Sterling Monetary Framework Annual Report 2013–14

Overview

This is the first in a new series of annual reports, designed to throw light on the operation of the Bank's published framework for implementing monetary policy and providing liquidity to the banking system, known as the Sterling Monetary Framework (SMF). As recommended by Bill Winters' review of the SMF, the Report draws on the views of a wide range of internal and external stakeholders to identify areas where the SMF works well, and areas where it might be improved. The Bank's Court has reviewed this Report and has endorsed its publication. The key findings are as follows:

Access to the SMF

Membership of the SMF has broadened considerably, from 70 participants in January 2007 to 139 at the end of the 2013/14 financial year. Most of this increase comes from smaller or 'challenger' banks and building societies. SMF members now account for 98% of sterling deposits, and there is a presumption that other banks or building societies meeting the Prudential Regulation Authority's Threshold Conditions are eligible to become SMF members. The Bank is assessing the scope for extending SMF membership to some non-bank financial institutions.

Implementing monetary policy

Overnight market interest rates remained close to Bank Rate — a primary objective of the SMF — throughout 2013/14. But the broader functioning of sterling money markets remained impaired. This reflected the large quantity of excess liquidity injected through quantitative easing, persistent counterparty credit concerns and the impact of regulatory change. Managing down the size of the Bank's balance sheet when the time comes to normalise monetary policy will present a number of practical challenges. In due course, when market expectations point to a near-term rise in Bank Rate, the Bank will review the approach it intends to take to deliver monetary control. Assessing this will require consideration of a number of complex issues, including the functioning of money markets and the future composition of the Bank's balance sheet. The process will take account of the views of SMF participants and other key stakeholders.

Providing liquidity insurance

As the Governor explained when launching the Bank's response to the Winters Review in October 2013, in providing liquidity insurance, the Bank is 'open for business'. Reforms to SMF liquidity insurance facilities announced alongside the Governor's speech — aimed at providing more liquidity at longer terms and cheaper rates — have been widely welcomed. But, as expected, use of the SMF facilities remained low in 2013/14, reflecting the large stock of central bank reserves in the system and banks' improving financial positions. In view of the recent changes to the Bank's facilities, no immediate changes to the SMF are proposed in this Annual Report, but the Bank will remain alert to signs that its facilities are inappropriately stigmatised.

Risk management

The amount of collateral delivered to the Bank for actual or potential use in its facilities (such as the Funding for Lending Scheme and those within the SMF) has increased substantially, and stood at almost £450 billion at the end of February 2014, consisting mainly of portfolios of residential mortgage loans. After valuation and haircuts, this provided banks and building societies with a total drawable value of around £280 billion in the Bank's facilities. In recent years, the range of eligible collateral has been broadened to include portfolios of corporate loans, social housing loans, unsecured personal loans, and revolving credit facilities.

The Bank is conscious of the operational costs of pre-positioning collateral, particularly for smaller firms. It continues to seek ways to reduce these costs where possible without risking public money. The Bank also seeks to set haircuts efficiently. As more accurate information about the risks in pre-positioned collateral becomes available, this may result in some reductions of haircuts from current levels.

Governance

Changes to the internal governance of the SMF were announced in October 2013. First, a new Operations Committee has reviewed the operation of the SMF, and helped develop the changes introduced in 2013/14. This process was overseen by the Oversight Committee of the Bank's Court. Second, the Monetary and Financial Policy Committees have agreed new Concordats setting out the arrangements for consultation and information sharing on SMF issues. Third, there has been more active engagement with internal and external stakeholders. And fourthly, this Report represents the conclusion of a new annual review process.

