



BANK OF ENGLAND

# Scottish & Northern Ireland Banknote Issuance Annual Report 2011

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

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## Introduction

1. The Bank of England (“the Bank”) assumed responsibility for the regulation of the note issue function of the seven commercial banks in Scotland and Northern Ireland authorised to issue their own banknotes (“the authorised banks”) 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 second such report, and covers the Bank’s activities from 1 March 2010 to 28 February 2011, the end of the Bank’s 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 Part 6 of the Banking Act 2009 (the Act), which came into effect on 23 November 2009, repealed the legislation under which banknote issuance was previously regulated and passed the responsibility for regulation to the Bank.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 updates and modernises the framework for commercial note issuance to provide enhanced noteholder protection.
4. The authorised banks are shown in the Table 1 below:

**Table 1**

<b>Authorised Bank</b>
AIB Group (UK) plc (trades as First Trust Bank in Northern Ireland)
Governor and Company of the Bank of Ireland
Bank of Scotland plc
Clydesdale Bank plc
Northern Bank Limited
The Royal Bank of Scotland plc
Ulster Bank Limited

## Legislative framework

5. The Act and 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 and the Bank is responsible solely for this aspect. The Bank is not responsible for the design of the authorised banks’ banknotes or their robustness against counterfeiting. 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.

6. The authorised banks' note issuance is governed by the Scottish and Northern Ireland Banknote Regulations 2009 (and the related Rules). These came into force on 23 November 2009 together with a Statement of Penalty Policy. Both the Rules and Statement of Penalty Policy are revised periodically. The latest versions came into effect on 24 June 2011, with revisions streamlining reporting requirements and providing improved guidance to the authorised banks.

7. In addition, the authorised banks must comply with General and Specific Conditions which set out the standards required for the holding of backing assets and Excluded Notes. As the 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 of England. Bank of England notes held as backing assets may be held at an authorised location or at the Bank of England. 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. At least 60% of the backing assets for NIC must be Bank of England notes or UK coin. The remaining 40% of the backing assets may be Bank of England notes, UK coin or funds in an interest bearing account at the Bank of England.
- **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. These notes may be backed with Bank of England notes, UK coin or funds in an interest bearing account at the Bank of England.

- **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. These notes are excluded from the requirement to be backed.

12. As at 28 February 2011, the three authorised banks in Scotland had a total of around £3,500 million of NIC, £700 million of NWPEC and £4,400 million in Excluded Notes. The four authorised banks in Northern Ireland had around £1,900 million of NIC, £130 million of NWPEC and £1,500 million in Excluded Notes.<sup>1</sup> As explained above, the authorised banks must hold backing assets in respect of NIC and NWPEC.

## Compliance framework

13. The Bank has a small team of staff within the Notes Division 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.

14. In addition to the on-going data monitoring and analysis, the Bank undertakes compliance visits to the locations used by each of the authorised banks for the storage of their notes and backing assets, to verify the value of backing assets and Excluded Notes held, and that the necessary conditions (e.g. security standards of sites storing backing assets) are met. During the year 15 compliance visits took place across the authorised banks' locations. These visits identified a number of shortcomings in security and operational processes, which the Bank has required the authorised banks to rectify to ensure full compliance with the regime. Where breaches of Regulations or Rules were identified, the Bank considered whether penalties should be imposed.

15. The Bank regularly re-evaluates its compliance and data analysis programme to ensure that all risks to noteholders are adequately mitigated.

## Compliance breaches

16. Since the start of the regime, the Bank has considered 100 breaches, of which 79 were investigated by the Bank's Committees (see paragraph 20). The remaining 21 breaches were considered too minor to justify referral to Committees and were laid on file for future reference without penalty.

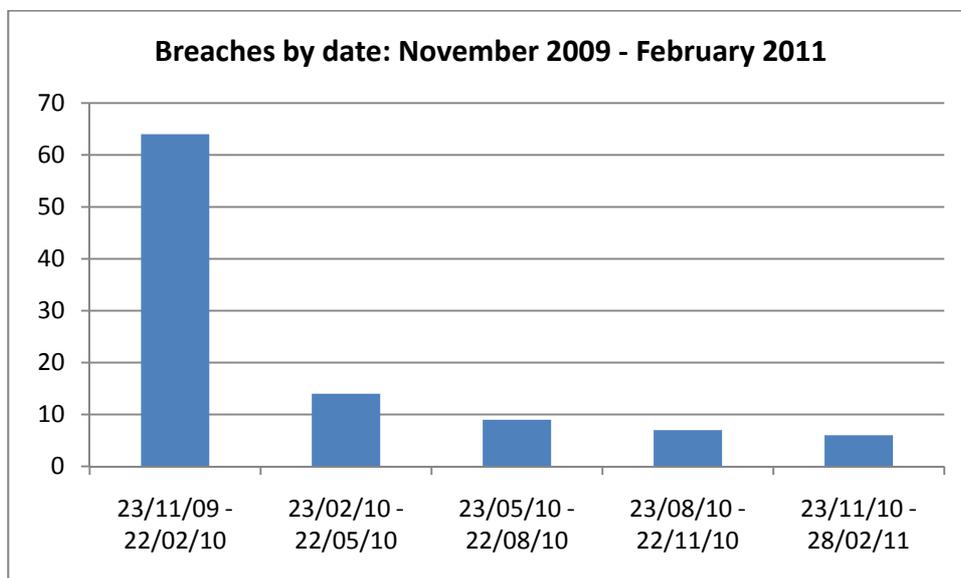
17. There has been a sharp reduction in the number of breaches since the regime began, with breaches falling 91% between the first quarter of the regime and the corresponding quarter a year later (see Chart 1).

