

# **Banknote issue arrangements in Scotland and Northern Ireland**

## **A consultation document**

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July 2005



HM TREASURY





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ISBN: 1-84532-103-0

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# INTRODUCTION

**1.1** The issuance of national banknotes is usually a monopoly of the central bank, which in the United Kingdom is the Bank of England. Scotland and Northern Ireland are among a few places in the world where a limited number of commercial banks are permitted to issue their own banknotes. This privilege is set out in the Bank Notes (Scotland) Act 1845 and Bankers (Northern Ireland) Acts 1845 and 1928. Currency, legal tender and banknotes are matters specifically reserved to the UK Parliament under the Scotland Act 1998 and excepted under the Northern Ireland Act 1998 and are therefore matters on which the UK Parliament continues to legislate following devolution.

**1.2** The proposals set out here are designed to strengthen this long-standing arrangement. The Government's priorities in regulating the issue of banknotes by commercial banks are to ensure that note holders are protected at all times and that note issuance does not distort competition in the banking industry.

**1.3** It is the intention of the Government to introduce a Bill, if Parliamentary time allows, that will modernise the arrangements under which note issuing banks issue banknotes. This Bill will principally seek to:

- Require all issuing banks to hold sufficient and appropriate note-covering assets at all times, thereby creating a level playing field for all institutions with respect to bank note supply;
- Strengthen the regulatory framework, including the transfer of current administrative responsibilities from the Commissioners for Revenue and Customs to the Bank of England; and
- Ensure that note holders, as creditors, can obtain value for their notes.

**1.4** These proposals are consistent with the Treasury's objective of promoting stable, fair and efficient financial markets, for users and for the economy.

## Policy Proposals

**1.5** Chapter 1 sets out the Treasury's proposal to **strengthen the regulatory framework**, including the transfer of administrative responsibilities from the Commissioners for Revenue and Customs to the Bank of England. The Bank has the appropriate expertise, skills and knowledge to be able to discharge these responsibilities effectively. The responsibilities would fit well with the Bank's core purpose of ensuring monetary stability, which involves maintaining confidence in the value and integrity of the currency. The transfer would also enable the Commissioners to focus fully on those areas that are core to their own objectives, notably the administration of stamp taxes.

**1.6** Chapter 2 sets out the Treasury's proposals to **protect note holders** by earmarking the note-covering assets required by the 1845 Acts of Parliament so that they are held for the benefit of note holders. This would ensure that, in the unlikely event of an issuing bank becoming insolvent, note holders would be able to receive value for their notes from these assets. We propose that this would be best achieved by providing either the issuing banks or the Bank of England with the statutory responsibility of holding the note-covering assets for the benefit of note holders. The

chapter also looks into options for the practical arrangements for giving value for notes in the event of an issuing bank becoming insolvent.

**1.7** Chapter 3 sets out the Treasury's proposals to **modernise the note issue arrangements** for Scottish and Northern Ireland banks, to bring them more closely into line with certain aspects of the note issuing arrangements for Bank of England notes. These amendments would also be necessary for the proposed arrangement for the protection of note holders to be workable and effective. This would include ensuring that the note-covering assets were clearly identified and held securely at all times for the benefit of note holders.

## Consultation

**1.8** The proposal to protect note holders would involve a change in their relative status, in the event of the insolvency of the issuing bank, compared with other creditors. This consultation exercise is intended to assist the Treasury in finalising the most appropriate way of achieving the policy aim of ensuring that, in the unlikely event of the insolvency of an issuing bank, note holders are protected.

**1.9** A number of issues and questions on which we would appreciate views are highlighted throughout this document. You should not confine your response to the questions if you wish to make further comments. We are particularly interested to receive comments and views on the best way to ensure that, in the unlikely event of an issuing bank becoming insolvent, note holders can obtain value for their notes.

## Partial Regulatory Impact Assessment

**1.10** We would also welcome comments on the partial Regulatory Impact Assessment (RIA) annexed to this document. The final RIA will be developed based on the responses to this consultation exercise. The RIA sets out primarily the Treasury's assessment of the impact of (i) requiring all note issuing banks in Scotland and Northern Ireland to back their note issue with appropriate note-covering assets at all times; and (ii) formalising a single unambiguous definition of notes that have to be backed, in order to avoid unfair competitive advantage between issuing and non-issuing institutions.

**1.11** We estimate that the proposed measures will result in note issuing banks foregoing a combined £80 million a year in income from the assets covering their note issues. It should be recognised that non-issuing institutions do not have access to a comparable income stream since they have to purchase banknotes from either the Bank of England or from an issuing bank.

**1.12** It is not the Treasury's intention to discourage note issuing commercial banks from continuing to issue their own notes. Rather, these proposed measures would provide greater confidence to note holders, which should support the continuation of the long standing arrangements for the issuance of these notes.

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## HOW TO RESPOND TO THE CONSULTATION

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**1.13** The deadline for all consultation responses is Friday 16 September 2005. Please address your response to:

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**1.14** You should note that, if requested to do so, the Treasury proposes to make public all responses to the consultation. If for commercial reasons you do not want your response to be made publicly available, we advise that you mark any such information as commercially sensitive. The Treasury will then aim not to disclose it to the extent that non-disclosure is compatible with the requirements of the Freedom of Information Act 2000.

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## OBTAINING COPIES OF THE CONSULTATION PAPER

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**1.15** An electronic copy can be downloaded from the Treasury's website at:

**[www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)**

**1.16** Alternatively, hard copies can be obtained from:

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# 2

## TRANSFER OF RESPONSIBILITIES

**To strengthen the regulatory framework for the issue of Scottish and Northern Ireland banknotes by transferring all existing administrative responsibilities from the Commissioners for Revenue and Customs to the Bank of England as well as granting additional powers.**

This chapter sets out the Treasury's proposal to transfer all existing administrative responsibilities for the issuance of Scottish and Northern Ireland banknotes from the Commissioners for Revenue and Customs to the Bank of England. The Bank has the appropriate expertise, skills and knowledge to be able to discharge these responsibilities effectively. The responsibilities would fit well with the Bank's core purpose of ensuring monetary stability, which involves maintaining confidence in the value and integrity of the currency. The transfer would also enable the Commissioners to focus fully on those areas that are core to their objectives, notably the administration of stamp taxes. Chapter Three sets out in detail the additional regulatory powers that would be provided to the Bank.

**2.1** Under the Bank Notes (Scotland) Act 1845 and Bankers (Northern Ireland) Acts 1845 and 1928, three banks in Scotland and five banks in Northern Ireland have the right to issue banknotes. The banks that are permitted to issue banknotes in Scotland are Bank of Scotland, Clydesdale Bank, and Royal Bank of Scotland. The banks that are permitted to issue banknotes in Northern Ireland are Bank of Ireland, First Trust Bank, National Bank, Northern Bank, and Ulster Bank.

**2.2** Branches of these banks based outside Scotland and Northern Ireland are not permitted to issue banknotes although these notes may be found in circulation outside Scotland and Northern Ireland. Under the Currency and Bank Notes Act 1954, banknotes issued by the Bank of England are permitted to be put into circulation in Scotland and Northern Ireland as well as in England and Wales.

**2.3** All note issuing banks are subject to supervision by the Financial Services Authority and must meet prudential requirements. Notes issued by banks in Scotland and Northern Ireland are liabilities of the issuing banks and not of the Bank of England.

**2.4** Under the 1845 Acts, the Commissioners of the Inland Revenue (Stamp Taxes, formerly the Stamp Office) are charged with carrying out certain administrative arrangements concerning the note issue of banks in Scotland and Northern Ireland. This responsibility was transferred to the Commissioners for Revenue and Customs i.e. HM Revenue and Customs (HMRC) under the Commissioners for Revenue and Customs Act 2005, although the associated tasks are still carried out by Stamp Taxes. Their main task is to ensure that the average value of notes in circulation for each issuing bank at the close of business on each Saturday over specified four week periods does not exceed the average value of note-covering assets held by that issuing bank at close of business on each Saturday during the same four week periods.