Introduction

The Sterling Monetary Framework (SMF) sets out the published operational framework under which the Bank uses its balance sheet to implement the monetary policy decisions of the Monetary Policy Committee (MPC) and provide liquidity to the banking system, during periods of both normal and abnormal market conditions. A brief outline of the SMF is provided in the box opposite.(1)

The SMF has been extensively reformed since the peak of the financial crisis. It now contains a much broader and more flexible range of tools for responding to developments than in the pre-crisis era, and is designed to provide a sound basis for supporting monetary and financial stability as the economic recovery progresses. At the same time, a key lesson of the crisis was that central banks must keep their operational frameworks under active review as the markets in which they operate evolve, and as they learn from experience about the efficacy of their tools. This process of review, if managed successfully, should help ensure that the SMF evolves more continuously, reducing the need for further wholesale reform in the future. To assist with that process, the Bank decided, following a review of the SMF commissioned by the Court of the Bank of England(2) and conducted by Bill Winters in 2012,(3) to carry out annual reviews of the SMF. These will draw on the staff's own experience of operating the SMF, together with the views of a wide range of other stakeholders both inside and outside the Bank. This Report sets out the outcome of that review for the Bank's 2013/14 financial year.(4)

The context in which this first Report is published is unusual in a number of respects. First, with Bank Rate at the effective lower bound and with banks and building societies holding a large stock of central bank reserves as a result of the MPC's programme of asset purchases (often referred to as quantitative easing, or 'QE'), some parts of the SMF are either temporarily suspended or have not been used in size for some time. Second, market participants are still working through the implications of the major package of post-crisis regulatory reforms, some of which may affect the way in which they use the SMF. And third, many of the reforms made to the SMF in response to the Winters Review — which itself involved extensive consultation with a wide range of stakeholders — have only recently been introduced, or remain work in progress. Against that backdrop, and looking backwards, the Report perhaps unsurprisingly identifies no other major deficiencies in the current framework. The main challenges to the SMF, however, lie ahead — in particular as monetary policy eventually begins to normalise. The specific areas in which these challenges arise are highlighted later in this Report.

The process of reform triggered by the Winters Review has been a positive development, which the Bank is keen to maintain in the years ahead. The Bank welcomes thoughts or comments from interested parties on this Report or the SMF more broadly. Details of how to submit views are provided at the end of the Report.

The objectives of the Sterling Monetary Framework

The Bank of England's mission is to promote the good of the people of the United Kingdom by maintaining monetary and financial stability. The Bank's operations in the sterling money markets — set out in the Sterling Monetary Framework — directly support this mission by:

(i) **Implementing the Monetary Policy Committee's decisions in order to meet the inflation target.** This is usually achieved by paying interest at Bank Rate on the reserves balances held at the Bank of England by commercial banks and building societies. It currently also involves undertaking any asset purchases — financed by the creation of central bank reserves — and sales mandated by the MPC.

(ii) **Reducing the cost of disruption to the liquidity and payment services supplied by banks and building societies to the UK economy.** The Bank does this by standing ready to provide liquidity in the event of unexpected developments by offering to swap high-quality but less liquid collateral for liquid assets (a so-called 'liquidity upgrade'). When the Bank lends in its operations, it does so against collateral of sufficient quality and quantity to protect itself from counterparty credit risk.

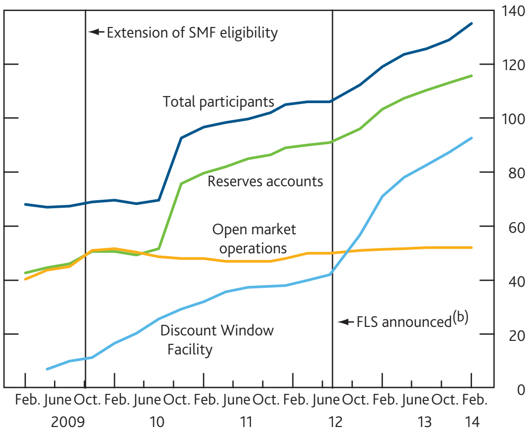
SMF membership

The Bank has broadened access to SMF facilities considerably in recent years. Since October 2013, there has been a presumption that any bank or building society meeting the Prudential Regulation Authority's (PRA's) Threshold Conditions for authorisation is eligible to become an SMF member, subject to the SMF eligibility criteria.(5)

(1) Details of the SMF are in the 'Red Book': www.bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf.
(2) The Court is the Bank of England's Board of Directors. For more information about the Court, see Lees, D and Footman, J (2014), 'The Court of the Bank of England', *Bank of England Quarterly Bulletin*, Vol. 54, No. 1, pages 28–35, available at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q103.pdf.
(3) The Winters Review is available at www.bankofengland.co.uk/publications/Documents/news/2012/cr2winters.pdf. The Bank's response to the Review is available at www.bankofengland.co.uk/publications/Pages/news/2013/124.aspx.
(4) This covers the period from 1 March 2013 to 28 February 2014.
(5) Eligibility criteria are set out in the SMF documentation at www.bankofengland.co.uk/markets/Pages/money/documentation.aspx.

