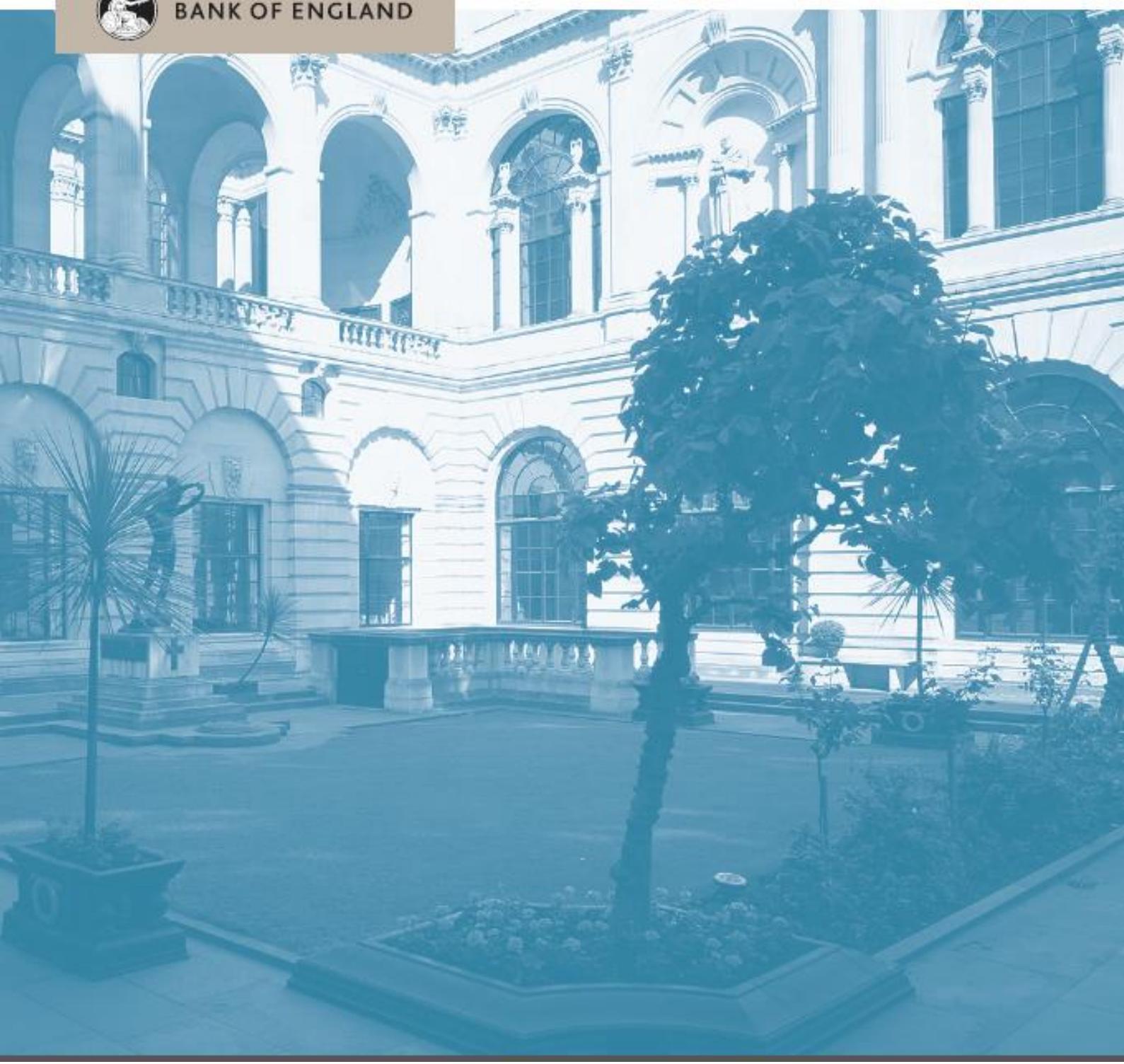


# The Bank of England's approach to regulating Scottish and Northern Ireland commercial banknotes

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**BANK OF ENGLAND**



## Introduction

1. The Bank of England (the “Bank”) has responsibility for regulating the treatment, holding and issuance of commercial banknotes in Scotland and Northern Ireland (the “Regime”). The Bank derives its responsibilities and powers from Part 6 of the Banking Act 2009 (the “2009 Act”).

2. The purpose of this document is to aid accountability by describing what the Bank seeks to achieve under the Regime and how it fulfils this role as a regulator in respect of the seven banks that are authorised to issue Scottish and Northern Ireland banknotes in accordance with the 2009 Act (the “authorised banks”)<sup>1</sup>. Additionally this document communicates to the authorised banks what the Bank expects of them, and what they can expect from the Bank in the course of supervision.