**2.5** The administrative function was established in the eighteenth century when stamp duty was levied on banknotes issued by commercial banks. Today stamp duty is not levied on banknotes. The institutional arrangements are no longer a good fit with the objectives of HM Revenue and Customs as Stamp Taxes are primarily focused on the administration of stamp taxes.

**2.6** The Treasury therefore proposes to transfer all the current responsibilities of HM Revenue and Customs in respect of Scottish and Northern Ireland note issue to the Bank of England ('the Bank'). We also propose to establish up to date regulatory responsibilities, to be assumed by the Bank. These responsibilities are set out in Chapter Three. Making the Bank responsible for regulating the issuance of notes by banks in Scotland and Northern Ireland would ensure there was a single and appropriate body responsible for regulating the issuance process for all notes issued in the UK. This would further enable the Bank to pursue its core purpose of ensuring monetary stability, which involves maintaining confidence in the value and physical integrity of the currency. The Bank would also be better placed to assume these responsibilities, given its skills and expertise in the area of banknotes.

**2.7** The Treasury does not foresee any conflict of interest between the regulatory responsibility that is being proposed and the Bank's existing role as a note issuer. The Bank is publicly owned and the profits of its own note issue are paid to the Treasury.

**2.8** It is proposed that all penalties due under the proposed regulatory regime will be paid over to the Treasury.

**2.9** We also intend to provide the Bank with statutory immunity for all the functions it carries out under the proposed legislation. This would bring the arrangements into line with the similar statutory immunity that the Financial Services Authority (FSA) has under the Financial Services and Markets Act 2000.

## **OBJECTIVES AND AIMS OF THE REGULATORY FRAMEWORK**

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**2.10** The objective of the proposed legislation would be:

**Promoting stable, fair and efficient financial markets, for users and for the economy by:**

- Providing a level playing field for all commercial institutions with respect to the costs of supplying banknotes, whether their own or those of another issuing bank;
- Ensuring that note holders, as creditors, can obtain value for their notes; and
- Ensuring there is a single and appropriate body responsible for regulating the issuance process for all notes issued in the UK.

**2.11** The objective of the Bank would be to use the powers conferred on it by the legislation to seek to ensure that the aims of the legislation are achieved. The Bank would do this through the pursuit of the following goals:

- Ensure all issuing banks maintain appropriate and adequate note cover at all times;
- Protect the note-covering assets on behalf of note holders at all times;
- Ensure, in the event of an issuing bank becoming insolvent, that note holders receive value for their notes from the note-covering assets;
- Ensure adequate security features are built into all notes issued by banks in Scotland and Northern Ireland;
- Provide flexibility to all issuing banks to manage their note issue in a manner that does not compromise note holders' interests; and
- Ensure that all functions carried out in its regulatory role are done in the most cost effective and efficient manner.

## **COSTS OF REGULATING THE NOTE ISSUE ARRANGEMENT**

**2.12** The Treasury proposes that all the costs of the Bank associated with the regulation of the note issue arrangement of banks in Scotland and Northern Ireland are funded from the income that accrues from the assets backing the issue of Bank of England notes.

**2.13** This would continue the existing practice of not charging issuing banks for the cost of regulating their note issue arrangements. It should be noted, however, that charging an industry for the costs of its regulation is not uncommon.



# 3

## PROTECTION OF NOTE HOLDERS

To earmark the note-covering assets so that they are held for the benefit of note holders.

This chapter sets out the Treasury's proposals to ensure that the note-covering assets are held for the benefit of note holders. This would have the effect that, in the unlikely event of an issuing bank becoming insolvent, note holders would receive value for their notes from the note-covering assets. We propose that this would be best achieved by providing either the issuing banks or the Bank of England with statutory responsibility to hold the note-covering assets for the benefit of note holders. The chapter also looks into the different possible options for how notes should be treated in the event of an issuing bank becoming insolvent.

**3.1** Under existing legislation all issuing banks are required to maintain cover for their note issues in the form of silver and gold coins and notes issued by the Bank of England. These note-covering assets can then form part of the general pool of assets held by each of the issuing banks. The vast majority of note-covering assets are currently held in the form of Bank of England notes, rather than coin.

**3.2** However, under existing legislation the purpose of the note-covering assets is not clearly set out. There is no provision in the legislation requiring that in the event that an issuing bank becomes insolvent, note holders be given value for their notes from the note-covering assets in priority over all other creditors. There is consequently a risk that the note-covering assets would fall into the estate of the issuing bank for the payment of creditors in accordance with insolvency laws. As the notes themselves do not confer any type of preferred creditor status, note holders would be treated as ordinary unsecured creditors.

**3.3** Our policy objective is to ensure that appropriate assets are 'ring-fenced' or earmarked in the event of the insolvency of an issuing bank, for the benefit of note holders. The Treasury has looked into the possibility of making note holders secured creditors through voluntary means. However, this would be a very complicated legal and administrative process with significant risks, not least that in the event of insolvency any voluntary agreement might be set aside or subject to restrictions by existing insolvency legislation. Primary legislation creating a trust or scheme under which the note-covering assets are held for the benefit of note holders seems to be the best means of providing protection to note holders.

**3.4** To achieve this we propose to provide in the Bill for the note-covering assets to be earmarked specifically and for the benefit of note holders. The legislation would effectively prevent an issuing bank from using these note-covering assets to secure its debts, or to meet any financial obligations or liabilities.

**Q1. Do you agree that the note-covering assets used to back the note issue should be earmarked specifically for the benefit of note holders?**

**Q2. What impact would earmarking the note-covering assets for the benefit of note holders have on (i) the issuing banks; and (ii) other creditors, including depositors, of the issuing banks?**

**3.5** To strengthen the proposed arrangement, in particular to overcome any insolvency issues that may arise, the Treasury is considering providing either the issuing banks or the Bank of England with the statutory responsibility to hold the note-covering assets for the benefit of note holders. If the issuing banks were to hold the note-covering assets on trust for the benefit of note holders, then in the event of an issuing bank becoming insolvent, it would be possible for the Bank of England to become trustee of that trust, in place of the issuing bank.

**3.6** This would strengthen the regulatory framework, providing reassurance to note holders that an independent agency was protecting their interests.

**Q3. Do you foresee issues with the issuing banks or the Bank holding the note-covering assets for note holders on trust or under a statutory scheme, for example in accounting procedures, or the impact on regulatory capital or liquidity requirements?**

**Q4. In the event of insolvency, should the issuing bank or the Bank have statutory responsibility for providing note holders with value for their notes from the note-covering assets?**

**Q5. Would the proposed arrangement be compatible with existing insolvency and trust laws or would existing insolvency and trust laws need to be amended?**

## TREATMENT OF NOTES

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**3.7** The proposed legislation will also need to set out how the notes issued by banks in Scotland and Northern Ireland should be treated in the event that an issuing bank is wound up. One option could be to allow a fixed period of time for note holders to claim against the note-covering assets. Another option would be to treat these notes exactly like Bank of England notes which are redeemable indefinitely. This would mean the notes could still continue to be used after the issuing bank has been wound up and could avoid a rush by note holders in the immediate aftermath of an issuing bank becoming insolvent. However, it would also mean that any note-covering assets remaining after all permitted claims by note holders had been settled would never be made available for payment to other creditors.

**Q6. Should there be a time limit for note holders to make a claim against the note-covering assets or, should the notes be treated like Bank of England notes and have an indefinite time period for redemption?**

**Q7. If a time limit were adopted, would one year be sufficient length of time for note holders to make a claim for their notes? Should there be flexibility for the Bank to be able to extend the one year time period, subject to Treasury approval?**

**3.8** The proposed legislation would also need to consider what should happen if there were an excess or insufficient note-covering assets at any point in time.