At the end of February 2014, 139 institutions were signed up to the SMF (**Chart 1**), up from 117 at the end of 2012 and 70 in January 2007. The operational requirements associated with SMF membership and pre-positioning collateral can initially be a challenge for smaller firms but, through working closely with the Bank, a large number have now signed up. Indeed, banks and building societies accounting for 98% of sterling deposits are now SMF members.

Chart 1 Number of institutions with access to the SMF[(a)]



(a) Quarterly averages.
(b) FLS is the Funding for Lending Scheme, launched on 13 July 2012.

Two main factors have encouraged increased SMF membership in recent years:

- The eligibility to apply for a reserves account at the Bank (part of the SMF) was widened to smaller institutions in October 2009 to give them a flexible way to hold the sterling portion of their liquid asset buffer. This led to an increase in the number of institutions with SMF access from 2010, after the submission and processing of applications.

- The launch of the Funding for Lending Scheme (FLS)[(1)] in July 2012 required banks and building societies who wanted access to the scheme to sign up for the Discount Window Facility (DWF), which is part of the SMF.

The Bank maintains close dialogue with all SMF participants, through regular contacts with the Bank's sterling dealing desk and by assigning a dedicated relationship manager to each firm. Relationship managers are responsible for understanding the business models of their firms in order to help support SMF participation, to ensure that the Bank is aware of developments in key sterling markets, and to support the Bank's wider policy goals and market intelligence efforts. The Bank also engages with SMF stakeholders through the Money Market Liaison Group (MMLG) and other fora.

As part of the reforms to the SMF announced in October 2013, the Bank is investigating the scope for expanding SMF access further to reflect the increasing role of non-banks and capital markets. Work on developing a possible framework for implementing this reform is currently under way.

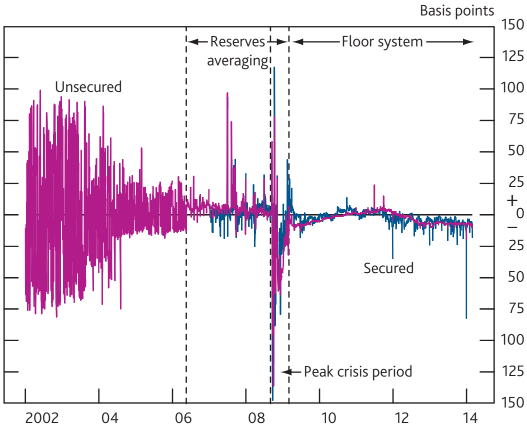
As part of its response to the Winters Review, the Bank has relaxed its previous rule allowing only one legal entity per banking group to have a reserves account. Groups facing regulatory or legal barriers to the movement of liquidity or collateral intragroup (including, in due course, those required by the ring-fencing rules in the Banking Reform Act) may now be able to hold more than one reserves account. The Bank is currently implementing this new policy.

Implementing monetary policy

The first purpose of the Sterling Monetary Framework is to implement decisions made by the MPC. Since March 2009, when QE was initiated, this has involved maintaining overnight market rates in line with Bank Rate and undertaking asset purchases financed by the creation of central bank reserves. Bank Rate was maintained at 0.5% throughout the 2013/14 financial year.

The Bank currently keeps overnight market rates in line with Bank Rate by paying Bank Rate on all cash held in reserves accounts. This 'floor' system remained effective in keeping market rates close to Bank Rate during 2013/14 (**Chart 2** and **Table A**). Indeed, throughout most of 2013/14, volatility of overnight interest rates remained at historically low levels. Secured overnight interest rates remained slightly more volatile than unsecured rates, in part reflecting fluctuations in the availability of collateral in the market.

Chart 2 Spread of sterling overnight interest rates to Bank Rate[(a)]



Sources: Wholesale Markets Brokers' Association (WMBA) and Bank calculations.

