

BANKNOTES: MEETING DEMAND

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Introduction

Thank you for inviting me to address you today. I would like to outline the Bank of England's public policy objectives for note issue and how these influence the role of the Bank and of the commercial sector, including ATM operators, during the life of a note. I will cover the Bank's two key objectives in banknote distribution: integrity and meeting the public's demand for notes. In particular, I want to explain why the denominational mix of notes entering circulation has risen up our priority list and the steps the Bank is undertaking to promote the circulation of low denomination notes: an area where ATM operators have a key role to play.

Bank of England Public Policy Objectives

The Bank of England has issued banknotes since 1694, and has been the sole issuer of notes in England and Wales since 1922. Different arrangements are in place in Scotland and Northern Ireland, but they are outside the scope of this talk. While our level of involvement in the various stages of the process has changed over time, we are guided by the ultimate objective of maintaining confidence in the currency. There are two key elements to this.

Through our involvement in the note cycle, the Bank seeks to ensure that there is public confidence in the physical integrity of notes – this includes ensuring notes in circulation are of a sufficiently high quality and that they incorporate strong anti-counterfeiting measures. And, we aim to ensure there are sufficient notes available to meet the public's demand – including a suitable mix of denominations. These objectives should be achieved with appropriate risk management, efficiency and value for money.

Before explaining how we meet our objectives, and the role that ATMs can play in this, let me set the context. At the end of May 2010, there were just under £48 billion worth of Bank of England notes in circulation. This represents 2.6 billion notes. Some people had predicted the “death of cash” but, perhaps in part due to the contribution of ATMs, there is more cash in circulation than ever before. The stock of notes in circulation has continued to grow year on year (See Chart 1). In recent years, year-on-year growth has averaged around 6%, which has accelerated to 7% growth in 2008 and 9% in 2009, partially due to an increase in demand for higher value notes during the financial crisis. Even if expressed as a percentage of nominal GDP, we have seen a rise in the value of notes in circulation from a low point of 2.4% in the mid 1990s to 3.2% today.

Over the past 20 years there has been a major change in the way notes are acquired by the public. In the early 1990s there were fewer than 20,000 ATMs in the UK accounting for only 25% of the cash acquired by individuals. Today there are more than 60,000 accounting for over 70% (See Chart 2). ATMs have modernised the distribution of cash by making it easier for the public to obtain cash on demand, outside normal business hours (See Chart 3). And ATMs themselves contain a stock of cash, which even while waiting to be dispensed are counted as issued by the Bank of England.

Role of the Bank of England in the Note Cycle and its Responsibilities

The two objectives – public confidence in physical integrity and the availability of sufficient notes to meet public demand – are put into practice by the work of both the Bank and the commercial sector. The Bank does not take a direct operational role in every stage of note distribution. Since the introduction of the Notes Held to Order Scheme in 1982, followed by the Note Circulation Scheme (NCS) in 2001, an increasing number of tasks in the cash cycle have been carried out by the commercial sector.

The Bank is involved in the design of notes and procures new notes from De La Rue, which is responsible for sourcing the materials and printing the notes. The Bank issues new notes to the wholesale cash industry and then, at the end of their lifespan, takes them back for destruction. Destruction can take place once the note is of insufficient quality, or its legal tender status is withdrawn, as will be the case for the Elgar £20 note from 30 June this year. In the middle of a note's life, the commercial sector undertakes the other necessary tasks, including fitness sorting, storage and retail distribution. Few other central banks have enabled the commercial sector to play such a large role in the cash cycle, but more are now moving in this direction.

Clearly, the Bank has a close interest in the activities the commercial sector undertakes. The main vehicle for the Bank's influence is its Note Circulation Scheme: NCS. Allow me – very briefly – to explain the principles of this. There are currently five Members of the NCS,¹ comprising commercial banks, specialised wholesale cash processors and the Post Office. These Members undertake all of the retail distribution of Bank of England notes to customers such as financial institutions and retailers. The Members sort notes to authenticate them and verify their fitness for recirculation, and prepare them to be dispensed. They also store the seasonal surplus in their cash

¹ On 1 June 2010, the Members of the NCS were: G4S Cash Centres (UK) Ltd, Bank of Scotland, Post Office Ltd, Royal Bank of Scotland plc and Vaultex UK Ltd.

centres so that the notes do not have to be physically returned to Bank of England premises when they are not needed immediately to meet public demand.

