



BANK OF ENGLAND

# Scottish & Northern Ireland Banknote Issuance Annual Report 2012

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

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## Executive Summary

- As at 29 February 2012, the three authorised banks in Scotland had a total of £3,763 million of Notes in Circulation (NIC) and £464 million of Notes with the Potential to Enter Circulation (NWPEC). The four authorised banks in Northern Ireland had £2,030 million of NIC and £121 million of NWPEC.<sup>1</sup> Each of the authorised banks fully backed their NIC and NWPEC at all times throughout the preceding twelve month period meaning that there were no category 1 breaches (instances of underbacking).
- The Bank of England (“the Bank”) conducted 15 compliance inspections across the authorised banks’ locations to verify the value of backing assets and Excluded Notes held. Where inspections identified shortcomings in security and operational processes, remedial actions were agreed with the banks.
- During the twelve months to 29 February 2012 the Bank considered 30 category 2 breaches (breaches that do not involve underbacking), four of which were investigated by the Bank’s Committees, and two of which led to penalties totalling £9,000 being imposed on First Trust Bank (**Table 1**). The remaining 26 breaches were considered too minor to justify referral to Committees and were laid on file for future reference without penalty. By comparison, the 2011 Annual Report<sup>2</sup> recorded 20 penalties totalling £53,200 imposed across four of the authorised banks.

**Table 1** Penalised breaches during the twelve months to 29 February 2012

Authorised Bank	Number of penalised breaches	Category 1 breaches: underbacking	Category 2 breaches: misreporting
Bank of Ireland	0	£0	£0
Bank of Scotland	0	£0	£0
Clydesdale Bank	0	£0	£0
First Trust Bank	2	£0	£9,000
Northern Bank	0	£0	£0
Royal Bank of Scotland	0	£0	£0
Ulster Bank	0	£0	£0
<b>Total</b>	<b>2</b>	<b>£0</b>	<b>£9,000</b>

- In May 2012 the Statement of Penalty Policy (SPP) was revised and reissued with the objective of simplifying the framework used to reach decisions on penalties for category 2 breaches (the maximum penalty for such breaches remains £20,000). The revised SPP also establishes a minimum penalty of £20,000 for a category 1 breach.
- In March 2012, Royal Assent was given to the Bank of Ireland (UK) Plc Private Bill which allowed for the transfer Bank of Ireland’s note issuing rights from the Governor and Company of the Bank of Ireland, incorporated in the Republic of Ireland, to its UK-incorporated subsidiary, Bank of Ireland (UK) plc on 15 May 2012.

<sup>1</sup>Source: Bank of England. Refer to paragraph 11 for definitions of NIC, NWPEC and Excluded Notes.

<sup>2</sup>The 2011 Annual Report covered penalties imposed during the period 23 November 2009 to 28 February 2011.

## 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 third such report, and covers the Bank’s activities from 1 March 2011 to 29 February 2012 (the Bank’s 2011/12 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:
  - 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; and
  - 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 (SPP). Both the Rules and SPP are revised periodically. The most recent

version of the Rules came into effect on 24 June 2011, streamlining reporting requirements and providing improved guidance to the authorised banks. At this point only minor changes were made to the SPP. The SPP was subsequently further changed and reissued in May 2012 (see below).

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.

## Compliance framework

12. The Bank has a small team of staff within its 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.

13. 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. The compliance visits enable the Bank to verify the value of backing assets and Excluded Notes held, and 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 all risks to noteholders are adequately mitigated.

## Compliance breaches

14. Compliance breaches can take a number of forms. Minor breaches are discussed with management of the authorised bank and laid on file for future reference without a penalty being imposed. More serious breaches are brought before the Bank's Committees (see paragraph 18) where a decision on whether or not to impose a penalty is discussed, and if, so at what level. There has been a sharp reduction in the number of breaches since the regime began (**Table 2**).

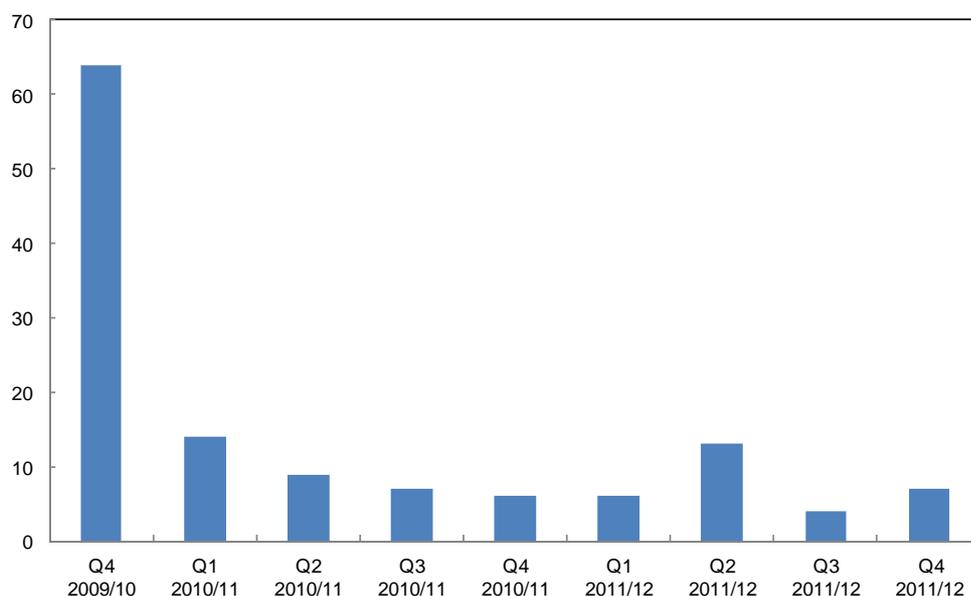
**Table 2** Number of breaches investigated to date

