Statement of Comprehensive Income		
Current year corporation tax	(5)	84
Deferred tax	(44)	82
	(49)	**166**
Other tax (credited)/charged directly to equity		
Current year corporation tax	–	(634)
Tax (credited) to equity	**(49)**	**(468)**

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

	2013 £m	2012* £m
Tax (credited)/charged to equity through the Statement of Comprehensive Income		
Revaluation of available for sale securities	(11)	100
Remeasurements on retirement benefits	(23)	78
Change in tax rate to 23% (2012: 25%)	(15)	(12)
	(49)	**166**
Other tax (credited) directly to equity		
Surplus from indemnified operations	–	(634)
Tax (credited) to equity	**(49)**	**(468)**

* The prior year has been restated. See note 2b for details.

The main UK corporation tax rate is 24% with effect from 1 April 2012. The rate reduction on the deferred tax balances as at 28 February 2013 has been disclosed in note 24.

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

	2013 £m	2012 £m
Payable 5 April	25	2,279
Payable 4 October (2012: 5 October)	30	19
	55	**2,298**

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 28 February 2013. 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. In the prior year the Bank and HM Treasury agreed to an additional payment in lieu of dividend for £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

	2013 £m	2012 £m
Cash	–	–
Balances with other central banks	787	372
	787	**372**

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

	2013 £m	2012 £m
Items in course of collection	–	–
Reverse repurchase agreements held at amortised cost	570	1,755
Reverse repurchase agreements held at fair value through profit or loss	11,145	12,984
Other loans and advances	4	418
	11,719	**15,157**

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 July 2012).

At 28 February 2013 loans and advances to banks and other financial institutions included cash and cash equivalents of £3.4 billion (2012: £5.7 billion) which are disclosed in note 27i.

11 Other loans and advances

	2013 £m	2012 £m
Overdrafts	–	–
Loan to the Bank of England Asset Purchase Facility Fund Ltd	375,193	286,579
Term loans	3	3
	375,196	**286,582**

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

	2013 £m	2012 £m
Money market instruments	–	129
Listed foreign government securities	3,573	4,653
	3,573	**4,782**

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 28 February 2013 this portfolio was financed by three $2 billion three-year bonds (2012: four $2 billion three-year bonds) issued through the Bank's annual programme of syndicated foreign currency bond issuance. In March 2013, the Bank launched a $2 billion three-year bond replacing the 2010 bond which matured on 18 March 2013. The assets in the portfolio are denominated in US dollars, euros and Japanese yen.

At 28 February 2013 securities held at fair value through profit or loss included cash and cash equivalents of £nil (2012: £0.1 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 28 February 2013 securities with a fair value of £205 million (2012: £265 million) and cash collateral of £nil (2012: £nil) 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 28 February 2013

	Contract notional amount £m	Fair values Assets £m	Liabilities £m
Cross-currency interest rate swaps	2,712	163	–
Interest rate swaps	7,928	36	(59)
Forward exchange contracts	13,350	135	(170)
Total recognised derivative assets/(liabilities)		**334**	**(229)**

b As at 29 February 2012

	Contract notional amount £m	Fair values Assets £m	Liabilities £m
Cross-currency interest rate swaps	3,684	35	(62)
Interest rate swaps	10,779	56	(75)
Forward exchange contracts	14,146	370	(95)
Total recognised derivative assets/(liabilities)		**461**	**(232)**

Notes to the Banking Department Financial Statements continued

14 Available for sale securities

	2013 £m	2012 £m
Debt securities at fair value		
British Government securities listed on a recognised UK exchange	4,265	4,406
Other sterling securities listed on a recognised exchange	435	446
	4,700	4,852
Unlisted equity investments at fair value	479	488
	5,179	**5,340**

The movement in available for sale securities comprises:

	2013 £m	2012 £m
Available for sale debt securities		
At 1 March	4,852	4,524
Purchases	235	323
Redemptions	(297)	(257)
Mark-to-market movements through equity	(35)	311
Amortisation of premium/discount	(52)	(49)
Movement in accrued interest	(3)	–
At 28 February	**4,700**	**4,852**
Available for sale unlisted equity investments		
At 1 March	488	417
Revaluation of securities	(9)	71
Disposal of securities	–	–
At 28 February	**479**	**488**
	5,179	**5,340**

There were no gains or losses on the sale of available for sale securities transferred to the Income Statement during the year (2012: gains of less than £1 million).

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 28 February 2013 the holding represents 8.5% (2012: 8.7%) of the issued share capital. The investment has been valued on a dividend yield basis providing a value of £474 million (2012: £484 million) at the year end. A discount rate of 6.5% (2012: 6.3%) was used. Increasing the discount rate by 1 percentage point would deflate the valuation by £108 million, while decreasing the discount rate by one percentage point would inflate the valuation by £202 million.

The Bank's holding in the European Central Bank (ECB) represents 0.8% (2012: 0.9%) of the ECB'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 €59 million (2012: 3.75% amounting to €59 million) of its total allocation of the ECB's subscribed capital of €1.6 billion (2012: €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% (2012: 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 (2012: £nil).