**Q8. What should happen to any note-covering assets remaining after all permitted claims on them by note holders have been settled? Should they be held for the benefit of the issuing bank, so that they can be used to satisfy the claims of other creditors?**

**Q9. If the surplus note-covering assets were held for the benefit of the issuing bank, what implications would this have, if any, for the proposal to make the Bank hold the note-covering assets on trust for note holders?**

**Q10. If there were insufficient note-covering assets, for example as a result of counterfeit notes being redeemed mistakenly, how should the claims of note holders be treated?**

**Q11. If note holders claimed value for their notes after surplus note-covering assets had been paid out to other creditors, how should the claims of note holders be treated?**

**3.9** The proposed legislation would also provide that in the event that an insolvent bank is recapitalised, it should lose its privilege to issue notes. It would nonetheless, continue to be required to hold note-covering assets for all outstanding notes in circulation. The same approach would be applied to a note issuing bank that voluntarily decided to cease issuing its own banknotes.

**Q12. Do you agree with this proposal?**



# 4

## MODERNISATION

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To modernise the note issue arrangements of note issuing banks in Scotland and Northern Ireland to ensure that the proposed trust arrangement for protection of note holders can be made to work effectively and that there is a level playing field with respect to the supply of banknotes for all issuing and non issuing institutions alike.

**4.1** This chapter sets out the Treasury’s proposals to modernise the note-issue arrangements for Scottish and Northern Ireland banks, to bring them more closely into line with certain aspects of the note issuing arrangements already in place for Bank of England notes. These changes would also help to ensure that the proposed arrangements for protecting note holders are workable.

**4.2** The proposals are also aimed at seeking greater transparency in note issue arrangements, to provide reassurance both to note holders that their interests are being protected and to the wider public that the integrity of the currency is being maintained.

**Q13. We would be interested to receive comments and views on these proposed changes, in particular the likely costs and benefits they would have for the issuing banks and others.**

**4.3** Some of the changes set out in this section may be included in secondary legislation made by the Treasury or by way of rules that the Bank of England would be empowered to make under the proposed legislation, subject to the written consent of the Treasury.

### NOTE-COVERING ASSETS

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**4.4** At present, the vast majority of note-covering assets take the form of Bank of England notes with only a small remainder being held as coin. We plan to require that only Bank of England notes may be used as note-covering assets.

**4.5** This would make it administratively easier for the Bank to identify the assets.

### FIDUCIARY LEVEL

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**4.6** Existing legislation allows issuing banks to have a small amount of notes in circulation (currently about 0.125% on average) without having to back them with note-covering assets. This is known as the fiduciary level.

**4.7** We intend to abolish the fiduciary level and to require that all issuing banks back 100% of their notes in circulation with note-covering assets. This would be necessary to ensure that there is protection for all note holders. Abolishing the fiduciary level would also level the playing field for all banks, as non-issuing institutions have to purchase notes in full from either the Bank of England or from an issuing bank.

## LOCATION OF NOTE-COVERING ASSETS

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**4.8** Existing legislation provides that coin or the Bank of England notes used as note-covering assets can be held at the following locations: at an issuing bank's head office or principal place of issue; and/or at up to a maximum of two of its offices in Scotland / Northern Ireland (approved by HM Treasury); and/or at the Bank of England on behalf of the issuing bank. Currently, over ninety percent of note-covering assets are held at the Bank of England.

**4.9** The proposed legislation will require **all** note-covering assets to be held at the Bank of England. Having the assets held at the Bank of England would make it easier to quantify and identify the assets; in the event of an issuing bank becoming insolvent it would also ensure that the assets did not fall into the possession of anyone other than the Bank. It would also be consistent with plans to transfer regulatory responsibility to the Bank.

**4.10** We also plan to provide the Bank with the power to set appropriate terms and conditions for how note-covering assets are to be held at the Bank of England. In doing so, the Bank would be required to set conditions that would not compromise the interests of note holders and that would be workable in practice.

## DEFINITION OF NOTES ISSUED

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**4.11** Under existing legislation, only notes in circulation (i.e. notes that have been issued by the issuing bank or its agent or servant) are required to be backed with note-covering assets. Notes that are held by an issuing bank for the purpose of till money and to store in Automated Teller Machines (ATMs) are not explicitly required to be backed. This may provide issuing banks with a financial advantage over non-issuing institutions that have to purchase Bank of England notes or notes from an issuing bank for the purpose of till money and notes to store in ATMs.

**4.12** A precise definition for notes 'in issue' (i.e. to be backed with covering assets) will need to be formulated. This will include all notes that are in circulation, together with notes that have the potential to enter circulation (such as those in ATMs). However, it is expected that there will be exemptions for certain notes that are not in circulation, as detailed below.

## NOTES EXEMPTED FROM ISSUE

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**4.13** The Treasury recognises that issuing banks would need the flexibility to manage their note issue for a number of reasons: to manage seasonal fluctuations in note demand; to manage the withdrawal of an existing note design and/or introduction of a new design; and for maintaining a stock of notes for contingency purposes.

**4.14** An issuing bank would be able to hold notes that are not required to be backed with note-covering assets under certain conditions. Some of the conditions are set out below:

**Location** **4.15** The locations for physically holding such notes would need to be approved by the Bank.

**Storage** **4.16** The physical conditions under which the notes are stored would need to be approved by the Bank.

- Access 4.17** The Bank (or its agent) would have the power to access all approved locations for inspection purposes at all times.
- Information 4.18** Issuing banks would need to provide information when requested by the Bank on the value of notes stored under this facility.
- Status 4.19** An issuing bank would be prevented from treating any notes not in issue (and therefore exempt from cover) as value items for its own benefit, for example as its own asset or as security for any purpose.
- Penalties 4.20** The Bank would have the power to impose a penalty if an issuing bank fails to comply with any relevant conditions.
- Guidelines 4.21** The proposed legislation would enable the Bank to make rules concerning these conditions following consultation with all issuing banks and any person it sees fit and, subject to written agreement with the Treasury. The rules would establish a scheme similar to the existing arrangements by which Bank of England notes may be held by commercial banks whilst remaining the property of the Bank and not being treated as in issue.
- Insolvency 4.22** It would also be necessary to provide the Bank with the power to take immediate physical ownership of any un-issued notes in the unlikely event of an issuing bank becoming insolvent, with a view to destroying them. Given that they are not backed by note-covering assets, any claim for value for such notes would undermine the proposed arrangement to protect note holders: there would be insufficient note-covering assets to redeem the exempted notes as well.

## SCOTTISH AND NORTHERN IRELAND BANK NOTE REGISTER

**4.23** To enable the Bank to discharge its responsibility for maintaining confidence in the physical integrity of all currency in the UK, a Scottish and Northern Ireland Bank Note Register would be set up, which the Bank would be responsible for managing. There would be a statutory duty on all issuing banks to register details of all note designs issued as well as providing the Bank with a specimen sample of all such notes. A note would only be permitted to be issued or withdrawn, **after** it has been registered.

**4.24** The register would contain at least the following information about each note issued by an issuing bank: denomination, size, design, substance it is made from, security features, date it was first and last issued, and, date it was registered (and, where appropriate re-registered).

**Q14. What other information should the Bank Note Register hold?**

## COUNTERFEITING

**4.25** Counterfeiting of banknotes is a crime with serious consequences for a country's economy. It undermines public confidence in the currency being used as a method of payment, costs businesses because counterfeit notes are not redeemable by the note issuer, and also leads to inconvenience and loss of value for holders of counterfeit notes.

**4.26** Maintaining confidence in the value and integrity of the currency is a prime objective of the Bank. In pursuing this objective we propose that the Bank would need

appropriate and well-defined powers to ensure that notes issued by banks in Scotland and Northern Ireland are adequately protected against counterfeit attacks. This would provide reassurance to note holders that their interests were being protected. Such powers would also assist law enforcement agencies dealing with counterfeit banknotes.

**Security features** **4.27** Under the proposed legislation, the Treasury is considering providing the Bank with power to ensure that all notes incorporate adequate security features. Such features should help to deter counterfeiting and to ensure that a genuine note can be easily and reliably distinguished from a counterfeit.

**4.28** To ensure that notes are not able to circulate once their security features have ceased to give sufficient protection against counterfeit attacks, we propose that if a note with particular security features continues to be issued for a period of more than five years, the note's security features would be required to be re-registered on the fifth anniversary of first issuance. At this point the Bank would have the statutory responsibility to satisfy itself that the note's security features continued to be adequate. Thereafter, the note would be required to be re-registered every three years as long as it continued to be issued with the same security features.