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<sup>1</sup>Source: Bank of England

The drop in the number of breaches reflects the authorised banks' increasing familiarity with the regime, a strong desire to comply with the Rules and Regulations, and ultimately a desire to avoid penalties.

**Chart 1**



N.B. The final quarter has been extended by 6 days to cover the period to the Bank's year end.

## Penalties and governance

18. 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 Statement of Penalty Policy published by the Bank alongside the Rules. Penalties are subject to a cap of 10% of an authorised bank's average NIC in any calendar year, as set out in paragraph 4 of Schedule 3 to the Regulations.

19. Penalties relate to three categories of 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. A category 3 compliance failure constitutes a breach to Rule 8.4 (the NIPS Code of Connection) where a zero penalty may be applied. A category 2 compliance failure is a compliance failure which does not fall into the other two categories,

20. Decisions on imposing penalties are made by the Chief Cashier on advice from two internal committees – the Assessment Committee, which makes initial recommendations, and a Review Committee. 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, who will advise the Chair. Members of the Appeal Panel are listed on the Bank's website.

21. The Regulations allow the Bank to publish information on penalties where all avenues of appeal have been exhausted. At the time of writing the previous Annual Report no penalties had reached this stage. This Report is therefore the first time the Bank has published details of breaches and associated penalties.

22. During the first three months of the regime the authorised banks implemented revised operational procedures as they adapted to the new regime. The Bank treated this as a familiarisation period, and where it imposed penalties did so below the maximum that could have been levied. The Bank did, however, ensure that where a category 1 compliance failure occurred, the penalty imposed fully recovered any seigniorage lost to HM Treasury. The familiarisation period ended on 28 February 2010.

23. Since the commencement of the regime 20 penalties have been issued and paid. All but two of the penalties issued were for failures occurring during the familiarisation period. Once received, penalties are passed to HM Treasury.

24. The Bank has penalised the authorised banks a total of £53,200. The following table gives a breakdown of the penalties by authorised bank and category. The penalties listed below are the total imposed on each occasion and in some cases are an aggregation of smaller penalties for breaches which occurred in the same period. The largest individual penalty issued was £12,500.

**Table 2**

<b>Authorised Bank</b>	<b>Number of penalised breaches</b>	<b>Category 1 breaches: underbacking</b>	<b>Category 2 breaches: misreporting</b>
Bank of Ireland	7	£500	£17,500
Bank of Scotland	10	£200	£25,000
Clydesdale Bank	0	£0	£0
First Trust Bank	0	£0	£0
Northern Bank	2	£0	£5,000
Royal Bank of Scotland	1	£5,000	£0
Ulster Bank	0	£0	£0
<b>Total</b>	<b>20</b>	<b>£5,700</b>	<b>£47,500</b>

25. Of the 20 penalties issued, four have been category 1 compliance failures (i.e. underbacking), the last of which occurred in December 2009. The remaining failures related to the misreporting of data, often

caused by manual inputting errors or process failures. The Bank has been working with the authorised banks to help prevent further failures from occurring.

## Other developments

26. Throughout the year the Bank has been working 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. The legislation sets out the high-level form that work would take, and the Bank has developed the practical processes that would need to be followed. 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 at full value.

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

27. The Bank of Ireland is proposing to transfer its note issuing rights from the Governor and Company of the Bank of Ireland, incorporated in the Republic of Ireland, to a new UK-incorporated subsidiary, Bank of Ireland (UK) plc, through a Private Bill in Parliament. The Bank of Ireland (UK) Plc Bill received its Second Reading in the House of Commons on 1 February 2011; the Bank is monitoring the progress of the Bill.

## Appendix 1: Legislative Documents

- The Banking Act 2009, Part 6 (“the Act”), which received Royal Assent in February 2010 and came into force on 23 November 2009  
[http://www.opsi.gov.uk/RevisedStatutes/Acts/ukpga/2009/cukpga\\_20090001\\_en\\_1](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](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20093056_en.pdf)).
- The Scottish and Northern Ireland Banknote Rules 2009 (“the Rules”) -  
[http://www.bankofengland.co.uk/banknotes/about/scottish\\_northernireland\\_notes\\_rules.pdf](http://www.bankofengland.co.uk/banknotes/about/scottish_northernireland_notes_rules.pdf)