## The Bank’s role as regulator and the objectives of the Regime

3. The Bank assumed its responsibilities under the Regime on 23 November 2009. The legislative framework underlying the Regime (set out in paragraphs 6 to 8 below), is designed to ensure the primary objective of the Regime; that holders of Scottish and Northern Ireland banknotes issued by the authorised banks receive a level of protection similar to holders of Bank of England banknotes. In particular, an authorised bank must hold backing assets equivalent to all of its banknotes that are in issuance. This is to ensure that if it were to fail, there would be sufficient funds to pay all noteholders full face value for the banknotes of that failed bank. Authorised banks may use a combination of Bank of

England banknotes, funds in an interest bearing bank account at the Bank and UK coin as backing assets.

4. The Bank is not responsible for other aspects of Scottish and Northern Ireland banknote issuance such as the design of the authorised banks’ banknotes, their robustness against counterfeiting, or cash services more generally.

5. Whilst the whole of the legislative framework serves the aim of noteholder protection under the Regime, the Bank has identified five components which it considers to be of particular importance to noteholder protection. Those five components are set out below and a more detailed explanation about what these components are and how they apply can be found in paragraphs 13 onwards. In summary the components are as follows:

- i) The authorised banks must act with due skill, care and diligence.
- ii) The authorised banks must deal with the Bank in an open and co-operative way.
- iii) All Scottish and Northern Ireland banknotes except Excluded Notes<sup>2</sup> must be fully backed with ring-fenced assets at all times.
- iv) Excluded Notes and backing assets must be held and transported securely.
- v) Acts or omissions of the authorised banks must not impede the conduct of an orderly Note Exchange Programme (“NEP”) by the Bank.

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<sup>1</sup> As defined by s.210 of the 2009 Act. Please see: [http://www.bankofengland.co.uk/banknotes/Pages/about/scottish\\_northernireland.aspx](http://www.bankofengland.co.uk/banknotes/Pages/about/scottish_northernireland.aspx) for an up-to-date list of all of the authorised banks.

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<sup>2</sup> Excluded Notes are those notes which are excluded from the backing asset requirement.

## The Regime's Legal Framework

6. Part 6 of the 2009 Act empowers HM Treasury to make Regulations about the treatment, holding and issuing of banknotes by the authorised banks. Pursuant to these powers HM Treasury made the Scottish and Northern Ireland Banknote Regulations 2009 (the "Regulations") which require or permit the Bank to make rules and conditions about any aspect of the treatment, holding or issuing of banknotes by the authorised banks.

7. The Bank has made the Scottish and Northern Ireland Banknote Rules (the "Rules"), the Scottish and Northern Ireland Banknote Conditions (the "General Conditions") and in respect of each authorised bank a set of Scottish and Northern Ireland Banknote Approvals and Specific Conditions (the "Specific Conditions" and together with the "General Conditions", the "Conditions"). The Rules and Conditions made by the Bank under the Regime have been implemented in a structure which is described in further detail below.

- **The S&NI Banknote Regime Fundamental Rules.** The Bank has implemented two overarching Rules that apply across all aspects of the S&NI Regime to embed institutional behaviours that are fundamental to the Regime. These Rules are consequently termed by the Bank as being 'Fundamental Rules' (set out in paragraphs 14 to 17) albeit that they have the same status as all other Rules in the Regime.

- **Rules.** Alongside the Fundamental Rules, the Bank has implemented the Rules which are more detailed and specific in relation to each relevant aspect of the treatment, holding and issuance of Scottish and Northern Ireland banknotes by the authorised banks.

- **Conditions.** Where the Regulations grant a power of approval upon the Bank, (e.g. the power of

the Bank to approve the secure locations where Excluded Notes can be held), the Bank may grant that approval subject to conditions. Consequently, the Bank has implemented the General Conditions, which are a set of requirements applicable to all of the authorised banks and which underpin the more general stipulations contained within the Rules. The General Conditions should be read in conjunction with the Specific Conditions, which apply the General Conditions to an authorised bank and set out any additional conditions specific to that authorised bank.

8. When proposing changes to the Regime's Rules, the Regulations require the Bank to consult with both HM Treasury and the authorised banks. It will also consult with the PRA and the FCA where appropriate. The Regulations also require the Bank to consult with the authorised banks on changes to Conditions or to the withdrawal of any approval that it has given using the powers of approval granted under the Regulations.

## The Bank's Regulatory Powers

9. The Bank, where practicable, seeks to supervise with the support of the authorised banks, having clearly explained the risk rationale for its Rules and Conditions. The Bank's supervision is, however, conducted on the basis of the powers granted by Parliament, which include the power to issue financial penalties to authorised banks, and these powers will be used as appropriate.