**4.29** The proposed legislation would also need to consider how notes already issued and in circulation prior to the commencement of the legislation should be treated. We propose that these notes should be registered but to enable flexibility, their security features would NOT need to be approved by the Bank. Instead, such notes would need to be re-registered after five years, and thereafter every three years, and on each re-registration the Bank would need to be satisfied that the security features continued to be adequate.

**4.30** Complementary to this role, the Treasury is also considering providing the Bank with the power to require all issuing banks to provide adequate educational material to members of the public and businesses in Scotland and Northern Ireland about the security features of their notes. Educating the public is a key weapon in the fight against counterfeiting and in many cases it assists members of the public and businesses in avoiding losses from accepting a counterfeit note. It would also have the effect of making it more difficult to pass counterfeit notes and would therefore help to deter counterfeiting.

**4.31** The proposed legislation would also require the Bank to publish guidelines that impose requirements in respect of security features. The Bank will also publish guidelines on the educational material that issuing banks are expected to provide for the public. These guidelines will be drafted in consultation with all issuing banks together with any other persons the Bank sees fit; they will also be subject to written agreement from the Treasury.

**Denominations** **4.32** In order to ensure that banknotes issued by banks in Scotland and Northern Ireland are adequately protected, in addition to having the power to ensure that notes have adequate security features, the Treasury is also considering providing the Bank with the power to approve the denominational values of banknotes issued.

**4.33** This is intended to ensure that high denomination notes, which are attractive targets for counterfeiters, are not issued, and would be consistent with the Bank's core purpose of maintaining the value and integrity of the currency. The intention is not, however, to remove any existing denominational values from circulation.

**4.34** A similar arrangement exists for Bank of England notes, where the Currency and Bank Notes Act 1954 requires denominations of Bank of England notes to be approved by the Treasury.

**Designs 4.35** Decisions relating to the graphic design of banknotes would be a matter solely for the issuing bank. We do not consider that the Bank or the Treasury should determine the general appearance of Scottish and Northern Ireland banknotes, save to ensure they have adequate security features to deter counterfeiting.

**4.36** However, the Treasury is considering whether the proposed legislation should require each issuing bank to issue only one note design for each denomination at any one time. Having several designs of a denomination in issue at the same time makes it easier to pass counterfeit banknotes.

**4.37** This would also have the effect of bringing the treatment of Scottish and Northern Ireland notes in line with Bank of England notes which only have only one design for each denomination in issue.

**Counterfeit attack 4.38** The Bank in its regulatory role would also need the power to be able to respond effectively and flexibly in the public interest to circumstances involving a major counterfeit attack on a Scottish or Northern Ireland note.

**4.39** One option would be to provide the Bank with the power to require an issuing bank to withdraw a particular note from issue and redeem all such notes with immediate effect. However, such power would only be allowed to be exercised after consultation with the issuing bank concerned and with any persons the Bank sees fit; it would also be subject to the written agreement of the Treasury.

**Q15. What costs and benefits do you see these anti-counterfeiting arrangements generating?**

## NOTE COVER

**Timing 4.40** Under existing legislation, the calculation of note cover is based on average notes in circulation and the average value of note-covering assets at the close of business on each Saturday. Some issuing banks have been replacing the (risk-free and non-interest bearing) note-covering assets maintained at weekends with other assets during the week. It is estimated that issuing banks are themselves currently realising a collective £70 million financial advantage over non-issuing institutions, and that the Exchequer does not obtain the seigniorage<sup>1</sup> income it would collect if notes were backed with Bank of England notes at all times. Under the proposed legislation all issuing banks would be required to back their entire note issue with note-covering assets at all times. To ensure that the notes are being backed at all times the regulatory framework would need to be strengthened by providing the Bank with power to seek information on note issue and note cover beyond the existing practice of obtaining information every Saturday.

<sup>1</sup> Seigniorage income is generated through the issuance of national currency and arises because banknotes and coins cost less to produce and issue than their face value. In the context of banknotes, seigniorage is realised through the profits of the Bank of England Issue Department which have to be paid entirely to the Exchequer under the Currency and Bank Notes Act 1928 and National Loans Act 1968. This profit arises because the liability of the Issue Department (i.e. Bank of England notes) is interest free whilst the assets that back the note issue earn interest.

**Calculation 4.41** Under existing legislation, levels of note cover are calculated using a formula involving the average over a four-week period based on sums held and notes in circulation on each Saturday of that period. This method would need to be amended in the light of the proposed legislation requiring all issuing banks to back the entire note issue in full at all times.

**4.42** The Treasury therefore proposes the following method for calculating note cover levels:

**The total value of notes issued must not exceed the total value of Bank of England notes held as note cover at any time.**

**4.43** Under current accounting and funding arrangements, the calculation for the number of Bank of England notes issued is a daily and incremental one. At the start of each day, banks must have purchased from the Bank of England all the notes that have been placed into circulation at the close of business the previous day, plus the notes they expect to place into circulation during the coming day. Additional purchases of Bank of England notes are required at the close of each day to cover any errors in these forecasts.

**4.44** A similar mechanism for Scottish and Northern Ireland notes can be set up under the proposed legislation. The value of Scottish and Northern Ireland notes issued must not exceed the value of Bank of England notes held as note-covering assets at any time. At the start of each day, therefore, each of the issuing banks must hold Bank of England notes to cover all their notes in circulation at the close of business the previous day, as well as their expected issuance for the coming day. Additional provision of note-covering assets will be required at the close of each day to cover any errors in these forecasts. Additionally the Bank will have the power to require issuing banks to adjust their start of day holdings if there are persistent and sizeable forecast errors.

**4.45** An alternative to specifying in the proposed legislation detailed arrangements for ensuring that Scottish and Northern Ireland note issues are backed with appropriate note-covering assets would be for the legislation to require the Bank to specify requirements on the following matters:

- definition of notes that need to be covered;
- types of assets that can be used as note cover;
- locations and conditions under which the note-covering assets can be held;
- provision of information to the Bank on the value of note issue and note cover; and
- note cover calculation and timing.

**4.46** This would bring the arrangement into line with the accounting and funding arrangements for Bank of England notes issued in England and Wales. Not setting out individual precise requirements in the legislation would also allow for greater flexibility in the arrangements over time.

**4.47** In drafting such requirements the Bank would be required to consult with all issuing banks and any persons the Bank sees fit; these would be subject to the written agreement of the Treasury.

**Q16. We would be interested to receive views and comments on whether the proposed legislation should permit the establishment of an arrangement similar to that for accounting for the value of Bank of England notes in issue instead of setting out in detail the note cover structure in the legislation itself.**

## BANK RETURNS

**Provision of information to the Bank of England** **4.48** Under existing legislation, in support of the calculations for cover required, issuing banks submit a weekly return to Stamp Taxes setting out the value of notes in circulation and value of note-covering assets as at close of business on Saturday.

**4.49** For consistency with the arrangements for Bank of England notes, the proposed new reporting arrangements would be on a daily basis in line with the revised calculations for notes in issue.

**Publication** **4.50** Under existing legislation, Stamp Taxes is required to publish returns showing the value of notes issued and note cover by each issuing bank in the London, Edinburgh and Belfast Gazettes.

**4.51** We propose to allow the Bank to publish the returns of each issuing bank in whatever manner it deems appropriate. This would enable the Bank to publish the information on its website or in its annual report which would have the effect of reaching a much wider audience.

**4.52** We also propose that all returns that are published should be signed by the Bank's Chief Cashier or, in his or her absence, by any person acting on his or her behalf such as a Deputy Chief Cashier. This would bring it in line with the arrangement in respect of the weekly Bank of England Return.

**Format** **4.53** The format of the return is currently set out in the legislation. In order to provide greater flexibility, especially to respond to technological changes that would inevitably arise over time, the Treasury is considering using the proposed legislation to provide the Bank with the power to determine the format of the return.

## PENALTIES

**4.54** Under existing legislation a penalty is imposed equal to the value of notes not backed with sufficient and appropriate note-covering assets i.e. £1 for every £1 not backed. In modernising the note issue arrangement we will consider introducing an alternative penalty structure.

