



BANK OF ENGLAND

Scottish & Northern Ireland Banknote Issuance Annual Report 2015

Report on the Bank of England's work under the Scottish & Northern Ireland Banknote Regulations 2009

Publication Date: 12 June 2015

Executive Summary

- Seven Scottish and Northern Ireland commercial banks are authorised to issue banknotes (the “authorised banks”), and are required to hold ringfenced assets that back their note issuance at all times. The aggregate backing requirement of all seven banks at end-February 2015 was £7.06bn, an increase of 3% from £6.87bn in 2014, while the average backing requirement over the twelve month period as a whole increased from £7.10bn to £7.17bn.
- At end-February 2015, the three authorised banks in Scotland had an aggregate backing requirement of £4.67bn, comprising £4.29bn of Notes in Circulation and £0.38bn of Notes with the Potential to Enter Circulation. The four authorised banks in Northern Ireland had an aggregate backing requirement of £2.39bn, comprising £2.27bn of Notes In Circulation and £0.12bn of Notes with the Potential to Enter Circulation.
- The Bank of England (“the Bank”) is responsible for the regulation of note issue by the seven authorised banks. In the year to end-February, the Bank conducted 14 compliance inspections across the authorised banks’ locations to verify the value of backing assets and Excluded Notes (types of notes that do not need to be backed) held. Where inspections identified shortcomings in security and operational processes or where other regulatory requirements were not met during the period, remedial actions were agreed with the authorised banks.
- There was a strong level of compliance with the regime during the year to end-February 2015. During the twelve month period, the Bank assessed two Category 2 compliance failures (breaches of the regime that do not involve underbacking or a breach of IT requirements)¹. Neither was considered severe enough to justify referral to the Bank’s internal decision making Committees and both were laid on file for future reference without penalty.

¹ Assessed compliance failures are published in this Annual Report in accordance with Regulation 16 of the Scottish and Northern Ireland Banknote Regulations 2009. Consequently, any compliance failures in the process of being assessed at the end of the reporting period will be disclosed in the next year’s report.

Introduction

1. The Bank assumed responsibility for the regulation of note issue by the three authorised banks in Scotland and four authorised banks in Northern Ireland on 23 November 2009.
2. Regulation 18 of the Scottish and Northern Ireland Banknote Regulations 2009 (“the Regulations”) requires the Bank to publish an annual report on the discharge of its functions under the Regulations. This is the sixth such report, and covers the Bank’s activities from 1 March 2014 to 28 February 2015 (the Bank’s 2014/15 financial year).

Historical background

3. The seven authorised banks (or their predecessors) have been regulated with regard to the backing of their banknotes since 1845. Part 6 of the Banking Act 2009 (“the Act”), which came into effect on 23 November 2009, repealed the legislation under which banknote issuance was previously regulated and passed the responsibility for regulation to the Bank. Part 6 of the Act updates and modernises the framework for commercial note issuance to provide enhanced noteholder protection.

4. The authorised banks are:

- AIB Group (UK) plc (trades as First Trust Bank in Northern Ireland);
- Bank of Ireland (UK) plc;
- Bank of Scotland plc;
- Clydesdale Bank plc;
- Northern Bank Limited (trades as Danske Bank in Northern Ireland);
- The Royal Bank of Scotland plc; and
- Ulster Bank Limited.

Legislative framework

5. The Act and the Regulations set out the framework for the Bank’s responsibilities for regulating the authorised banks’ note issuance. The primary objective of the legislation is noteholder protection. The provisions in the legislation are designed to ensure that holders of genuine banknotes issued by the authorised banks receive a level of protection similar to that provided to holders of Bank of England notes, through the full backing of notes at all times. The Bank is not responsible for the design of the authorised banks’ banknotes or their robustness against counterfeiting.