(a) In the brokered secured market, interest rates are represented by the repurchase overnight index average (RONIA), the daily weighted average interest rate of transactions secured against UK government debt, brokered by members of the WMBA. Interest rates in the brokered unsecured market are represented by the sterling overnight index average (SONIA), which is the daily weighted average interest rate of unsecured overnight transactions brokered by WMBA members. For further details on RONIA and SONIA, see www.wmba.org.uk.

(1) For more details on the FLS, see www.bankofengland.co.uk/markets/Pages/FLS/default.aspx.

Table A Deviation of sterling overnight interest rates from Bank Rate[a]

Basis points	Mean		Standard deviation	
	Unsecured	Secured	Unsecured	Secured
Pre-reserves averaging[b]	-4	–	37	–
Reserves averaging:				
to August 2008[c]	6	3	9	11
peak crisis[d]	-27	-19	29	34
Floor system:				
to February 2013[e]	-2	-1	4	5
in 2013/14[f]	-7	-7	1	6

Sources: WMBA and Bank calculations.

(a) The secured and unsecured rates are RONIA and SONIA respectively, as defined in **Chart 2**. (RONIA data not available before January 2007.)
(b) January 2002–May 2006.
(c) May 2006–August 2008.
(d) September 2008–March 2009.
(e) March 2009–February 2013.
(f) March 2013–February 2014.

The tendency for unsecured interest rates to trade slightly below Bank Rate throughout 2013/14 reflected the fact that some lenders without reserves accounts at the Bank were willing to lend cash overnight at below Bank Rate. Reserves account holders chose not to arbitrage away all of this difference — by accepting deposits at below Bank Rate and placing them in their reserves accounts at Bank Rate — in part because doing so would increase gross balance sheet metrics, including reported leverage ratios.

Secured overnight interest rates fell sharply on the last day of 2013, with RONIA (the brokered, secured overnight interest rate average) falling to -0.32%, compared with +0.35% the previous day. SONIA (the brokered, unsecured overnight interest rate average), fell by somewhat less, from +0.42% to +0.31%. According to market contacts, this reflected the reluctance of financial institutions to borrow cash over year end, as this was a key reporting date for balance sheets, including for published leverage ratios. As a result, non-bank market participants without access to a reserves account at the Bank were able to lend only at reduced rates. Market rates recovered the next business day. Contacts reported that the majority of investors were well prepared for year end, having discussed in advance with counterparties how much cash they would be able to place.

The Bank pays close attention to the money markets because they are intimately linked with the SMF: interbank transactions are settled directly or indirectly by transfers between banks' reserves accounts at the Bank and so the sterling interbank market is also a market for sterling reserves balances. In the presence of a floor system with a large-scale injection of reserves, however, there is less need for banks to manage their liquidity actively among themselves and so there is much less activity in money markets at present. Overseas money markets, including in the United States[1] and euro area,[2] have also seen declines in activity.

According to market participants responding to the most recent MMLG Sterling Money Market Survey,[3] functioning in the sterling unsecured market — and the interbank market in particular — remained impaired. Incentives for banks to trade on an unsecured basis were low, with many instead allowing their reserves balances at the Bank to fluctuate in response to daily payment needs. As a result, estimated activity in the unsecured overnight money market has fallen since 2007–08, but has been stable at around £40 billion since 2012.[4]

A range of factors are bearing down on money market activity at present, some temporary — most importantly, the impact of QE — but others with potentially more lasting effects. For example, global liquidity standards will be introduced for the first time through the Basel III framework, which includes the Liquidity Coverage Ratio (LCR). The LCR will require banks and building societies to hold a stock of high-quality liquid assets against net wholesale outflows during a 30-day stress scenario. Many MMLG survey respondents felt that, in addition to credit risk concerns, existing and prospective liquidity regulations had limited their appetite to transact in the unsecured market.

By contrast, the secured money market continued to function well during most of 2013/14. Secured trades make up around two thirds of the money market turnover reported in the MMLG survey. Market contacts suggested that the preference for secured trading reflected liquidity regulations and a continued aversion to lending unsecured to other banks. That said, secured trading volumes declined by 15% in the six months to November 2013. Contacts suggested that a contributory factor could have been an increased focus on leverage and other metrics of balance sheet usage in anticipation of regulatory requirements.