**Q17. We would be interested to receive views on a suitable and appropriate penalty structures for failure to provide sufficient note cover.**

**Q18. We would also be interested in views on a suitable and appropriate penalty structure for failure to provide the required information to the Bank on time.**

**4.55** Under the proposed new regulatory framework, all penalties collected by the Bank would be paid over to the Treasury.

## TRANSPARENCY OF THE NOTE ISSUE ARRANGEMENT

**Information 4.56** To ensure that note holders' interests are protected at all times and that the integrity of the currency is maintained, a more modern regulatory framework would need to be established. This would be done by requiring issuing banks to submit the following information (in addition to the value of note issue and cover): monthly data on the number of counterfeit notes taken out of circulation by denomination; and an annual external audit assurance of an issuing bank's note issue figures.

**4.57** Providing an external audit of note issue figures would be necessary to obtain independent verification of note issue and avoid the implications for note holders in the unlikely event of an underestimate combined with insolvency.

**Q19. What other information should issuing banks provide to the Bank and how often should this be provided?**

**Q20. What costs and benefits do you see these information and auditing arrangements generating?**

**Publication 4.58** Under the proposed legislation the Bank of England would be required to make publicly available information about the note issue arrangements for banks in Scotland and Northern Ireland. It would also have the power to publish this information in any manner it sees fit, for example on its website and/or in its annual report. This would have the effect of reaching a much wider audience than publication in the London Gazette.

**4.59** The Treasury does not propose to make it a statutory requirement for issuing banks to publish information on their note issue, other than educational material for the public on the features of their notes. This is because it would be more administratively convenient for note holders to have all the necessary information on the note issue arrangement of banks in Scotland and Northern Ireland in one place, maintained by the Bank. It would also avoid unnecessary regulatory burden on the banks concerned.

**4.60** The proposed legislation would require the Bank to make publicly available the following information:

- Value of notes issued by each note issuing bank in Scotland and Northern Ireland;
- Value of Bank of England notes held as note-covering asset by each note issuing bank;
- Cost of regulating the note issue of banks in Scotland and Northern Ireland during the Bank's financial year;
- Total value of penalties collected during the Bank's financial year; and
- The numbers of counterfeit notes taken out of circulation by each issuing bank by denomination.

**Q21. What other information on the note issue arrangement of banks in Scotland and Northern Ireland should be published by the Bank?**

**Q22. What costs and benefits do you see these publication arrangements generating?**



# PARTIAL REGULATORY IMPACT ASSESSMENT

## TITLE OF PROPOSAL / PROPOSED REGULATION

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**4.61** Strengthening the note issuing arrangements of banks in Scotland and Northern Ireland

## PURPOSE AND INTENDED EFFECT OF MEASURE

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### Objective

**4.62** Promoting stable, fair and efficient financial markets, for users and for the economy by:

- Providing a level playing field for all commercial institutions with respect to the costs of supplying banknotes, whether their own or those of another issuing bank;
- Ensuring that note holders, as creditors, can obtain value for their notes; and
- Ensuring there is a single and appropriate body responsible for regulating the issuance process for all notes issued in the UK.

**4.63** These objectives will in turn be achieved by:

- Amending existing legislation so as to require issuing banks to hold sufficient risk free note-covering assets (typically Bank of England notes) at all times;
- Strengthening the regulatory framework including the transfer of current administrative responsibilities from the Commissioners for Revenue and Customs to the Bank of England; and
- Earmarking the note-covering assets specifically for the benefit of the holders of Scottish and Northern Ireland banknotes.

**4.64** In order to ensure that the proposed earmarking arrangements work as effectively as possible, amendments to the existing note issue arrangements will need to be made. These would also have the effect of modernising the note issue arrangements and providing for greater transparency. The changes would:

- Clearly define the scope of banknotes that have to be backed with note-covering assets as including all notes held by an issuing bank. This would include all notes that are in circulation, together with notes that have the potential to enter circulation (such as those in ATMs);
- Enable banks to manage their stocks of notes in a flexible way, by allowing them to store certain notes that are not required to be backed with note-covering assets;
- Make Bank of England notes the sole note-covering assets, and abolish the use of coin for this purpose;
- Abolish the practice of holding the note-covering assets other than at the Bank of England;

- Abolish the fiduciary level which enables a small proportion of Scottish and Northern Ireland notes in circulation not to be backed with note-covering assets;
- Provide for the issuing banks or the Bank of England ('the Bank') to hold the note-covering assets on trust for note holders. In the event of an issuing bank becoming insolvent, the issuing banks or the Bank would have a statutory responsibility to pay out claims by the note holders from the note-covering assets;
- Provide that all penalties due under the proposed regulatory regime will be paid over to the Treasury. This should reinforce the impartiality of the Bank in its new regulatory role;
- Set up a Bank Note Register containing details of all notes issued, to be maintained by the Bank of England;
- Give the Bank responsibility for ensuring that there are adequate security features built into Scottish and Northern Ireland notes and that educational material is made available to the public, in order to deter counterfeiting;
- Make issuing banks provide information to the Bank to support the above requirements; and
- Make issuing banks provide the Bank with information on numbers of counterfeit notes taken out of circulation, and with external quality assurance on their note issue figures.

## Who it will affect

**4.65** The Bank of England and HM Revenue and Customs (Stamp Taxes) will be directly affected. Stamp Taxes will be able to focus its resources more on those activities that are core to its objectives. Making the Bank responsible for regulating the issuance of notes by banks in Scotland and Northern Ireland would ensure there was a single and appropriate body responsible for regulating the issuance process for all notes issued in the UK. This would further enable the Bank to pursue its core purpose of ensuring monetary stability, which involves maintaining confidence in the value and physical integrity of the currency. The Bank would also be better placed to assume these responsibilities, given its skills and expertise in the area of banknotes.

**4.66** Also directly affected will be banks in Scotland and Northern Ireland who issue their own notes. They will need to submit information on their note issue to the Bank of England instead of Stamp Taxes and will need to do so on a more regular basis than currently required. They will also need to ensure that all their notes in circulation (including notes, such as notes in ATMs, that have the potential to enter circulation) are backed in full with sufficient and appropriate note-covering assets at all times.

**4.67** Indirectly the changes will affect holders of Scottish and Northern Ireland notes as they will be able to claim on the note covering assets so as to recover value for their notes in the unlikely event of an issuing bank becoming insolvent. Non-issuing institutions will benefit from a more level playing field with respect to the costs of supplying banknotes. The changes may also affect other creditors of the banks concerned. The consultation intends to establish the extent of any likely impact.

## BACKGROUND

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**4.68** The issuance of national banknotes is usually a monopoly of the central bank, which in the United Kingdom is the Bank of England. Scotland and Northern Ireland are among a few places in the world where a limited number of commercial banks are permitted to issue their own banknotes. This privilege is set out in the Bank Notes (Scotland) Act 1845 and Bankers (Northern Ireland) Acts 1845 and 1928.

**4.69** The banks that are permitted to issue banknotes in Scotland are Bank of Scotland; Clydesdale Bank; and Royal Bank of Scotland. The banks that are permitted to issue banknotes in Northern Ireland are Bank of Ireland; First Trust Bank; National Bank; Northern Bank; and Ulster Bank.

**4.70** Branches of these banks based outside Scotland and Northern Ireland are not permitted to issue banknotes although their notes may be found in circulation outside Scotland and Northern Ireland. Under the Currency and Bank Notes Act 1954, banknotes issued by the Bank of England are permitted to be put into circulation in Scotland and Northern Ireland as well as in England and Wales.

**4.71** The 1845 Acts requires all Scottish and Northern Ireland issuing banks to back their note issues, above a small set fiduciary level, with note-covering assets comprising silver and gold coins. The Currency and Bank Notes Act 1928 extended the definition of note-covering assets to include notes issued by the Bank of England. Today Bank of England notes are the main asset used to back the notes issued by Scottish and Northern Ireland banks.

**4.72** The note-covering assets may be held at an issuing bank's head office or principal place of issue; and/or held at a maximum of two offices in Scotland / Northern Ireland approved by HM Treasury; and/or, held at the Bank of England on behalf of the issuing bank. Currently they are held mainly at the Bank of England.