The Bank recognises that the costs of holding stocks of notes could be a disincentive to commercial sector organisations wishing to undertake the sorting and storage of notes. To encourage Members to undertake these activities, which are important in providing notes to the general public, the NCS arrangements therefore allow Members to hold in their cash centres notes which are owned by the Bank and therefore do not need to be funded on their balance sheets.

In exchange for the reduction in balance sheet costs of the notes which are not considered to be in circulation, Members must comply with the rules of the Scheme. These include authenticating (to remove counterfeits) and fitness sorting notes on high speed note sorters, for secure storage, packaging requirements and rules about the notes that can be delivered to the Bank for destruction. The Bank monitors compliance with the requirements and there are sanctions for Members if they do not meet to their obligations.

Influencing Denominational Mix as Well as Integrity and Authentication

As mentioned above, for the Bank, a key objective is to maintain confidence in the currency. The first step is in designing notes with effective security features. But these are only as good as the authentication checks made on these notes. It is essential that any counterfeit notes are removed from circulation along with poor quality notes as soon as possible. The responsibility for note sorting and removing counterfeits, including ensuring none enter ATMs, lies with the NCS Members, but with guidance from the Bank. The Bank also works closely with law enforcement agencies to assist their investigation of counterfeit notes. It is clearly in everyone's interests to remove counterfeits, ideally before there is any attempt to pass them.

Alongside the focus on note integrity, the Bank has increasingly devoted effort to ensuring that there is an appropriate mix of different denomination notes available to the public. This is the result of evidence over a number of years about the squeeze on our lowest denomination: the £5.

While the value of notes in circulation has risen over recent years, the value of £5s has remained broadly flat. In 1990, £5s made up nearly 11% of the value of notes in circulation. By 2000, this had fallen to 4%. Today there are around £1.3 billion worth of £5s in circulation— just 2.7% of the total.

The relatively small quantity of £5s in circulation has led to a quality problem: when £5s do go into circulation, they tend to stay in circulation for longer and exchange hands more often than other denominations.

Over the past decade, the ‘velocity of circulation’² of the £5 has slowed (See Chart 4). Today, the average £5 is sorted in a cash centre about 1½ times a year, compared with nearly ten times for a £10 and four times for a £20. In other words, £5 notes return to be sorted less than the £10 and £20 and less often than they used to be. This goes a long way to explaining the poorer quality of £5s. We need to see more dispensed so that they are less scarce and therefore return to cash centres for sorting more frequently.

The Bank regularly conducts public opinion surveys to understand the demand for £5s. Consistently, the evidence says that people want to acquire more £5 notes. For example, less than 10% of the public would prefer to get £5 worth of change in coins rather than a £5 note, but the majority say that they get coins much of the time when receiving £5 or more in change. Almost half of the public say that they would go out of their way to visit a less conveniently placed ATM if they knew that it dispensed £5s.

While the £5 has become scarcer, the £20 has become increasingly dominant (See Chart 5). Today, £20s (the dominant ATM note) make up around 65% of the value of all Bank of England notes in circulation, a proportion that has steadily risen alongside the number of ATMs. But without an appropriate mix of notes of lower denominations in circulation, retailers cannot make change using a minimum number of notes and coins.

The story of the £5 illustrates the growing importance of denominational mix in our note distribution policy. For notes to continue to fulfil a proper, efficient transactional role, this needs to be addressed.

Getting adequate numbers of £5s into circulation to meet public demand is a challenge the cash industry must meet. The Governor of the Bank of England drew the problem to public attention in his June 2007 Mansion House speech. At the heart of the problem is that few ATMs dispense £5s: only a small fraction of 1% of the cash acquired from ATMs is £5 notes. Yet the public is acquiring an ever larger proportion of its cash from ATMs. As a result, there is no significant channel for getting £5s into circulation.

² The velocity of circulation of notes measures how fast they move around the cash cycle by estimating how often they are sorted in NCS cash centres.

What is the Bank doing to promote a better denominational mix?

The Bank is committed to working with the cash industry to meet the public's demand for a mix of notes of different denominations. We are undertaking a series of activities that, taken together, should make a visible change to the circulation of the £5. There are three main strands to our approach: first, changes to the rules of the NCS; second, an initiative to increase the dispense of £5s from ATMs; and, third, engagement with retailers to encourage them to order more £5s from their cash suppliers to use as change.