Some of the temporary factors bearing down on money market activity may abate. One key influence will be the system of monetary control that the Bank will choose to operate as monetary policy normalises. Some possible frameworks — including in particular the pre-crisis system of 'reserves averaging' (see the box on page 222) — require banks and building societies to manage their liquidity actively and so are likely to result in some recovery in money market activity, perhaps especially in the secured market. Other frameworks imply less active use of short-term money markets. As recommended in the Winters Review, the Bank will review its presumption of returning to reserves averaging (as opposed to retaining the floor system or adopting some other approach)

(1) See www.newyorkfed.org/markets/omo/omo2013.pdf.
(2) See www.ecb.europa.eu/pub/pdf/other/euromoneymarketsurvey 201311en.pdf??e34259b291b21d9dee4bc45bcc611b95.
(3) Available at www.bankofengland.co.uk/publications/Documents/other/markets/mmlg/smms2013h2.pdf.
(4) The MMLG survey accounts for all interbank and non-interbank activity in the sterling money market. This is in contrast to SONIA, which covers brokered transactions only.

Reserves averaging

Before the start of the financial crisis, the Bank used a 'reserves averaging' system for implementing monetary policy.

In the reserves averaging scheme, for each reserves maintenance period (running from the date of one MPC policy decision to the next) the MPC set the reserves remuneration rate (Bank Rate) and each scheme participant set a target for the average amount of reserves they would hold, taking into account their own liquidity management needs. They could adjust their targets from maintenance period to maintenance period if those needs changed. And within each maintenance period, a bank could vary its reserves holdings from day to day. Those holdings were remunerated at Bank Rate so long as they were, on average over the maintenance period, within a small range around the target.

Average reserves outside the target range attracted a charge. But a bank could avoid that charge by making use of the Bank's Operational Standing Facilities (OSFs). These bilateral facilities allow banks to borrow overnight from the Bank (against high-quality collateral) at a rate above Bank Rate or to deposit reserves overnight with the Bank at a rate below Bank Rate. Commercial banks will typically be unwilling to deal in the market on worse terms than those available at the Bank. So these facility rates acted as a ceiling and floor in rate setting, forming an interest rate corridor around the rates at which banks were willing to deal in the market.

The Bank undertook to supply, in aggregate, the reserves that banks needed to meet their collective targets. It used its open market operations (OMOs) to achieve that, settled by movements on and off banks' reserves accounts. But the supply of reserves was affected not only by OMOs but also by other transactions undertaken by the Bank. For example, when demand for banknotes increased, banks paid for the additional notes with reserves from their accounts at the Bank. The net amount of reserves which the Bank aimed to supply in its OMOs therefore reflected not only the banks' demand for reserves, expressed in their reserves targets, but also the predicted impact of these other factors.

For more details see 'The Bank's money market framework', at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb100404.pdf.

when market prices suggest a near-term increase in Bank Rate. Assessing this will involve considering a number of complex issues such as the functioning of money markets, and interacts with wider considerations on the future composition of the Bank's balance sheet. This work will take account of the Bank's policy objectives and the views of SMF participants and other key stakeholders.

Providing liquidity insurance

The second purpose of the SMF is to provide liquidity insurance to banks and building societies, by offering to swap high-quality but less liquid collateral for liquid assets. The objective is to reduce the cost of disruption to the liquidity and payment services supplied by banks and building societies to the UK economy. The Court of the Bank commissioned a review into the operation of the SMF by Bill Winters in 2012. As the Governor explained when launching the Bank's response to the Winters Review in October 2013, in providing liquidity insurance, the Bank is 'open for business'.(1) The SMF operates according to four main principles:

- **Availability.** The Bank stands ready to provide solvent participants with highly liquid assets in exchange for a wide range of collateral assets of good credit quality but lower market liquidity in sufficient size and at an appropriate maturity.

- **Appropriate terms.** The terms of the Bank's liquidity insurance facilities are set so as to ensure that SMF participants have the incentive to manage their liquidity primarily through markets in normal times.