15 Investments in subsidiaries

The Bank has a number of subsidiaries, which are wholly owned, that are stated in the Bank's balance sheet at an aggregate cost under £1 million. These are:

The Securities Management Trust Ltd	1,000 ordinary shares of £1
Bank of England Asset Purchase Facility Fund Ltd	100 ordinary shares of £1
Houblon Nominees	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
Prudential Regulation Authority	1 ordinary share of £1

Notes to the Banking Department Financial Statements continued

16 Property, plant and equipment

For the year to 28 February 2013

	Freehold land and buildings £m	Leasehold improvements £m	Equipment* £m	Total £m
Cost or valuation				
At 1 March 2012	204	–	50	254
Additions	13	10	14	37
Disposals/write-offs	(1)	–	(7)	(8)
Revaluation of properties	(6)	–	–	(6)
At 28 February 2013	**210**	**10**	**57**	**277**
Accumulated depreciation				
At 1 March 2012	–	–	36	36
Charge for the year	6	–	5	11
Disposals/write-offs	–	–	(7)	(7)
Revaluation of properties	(6)	–	–	(6)
At 28 February 2013	**–**	**–**	**34**	**34**
Net book value at 1 March 2012	204	–	14	218
Net book value at 28 February 2013	**210**	**10**	**23**	**243**

* Net book value of equipment at 28 February 2013 included £4 million held under finance leases.

Included within property, plant and equipment is £22.8 million of capital expenditure relating to the set up of the PRA.

For the year to 29 February 2012

	Freehold land and buildings £m	Leasehold improvements £m	Equipment* £m	Total £m
Cost or valuation				
At 1 March 2011	203	–	49	252
Additions	12	–	5	17
Disposals/write-offs	–	–	(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/write-offs	–	–	(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.

The figures for freehold land and buildings reflect independent professional valuations on a market value basis as at 28 February 2013 by Deloitte LLP, 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

	2013 £m	2012 £m
Cost		
At 1 March	35	33
Additions	5	3
Disposals/write-offs	(3)	(1)
At 28 February	**37**	**35**
Accumulated amortisation		
At 1 March	25	23
Charge for the year	4	3
Disposals/write-offs	(3)	(1)
At 28 February	**26**	**25**
Net book value at 1 March	10	10
Net book value at 28 February	**11**	**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 pension scheme is an HMRC registered pension scheme and is subject to standard UK pensions and tax law. This means that the payment of contributions and benefits are subject to the appropriate tax treatments and restrictions and the scheme is subject to the scheme funding requirements outlined in section 224 of the Pensions Act 2004.

In accordance with UK trust and pensions law, the pension scheme has appointed trustees who are independent of the Bank. Although the Bank bears the financial cost of the scheme, the responsibility for the management and governance of the scheme lies with the trustees, who have a duty to act in the best interest of members at all times.

The pension scheme's assets are mostly invested in fixed interest and index-linked gilts which are intended to match the nature of the future benefit payments due from the scheme. The effect of the liability-matching investment policy is not fully reflected in the accounting figures as the assumptions used for the purposes of the valuation under IAS 19 are different from those used for the funding valuation.

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 normal future service contribution.

The valuation as at 28 February 2011	£m
Value of Fund assets	2,522
Actuarial value of scheme liabilities in respect of:	
— In-service members	(442)
— Deferred pensioners	(499)
— Current pensioners and dependants	(1,682)
— Members' additional voluntary contributions	(4)
Total	(2,627)
Scheme deficit	**(105)**

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 and it was agreed to maintain the previously agreed plan, at the balance sheet date there were two 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

In the statutory financial statements the Bank accounts for pension costs, other post-retirement benefits and related redundancy provisions in accordance with IAS19 (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 accounting value is different from the result obtained using the funding basis.

The accounts show the main scheme in surplus, while the Bank is making good the deficit revealed by the funding valuation. The main reason for this is the different assumptions used to value the liabilities in the accounting and funding valuations for the main scheme. The aim of the liability matching policy is that by investing in a range of assets (mostly government bonds) that broadly match the expected future benefit payments from the scheme, no surplus or deficit will arise.

The funding valuation, therefore, discounts expected future benefit payments at the appropriate yield available on government bonds to produce the value of the funding liabilities. The accounting standard requires that expected future benefit payments are discounted at the appropriate yield available on high quality corporate bonds, which is higher than the corresponding yield available on government bonds. The value placed on the liabilities for accounting purposes is, therefore, lower than for the funding valuation.

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 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, with the expected rate of return on assets aligned with the discount rate applied to the scheme's liabilities. The effect of this is to reduce the net expense for the year ending 28 February 2013 to £16 million from £65 million. In line with IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors) all changes have been applied retrospectively leading to a restatement of balances for the year ending 29 February 2012 to £30 million from £48 million. In addition there have been amendments made to the disclosure requirements which have been implemented in the note.