**4.73** Under the 1845 Acts, the Commissioners for Revenue and Customs (Stamp Taxes) were charged with carrying out certain administrative arrangements concerning the Scottish and Northern Ireland note issues. Stamp Taxes has to ensure that each bank's average amount of notes in circulation over specified four-week periods does not exceed the average value of covering assets over the same four-week periods. The averages are based on the value of notes in circulation and the covering assets at the close of business on each Saturday.

## RISK ASSESSMENT

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### Level Playing Field

**4.74** Under existing legislation, the calculation of note cover is based on average notes in circulation and the average value of note-covering assets at the close of business on each Saturday. Some issuing banks have been replacing the (risk-free and non-interest bearing) note-covering assets maintained at weekends with other assets during the week. It is estimated that issuing banks are themselves currently realising a collective £70 million financial advantage over non-issuing institutions, and that the Exchequer does not obtain the seigniorage<sup>1</sup> income it would collect if notes were

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<sup>1</sup> Seigniorage income is generated through the issuance of national currency and arises because banknotes and coins cost less to produce and issue than their face value. In the context of banknotes, seigniorage is realised through the profits of the Bank of England Issue Department which have to be paid entirely to the Exchequer under the Currency and Bank Notes Act 1928 and

backed with Bank of England notes at all times. Under the proposed legislation all issuing banks would be required to back their entire note issue with note-covering assets at all times. To ensure that the notes are being backed at all times the regulatory framework would need to be strengthened by providing the Bank with power to seek information on note issue and note cover beyond the existing practice of obtaining information every Saturday.

**4.75** An additional £10 million seigniorage may be lost from banks not being required to back notes held as till money or in ATMs.

**4.76** Based on Bank of England figures for January to April 2005, the average reduction in Bank of England notes held as note-covering assets by the Bank of England from those held on Saturdays to those held during the week on behalf of the issuing banks is around £2.5 billion.

**4.77** If these note-covering assets were held for the full seven days (as originally intended by the 1845 Acts) instead of the current three days then the Bank and ultimately the Exchequer would have earned about £119 million a year (4.75% of £2.5 billion) instead of the £49 million (3/7th of £119 million as it is invested for only three days) currently received. The issuing banks are profiting collectively by the same amount.

**4.78** The existing regime therefore enables the issuing banks concerned to enjoy a financial advantage over non-issuing institutions. Non-issuing institutions have to purchase notes from either the Bank of England or from another issuing bank in order to provide notes to their customers or to store as till money and in ATMs. In addition to this financial advantage, a commercial bank issuing its own notes enjoys the additional, if unquantifiable, benefits of prestige and advertising.

## Protecting Note Holders

**4.79** Under existing legislation, beyond requiring issuing banks to hold note-covering assets, the precise purpose of these note-covering assets is not set out. There is no provision in the legislation requiring that, in the event an issuing bank becomes insolvent, note holders be given value for their notes from the note-covering assets in priority over all other creditors. As the notes themselves do not confer preferred creditor status, note holders may not receive value for the notes they hold. It is possible that note holders would claim that the intention of the legislation was to ensure they would be guaranteed value for the notes they held from the note-covering assets and might expect the Government to compensate them accordingly.

## Transfer of Regulatory Responsibility

**4.80** The Treasury do not see the role of Stamp Taxes in administering the issuance of banknotes as central to the objectives of HM Revenue and Customs. Transferring these responsibilities to the Bank would, however, be consistent with the core purposes of the Bank.

**4.81** The Treasury does not foresee any conflict of interest between the regulatory responsibility that is being proposed and the Bank's existing role as a note issuer. The Bank is publicly owned and the profits of its own note issue are paid to the Treasury.

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National Loans Act 1968. This profit arises because the liability of the Issue Department (i.e. Bank of England notes) is interest free whilst the assets that back the note issue earn interest.

**4.82** All penalties due under the proposed regulatory regime will be paid over to the Treasury.

**4.83** The cost of regulating the issue of Scottish and Northern Ireland notes would be financed from the investment income from the assets backing the issue of Bank of England notes. This would bring it in line with the treatment of Bank of England notes and therefore, the current practice of not charging issuing banks for the cost of regulating the arrangement would continue. We also intend to provide the Bank with statutory immunity for all the functions it carries out under the proposed legislation. This would bring the arrangements into line with the similar statutory immunity that the Financial Services Authority (FSA) has under the Financial Services and Markets Act 2000

## OPTIONS

### Option 1 - Status Quo

**4.84** If no further action were taken then the current situation would continue. Note-issuing banks would continue to have an unfair financial advantage over non-issuing institutions. Note holders would have limited protection in the event of the insolvency of an issuing bank. Stamp Taxes would continue to hold a responsibility that is not core to the objectives and expertise of HM Revenue and Customs.

### Option 2 – Voluntary Agreement

**4.85** A voluntary option would involve the Treasury writing to the chief executives of the issuing banks requesting they hold appropriate note cover at all times and seeking a voluntary arrangement to earmark the note-covering assets for the benefit of note holders. However, this would be a very complicated legal and administrative process with significant risks, not least that in the event of insolvency any voluntary agreement might be set aside or subject to restrictions by existing insolvency legislation.

### Option 3 – Secondary Legislation

**4.86** Transfer of current administrative responsibilities from Stamp Taxes to the Bank of England, using a Contracting-Out Order under the Deregulation and Contracting Out Act 1994. Stamp Taxes would continue to be ultimately responsible for overseeing the issue of Scottish and Northern Ireland notes, although the specific functions involved would be “outsourced” on a day-to-day basis to the Bank of England. The duration of such a contracting order would only last for a maximum of ten years.

**4.87** This would not address the issues of making issuing banks back their note issue in full at all times, nor would it provide protection to note holders in the unlikely event of an issuing bank becoming insolvent.

### Option 4 – Primary Legislation

**4.88** Primary legislation would require that the entire note issues of Scottish and Northern Ireland banks were backed in full with appropriate note-covering assets at all times. It would also provide protection to note holders by ensuring that these note-covering assets were earmarked for their benefit.

**4.89** Legislation would also transfer existing administrative responsibilities from the Commissioners for Revenue and Customs to the Bank of England i.e. a body with the

appropriate objectives and relevant knowledge and expertise to discharge these responsibilities.

## **COSTS AND BENEFITS**

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### **Business Sectors Affected**

**4.90** In Scotland three banks will be affected and in Northern Ireland five banks will be affected. However, some of these banks are owned by other banks, as set out **Annex B**. Whilst there are eight issuing banks, in terms of group ownership six banking groups will be affected.

**4.91** All non-issuing institutions should benefit from a more level playing field with regards to the costs of supplying notes.

## **ASSUMPTIONS**

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**4.92** The following assumptions have been made to calculate the financial advantage issuing banks gain from having notes in circulation not backed with note-covering and holding notes for the purpose of till money and to store in ATMs which are not required to be backed with note-covering assets:

- an interest rate of 4.75% - the current Bank of England repo rate;
- that notes held by an issuing bank as part of their till money and ATMs constitute about 5% of notes in circulation. (**We would welcome a more accurate figure as part of the consultation process**);
- that the number of notes in circulation are constant over time;
- that about £2.5 billion of Scottish and Northern Irish notes are not backed between Monday and Thursday;
- that there are about £4 billion worth of Scottish and Northern Ireland notes in circulation (based on latest figures available from Stamp Taxes);
- that there are about £200 million of notes held by issuing banks as till money, notes held in ATMs and for other purposes – (based on the assumption of 5% of notes in circulation (£4 billion)); and
- that the fiduciary level (amount of notes that are not required to be backed) amounts to £5 million (0.125% of notes in circulation);

**4.93** Any significant changes to the above assumptions would affect the estimated size of the financial advantage issuing banks enjoy over non-issuing institutions. However, in absolute terms the size of the financial advantage would still represent a sufficient amount to justify seeking amendments to the current legislation.