(i) NCS Reforms

The Bank is undertaking a review of the design of the NCS, among other things, to ensure it does not discriminate against the dispense of lower denomination notes, in particular the £5. This work includes acknowledging that there can be additional costs in preparing lower denomination notes, and that these should be reduced over time as the quality of notes improves.

(ii) ATMs

In addition, the Bank is working with ATM estate owners to increase the value of £5s dispensed by ATMs. As I mentioned, the UK public is obtaining an increasingly large proportion of its cash from ATMs, so ATMs are key to the long-run solution to the £5 quality and quantity problems. (See Chart 6)

Between July and October 2009 the Bank worked with HSBC to pilot increasing the dispense of £5s from ATMs. In addition to the machines it already had dispensing £5s, HSBC stocked an additional 100 of its ATMs with £5 notes. Half of the pilot ATMs were street-facing branch ATMs, the others on remote sites, such as supermarkets and petrol stations.

The aim of the pilot was to dispel concerns about the objections to putting £5s into ATMs, and the pilot provided very encouraging results.

The first concern was that putting £5s in an ATM will invariably increase the cost and frequency of ATM refilling. The pilot found that refill frequency and cost could be minimised by a careful selection of ATMs. ATMs filled on a regular schedule often have notes left in them at the time of

refilling. For those left with a sizable buffer in the normal process, the refill frequency might not need to change to accommodate their dispense of £5s.

A second concern was the cost of converting ATMs to handle £5s. The HSBC pilot identified that there were some one-off costs for ATM cassette re-configuration and to update the software on machines. However, it appeared that these costs could be fairly small.

Another potential area of concern addressed by the HSBC pilot is the level of ATM downtime and maintenance for machines dispensing £5s. The average quality of £5s currently in circulation is lower than the average quality of other denominations. It is therefore necessary to use an enhanced quality of £5s in ATMs to minimise the interruptions from maintenance incidents. The pilot study showed when ATMs were filled with £5s sorted to a superior quality ATM-fit standard, they had the same frequency of maintenance incidents as when filled only with £10s and £20s. This demonstrated that securing higher quality ATM-fit £5s from cash suppliers is a prerequisite for the viable ATM dispense of more £5s. It also has the benefit that better quality £5s will be entering circulation: this is important as £5s circulate for longer than £10s and £20s before being returned to a cash centre for sorting, so the poor quality notes can be removed. The Bank is working with the cash industry to ensure that higher quality ATM-fit £5s can be made available to meet an increase in demand.

The ATM pilot also confirmed the Bank's earlier survey data, that the majority of the public prefers or is indifferent to receiving £5s from ATMs. During the pilot period, the number of transactions at the ATMs labelled as dispensing £5s increased while the number of transactions at other ATMs in the same HSBC branch decreased.

The Bank recognises that this pilot took place in the particular context of a single financial institution. It is inevitable that there will be differences across different ATM estates. But it is hoped that most of the lessons and benefits from the pilot will be transferable to others.

In the wake of the successful pilot, the Bank has written to UK ATM estate owners with a target for £5 dispense from their ATMs. That is, they should ensure that £5 notes account for a minimum of 1.2% of the overall value of their estate's outflows of Bank of England notes. At the same time, the Bank has asked estate owners to put a ceiling on their dispense of £20 notes at 65% of the overall value of their estate's outflows.

The Bank has started to engage with the owners of the ATM estates in the UK with the largest share of ATM dispense. The response from the larger ATM estate owners has been positive. And I would like to take this opportunity to thank them for their support, which is a significant move forward in giving their customers the £5 notes they want so that cash functions as an efficient means of payment. The Bank will be monitoring this carefully over the coming months and plans to provide updates on the progress.

(iii) Retailers

A further strand of action is to promote £5 dispense among retailers. While they cannot solve the £5 problem on their own, they have a key role to play as “front line” cash users and can make an important contribution to resolving the quality and quantity problems.

In 2009, the Bank worked with Sainsbury’s supermarket in a pilot to increase the number of £5s they order as change for tills. The pilot took place in four stores initially and proved so successful that now all Sainsbury’s stores have the ability to order £5s and are being encouraged to do so by their management.

The pilot found that it was financially neutral to rebalance a store’s change order between £5s and coins. It also found that there were some non-financial benefits in relation to logistics.