6. The authorised banks’ note issuance is governed by the Regulations and the related Scottish and Northern Ireland Banknotes Rules (“the Rules”). These came into force in November 2009 together with a Statement of Penalty Policy (“the SPP”). Both the Rules and SPP are revised periodically, most recently in June 2015. For the 2014/15 reporting period, the previous version of the Rules and SPP, dated June 2011 and May 2012 respectively, were in effect.

7. In addition, the authorised banks must comply with both General Conditions and Specific Conditions that set out the requirements for the holding of backing assets and Excluded Notes. As the General Conditions and Specific Conditions include sensitive material such as the security standards that sites holding backing assets must meet, they are not published.

8. The Bank has the authority to impose financial penalties on the authorised banks for non-compliance with the Regulations and the Rules.

Noteholder protection

9. Under the Regulations, the authorised banks are required to hold backing assets for their notes at all times. In the event of an authorised bank entering an insolvency process as defined in the Regulations, those assets will be ring-fenced for one year or any longer period that HM Treasury may decide, for the sole purpose of reimbursing noteholders through a note exchange programme.

10. To back their note issue, authorised banks may use a combination of Bank of England notes, UK coin and funds in an interest bearing bank account at the Bank. Bank of England notes held as backing assets may be held at an authorised location or at the Bank. Notes held at the Bank may include £1 million notes (Giants) and £100 million notes (Titans), which in physical terms are permanently held at the Bank.

11. For the purpose of backing requirements, notes issued by an authorised bank are always considered to be one of three mutually exclusive classes, as set out below.

- **Notes In Circulation (“NIC”)**: notes that have been issued by the authorised bank and are now in general circulation, e.g. notes in wallets and purses.
- **Notes With the Potential to Enter Circulation (“NWPEC”)**: notes that are held by or on behalf of the authorised banks but which are available to be issued, e.g. notes held in ATMs or in bank branches.
- **Excluded Notes**: notes which are held by or on behalf of the authorised banks, which fulfil specific requirements and conditions imposed by the Bank, e.g. are securely stored in a banknote cage. This includes notes which have been printed but which have not yet been collected from the printer.

12. NIC and NWPEC must be fully backed with backing assets. At least 60% of NIC must be backed by backing assets in the form of Bank of England notes or UK coin. The remaining 40% of NIC and 100% of NWPEC must be backed by backing assets in the form of Bank of England notes, UK coin, or funds in an interest-bearing account at the Bank. Excluded notes are excluded from the backing requirement.

13. The aggregate backing requirement of all seven banks at end-February was £7.06bn, the breakdown of which is shown in Table 1, an increase of 3% from £6.87bn in 2014. The average backing requirement over the twelve month period as a whole increased from £7.10bn to £7.17bn. This compares to an

average NIC of Bank of England notes of £62.48bn in the year ending 28 February 2015 and £59.88bn the previous year.

Table 1 Breakdown of backing requirement and comparison with previous year

	28 February 2014	28 February 2015
Scotland authorised banks	£4.57 bn	£4.67 bn
<i>NIC</i>	£4.11 bn	£4.29 bn
<i>NWPEC</i>	£0.46 bn	£0.38 bn
Northern Ireland authorised banks	£2.30 bn	£2.39 bn
<i>NIC</i>	£2.18 bn	£2.27 bn
<i>NWPEC</i>	£0.12 bn	£0.12 bn
Aggregate backing requirement	£6.87 bn	£7.06 bn

Compliance framework

14. The Bank has a small team of staff within its Notes Directorate to monitor compliance with the regime. The team analyses the daily and weekly data reported by the authorised banks to ensure that both the total value and the composition of backing assets held are at all times in accordance with the legislation. In addition, the Bank undertakes compliance visits to the locations used by each of the authorised banks for the storage of their notes and backing assets. The compliance visits enable the Bank to verify the value of backing assets and Excluded Notes held, and to confirm that the necessary conditions (e.g. security standards of sites storing backing assets) are met. The Bank regularly re-evaluates its compliance and data analysis programme to ensure that risks to noteholders are adequately mitigated.