## BENEFITS

### Option 1 - Status Quo / Option 2 - Voluntary Agreement / Option 3 - Secondary Legislation

**4.94** Options 1, 2 and 3 would either fail immediately, or lack the effectiveness and credibility to achieve the desired policy aim. There would be no benefits arising for note holders who would continue to be treated as ordinary unsecured creditors and might not be assured to receive value for their notes from the note-covering assets in the unlikely event of the insolvency of an issuing bank. Non-issuing institutions would continue to be at a financial disadvantage.

### Option 4 - Primary Legislation

**4.95** This option would ensure that:

- note holders would be protected in the event of insolvency by being entitled to claim value for their notes from the note-covering assets;
- all notes (including those held as till money and in ATMs) would be backed in full at all times with appropriate note-covering assets resulting in a level playing field for all banks;
- Stamp Taxes would no longer administer a responsibility that is not core to the objectives of HM Revenue and Customs;
- the Treasury would receive the full seigniorage income from all banknotes issued in the UK; and
- legislation would contribute to the Treasury's objective of promoting efficient, stable and fair financial markets, for users and the economy.

**4.96** This is the only option that would be effective in achieving the policy goal. A legislative solution would ensure that the financial advantage which issuing banks are currently enjoying or have the potential to enjoy would be eliminated. This would level the playing field for all banks. It would also assure note holders.

**4.97** Issuing banks enjoy the prestige, advertising and status they receive from issuing their own notes, which are difficult to quantify in monetary terms. The measures proposed in the legislation, albeit increasing regulation, would not diminish these benefits. Note holders would have greater confidence in using Scottish and Northern Ireland notes knowing they are backed at all times and that in the unlikely event of an issuing bank becoming insolvent they would receive value for their notes from the note-covering assets.

**4.98** The Bank has the appropriate skills, expertise and objectives to manage the regulation effectively and efficiently. It would also ensure Stamp Taxes were able to focus their skills and expertise on its core objective of managing the administration of stamp taxes. We have no estimate in quantitative/monetary terms for the benefit of transferring the regulatory responsibility, but it would represent a more efficient use of resources.

## COSTS

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### Option 1 - Status Quo

**4.99** There are no costs incurred by the banks concerned. Holders of Scottish and Northern Ireland notes continue to be unsecured creditors and would not necessarily receive value for their notes in the unlikely event of insolvency.

- Note holders continue to be exposed to a small credit risk;
- Government continues to allow issuing banks to have an unfair financial advantage with respect to banknote supply over non-issuing institutions;
- The Treasury continues to receive less banknote seigniorage income than it would have if all notes issued in the UK were backed with appropriate assets;
- If an issuing bank were to become insolvent, holders of that bank's notes might not receive value for these notes from the note-covering assets. This could potentially undermine confidence in the entire arrangement by which Scottish and Northern Ireland notes are issued;
- Stamp Taxes would continue to administer a responsibility that is not core to the objectives and skills and expertise of HM Revenue and Customs; and
- The existing regulatory framework would provide no powers to influence anti-counterfeiting measures;

### Option 2 - Voluntary Agreement

**4.100** If adopted, there would be a reduction in the investment income of the banks concerned estimated at £80 million a year as a result of having to back their note issue (including notes held as till money and in ATMs) at all times with note-covering assets. However, holders of Scottish and Northern Ireland notes would continue to rank as unsecured creditors in the unlikely event of an issuing bank becoming insolvent.

- The banks could choose not to comply with the agreement on the basis that they are not currently doing anything unlawful and because they have an ultimate duty to shareholders to take advantage of any legitimate means of making profits;
- Any agreement cannot be guaranteed to be permanent, nor would there be any legal authority to monitor and enforce any voluntary agreement;
- Even if all banks backed all notes in full at all times, note holders might still not be entitled to receive value for their notes from the note-covering assets in the event of an issuing bank becoming insolvent;
- Note holders continue to be exposed to a small credit risk;
- Seeking a voluntary agreement to ring fence the note-covering assets for the benefit of note holders would be very complicated legally and administratively and in the event of insolvency would be superseded by existing insolvency laws; and
- Stamp Taxes would continue to administer a responsibility, which is not core to the objectives and skills and expertise of HM Revenue and Customs.

### Option 3 - Secondary Legislation

**4.101** Contracting out the existing regulatory functions to the Bank of England would not involve any costs to the banks concerned. However, holders of Scottish and Northern Ireland notes would continue to be unsecured creditors in the unlikely event of an issuing bank becoming insolvent.

- The duration of such a contract could only be a maximum of ten years;
- This option would not be able to provide additional and necessary regulatory powers in order to strengthen and modernise the regulatory framework;
- This option fails to ensure that issuing banks back all their note issue (including notes held as till money and in ATMs) at all times;
- The Treasury continues to receive less banknote seigniorage income than it would have if all notes issued in the UK were backed with appropriate assets; and
- If an issuing bank were to become insolvent, note holders of that bank would not be entitled to claim value for their notes from the note-covering assets. This could potentially undermine confidence in the entire arrangement by which Scottish and Northern Ireland notes are issued.

### Option 4 - Primary Legislation

**4.102** We estimate that requiring all issuing banks to back their entire note issue (including notes held as till money and in ATMs) in full at all times with appropriate note-covering assets would result in a reduction in their combined investment income from the assets backing the note issue of about £80 million. This comprises of about £70 million from requiring banks to back notes throughout the week; £10 million for ensuring notes held by an issuing banks as till money and in ATMs are backed; and, £0.25 million from abolishing the fiduciary level.

**4.103** The change does not discriminate against note-issuing banks in Scotland and Northern Ireland. Non-issuing institutions have no access to a comparable investment income because they must purchase banknotes from either the Bank of England or from an issuing bank. Issuing banks would forgo this income if all banks in the UK issued only Bank of England notes or a bank decided to stop issuing notes. We do not see this as an incentive for any issuing bank to discontinue note issuance and it is not intended to stop issuing banks from issuing their own notes.

**4.104** Any issuing bank that currently complies with the spirit of the legislation and holds sufficient and appropriate note-covering assets at all times would not be affected by the changes. We do not expect the £80 million to be passed to consumers through higher banking charges but rather to shareholders of the issuing banks that are currently enjoying this financial advantage.

**4.105** We do not foresee any financial costs to the issuing banks as a result of earmarking the note-covering assets specifically for the benefit of note holders. However, an aim of the consultation is to establish whether there is an impact.

**4.106** We do not foresee any significant impact on the cost of issuing notes as a result of providing the Bank with the power to ensure there are **adequate security features** contained in the notes to deter counterfeiting and to ensure issuing banks are providing

**adequate educational material** to the public about the identification and security features of their notes. We would expect these notes to contain adequate security features already and all future note issues to do likewise. Similarly, we would already expect issuing banks to be providing adequate information to the public about their notes' identification and security features. Rather, the proposed measures are aimed at defining a new regulatory framework in order to provide reassurance to note holders as well as the wider public that the integrity of the currency is being maintained. Ensuring there are adequate note security features to deter counterfeiting is ultimately to the advantage of the banks concerned, as it would provide greater confidence to note holders in using these notes.

**4.107** We do not foresee a substantial cost arising as a result of setting up a **banknote register** or providing **information on the number of counterfeits withdrawn from circulation**. Most note issuing banks already collate this information and registering a note is not a task that would entail a major administrative burden, especially as banknotes are not issued or withdrawn frequently.

**4.108** There would, however, be an increase in costs for issuing banks as a result of having to provide **information on the value of their notes issued on a more regular basis** and provide **an annual external quality assurance audit of their note issue figures**. We have no estimate of these costs but we would expect issuing banks at present to collate information on their note issue on a daily basis and as a result, we do not foresee a very substantial increase in their administrative cost for managing their note issue. However, the consultation will assist us in determining the scale of this cost.

**4.109** Overall, we do not foresee that any of the proposed measures would act as an incentive for any issuing bank to discontinue their note issuance. The benefits that accrue to a commercial bank from issuing their own notes - advertising, status and prestige - outweigh the financial costs. The proposed measures are intended to strengthen this long standing arrangement by providing note holders with the confidence that their notes are backed at all times and that they would be entitled to claim value for their notes from the note covering assets in the unlikely event of insolvency.