Both the retailer and the ATM pilot have provided invaluable information, which has informed our discussions on £5 notes with the commercial sector. The Bank would like to thank HSBC and Sainsbury’s for their time and effort participating in the pilots.

Concluding remarks

All three of these areas of change – reforms to the design of the NCS, increased £5 dispense by ATMs and increased ordering of £5s as change items by retailers – require the cash industry to work alongside the Bank to increase the flow of £5s to the public. The Bank is keen to engage with the cash industry, retailers, financial institutions, manufacturers and others to improve denominational mix. It is only by working together that we can solve the £5 problem and have a better balance of denominations to benefit all users of cash. And for our part, we will be ready to issue many more crisp new £5 notes to meet this demand.

ANNEX

Chart 1

Stock of Notes in Circulation

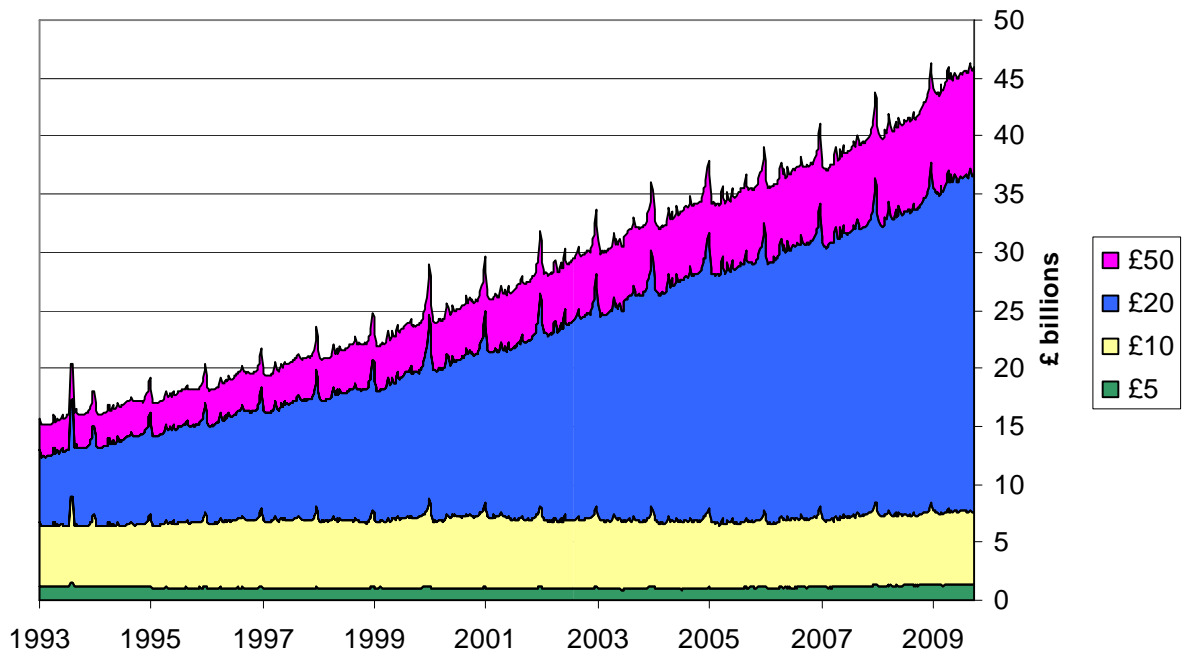
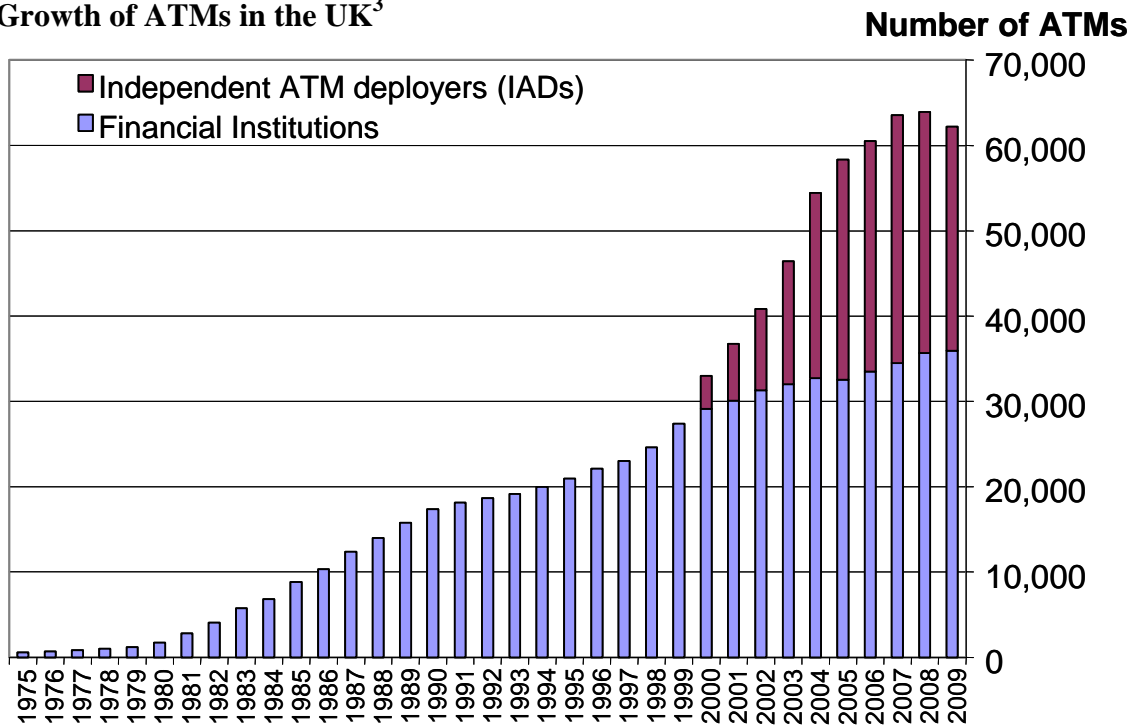