10. The Bank's regulatory powers can be broadly divided into four categories:

- a) Powers to make and implement the Regime's Rules and Conditions;
- b) Powers granting approvals, for example to approve locations at which the authorised banks can hold backing assets or approve

agents who can hold notes on an authorised bank's behalf;

c) Information-gathering powers;

d) The power to issue financial penalties.

11. The Bank's main enforcement power under the Regime is its ability to impose financial penalties when the authorised banks fail to comply with the Regulations or Rules.

12. The Bank is required to publish a Statement of Penalty Policy (SPP)<sup>3</sup>. The SPP outlines the process the Bank will follow when it imposes a financial penalty which includes details about the types of factors that the Bank will take into account in assessing a breach and what, if any, penalty to impose. The SPP also provides guidance on the amount of any financial penalty, and details of the other enforcement powers available to the Bank.

## **How the Regime ensures noteholder protection**

13. To advance the Regime's noteholder protection objective, the Bank identified the key components of noteholder protection in paragraph 5. This section sets out what those components mean in terms of Regime requirements on the authorised banks and how the Bank should discharge its responsibilities as regulator.

### ***The S&NI Banknote Regime Fundamental Rules***

14. There are some institutional behaviours that are fundamental to the Regime's objectives. Consequently, these behaviours must be demonstrated by the authorised banks across all note issuance activities covered by the Regime. Given their importance, these key components of noteholder protection are embodied and implemented

in the Regime in the form of two Fundamental Rules, (i) and (ii) below. Given their importance, these Fundamental Rules are also key factors in the Bank's assessment of all breaches.

**i) An authorised bank must act with due skill, care and diligence in relation to any aspect of the treatment, holding or issuing of banknotes that could impact noteholder protection.**

15. The Bank considers a lack of skill, care and diligence to increase the likelihood of all material risk events occurring. Therefore the Bank sees it as a key component of noteholder protection and vital to the functioning of the entire Regime.

16. The authorised banks should be familiar with the requirements of the Regime and have robust plans and controls in place to reduce the likelihood of breaches. Failure to conduct business with due skill, care and diligence could result in unwanted consequences such as wide ranging control failures, fraud, theft, and ultimately lead to other breaches of the Regime, resulting in underbacking or an impediment to the Bank conducting an orderly NEP (as explained at paragraph 24 below).

**ii) An authorised bank must deal with the Bank in an open and co-operative way, and must disclose appropriately to the Bank anything of which the Bank could reasonably expect notice in relation to any aspect of the treatment, holding or issuing of banknotes that could impact noteholder protection.**

17. The Bank sees openness as critical to any regulatory regime; therefore proactive reporting of relevant information – where appropriate beyond specific requirements set out in the Regime's Rules – is a key component of note holder protection.

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<sup>3</sup> As per Schedule 3, paragraph 5 of the Regulations.

### ***Specific requirements on authorised banks***

18. The three other key components of noteholder protection, (iii) to (v) below, can be implemented most effectively in the form of specific regulatory requirements. These requirements underpin the majority of the Rules and Conditions.

#### **iii) All Scottish and Northern Ireland banknotes except Excluded Notes must be fully backed with ring fenced assets at all times.**

19. The requirement that the authorised banks must fully back their banknote issuance at all times, using assets which carry no credit risk, underpins noteholder protection. It seeks to ensure that noteholders can obtain full value for their Scottish and Northern Ireland banknotes in the event of the failure of an authorised bank, through an NEP. If an authorised bank was underbacked at the point of insolvency, there could be insufficient backing assets to pay noteholders. The importance of this component is also reflected in the weight the Bank places on compliance with this requirement.

20. The authorised banks must ensure they have adequate controls in place to meet the requirements of the Regime as a deficient control environment could pose a danger to noteholder protection by increasing the likelihood of risk events.

21. For example, the Rules require the authorised banks to report various information on a regular basis, which enables the Bank to monitor compliance with the Regime and to ensure that the Bank has an accurate record of the entirety of each of the authorised bank's notes. Misreporting data could pose a risk to noteholder protection, for example if it resulted in oversight failures which led to underbacking. It could also delay the start of an NEP or cause a disorderly start to an NEP if the Bank were unable to ascertain the correct value of backing

assets and Excluded Notes held at local cash centres.

#### **iv) Excluded Notes and backing assets are held and transported securely.**

22. It is important that Excluded Notes and backing assets are held and transported securely. If Excluded Notes were lost or stolen and subsequently entered circulation then noteholders may not be afforded appropriate protection in the event of an NEP. Lost or stolen backing assets could reduce a bank's aggregate backing level below the amount of its notes in circulation, with a similar impact on noteholder protection.

#### **v) Acts or omissions of the authorised banks must not impede the conduct of an orderly Note Exchange Programme by the Bank.**

23. The remaining key component of noteholder protection is vital to what would happen in the event of the insolvency of an authorised bank.