## **ENVIRONMENTAL AND SOCIAL COSTS AND BENEFITS**

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**4.110** We do not foresee any environmental or social costs or benefits.

## **EQUITY AND FAIRNESS**

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**4.111** Key groups that could be disproportionately affected or disadvantaged under each option:

**4.112** Option 4 (pursue primary legislation) will improve equity and fairness. It will provide a level playing field for all banks and ensure holders of Scottish and Northern Ireland notes are able to receive value for their notes from the note-covering assets in the unlikely event of insolvency. Those issuing banks that do not currently back their notes at all times will be disadvantaged.

**4.113** Options 1, 2 and 3 would disadvantage the following groups:

- **Non-issuing institutions**, who have to continue to purchase in full and at all times, sufficient Bank of England notes or notes from an issuing bank to

issue to their customers and to store as till money and in ATMs. This puts them at a financial disadvantage compared with the issuing banks; and

- **Note holders** of Scottish and Northern Ireland banknotes would not be protected in the unlikely event of an issuing bank becoming insolvent.

## SMALL FIRMS' IMPACT TEST

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**4.114** None of the measures proposed would have any impact on small businesses (or for that matter any other type or size of business) even if they were heavy users or holders of Scottish and Northern Ireland notes. Compared to the status quo, earmarking of note-covering assets specifically for the benefit of note holders would increase financial protection for small businesses (or for that matter any other type or size of business) that carry out cash transactions and hold Scottish and Northern Ireland notes.

## COMPETITION ASSESSMENT

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**4.115** Annex C provides information about each Scottish issuing bank's share of Scottish notes in circulation and each Northern Ireland issuing bank's share of Northern Ireland notes in circulation based on average notes in circulation on selected dates between December 2004 and February 2005.

**4.116** We have undertaken a competition assessment test and there is no detrimental impact on competition. On the contrary, ensuring that all notes issued by Scottish and Northern Ireland issuing banks are backed in full at all times with note-covering assets would provide a level playing field for all banks.

**4.117** If an option other than a legislative route is taken it would continue to provide issuing banks with a financial advantage over their non-issuing rivals estimated at £80 million a year. Neither existing nor the proposed legislation enables any commercial bank to issue their own notes other than the banks listed in the 'background' section (who were already established as note issuers prior to the 1845 Acts).

## COMPENSATORY SIMPLIFICATION MEASURES

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**4.118** The note issue arrangements of banks in Scotland and Northern Ireland are 160 years old and our proposed changes are designed to modernise the arrangements, bringing them in line with the note issue arrangement of the Bank of England. Ensuring notes are backed at all times and earmarking the note-covering assets for the benefit of note holders is not introducing new regulation but ensuring that the provisions of existing legislation are strengthened so that notes are backed throughout the week and note holders are protected.

**4.119** In modernising the arrangement we will ensure where possible that note issuing banks are not confronted with a heavy regulatory burden.

**4.120** Examples of these simplification measures are as follows:

- We do not propose to charge issuing banks for the cost of regulating the note issue arrangement. It should be noted, however, that charging an industry for the costs of its regulation is not uncommon;
- The consultation is seeking views on whether an alternative penalty regime should replace the current regime;

- We propose to provide banks with the flexibility to hold notes that are not required to be backed with note-covering assets under certain conditions;
- The proposed legislation would also require the Bank to consult with all issuing banks when preparing guidelines that impose requirements in respect of security features;
- We do not propose to make it a statutory requirement for issuing banks to make information on their note issue arrangements publicly available; and
- We are looking into the possibility of amending the legal treatment of cheques in Scotland which would remove an administrative expense to Scottish clearing banks estimated to cost them £270 000 a year each. These measures would improve the cash flow of small businesses and bring the treatment of cheques in line with practice followed in other parts of the UK. All three note issuing banks in Scotland (as well as non issuing banks) would benefit from this amendment.

## ENFORCEMENT AND SANCTIONS

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**4.121** The Commissioners for Revenue and Customs (Stamp Taxes) currently oversee the arrangements by which Scottish and Northern Ireland banknotes are issued. The proposed legislation will transfer all regulatory (monitoring and enforcement) responsibilities from Stamp Taxes to the Bank of England. This would ensure there is a single and more appropriate body responsible for regulating the issuance process for all notes issued in the UK, which would be consistent with the Bank's core purpose of ensuring monetary stability.

**4.122** Under existing legislation an issuing bank which fails to cover their note issue is charged an amount equal to the value of notes not backed with appropriate note-covering assets. In modernising the note issue arrangement we will consider introducing an alternative penalty structure. The proposed legislation seeks to ensure all penalties due under the proposed regulatory regime will be paid over to the Treasury.

## MONITORING AND REVIEW

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**4.123** The Treasury will undertake a review within three years of the legislation coming into force. We will seek views from all issuing banks, their representative bodies and from the Bank of England on the workings of the new regulatory regime.

## SUMMARY AND RECOMMENDATION

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**4.124** Primary legislation is the only effective and credible way of strengthening the long standing tradition by which banks in Scotland and Northern Ireland issue their own notes.

**4.125** The proposed regulatory amendments will provide a level playing field for all banks as well protection for note holders. **Ultimately, to the advantage and benefit of all issuing banks.**

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## MINISTERIAL DECLARATION

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**4.126** I have read the Regulatory Impact Assessment (RIA) and I am satisfied that the benefits justify the costs.

Ivan Lewis MP  
Economic Secretary to the Treasury  
HM Treasury

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## CONTACT POINT

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# B

## NOTE ISSUING BANKS OWNERSHIP STRUCTURE

**Table B.1: Group ownership structure of note issuing banks in Scotland and Northern Ireland**

<b>Issuing Bank:</b>	<b>Owned by:</b>
<b>Scottish Issuing Banks:</b>	
Bank of Scotland	Halifax Bank of Scotland (HBOS)
Royal Bank of Scotland	Royal Bank of Scotland (RBS) Group
Clydesdale Bank	National Australia Bank (NAB) Group
<b>Northern Ireland Issuing Banks:</b>	
Bank of Ireland	Bank of Ireland (BOI) Group
First Trust Bank	Allied Irish Banks (AIB) Group
National Bank	Royal Bank of Scotland (RBS) Group
Northern Bank	Danske Bank Group
Ulster Bank	Royal Bank of Scotland (RBS) Group



## C

## SHARE OF NOTES IN CIRCULATION BY ISSUING BANK

**Table C.1: Value and share of banknotes in circulation in Scotland and Northern Ireland by issuing bank (based on average notes in circulation on selected dates between December 2004 and February 2005).**

Issuing Bank	Notes in circulation (£million)	Share of non-Bank of England notes in Scotland (%)	Share of non-Bank of England notes in Northern Ireland (%)
Bank of Scotland	812	30	-
Royal Bank of Scotland	1,011	37	-
Clydesdale Bank	906	33	-
<b>TOTAL</b>	<b>2,729</b>	<b>100</b>	
Bank of Ireland	535	-	37
First Trust Bank	282	-	20
Northern Bank	303	-	21
Ulster Bank	322	-	22
National Bank	0.06	-	0.04
<b>TOTAL</b>	<b>1,442</b>	<b>-</b>	<b>100</b>

*SOURCE: Stamp Taxes*



# D

## HOW TO RESPOND TO THE CONSULTATION

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The deadline for all consultation responses is Friday 16 September 2005. Please address your response to:

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You should note that we propose to make public all responses to the consultation if requested to do so. If you do not want your response to be made publicly available for commercial reasons we advise that you mark any such information as commercially sensitive so that we may endeavour not to disclose it to the extent that such non-disclosure is permissible under the Freedom of Information Act 2000 which the Treasury is subjected to.



# E

## **OBTAINING COPIES OF THE CONSULTATION DOCUMENT**

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An electronic copy of the consultation paper can be downloaded from the Treasury's website at:

[www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

Hard copies can be obtained from:

**Public Enquiries Unit**

**HM Treasury**

**1 Horse Guards Road**

**London**

**SW1A 2HQ**

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ISBN 1-84532-103-0



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