Chart 2

Growth of ATMs in the UK³



³ Source: UK Payments

Chart 3
ATM Withdrawals as % of all cash acquired by individuals in the UK⁴

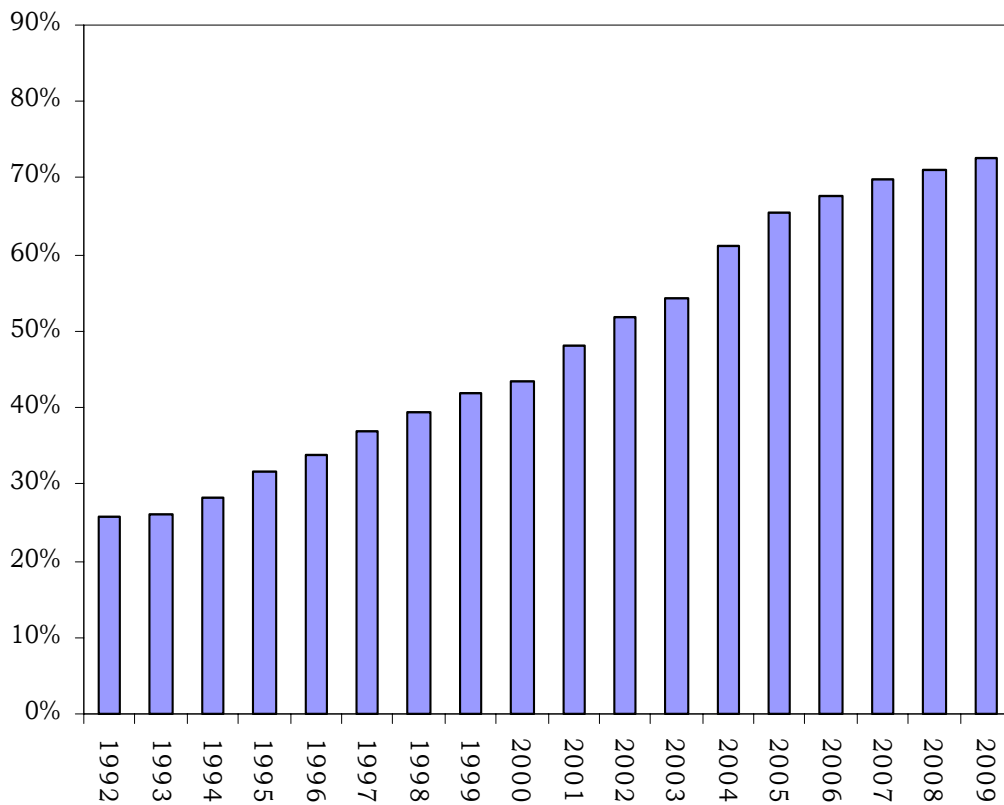
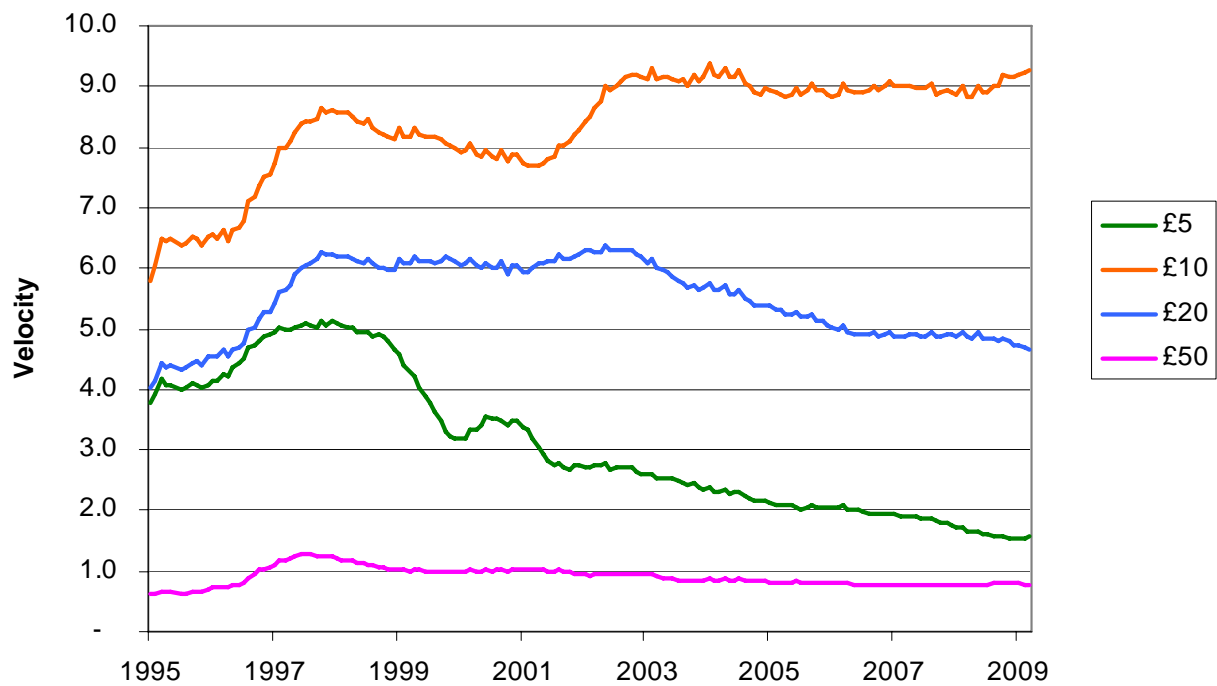


Chart 4
Velocity of Circulation



⁴ Source: UK Payments

Chart 5
Changing Proportions of £5 NIC over time (by Value)

