



BANK OF ENGLAND

Scottish & Northern Ireland Banknote Issuance Annual Report 2014

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

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Executive Summary

- As at 28 February 2014, the three authorised banks in Scotland had a total of £4,106 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 £2,181 million of NIC and £123 million of NWPEC.¹ These figures compare with the year ending 28 February 2013 when the authorised banks in Scotland had a total of £3,980 million of NIC and £760 million of NWPEC and the authorised banks in Northern Ireland had £2,113 million of NIC and £126 million of NWPEC. The aggregate backing requirement of all seven banks at the end of the reporting period decreased by 1.5% from £7 billion in 2013 to £6.9 billion in 2014, although the average backing requirement over the year as a whole increased from £6.9 billion to £7.1 billion.
- The Bank of England (“the Bank”) conducted 17 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.
- Category 1 breaches:** We continued to see a strong level of compliance with the regime during the year to 28 February 2014. Each of the authorised banks fully backed their NIC and NWPEC at all times meaning that there were no Category 1 breaches (instances of underbacking). The 2013 and 2012 Annual Reports also recorded no Category 1 breaches.
- Category 2 breaches:** During the twelve month period, the Bank considered seven Category 2 breaches (breaches that do not involve underbacking), two of which were investigated by the Bank’s Committees. Both of these resulted in fines being imposed: £15,000 for Clydesdale Bank and £10,000 for Royal Bank of Scotland (**Table 1**). The remaining five breaches were not considered severe enough to justify referral to Committees and were laid on file for future reference without penalty. By comparison, the 2013 Annual Report recorded ten Category 2 breaches: one penalty of £10,000 was imposed on Danske Bank, a further two breaches were considered by the Committee but not penalised and five breaches were laid on file.

Table 1 Penalised breaches during the twelve months to 28 February 2014

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	1	£0	£15,000
Danske Bank	0	£0	0
First Trust Bank	0	£0	£0
Royal Bank of Scotland	1	£0	£10,000
Ulster Bank	0	£0	£0
Total	2	£0	£25,000

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

Introduction

1. The Bank of England (“the Bank”) assumed responsibility for the regulation of the note issue function of the three commercial banks in Scotland and four commercial banks in 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 fifth such report, and covers the Bank’s activities from 1 March 2013 to 28 February 2014 (the Bank’s 2013/14 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);
 - 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 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 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 Scottish and Northern Ireland Banknote Regulations 2009 (and the related Rules). These came into force in 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 in June 2011 and the SPP was changed and reissued in May 2012.

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. The General Conditions were updated in May 2014.

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.
- **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 of England. Excluded notes are, as the name indicates, excluded from the backing requirement.

13. As at 28 February 2014, the three authorised banks in Scotland had a total of £4,106 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 £2,181 million of NIC and £123 million of NWPEC. These figures compare with the year ending 28 February 2013 when the authorised banks in Scotland had a total of £3,980 million of NIC and £760 million of NWPEC and the authorised banks in Northern Ireland had £2,113 million of NIC and £126 million of NWPEC. Over the course of the year up to 28 February 2014, the three authorised banks in Scotland had a combined average NIC of £4,148 million and an average NWPEC of £641 million (compared with £4,019 million and £584 million the previous year) and the four authorised banks had a combined average NIC of £2,174 million and an average NWPEC of £139 million (compared with £2,119 million and £140 million the previous year). This compares to an average NIC of Bank of England notes of £59.9 billion in the year ending 28 February 2014 and £57.2 billion the previous year.

14. The aggregate backing requirement of all seven banks at the end of the reporting period decreased by 1.5% from £7 billion to £6.9 billion, although the average backing requirement over the year as a whole increased from £6.9 billion to £7.1 billion.

Compliance framework

15. 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. 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 breaches

16. Compliance breaches 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 noteholders are not at risk, and there is no breach of Rule 8.4 (the NIPS Code of Connection).

- **Category 3 compliance failure:** A Category 3 compliance failure constitutes a breach to Rule 8.4 (the NIPS Code of Connection).