Compliance failures

15. Compliance failures can take a number of forms:

- **Category 1 compliance failure:** A Category 1 compliance failure arises when the total value of backing assets held by an authorised bank falls below the value required by the legislation, or when the value of backing assets held in the form of Bank of England notes and UK coin falls below 60% of NIC.
- **Category 2 compliance failure:** A Category 2 compliance failure is a compliance failure which does not fall into the other two categories; i.e. there is a breach of a rule but NIC and NWPEC are fully backed and there is no breach of Rule 8.4.
- **Category 3 compliance failure:** A Category 3 compliance failure constitutes a breach to Rule 8.4 (the Notes Integrated Processing System (NIPS) Code of Connection, which is a set of IT requirements related to the NIPS system used for regulatory reporting).

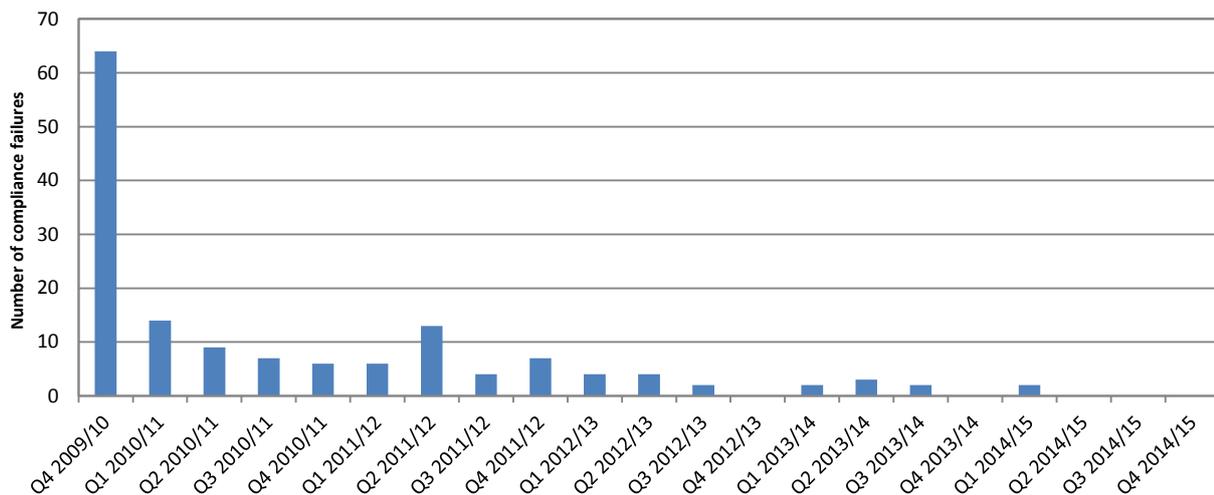
16. Minor compliance failures are discussed with the management of the authorised bank and laid on file for future reference without a penalty being imposed. Serious compliance failures are brought before the Bank's Committees (see paragraph 19) where a decision on whether or not to impose a penalty is discussed, and if so, at what level. During the year to end-February 2015, the Bank assessed two

Category 2 compliance failures. Neither was considered severe enough to justify referral to the Bank’s internal decision making Committees and both were laid on file for future reference without penalty. By comparison, in the year to February 2014 there were seven Category 2 compliance failures: two of which were investigated by the Bank’s Committees and were penalised. As shown in **Table 2** and **Chart 1**, the number of assessed compliance failures has decreased significantly over time, particularly in comparison with the start of the regime.