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

		2013 £m	2012 £m
Funded pension schemes	(a)	460	564
Unfunded post-retirement benefits:			
Redundancy provisions	(b)	(81)	(78)
Other pension schemes	(c)	(8)	(7)
Medical scheme	(d)	(113)	(167)
		258	**312**

Pension expense recognised in the income statement

		2013 £m	2012* £m
Funded pension schemes	(a)	4	18
Unfunded post-retirement benefits:			
Redundancy provisions	(b)	4	4
Other pension schemes	(c)	–	–
Medical scheme	(d)	8	8
		16	**30**

* 2012 expense has been restated following the application of revised IAS 19.

Notes to the Banking Department Financial Statements continued

18 Retirement benefits continued

Remeasurements recognised in the Statement of Comprehensive Income

		2013 £m	2012* £m
Funded pension schemes	(a)	(148)	324
Unfunded post-retirement benefits:			
Redundancy provisions	(b)	(4)	(4)
Other pension schemes	(c)	(1)	–
Medical scheme	(d)	58	(14)
		(95)	**306**

* 2012 expense has been restated following the application of revised IAS 19.

a Funded pension scheme

As described above, The Bank has a final salary section within the pension scheme that provides pensions based on members' pensionable service and final salary at retirement. The pension is payable for life and increases in payment in line with inflation. Existing members of this section of the scheme continue to accrue future benefits but it is closed to new members.

For new employees, following a one year waiting period, the Bank offers a career average revalued earnings (CARE) section of the pension scheme that provides pensions based on members' earnings each year revalued in line with inflation up to retirement. The pension is payable for life and increases in payment in line with inflation.

b 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.

c Other pension schemes

As explained in the Remuneration section of the *Annual Report* on page 44, 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.

d Medical scheme

Some current and former 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 scheme. The defined benefit liability is the expected cost to the Bank of the claims expected to be incurred by the eligible members once in retirement.

Risks

The main risks to which the Bank is exposed in relation to the funded pension scheme are:

- Mortality risk — the assumptions adopted by the Bank make allowance for future improvements in life expectancy. However, if life expectancy improves at a faster rate than assumed, this would result in greater payments from the Fund and consequently increases in the scheme's liabilities. The Bank and the scheme's trustees review the mortality assumption on a regular basis to minimise the risk of using an inappropriate assumption.
- Investment risk — the Fund invests the vast majority of its assets in a portfolio of UK Government bonds to match the profile of the Fund's liabilities. There remains the residual risk that the selected portfolio does not match the liabilities closely enough or that as it matures there is a risk of not being able to reinvest the assets at the assumed rates. The scheme's trustees review the structure of the portfolio on a regular basis to minimise these risks.
- Yield risk — a fall in government bond yields will increase both the scheme's assets and liabilities. As the scheme's liabilities, on the funding basis used to calculate the Bank's contributions to the scheme, are greater than its assets until the deficit is made good, during that time the liabilities may grow by more in monetary terms, increasing the deficit in the scheme.
- Inflation risk — the majority of the scheme's liabilities increase in line with inflation and so if inflation is greater than expected, the liabilities will increase. The scheme's investment strategy is to hold government bonds that are also linked to inflation to match those liabilities that are linked to inflation so this risk is mostly mitigated.

The redundancy provision and other pension schemes are primarily exposed to the mortality and inflation risks above. As they are not backed by any assets, these risks cannot be so easily managed. However, these arrangements (and therefore the risks associated with them) are small in comparison to the funded pension scheme.

The two main risks to which the Bank is exposed in relation to the medical scheme are mortality risk, as described above, and increases in the costs incurred being greater than assumed, either due to inflation of future medical costs or the frequency of members' claims.

Components of pension expense in the Income Statement

	2013			2012		
	Main pension scheme £m	Other pensions £m	Medical scheme £m	Main pension scheme £m	Other pensions £m	Medical scheme £m
Current service cost	32	–	1	32	–	1
Net interest on the net defined (liability)/asset	(28)	4	7	(14)	4	7
Total pension expense	**4**	**4**	**8**	**18**	**4**	**8**

Remeasurements recognised in other comprehensive income

	2013			2012		
	Main pension scheme £m	Other pensions £m	Medical scheme £m	Main pension scheme £m	Other pensions £m	Medical scheme £m
Remeasurements recognised at the beginning of the period	223	(21)	(53)	(101)	(17)	(39)
Actuarial gains/(losses) arising from changes in demographic assumptions	62	–	68	38	1	(2)
Actuarial losses arising from changes in financial assumptions	(210)	(5)	(12)	(122)	(4)	(11)
Actuarial losses/(gains) arising from experience on the scheme's liabilities	(18)	–	2	(14)	(1)	(1)
Return on schemes' assets excluding interest income	18	–	–	422	–	–
Remeasurements recognised at the end of the period	**75**	**(26)**	**5**	**223**	**(21)**	**(53)**