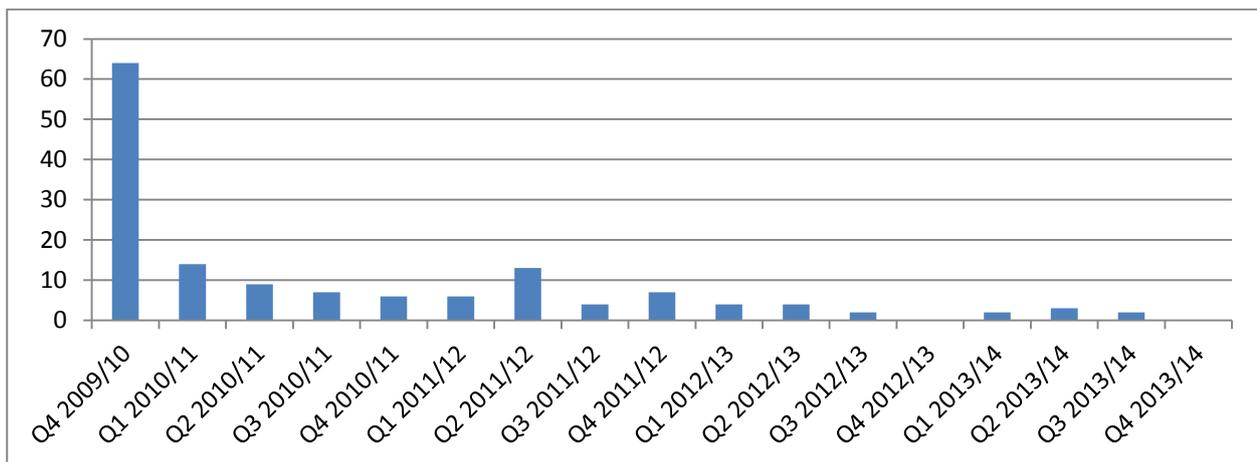
17. More minor breaches are discussed with management of the authorised bank and laid on file for future reference without a penalty being imposed. Serious breaches are brought before the Bank's Committees (see paragraph 21) where a decision on whether or not to impose a penalty is discussed, and if so, at what level. There was a further reduction in the number of breaches in the year ending 28 February 2014, as shown in **Table 2**.

Table 2 Number of breaches investigated to date

Number of breaches ²	2011	2012	2013	2014	Total since start of regime
Investigated by the Bank's Committees	79	4	3	2	88
<i>(of which Penalised breaches)</i>	<i>(20)</i>	<i>(2)</i>	<i>(1)</i>	<i>(2)</i>	<i>(25)</i>
Laid on file for future reference	21	26	7	5	59
Total	100	30	10	7	147

18. The continued trend of a reduced number of breaches, as shown in **Table 2** and **Chart 1**, reflects that the regime has bedded down, and that the authorised banks have a strong desire to comply with the Rules and Regulations and ultimately avoid penalties. There was a high number of breaches recorded in Q4 2009/10, which decreased significantly as banks familiarised themselves with the regime's requirements.

Chart 1 Breaches by date: November 2009 – February 2014



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.

² The year corresponds to the Annual Report in which a breach was presented.

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 Statement of Penalty Policy published by the Bank alongside the Rules. In addition to materiality, the Bank will take into account three key factors: whether the compliance failure was proactively disclosed by the authorised bank or discovered by the Bank or a third party; whether the Bank considers that the compliance failure was deliberate; and whether the Bank considers that the authorised bank exercised reasonable care.

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

- 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. Since May 2012 a Category 1 breach has been subject to a minimum penalty of £20,000.
- Category 2 penalties are subject to a cap of £20,000.
- Category 3 penalties do not attract financial penalties.

21. 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.

22. Since the commencement of the regime, 25 breaches have been penalised and penalties amounting to £97,200 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 (by Clydesdale Bank and Royal Bank of Scotland) were penalised during the twelve months to 28 February 2014 and the penalties imposed for these breaches (amounting to £15,000 and £10,000 respectively) have been paid. These were both Category 2 (misreporting) breaches.

Other developments

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.

25. As part of wider contingency preparations, the Bank facilitated joint regional business continuity exercises in Northern Ireland and in Scotland with a scenario based on the failure of alternative payment systems and a subsequent spike in demand for banknotes.

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 2011 (“the Rules”) (http://www.bankofengland.co.uk/banknotes/about/scottish_northernireland_notes_rules.pdf).