24. The Regulations require the Bank to arrange an NEP if an authorised bank were to become insolvent. In practice, this means making arrangements to enable holders of the notes issued by the failed authorised bank to get value for these banknotes. Failure to conduct an orderly NEP could result in noteholders being unable to get value for the banknotes of the failed bank in a timely fashion, which in turn could lead to a loss of confidence in commercial banknote issuance which, in a worst case scenario, could negatively impact financial stability.

25. There is interdependence between this component and the other key components of noteholder protection. The requirement that all Scottish and Northern Ireland banknotes (except Excluded Notes) must be fully backed with ring-fenced assets

at all times is particularly relevant to this component. This is because if an authorised bank failed, all noteholders could be assured that when the Bank conducted an NEP they would receive value for the banknotes that had been issued by the insolvent authorised bank. The Bank has detailed contingency plans in place in the event that an NEP is required, which include commitments from the authorised banks to provide assistance in such a scenario.

### ***The Bank's approach to supervision***

26. The focus of the Bank's supervision is on assessing compliance with the Regime's requirements. In doing so, the Bank seeks to assess whether authorised banks' controls and operational processes pose risks to noteholder protection. In setting regulatory requirements, the Bank takes a forward-looking approach in order to both mitigate future risks to noteholder protection and to support developments in the authorised banks' note issuance business.

27. The most significant supervisory activities undertaken by the Bank are as follows.

- Unannounced visits to the authorised banks' cash centres to confirm their compliance with the Regime, including auditing of banknote stocks and adherence to security and operational requirements. Breaches are investigated to identify the underlying cause. Where necessary, the Bank will specify a timetable for rectifying any outstanding problems, including provision for re-inspection.
- Gathering and analysis of regulatory reporting data, for example daily information on banknotes in circulation, printed banknotes and destroyed banknotes to confirm that the authorised banks' banknote issuance is fully backed at all times. The Bank may request

additional data from the authorised banks as required.

- Review of other regular reporting data, including business continuity plans and an annual report prepared by a suitably qualified and experienced independent auditor on relevant compliance, controls and procedures.
- The Bank will undertake thematic work if patterns of risk emerge, subsequently reviewing and updating the Regime's requirements if necessary.

28. Where the Bank discovers a breach, it may judge that it is necessary to impose a financial penalty. When making these judgements the degree of compliance with the fundamental rules will often be a highly relevant factor.

29. The Bank also undertakes regular assessments of its own planning to ensure an NEP can be implemented and run in a timely and efficient manner should the need arise.

### **HMT, the Bank and the S&NI Regime**

30. There are two main contexts in which HM Treasury engages with the Regime. The first relates to legislation and the second relates to seigniorage. As described above, HM Treasury makes the Regulations which form part of the legislative framework underlying the Regime. Those Regulations then empower the Bank to make Rules and Conditions in relation to the Regime. The Bank consults with HM Treasury on changes to the Rules.

31. The Regulations also give the Bank the secondary objective of ensuring that seigniorage<sup>4</sup> is earned on Scottish and Northern Ireland banknotes by HM Treasury. A failure of an authorised bank to comply with the Regime's requirements that results in a loss of seigniorage could give rise to a financial penalty under the Regime.

## Accountability and transparency

32. In discharging its responsibilities as regulator of the Regime, the Bank follows the general principles of public law about how regulators and public authorities should behave.

33. Accountability and transparency is important in ensuring the ongoing effectiveness of the Regime. As regulator of the Regime, the Bank must be clear on the objective of the Regime, the risks to that objective, and the scope and effectiveness of the controls (both requirements on the authorised banks and those that are the responsibility of the Bank) in reducing the likelihood and impact of those risks.

34. The Bank will implement this approach by communicating clear and proportionate requirements to authorised banks, by assessing appropriately the impact of breaches, and by ensuring the Bank takes consistent and rigorous supervisory decisions that are based on evidence and risk mitigation.

35. The Bank also seeks to ensure that its approach to regulatory activities is transparent, for example through the issuance of this document and the Bank's publication of an Annual Report detailing

the operation of the Regime for the previous financial year. These documents are also made available on the Bank's website, alongside the Scottish and Northern Ireland Banknote Rules and Statement of Penalty Policy<sup>5</sup>.

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<sup>4</sup> The UK government earns seigniorage from the issuance of Bank of England (BoE) banknotes and UK coin. BoE notes in circulation are non-interest bearing liabilities; seigniorage is the interest earned on the corresponding assets backing the note issuance. For UK coin, seigniorage represents the difference between the cost of production and the revenue of net coin issuance. Because the authorised banks are required to hold a minimum of 60% of their S&NI backing assets in BoE notes or UK coin, this results in the UK Government receiving seigniorage in relation to Scottish and Northern Ireland banknote issuance.