Notes to the Banking Department Financial Statements continued

18 Retirement benefits continued

Reconciliation of present value of defined-benefit obligation

	2013			2012		
	Main pension scheme £m	Other pensions £m	Medical scheme £m	Main pension scheme £m	Other pensions £m	Medical scheme £m
Present value of defined-benefit obligation at the beginning of the period	2,470	85	167	2,327	82	149
Current service cost	32	–	1	32	–	1
Interest expense	109	4	7	111	4	7
Actuarial (gains)/losses arising from changes in demographic assumptions	(62)	–	(68)	(38)	(1)	2
Actuarial losses arising from changes in financial assumptions	210	5	12	122	4	11
Actuarial losses/(gains) arising from experience on the scheme's liabilities	18	–	(2)	14	1	1
Benefits paid out	(101)	(5)	(4)	(98)	(5)	(4)
Present value of defined obligation at the end of the period	**2,676**	**89**	**113**	**2,470**	**85**	**167**

During the reporting period there have been no plan amendments, curtailments or settlements.

Reconciliation of the fair value of assets

	2013			2012		
	Main pension scheme £m	Other pensions £m	Medical scheme £m	Main pension scheme £m	Other pensions £m	Medical scheme £m
Fair value of schemes' assets at the beginning of the period	3,034	–	–	2,518	–	–
Interest income	137	–	–	125	–	–
Return on schemes' assets excluding interest income	18	–	–	422	–	–
Bank contributions	48	5	4	67	5	4
Benefits paid out	(101)	(5)	(4)	(98)	(5)	(4)
Fair value of schemes assets at the end of the period	**3,136**	**–**	**–**	**3,034**	**–**	**–**

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

	2013 %	2012 %
Discount rate	4.1	4.5
Rate of increase in salaries	4.55	4.55
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, as required by the standard.

The assumption on salary growth is for the long term over the life of the scheme. For the purposes of the valuation this assumption has been modified to reflect the Bank continuing to abide by public sector pay guidelines.

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 2013 will live for 29.6 years (2012: 29.5 years) and a female member 30.3 years (2012: 30.0 years), and a male member reaching 60 in 2033 will live for 32.7 years (2012: 32.5 years) and a female member 33.3 years (2012: 33.2 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 were:

	2013		2012	
	Value £m	**Percentage of total value %**	Value £m	Percentage of total value %
UK Government fixed interest bonds	242	7.7	145	4.8
UK Government index-linked bonds	2,468	78.7	2,466	81.3
Corporate index-linked bonds	405	12.9	401	13.2
Cash and other assets	21	0.7	22	0.7
Total market value of investments	**3,136**	**100.0**	**3,034**	**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. Of the corporate index-linked bonds £93 million were quoted and £312 million were unquoted (2012: £88 million quoted and £313 million unquoted), of the unquoted bonds £290 million (2012: £286 million) were guaranteed by the UK Government.

Notes to the Banking Department Financial Statements continued

18 Retirement benefits continued

Main scheme

	2013 £m	2012 £m
Present value of defined-benefit obligations	(2,676)	(2,470)
Assets at fair value	3,136	3,034
Defined-benefit asset (liability)	**460**	**564**

The duration of the pension scheme liabilities is in the region of 19 years. A +/- 0.1% change to the discount rate would change the surplus on the pension scheme by +/- £48 million (2012: +/- £42 million).

A +/- 0.1% change to the assumed difference between CPI and RPI inflation would change the present value of defined-benefit obligations for the pension scheme by +/- £39 million with a similar offsetting change expected in the value of the pension scheme's assets given the matching nature of the investment strategy.

A +/- 0.5% change to the assumed rate of increases in salaries would change the surplus on the pension scheme by -/+ £32 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 £71 million (2012: £72 million).

The Bank expects to pay contributions of £74 million in respect of 2013/14 (2012/13: £48 million).

Redundancy provisions

	2013 £m	2012 £m
Unfunded defined-benefit liability	**(81)**	**(78)**

The Bank expects to make payments of £5 million in the forthcoming year (2012: £5 million).

Other pension schemes

	2013 £m	2012 £m
Unfunded defined-benefit liability	**(8)**	**(7)**

The Bank expects to make payments of less than £1 million in the forthcoming year (2012: less than £1 million).

During the year to 28 February 2013 the Bank incurred services costs of less than £1 million (2012: less than £1 million).

Medical scheme

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.

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 (see (a)). Following a review of the recent experience of the medical scheme, the level at which claims are assumed to arise on average has been updated. This has resulted in a reduction of £58 million in the unfunded defined-benefit recognised. Additionally, for accounting purposes the following assumptions have been made in respect of medical expense inflation:

	2013	2012
Initial medical trend	5.5%	6.5%
Ultimate medical trend	5.0%	5.0%
Years to ultimate	1	2

	2013 £m	2012 £m
Unfunded defined-benefit liability	**(113)**	**(167)**

Sensitivity analysis provided by the actuary indicates that 0.1% decrease in the discount rate would change the deficit on the other post-retirement benefits by £2 million (2012: £3 million) and a 1% increase in the rate of medical claims by £22 million (2012: £33 million). If the 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 £4 million (2012: £7 million).