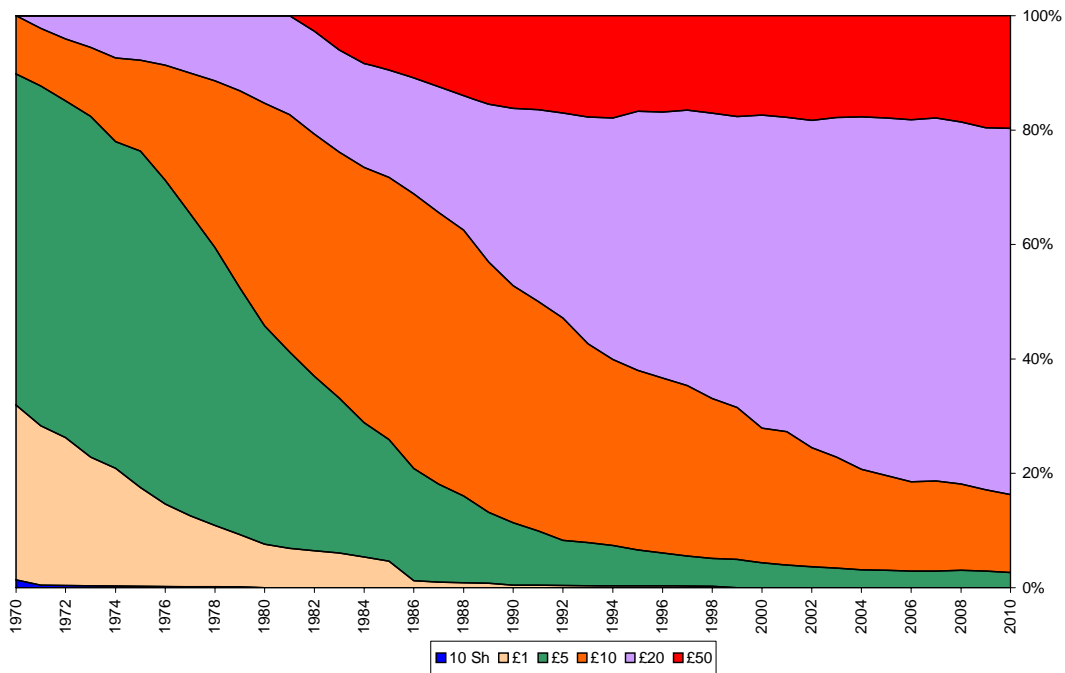
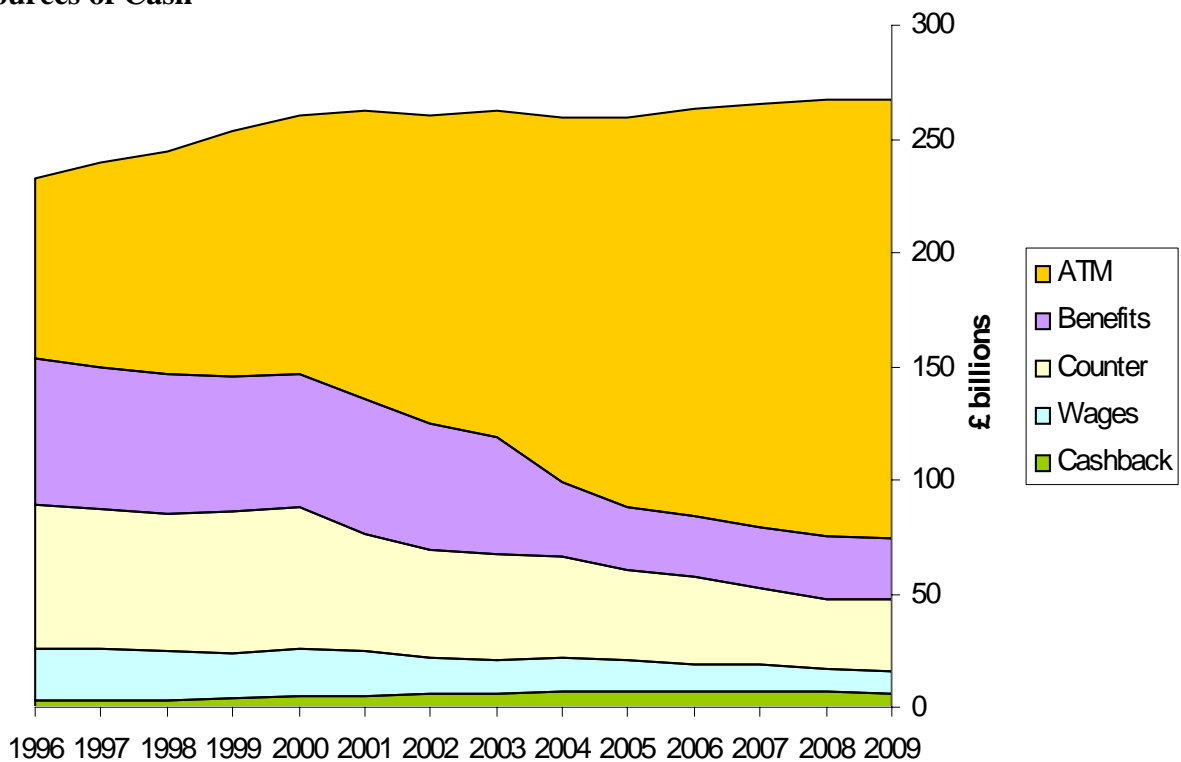


Chart 6
Sources of Cash⁵



⁵ Source: UK Payments