- **Clarity.** The Bank aims to give SMF participants as much certainty as possible about the circumstances in which they can expect to borrow from SMF facilities, so they can plan ahead.

- **Flexibility.** Given the difficulty of knowing where future liquidity risks will emerge, the Bank maintains a range of liquidity insurance facilities capable of tackling a wide variety of eventualities.

Although the liquidity insurance facilities provided by the Bank were used extensively during the financial crisis, lending via these facilities has been lower in recent years. This reflects a number of factors, including the improving financial positions of banks and building societies, and the greater liquidity provided by the Bank through QE and, more recently, the FLS. As a result, the Bank's liquidity insurance facilities saw relatively modest use in 2013/14 (**Chart 3**).

Significant changes were announced to the Bank's liquidity insurance facilities in October 2013 in response to the Winters Review. These included changes to the three main liquidity insurance facilities — the Indexed Long-Term Repo (ILTR) facility, Discount Window Facility (DWF) and Contingent Term Repo Facility (CTRF). These are summarised in the box on page 223.

(1) See www.bankofengland.co.uk/publications/Pages/speeches/2013/690.aspx.

Key changes announced in October 2013

The Bank introduced a number of significant changes to the SMF in late 2013 and early 2014, designed to reduce stigma and increase the flexibility of the Bank's ability to provide liquidity insurance:

- The monthly market-wide ILTR auctions were expanded in February 2014, with reduced prices, a longer maturity and a wider range of eligible collateral. An important innovation in the design of the new ILTR auctions is that they are responsive to market conditions, with the amount of liquidity available rising automatically if there is greater demand, in contrast to the fixed-size auctions used previously.

- The bilateral DWF was repriced, introducing significantly lower, flat-rate 'entry fees', and smoothing the increase in fees for higher usage. The Bank sought to reduce the financial stability risks posed by premature disclosure of DWF drawings, by extending its own disclosure lag and ensuring that firms have the capacity to turn over their liquid assets in repo markets regularly. The Bank continues to argue the case for ensuring that new national and international liquidity disclosure regimes do not increase that risk through other channels.

- The market-wide CTRF was retained, allowing the Bank to provide whatever liquidity is required in conditions of actual or prospective market-wide stress, against the widest range of collateral, and at a price it chooses.

- The Bank's list of eligible collateral, which had already expanded significantly in recent years, was extended even further to include the drawn portions of corporate revolving credit facilities.

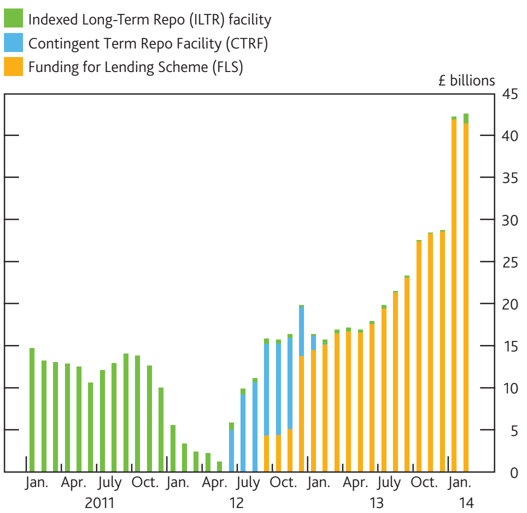
- The certainty with which banks and building societies can expect to be able to borrow from the Bank was reinforced through a presumption that all banks and building societies that meet the PRA's Threshold Conditions may sign up for the SMF and have full access to borrow in its facilities.

- The Bank announced its intention to use the new opportunities made available by the creation of the PRA to ensure that banks and building societies better integrate the availability of liquidity insurance into their liquidity planning and use the Bank's facilities at the appropriate time.

- The Bank's rule limiting banking groups to a single reserves account was relaxed.

Further details are available in 'Developments in the Bank of England's approach to liquidity insurance', available at www.bankofengland.co.uk/markets/Documents/money/publications/liquidityinsurance.pdf.