The Bank expects to pay premiums of £4 million in the forthcoming year (2012: £4 million).

19 Other assets

	2013 £m	2012 £m
Items in course of settlement	–	1,247
Finance lease receivables	6	6
Short-term debtors and other assets*	205	733
	211	**1,986**

* Includes £56 million due in more than 1 year (2012: £6 million).

20 Deposits from central banks

	2013 £m	2012 £m
Deposits repayable on demand	1,994	1,216
Term deposits held at fair value through profit or loss	12,377	13,590
	14,371	**14,806**

Notes to the Banking Department Financial Statements continued

21 Deposits from banks and other financial institutions

	Note	2013 £m	2012 £m
Deposits repayable on demand:			
Sterling		294,488	214,719
Non-sterling		157	270
Repurchase agreements		–	248
Cash Ratio Deposits		2,479	2,386
		297,124	**217,623**

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

	2013 £m	2012 £m
Deposit by Issue Department	52,744	47,562
Public deposits:		
Repayable on demand	949	1,234
Other deposits repayable on demand	24,370	21,367
	78,063	**70,163**

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

	2013		2012	
	£m Fair value	$m Nominal	£m Fair value	$m Nominal
Total amounts issued to third parties	**4,007**	**6,000**	**5,104**	**8,000**

All changes in fair values since 1 March 2012 are considered attributable to changes in prevailing interest rates and movements in relative foreign currency exchange rates.

At 28 February 2013, as part of the Bank's annual medium-term security issuance programme the Bank had three $2 billion three-year dollar bonds in issue (2012: four $2 billion three-year dollar bonds); the first maturing on 18 March 2013, the second on 7 March 2014 and the third on 6 March 2015.

The most recent bond (the seventh in the overall programme) was issued on 11 March 2013 with settlement on 19 March 2013. This bond matures on 21 March 2016.

Of the above liabilities to third parties, £1,339 million (2012: £1,282 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 23% (2012: 25%).

A reduction in the rate from 25% to 24% (effective from 1 April 2012) was substantially enacted on 26 March 2012 and then a further reduction in the rate from 24% to 23% (effective from 1 April 2013) was substantively enacted on 17 July 2012 and therefore the effect of the rate reduction on the deferred tax balances as at 28 February 2013 has been included in the figures below.

In the 2013 Budget on 28 March 2013 the Chancellor announced that the UK main corporation tax rate will be reduced to 21% with effect from 1 April 2014, the effect of the rate would create an additional reduction in the deferred tax liability of approximately £15m. This has not been reflected in the figures below as it was not substantively enacted at the balance sheet date.

The Chancellor also proposed changes to further reduce the main rate of corporation tax to 20% by 1 April 2015, but these changes have not yet been substantively enacted. The effect of the further reductions from 21% to 20%, if applied to the deferred tax balance at 28 February 2013 would be to reduce the deferred tax liability by a further £7 million approximately. This is in addition to the reduction of approximately £15 million arising from the reduction in the tax rate from 23% to 21% with effect from 1 April 2014.

The movement on the deferred tax account is as follows:

	Note	**2013 £m**	2012* £m
Deferred tax			
Net liability at 1 March		(201)	(105)
Income statement charge	7	(9)	(14)
Tax credited/(charged) directly to equity		44	(82)
Net liability at 28 February		**(166)**	**(201)**

	2013 £m	2012* £m
Deferred tax liability relates to:		
Available for sale securities	(110)	(127)
Pensions and other post-retirement benefits	(59)	(77)
Other provisions	3	3
	(166)	**(201)**

* The prior year has been restated. See note 2b for details.

Notes to the Banking Department Financial Statements continued

25 Other liabilities

	Note	2013 £m	2012 £m
Items in course of collection		1	1,260
Payable to HM Treasury	8	55	2,298
Short term creditors and other liabilities		136	102
Onerous lease provision		19	–
		211	**3,660**

Onerous Lease Provision

The Bank has undertaken to bear the costs arising from certain leased property previously occupied by the FSA and which was vacated upon the commencement of the new regulatory regime.

This obligation crystallised when the Bank agreed, on 27 April 2012, to lease a property at 20 Moorgate from which to operate the PRA. The amount provided for represents the net present value of the future lease payments and the cost of dilapidations required as part of the lease less any expected lease income from sub-letting the floor space. The lease expires in November 2018. The cash flows are discounted at a risk free rate as at 28 February 2013.

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.

27 Cash and cash equivalents

i Analysis of cash balances

	Note	At 1 March 2012 £m	Cash flows £m	At 28 February 2013 £m
Cash and balances with other central banks	9	372	415	787
Loans and advances to banks and other financial institutions	10	5,671	(2,318)	3,353
Securities held at fair value through profit or loss	12	129	(129)	–
		6,172	**(2,032)**	**4,140**

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, 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 through both direct exposures and 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 securities, which are issued chiefly by governments, government agencies and supranational organisations, which meet the Bank's minimum standards of liquidity and credit risk. 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, Extended Collateral Term Repo Operations and Funding for Lending Scheme(2), 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, other asset-backed securities (such as asset-backed securities backed by credit card receivables, student loans or auto loans), or pools of 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, Extended Collateral Term Repo Operations and Funding for Lending Scheme, 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 financial credit risk, including indemnities from HM Treasury.