Table 2 Number of compliance failures assessed

Number of compliance failures assessed	2010/11	2011/12	2012/13	2013/14	2014/15	Total since start of regime
Investigated by the Bank's Committees <i>(of which Penalised)</i>	79 <i>(20)</i>	4 <i>(2)</i>	3 <i>(1)</i>	2 <i>(2)</i>	0 <i>(0)</i>	88 <i>(25)</i>
Laid on file for future reference	21	26	7	5	2	61
Total	100	30	10	7	2	149

Chart 1 Assessed compliance failures by date: November 2009 – February 2015



Note: The four quarters to Q3 2010/11 are based on the date that the new regime came into force (23 November 2009). Q4 2010/11 was extended by 6 days in order that it and subsequent quarters align with the Bank’s financial year, which runs from 1 March. Any compliance failures in the process of being assessed at the end of the reporting period are shown as occurring in Q1 of the subsequent financial year.

Penalties and governance

17. The value of the penalties that the Bank can impose in the event of a breach of the Regulations or the Rules (a compliance failure) is set out in the SPP published by the Bank alongside the Rules.

18. Penalties relate to the three categories of compliance failure:

- Category 1 compliance failures are subject to a penalty cap of 10% of an authorised bank’s mean average value of NIC in the previous calendar year, as set out in paragraph 4 of Schedule 3 to the

Regulations. Since May 2012, the normal minimum penalty for a Category 1 compliance failure has been £20,000.

- Category 2 compliance failures are subject to a penalty cap of £20,000.
- Category 3 compliance failures do not attract financial penalties.

19. Serious compliance failures are first considered by an internal Assessment Committee, which makes initial recommendations to an internal Review Committee. Decisions on imposing penalties are then made by the Bank's Chief Cashier on advice from the Review Committee, taking into account considerations set out in the SPP. Where the Bank proposes to impose a penalty on an authorised bank, the authorised bank has the right to make representations to the Bank. Representations, if any, will be considered, and the Bank will then decide whether or not to impose the penalty. The Rules also make provision for matters to be considered by an Appeal Panel. The Appeal Panel comprises three individuals; a Chair (a member of the Bank's staff with no previous involvement in the case) and two external appointees. Members of the Appeal Panel are listed on the Bank's website.

20. As outlined in Table 2, no penalties were imposed during the 2014/15 reporting period. Between the commencement of the regime and end-February 2015, 25 compliance failures have been penalised, and penalties amounting to £97,200 have been issued and paid². Once received, penalties are passed to HM Treasury.

Other developments

21. The Bank continues to ensure that, in accordance with the Regulations, the necessary preparations are in place to implement a note exchange programme (NEP) in the event that one was required, e.g. if an authorised bank entered insolvency. In broad terms the work that the Bank would undertake can be categorised as:

- a) Ensuring continuity of banknote supply in the relevant territory without the notes of the failed bank;
- b) Operating an NEP to ensure that all noteholders of the failed bank are reimbursed for their notes.

22. These actions, which would only be used in extremis, are intended to provide confidence to noteholders and to deliver them protection similar to that provided to holders of Bank of England notes.

23. As part of wider contingency preparations, the Bank facilitated joint regional business continuity exercises in Northern Ireland and in Scotland with a scenario involving a strike affecting Cash In Transit suppliers combined with the banks being unable to access stocks of new notes for a sustained period of time.

² Penalties are published in this Annual Report in accordance with Regulation 16 of the Scottish and Northern Ireland Banknote Regulations 2009.

Appendix 1: Legislative Documents

- The Banking Act 2009, Part 6 (“the Act”), which received Royal Assent in February 2009 and came into force on 23 November 2009
(http://www.opsi.gov.uk/RevisedStatutes/Acts/ukpga/2009/cukpga_20090001_en_1).
- The Scottish and Northern Ireland Banknote Regulations 2009 (“the Regulations”), which were made by Parliament on 18 November 2009 and came into force on 23 November 2009
(http://www.opsi.gov.uk/si/si2009/pdf/uksi_20093056_en.pdf).
- The Scottish and Northern Ireland Banknote Rules 2015 (“the Rules”)
(http://www.bankofengland.co.uk/banknotes/about/scottish_northernireland_notes_rules.pdf).