Chart 3 Outstanding amounts lent in SMF liquidity facilities and the FLS(a)



(a) Prior to January 2014, the CTRF was called the Extended Collateral Term Repo facility. The FLS (including the FLS Extension) lies outside the SMF and is not a liquidity insurance facility, but has the result of providing liquidity to the banking sector. There has been no Discount Window Facility usage up to the most recent disclosure point (as specified in the Bank's 'Red Book').

In general, the updates to the SMF have been well received by market participants and other commentators. Many market participants reported that they appreciated the increased clarity around the circumstances under which they could expect to borrow from the SMF, and thought that the changes would have the intended, positive impact of reducing stigma during times of stress. The changes have also been noted by ratings agencies, some of which have issued guidance suggesting there would be no negative ratings penalty for banks and building societies running down excessive liquid asset buffers as a result of increased funding routinely available through the ILTR. The Bank welcomes feedback on these or any other aspects of the SMF at any time (see the end of this Report for further details).

Banks and building societies have begun to work through the implications of the changes for their liquidity planning, with the active assistance of the Bank's supervisory and markets teams.

The changes to the SMF liquidity facilities provide the Bank with a much more flexible range of tools to deal with a variety of liquidity scenarios. But whether in practice this translates to more regular business-as-usual usage of the SMF facilities, or earlier approach to the Bank for liquidity support in times of stress, is something that will need to be monitored carefully throughout 2014 and beyond. In view of the very recent updates to the Bank's facilities, no further changes to the SMF are proposed in this Report, but the Bank will remain alert to any signs that its facilities are inappropriately stigmatised.

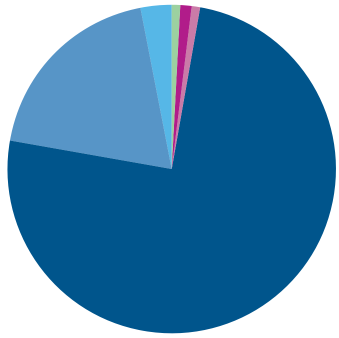
Risk management

The design of the SMF reflects the Bank's objective of achieving its broader policy aims while minimising the risk to public money on its balance sheet. In SMF facilities, the Bank is not generally exposed to market risk — exchange rate or interest rate risk — as lending is in sterling and is typically indexed to Bank Rate. So the main financial risk to which the Bank is exposed is counterparty credit risk. As noted above, the Bank now has a presumption that all banks and building societies that meet the PRA's Threshold Conditions for authorisation may sign up for the SMF and have access to borrow in SMF facilities against eligible collateral. Due diligence is undertaken on all prospective SMF participants and risk protection is further enhanced by the fact that all lending by the Bank is against collateral of sufficient quality and quantity. Collateralised lending is subject to suitably conservative 'haircuts' (that is, the Bank lends an amount less than the market value of the collateral it takes). If a counterparty fails to repay when due, the Bank can sell or retain the collateral to make good any loss it may face.[(1)]

The amount of collateral delivered to the Bank for actual or potential use in its facilities (such as the FLS and those within the SMF) has increased substantially over recent years, and stood at almost £450 billion at the end of February 2014. After valuation and haircuts, this provided banks and building societies with a total drawable value of around £280 billion in the Bank's facilities. Part of the collateral pre-positioned at the Bank comprises securities, such as residential mortgage-backed securities, but around three quarters is in the form of portfolios of loans (**Chart 4**). In total, at the end of February 2014, 40 banks and building societies had loans placed at the Bank as collateral, involving around 150 loan portfolios. The ability to use less liquid collateral such as loans in various SMF facilities has made these facilities a more efficient source of liquidity for banks and building societies. The Bank has responded to increased demand from SMF participants to pre-position such collateral by allocating additional internal resources to this function.

The bulk of loans currently pre-positioned are residential mortgage loans, reflecting their prevalence on SMF members' balance sheets. But the Bank has actively sought to extend the range of eligible collateral. For example, in recent years the Bank has accepted pre-positioning of other asset classes including portfolios of corporate loans (mainly loans to small and medium-sized enterprises), social housing loans,

Chart 4 Collateral pre-positioned by asset class[(a)]



(a) As at 28 February 2014. Level A comprises highly liquid, high-quality sovereign debt; Level B comprises other high-quality sovereign bonds, supranational bonds, covered bonds and liquid securitisations and corporate bonds; and Level C comprises own-named securities, portfolios of loans and less liquid securitisations and corporate bonds. Further detail is available at www.bankofengland.co.uk/markets/Pages/money/eligiblecollateral.aspx.

unsecured personal loans, and revolving credit facilities. Although the Bank's collateral list is already very broad, the Bank has made it clear that the list extends in principle to any asset that the Bank judges it can effectively and efficiently risk manage. The Bank will therefore keep under review the case for any further widening of the range of eligible collateral.