(1) See www.bankofengland.co.uk/markets/Pages/money/eligiblecollateral.aspx.
(2) See Review 2012/13 on page 15.

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:

	2013 £m	2012 £m
Assets		
United Kingdom	389,508	304,263
Rest of Europe	6,133	8,854
Rest of the world	2,084	2,355
	397,725	**315,472**
Liabilities & Equity		
United Kingdom	369,064	300,174
Rest of Europe	14,993	3,471
Rest of the world	13,668	11,827
	397,725	**315,472**

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 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	2013 £m	2012 £m
At 28 February	76.7	92.0
Average	86.5	84.5

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 2011 to 28 February 2013 as a basis for determining the possible ranges of outcomes and may not always cover all possible scenarios, especially those of an exceptional nature.

Notes to the Banking Department Financial Statements continued

28 Financial risk management continued

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.

Currency risk

The Bank may take currency risk in the context of foreign exchange intervention and 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 £474 million (2012: £484 million). Excluding this, the Bank's net foreign exchange exposure at 28 February 2013 was £17 million (2012: £8 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 2012/13 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 28 February 2013

	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	786	–	–	–	–	786
Loans and advances to banks and other financial institutions	1,344	6,040	3,766	–	–	11,150
Securities held at fair value through profit and loss	564	483	470	2,059	–	3,576
Derivative financial instruments						
Cash inflow	2,427	4,128	2,032	1,869	–	10,456
Cash outflow	(2,121)	(4,037)	(1,982)	(1,731)	–	(9,871)
Other assets	–	–	–	–	–	–
Total assets	**3,000**	**6,614**	**4,286**	**2,197**	**–**	**16,097**
Liabilities						
Deposits from central banks	1,240	4,384	3,698	–	–	9,322
Deposits from banks and other financial institutions	157	–	–	–	–	157
Other deposits	410	–	–	–	–	410
Foreign currency bonds in issue	1,351	–	12	2,654	–	4,017
Derivative financial instruments						
Cash inflow	(1,574)	(302)	(1,691)	(4)	–	(3,571)
Cash outflow	1,885	2,042	1,789	29	–	5,745
Other liabilities	–	–	–	–	–	–
Total liabilities	**3,469**	**6,124**	**3,808**	**2,679**	**–**	**16,080**
Net liquidity gap	**(469)**	**490**	**478**	**(482)**	**–**	**17**
Cumulative gap	**(469)**	**21**	**499**	**17**	**17**	

Notes to the Banking Department Financial Statements continued

28 Financial risk management continued

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**	

d Fair value of financial assets and liabilities

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

As at 28 February 2013

	Note	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets					
Loans and advances to banks and other financial institutions	10	–	11,145	–	11,145
Securities held at fair value through profit or loss	12	3,573	–	–	3,573
Derivative financial instruments	13	–	334	–	334
Available for sale securities	14	4,700	–	479	5,179
		8,273	**11,479**	**479**	**20,231**
Liabilities					
Deposits from central banks	20	–	12,377	–	12,377
Foreign currency bonds in issue	23	4,007	–	–	4,007
Derivative financial instruments	13	–	229	–	229
		4,007	**12,606**	**–**	**16,613**

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**

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 £179 million (2012: £175 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 (2012: 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 28 February 2013 amounted to £11 million (2012: £4 million).

In addition the Bank did not have any contingent capital commitments outstanding at 28 February 2013 (2012: £6 million).

c Operating lease commitments — minimum lease payments

	2013		2012	
	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	7,865	194	59	109
Between one and five years	31,353	282	829	90
Expiring in five years or more	50,884	–	820	–
	90,102	**476**	**1,708**	**199**

The Bank leases the premises occupied by its Agencies and the PRA.

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 disclosed in note 22 as public deposits. The total charges made to the Government are disclosed in note 4.

Debt Management Office and Debt Management Account

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

At 28 February 2013 the Bank had a loan from the DMA of £193 million (2012: £508 million) in relation to the provision of funding to the Bank of England Asset Purchase Facility Fund Ltd.

At 28 February 2013 the Bank had borrowed Treasury bills with a nominal value of £15.2 billion (2012: £nil) under the Bank's Funding for Lending Scheme. The Bank has paid the DMA a loan fee for the Treasury bills borrowed.

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

HM Treasury

HM Treasury continued 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 PRA and the FCA (formerly the FSA), although accountable to them and ultimately to HM 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, which are included within note 21.

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.

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 28 February 2013 the loan from the Bank to BEAPFF was £375.2 billion (2012: £286.6 billion). Interest on this loan is receivable at Bank Rate and amounted to £1.7 billion for the year ending 28 February 2013 (2012: £1.1 billion).

