BANK OF ENGLAND

Scottish & Northern Ireland Banknote Issuance Annual Report 2016

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

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Executive Summary

- Four commercial banks in Northern Ireland and three commercial banks in Scotland are authorised to issue their own 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 2016 was £7.3bn, an increase of 4% from £7.1bn in 2015.
- At end-February 2016, the three authorised banks in Scotland had an aggregate backing requirement of £4.9bn, comprising £4.5bn of Notes in Circulation and £0.4bn of Notes with the Potential to Enter Circulation. The four authorised banks in Northern Ireland had an aggregate backing requirement of £2.5bn, comprising £2.4bn of Notes in Circulation and £0.1bn 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. The Bank undertakes a range of supervisory and compliance activity throughout the year, including compliance visits and analysis of daily regulatory reporting provided by all authorised banks. In the year to end-February 2016, this included the Bank conducting 15 compliance visits across the authorised banks’ locations to verify the value of backing assets and Excluded Notes (as defined in paragraph 11) held. Where compliance visits 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 satisfactory level of compliance with the regime during the year to end-February 2016. During the twelve month period, the Bank finalised one Category 1 compliance failure (the categories of failures are defined in paragraph 15). This resulted in a penalty of £7,500 being imposed on Clydesdale Bank plc, which was a reduced penalty from the £20,000 minimum normally applied for Category 1 compliance failures. This departure from the normal penalty was because the Bank judged that the compliance failure represented no material risk to noteholder protection (see paragraph 17 for more detail). There were four Category 2 compliance failures, none of which were considered severe enough to justify referral to the Bank’s internal decision making Committees and all were laid on file for future reference without penalty[1].

[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 seventh such report, and covers the Bank's activities from 1 March 2015 to 29 February 2016 (the Bank's 2015/16 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 updated and modernised 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 (see Noteholder Protection paragraphs below for more detail). 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 Act, 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.

7. In addition, the authorised banks must comply with conditions, known as 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 placed on deposit in sterling in an interest bearing bank account at the Bank. The legislation imposes certain requirements on the kinds of backing assets held. Bank of England notes held as backing assets may be held at locations approved by the Bank or at the Bank. Notes held as backing assets 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 do not need to be backed. These notes are held by or on behalf of the authorised banks, which fulfil specific requirements and conditions (known as General Conditions and Specific Conditions) imposed by the Bank, e.g. are stored in a banknote cage in a secure vault. 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 placed on deposit in sterling in an interest-bearing account at the Bank. Excluded Notes are excluded from the backing requirement.

13. At end-February 2016, the aggregate NIC and NWPEC of all seven banks was £6.8bn and £0.5bn respectively. As a consequence, the total backing requirement of all seven banks was £7.3bn, the breakdown of which is shown in Table 1, an increase of 4% from £7.1bn in 2015. The banks' combined average NIC over the twelve month period as a whole increased from £6.6bn to £6.8bn. In comparison, the average Bank of England notes in circulation increased from £62.5bn to £66.3bn in the same period.

Table 1 Breakdown of backing requirement and comparison with previous year

	28 February 2015	29 February 2016
Scotland authorised banks	£4.7 bn	£4.9 bn
NIC	*£4.3 bn*	*£4.5 bn*
NWPEC	*£0.4 bn*	*£0.4 bn*
Northern Ireland authorised banks	£2.4 bn	£2.5 bn
NIC	*£2.3 bn*	*£2.4 bn*
NWPEC	*£0.1 bn*	*£0.1 bn*
Aggregate backing requirement	£7.1 bn	£7.3 bn

Note: Figures may not sum due to rounding.

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. The Bank undertakes a range of other supervisory and compliance activity throughout the year, including 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. In the year to end-February 2016, the Bank conducted 15 such compliance visits. The Bank regularly re-evaluates its supervisory activity 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. Since June 2015, a Category 2 compliance failure can also arise where the Bank has exercised discretion to treat a compliance failure affecting Excluded Notes, which would otherwise be categorised as a Category 1 compliance failure, as a Category 2 compliance failure, based on

the extent to which it represented a material risk to noteholder protection. This discretion is set out in paragraph 13 of the SPP.

- **Category 3 compliance failure:** A Category 3 compliance failure constitutes a breach to Rule 8.4 (the Notes Integrated Processing System Code of Connection, which is a set of IT requirements related to the 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 21) 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 2016, the Bank imposed one Category 1 compliance penalty and assessed four Category 2 compliance failures.