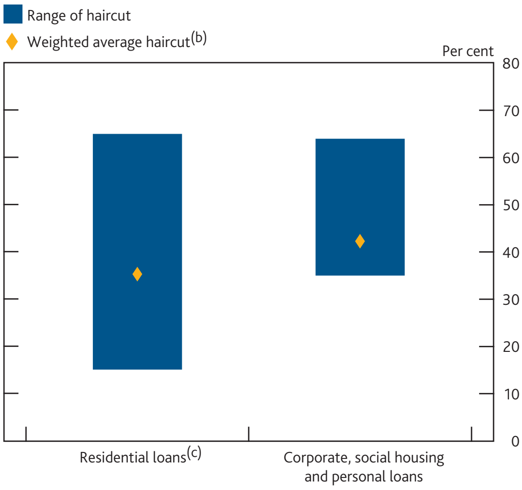
When valuing collateral, the Bank applies haircuts, which are designed to protect the Bank against possible further falls in the value of collateral in the period between the default of a counterparty and the realisation of collateral, including in times of illiquid markets or severe economic stress. The Bank publishes 'base haircuts' that it applies to different classes of securities.[(2)] Base haircuts are not applied to portfolios of loan collateral. Instead, haircuts applied to loans reflect the particular characteristics of individual portfolios and so vary according to the composition of each pool of loans (**Chart 5**).

The Bank is conscious of the operational costs associated with pre-positioning assets, particularly for smaller banks and building societies, and continues to seek ways to reduce them where it can do so without putting public money at risk. For example, the Bank is providing more information on the process for assessing collateral and determining haircuts, including providing an early indication of likely eligibility where possible.

The Bank seeks to set haircuts efficiently. As more accurate information about the risks in pre-positioned collateral becomes available, this may result in some reductions of haircuts from current levels.

(1) For further details, see 'Risk managing loan collateral at the Bank of England', available at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q208.pdf.
(2) See www.bankofengland.co.uk/markets/Documents/money/publications/summary_haircuts.pdf.

Chart 5 Haircuts applied to pre-positioned loan portfolios(a)



(a) As at 31 December 2013.
(b) Weighted by nominal value of loan portfolios, before haircuts are applied.
(c) Excludes social housing loans.

Governance

As the Bank announced in October 2013, a number of important changes have been made to the governance of policy formulation and decision-making around the SMF. These ensure that the SMF benefits from a broader range of input and challenge from inside and outside the Bank, and is subject to periodic scrutiny by the Bank's Court and the public. First, a new Operations Committee — an executive-level committee of the Bank chaired by a Deputy Governor — has discussed SMF-related issues regularly and played an integral role in developing the significant changes to the SMF introduced in late 2013 and early 2014. This process is overseen by the Oversight Committee of Court, which has full access to the minutes and papers of the Operations Committee. Second, a number of discussions have taken place with the Monetary and Financial Policy Committees under the aegis of the new Concordats setting out arrangements for consultation and information sharing on SMF issues relevant to those Committees' remits. Third, there has been more active engagement on SMF-related issues, both internally with Bank staff and externally with key stakeholders. And, fourth, this Report itself represents the conclusion of a new annual review process, drawing on the staff's own experience of operating the framework and on the views of a wide range of other stakeholders from inside and outside the Bank.

Conclusions

The process of reform triggered by the Winters Review has been a positive development, which the Bank is keen to maintain in the years ahead.

The Bank's Court has reviewed this Report — welcoming in particular improvements to the governance of the SMF — and endorsed its publication.

The Bank would welcome thoughts or comments from interested parties on anything in this Report or relating to the SMF more broadly. All comments should be sent to:

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or by email to: SMFfeedback@bankofengland.co.uk.