At the year end BEAPFF held a deposit at the Bank of £24.1 billion (2012: £20.7 billion), which is included in other deposits (note 22). Interest on this deposit is payable at Bank Rate and totalled £132 million for the year ending 28 February 2013 (2012: £85 million).

A management fee of £2 million was payable by BEAPFF to the Bank in respect of the year ended 28 February 2013 (2012: £2 million).

Prudential Regulation Authority (PRA)

The PRA is a wholly-owned subsidiary of the Bank. The company was established on 21 November 2011 and began to operate when the new regulatory framework for the United Kingdom's financial sector came into effect on 1 April 2013. To fulfil the requirements of the Financial Services Act 2012 the PRA is responsible for the prudential regulation of banks, building societies and credit unions, insurers and major investment firms. As prudential regulator, the PRA will promote the safety and soundness of these firms, seeking to minimise the adverse effects that they can have on the stability of the UK financial system; and contribute to ensuring that insurance policyholders are appropriately protected.

The Bank incurred costs in relation to the set up of the PRA of £48.5 million in the year (2012: £14.7 million, 2011: £1.5 million) and has charged the current and previous years' costs to the PRA. The PRA Board has agreed that the costs of the transition will be recovered from the fee-payers over a period of five years. The PRA has a liability to the Bank and the Bank has a receivable from the PRA as at the year end of £64.7 million (2012: £nil) which is disclosed within note 19. The Bank held on balance sheet as at 28 February 2013 £22.8 million of property, plant and equipment related to the set up of the PRA which is disclosed within note 16.

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 28 February 2013, the number of key management personnel was 22 (2012: 22).

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

	2013 £000	2012 £000
Loans		
Balance brought forward	32	44
Loans made during year	22	12
Loans repaid during year	(26)	(24)
	28	**32**
Interest income earned	2	1
Number of key management personnel with loans at 28 February	3	3

No provisions have been recognised in respect of loans given to related parties (2012: £nil).

	2013 £000	2012 £000
Deposits		
Governors and Executive Directors		
Balance brought forward	745	849
Deposits taken during year	592	683
Deposits repaid during year	(465)	(787)
	872	**745**
Non-executive Directors		
Balance brought forward	5,548	4,538
Deposits taken during year	611	1,010
Deposits repaid during year	–	–
	6,159	**5,548**
Interest expense on above deposits	16	15
Number of key management personnel with deposits at 28 February	7	7

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, 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.

Staff, including Governors and Executive Directors, holding current and interest-bearing deposit accounts at the Bank of England receive interest at commercial rates.

30 Related parties continued

Key management remuneration

	2013 £000	2012* £000
Salaries and short-term benefits	3,329	3,369
Post-employment benefits	374	330
	3,703	3,699

* The prior year has been restated.

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 28 February 2013 no charge was made for these services (2012: £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 £48 million (2012: £67 million). There were no other material transactions between the Bank and the pension scheme during the year to 28 February 2013. At 28 February 2013 the balances on accounts held with the Bank were £11 million (2012: £19 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 Date of approval

The Members of Court approved the financial statements on pages 52 to 98 on 28 May 2013.

Issue Department
Account: for the period ended 28 February 2013

	Note	2013 £m	2012 £m
Income and profits			
Securities of, or guaranteed by, the British Government		330	666
Other securities and assets		262	258
		592	**924**
Expenses			
Cost of production of Bank notes		40	36
Cost of issue, custody and payment of Bank notes		27	26
Other expenses		8	9
		75	**71**
Payable to HM Treasury		**517**	**853**

Statement of Balances: 28 February 2013

	Note	2013 £m	2012 £m
Assets			
Securities of, or guaranteed by, the British Government	3	5,263	5,749
Other securities and assets including those acquired under reverse repurchase agreements	4	52,759	49,172
Total assets		**58,022**	**54,921**
Liabilities			
Notes issued:			
In circulation	5	58,022	54,921
Total liabilities		**58,022**	**54,921**

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 100 and 101 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 27 February 2013.
- 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 taken to income in the year to 28 February 2013 amounted to £82 million (2012: gain £396 million) and total deficits paid by the National Loan Funds amounted to £195 million (2012: deficit £2 million).
- Notes in circulation exclude those 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 28 February 2013 was £78 million (2012: £72 million).

3 Securities of, or guaranteed by, the British Government

	2013 £m	2012 £m
British Government Stocks	4,893	5,379
Ways and Means advance to the National Loans Fund	370	370
	5,263	**5,749**

The Ways and Means advance earns interest at Bank Rate.

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

	2013 £m	2012 £m
Deposit with Banking Department	52,744	47,562
Reverse repurchase agreements	15	1,610
	52,759	**49,172**

5 Notes in circulation

	2013 £m	2012 £m
£5	1,526	1,477
£10	7,234	6,841
£20	35,163	33,129
£50	10,323	9,899
Other notes*	3,776	3,575
	58,022	**54,921**

* 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 28 February 2013, the assets of the Issue Department had the following repricing period profile.