Number of breaches <sup>3</sup>	2012	2011	Total since start of regime
Investigated by the Bank's Committees	4	79	83
<i>(of which Penalised breaches)</i>	<i>(2)</i>	<i>(20)</i>	<i>(22)</i>
Laid on file for future reference	26	21	47
Total	30	100	130

15. The sum total of breaches occurring during the last eight quarters (66) is only marginally higher than the number of breaches arising in the first quarter of the new regime (64) (**Chart 1**). The low number of breaches in later quarters reflects the authorised banks' familiarity with the regime, a strong desire to comply with the Rules and Regulations, and ultimately a desire to avoid penalties.

<sup>3</sup> The year corresponds to the Annual Report in which a breach was presented. The 2011 report covered all breaches in the period between the start of the regime (on 23 November 2009) and the end of the Bank's 2011 financial year (end February 2011).

**Chart 1** Breaches by date: November 2009 – February 2012



N.B. 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.

## Penalties and governance

16. 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.

17. Penalties relate to three categories of compliance failure:

- **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 1 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.
- **Category 2 compliance failure:** A category 2 compliance failure is a compliance failure which does not fall into the other two categories; i.e. NIC and NWPEC are fully backed and noteholders are not at risk, and there is no breach to Rule 8.4 (the NIPS Code of Connection). Category 2 penalties are subject to a cap of £20,000.
- **Category 3 compliance failure:** A category 3 compliance failure constitutes a breach to Rule 8.4 (the NIPS Code of Connection). Category 3 penalties do not attract financial penalties.

18. Decisions on imposing penalties are made by the Bank's Chief Cashier on advice from an internal Review Committee. Matters are first considered by an internal Assessment Committee, which makes initial

recommendations to the 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. The Regulations allow the Bank to publish information on penalties where all avenues of appeal have been exhausted.

19. Since the commencement of the regime 22 breaches have been penalised and penalties amounting to £62,200 have been issued and paid. Of the penalties issued since the start of the regime, 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. Once received, penalties are passed to HM Treasury. Only two breaches (both by First Trust Bank) occurred during the twelve months to 29 February 2012 and the penalties imposed for these breaches amounting to £9,000 have been paid.

20. The following table (**Table 3**) 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.

**Table 3** Penalised breaches by year<sup>4</sup>

Authorised Bank	Number of penalised breaches		Category 1 breaches: underbacking		Category 2 breaches: misreporting	
	2012	2011	2012	2011	2012	2011
Bank of Ireland	0	7	£0	£500	£0	£17,500
Bank of Scotland	0	10	£0	£200	£0	£25,000
Clydesdale Bank	0	0	£0	£0	£0	£0
First Trust Bank	2	0	£0	£0	£9,000	£0
Northern Bank	0	2	£0	£0	£0	£5,000
Royal Bank of Scotland	0	1	£0	£5,000	£0	£0
Ulster Bank	0	0	£0	£0	£0	£0
<b>Total</b>	<b>2</b>	<b>20</b>	<b>£0</b>	<b>£5,700</b>	<b>£9,000</b>	<b>£47,500</b>

## Other developments

21. In May 2012 the Statement of Penalty Policy (SPP) was revised and reissued with the objective of simplifying the framework used to reach decisions on penalties for category 2 breaches (the maximum

<sup>4</sup> The year corresponds to the Annual Report in which a breach was presented. No penalties were presented in the 2010 report because the Regulations do not allow the Bank to publish information on penalties until all avenues of appeal have been exhausted and at the time of writing no penalties had reached this stage.

penalty for such breaches remains £20,000). The revised SPP also establishes a minimum penalty of £20,000 for a category 1 breach.

22. In March 2012 Royal Assent was given to the Bank of Ireland (UK) Plc Private Bill which allowed for the transfer Bank of Ireland's note issuing rights from the Governor and Company of the Bank of Ireland, incorporated in the Republic of Ireland, to its UK-incorporated subsidiary, Bank of Ireland (UK) plc on 15 May 2012. This reflects the transfer of significant parts of the UK business of Bank of Ireland to the UK subsidiary and means that, for the first time, all of the authorised banks are UK entities regulated by the Financial Services Authority.

23. The Bank has continued with its work 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 at full value.

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.

## 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](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 2011 (“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)).