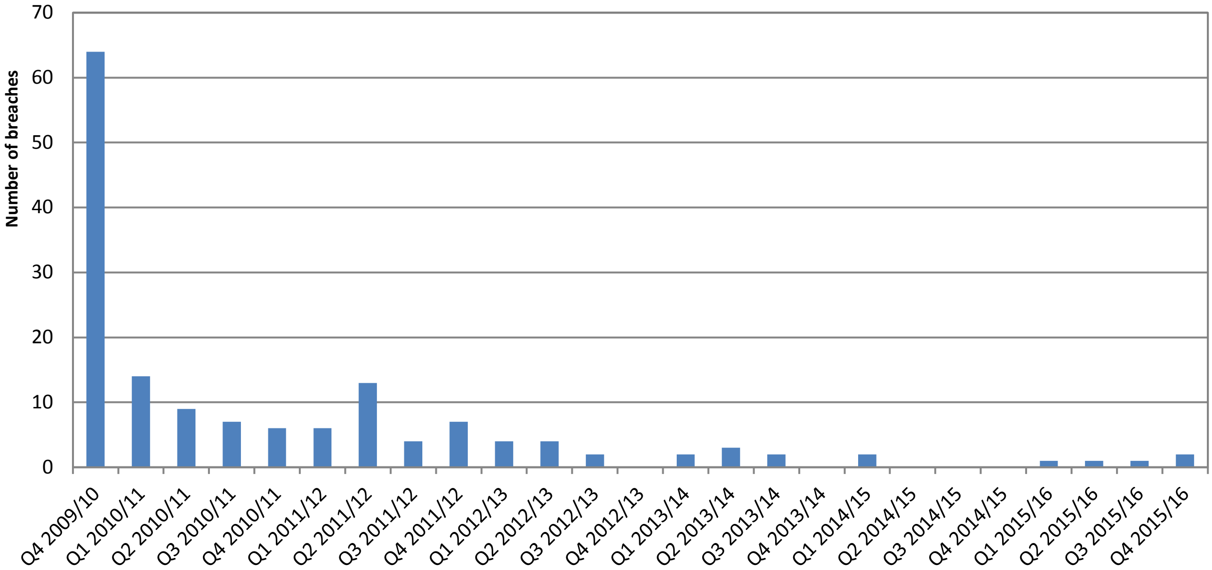
17. The Category 1 compliance failure, which occurred in November 2014, related to non-compliance with certain security requirements by Clydesdale Bank plc. As a consequence, all Excluded Notes (notes that do not need to be backed, subject to meeting all relevant requirements) at the location in question lost their Excluded status for the duration of the compliance failure. Clydesdale Bank plc did not have sufficient surplus backing assets to cover this temporary increase in their backing requirements. A range of other security controls at the location meant that the notes in question were held securely and so the Bank judged that whilst there had been control failures, the compliance failure did not represent a material risk to noteholder protection. The Bank imposed a penalty of £7,500, reduced from the normal £20,000 minimum for Category 1 compliance failures. The assessment process was completed in March 2015; at that time the Bank had no discretion to treat the compliance failure as a Category 1 or a Category 2 compliance failure.

18. None of the four Category 2 compliance failures were considered severe enough to justify referral to the Bank's internal decision making Committees and all four were laid on file for future reference without penalty. By comparison, in the year to end-February 2015 there were two Category 2 compliance failures, neither of which were investigated by the Bank's Committees. As shown in **Table 2** and **Chart 1**, the number of assessed compliance failures has decreased significantly since 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	2015/16	Total
Investigated by the Bank's Committees	79	4	3	2	0	1	89
(of which Penalised)	*(20)*	*(2)*	*(1)*	*(2)*	*(0)*	*(1)*	*(26)*
Laid on file for future reference	21	26	7	5	2	4	65
Total	100	30	10	7	2	5	154

Chart 1 Assessed compliance failures by date: November 2009 – February 2016



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

19. 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.

20. 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.

21. Category 1 compliance failures and serious Category 2 compliance failures are first considered by an internal Assessment Committee, which makes initial recommendations to an internal Review Committee (together the "Committees"). 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.

22. As outlined in Table 2, one penalty was imposed during the 2015/16 reporting period on Clydesdale Bank Plc for £7,500. Between the commencement of the regime and end-February 2016, 26 compliance failures have been penalised, and penalties amounting to £104,700 have been issued and paid[2]. Once received, penalties are passed to HM Treasury.

Other developments

23. The Bank continues to ensure that, in accordance with the Regulations, the necessary preparations are in place to implement a note exchange programme 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 a note exchange programme to ensure that all noteholders of the failed bank are reimbursed for their notes.

24. 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.

25. As part of wider contingency preparations in 2015/16, the Bank facilitated joint regional business continuity exercises in Northern Ireland and in Scotland, which were focused on a scenario involving banks having to unexpectedly withdraw one or more denominations of their notes from circulation.

[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).