	2013 £m	2012 £m
Repricing up to one month	53,129	49,542
Repricing in greater than one month but less than three months	–	–
Repricing in greater than three months but less than six months	–	379
Repricing in greater than six months but less than twelve months	404	–
Repricing in greater than twelve months	4,489	5,000
	58,022	**54,921**

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 in course of the circulation of bank notes (including under the Notes Circulation Scheme, Agency Notes Store and Notes Printing Contract) and as a result of the Bank providing liquidity to financial institutions via open market operations.

In providing liquidity via routine open market operations 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 28 February 2013 the unrecognised accrued interest on the assets held on the Issue Department Statement of Balances was £80 million (2012: £86 million).

8 Date of approval

The Members of Court approved the statements of account on pages 99 to 101 on 28 May 2013.

Glossary of key abbreviations

ALCo – Assets and Liabilities Advisory Committee.
APF – Asset Purchase Facility.
ARCo – Audit and Risk Committee.
ATM – Automated Teller Machine.
BAME – Black, Asian and Minority Ethnic.
BCBS – Basel Committee on Banking Supervision.
BEAPFF – Bank of England Asset Purchase Facility Fund Ltd.
BRC – Business Risk Committee.
BU – Banking Union.
CCP/SSS – Central Counterparties and Security Settlement Systems.
CHAPS – Clearing House Automated Payment System.
CPI – Consumer Prices Index.
CPSS – Committee on Payment and Settlement Systems.
CRD – Cash Ratio Deposit.
CRD/CRR – Capital Requirements Directive and Regulation.
DWF – Discount Window Facility.
ECB – European Central Bank.
ECTR – Extended Collateral Term Repo.
ED – Executive Director.
EEA – Exchange Equalisation Account.
ELA – Emergency Liquidity Assistance.
EMIR – European Market Infrastructure Regulation.
ESMA – European Securities and Markets Authority.
ESRB – European Systemic Risk Board.
ET – Executive Team.
FLS – Funding for Lending Scheme.
FMI – Financial Market Infrastructure.
FMLC – Financial Markets Law Committee.
FPC – Financial Policy Committee.
FRC – Financial Reporting Council.
FSA – Financial Services Authority.
FSAC – Financial System Advisory Committee.
FSB – Financial Stability Board.
FSMA – Financial Services Markets Act.
FSR – Financial Stability Report.
GDP – Gross Domestic Product.
G-SIFI – Globally Systemically Important Financial Institution.
ICB – Independent Commission on Banking.
IOSCO – International Organization of Securities Commissions.
ISTD – Information Systems Technology Division.
LCR – Liquidity Coverage Ratio.
MI – Market Intelligence.
MPC – Monetary Policy Committee.
MSROD – Markets Strategy and Risk Operations Division.
NCS – Notes Circulation Scheme.
NedCo – Non-Executive Directors' Committee.
ORC – Operational Risk Committee.
OTC – Over The Counter.
PRA – Prudential Regulation Authority.
RMD – Risk Management Division.
ROU – Risk Oversight Committee.
RTGS – Real Time Gross Settlement.
SCP – Single Collateral Pool.
SHE – Safety, Health and Environment.
SLS – Special Liquidity Scheme.
SME – Small and Medium-Sized Enterprise.
SMF – Sterling Monetary Framework.
SRR – Special Resolution Regime.
VAT – Value Added Tax.

Contacts

Head Office

Threadneedle Street
London EC2R 8AH
020 7601 4444*

Agencies

The South East and East Anglia
Threadneedle Street
London EC2R 8AH
020 7601 5711

Greater London
Threadneedle Street
London EC2R 8AH
020 7601 5504

Central Southern England
First Floor
Unit 4, Fulcrum 2
Solent Way
Solent Business Park
Whiteley
Fareham PO15 7FN
01489 570603

South West
11-15 Dix's Field
Exeter EX1 1QA
01392 438302

Wales
4 Village Way
Greenmeadow Springs
Tongwynlais
Cardiff CF15 7NE
029 2061 4678

West Midlands and Oxfordshire
Cornwall Court
19 Cornwall Street
Birmingham B3 2DT
0121 200 2599

East Midlands
6 Experian Way
ng2 Business Park
Nottingham NG2 1EP
0115 985 0174

Yorkshire and the Humber
West One
Wellington Street
Leeds LS1 1BA
0113 242 0355

Northern Ireland
Harvester House
4-8 Adelaide Street
Belfast BT2 8GA
028 9024 1692

North East
Dobson Building
Prestwick Business Park
Newcastle Upon Tyne
NE20 9SJ
01661 871432

North West
Suite 401
Thomson House
Faraday Street
Birchwood Park
Warrington WA3 6GA
01925 813703

Scotland
177 West George Street
Glasgow G2 2LB
0141 221 7972

* General enquiries relating to the Bank may be made on 020 7601 4878 or by email to enquiries@bankofengland.co.uk. Information about the Bank and its publications and additional telephone numbers and email addresses are available on the Bank's website at www.bankofengland.co.uk.
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.