THE DEVELOPMENT OF THE BANK OF ENGLAND'S MARKET OPERATIONS

This note accompanies the Bank's News Release. It provides a brief summary of the principal changes proposed in the consultation document. The appendix gives an overview of the Bank's existing framework.

The Bank of England has reviewed its market operations and is now proposing a series of changes to its existing framework. The Bank has published a consultation document *'The Development of the Bank of England's Market Operations'*, which sets out its proposals and seeks views from market participants and other interested parties. The paper is not about the range of exceptional operations and facilities currently being offered by the Bank. It is about plans for a permanent framework that will persist once the current crisis has eventually passed.

Proposals

The consultation document sets out plans for three major reforms. Together, they are designed to improve the functioning of the existing framework and to introduce two new permanent facilities (2 & 3 below) for banks to access in stressed financial conditions:

(i) Replacing the existing Standing Facilities with Operational Standing Facilities, with less disclosure and a lower fee. This is to underline that they exist to absorb technical problems in the operation of the money markets and payment systems and not to provide longer term liquidity insurance to stressed firms. *These changes will be introduced on Monday 20 October.*

(ii) The establishment of a Discount Window Facility. This will enable banks to borrow government securities against a wide range of collateral, at any time, at fees reflecting the type of collateral and the size of drawing. It has been designed to avoid encouraging imprudent liquidity management. *The Discount Window Facility will be introduced on Monday 20 October.*

(iii) The introduction, after further consultation, of permanent long-term repos against high-quality private sector securities. The auctions will be designed to allot differing amounts at different prices for different collateral types, reflecting the pattern of demand revealed in the bids and depending on the degree of stress in the system.

These principal reforms are summarised below. Additional proposals are contained in the consultation document.

Standing facilities

The 2006 operational framework introduced Standing Facilities for banks to borrow from and deposit with the Bank in unlimited amounts throughout the day, every day. The facilities are currently priced at 100 basis points above and below the Bank Rate, except on the final day of the monthly maintenance period when they are priced at 25 basis points above and below Bank Rate.

However, the Standing Lending Facility became stigmatised after August 2007 when operational use was mis-interpreted as a sign of financial difficulty. If banks are unwilling to use the Standing Lending Facility, it cannot be relied upon to set a ceiling on overnight market rates, increasing their potential volatility following temporary technical disturbances to the payments system. The recent widening of the banks' reserves target range has ameliorated the effect on overnight rates, but that cannot insulate the system entirely from major technical shocks to the payments system.

The Bank therefore plans to replace the current Standing Facilities with two new facilities:
Operational Standing Facilities, the principal aim of which is rate-setting and so absorbing essentially technical frictions in the overnight money markets.
A Discount Window Facility, the principal function of which will be to provide liquidity insurance in the event of stress.

For the Operational Standing Facilities, the maturity will remain overnight and the rate will on all days be +/-25 basis points relative to Bank Rate. For the lending facility, the eligible collateral will remain those instruments that are eligible in the Bank's short-term repo OMOs, i.e. very high-quality industrialised-country sovereign bonds.

The Bank is also amending its disclosure of the use of the Operational Standing Facilities to remove the possibility of adverse commentary following any large use. With effect from Monday 20 October, disclosure of average use will be made after the end of the relevant maintenance period. The Bank's expectation is that Operational Standing Facilities use should cease to be stigmatised.

Ranges around reserves targets
Reflecting the stigma attached to use of the Bank's Standing Lending Facility, the Bank introduced and maintained wider ranges around banks' reserves targets. The Bank believes that a narrower range would be appropriate as market conditions normalise, as that encourages reserves banks to choose the target level of balances they do, in fact, need; and because wider ranges should be reserved for contingencies.

Given the planned reforms, described above, to destigmatise the Standing Facilities, the Bank is minded to set the range around reserves targets in steady state at +/-5% (+/-40% in the current maintenance period and +/-20% for much of the last year).

Discount window facility

The Bank will add a permanent Discount Window Facility to its framework, from Monday 20 October. This will allow commercial banks to swap eligible collateral for UK government securities at any time. At the Bank's discretion, it may offer cash. The facility will be open to banks to use any securities borrowed from the discount window in the Bank's regular open market operations, or in the market, as a way of raising cash.

The facility is explicitly designed to help contain financial system stress by providing financing against assets that may become illiquid in stressed conditions.

Loans from the Discount Window Facilities will attract appropriate valuations (haircuts) and fees dependent on the type of collateral offered. The price will increase with the scale of access and with the riskiness of the collateral posted. Drawings in normal circumstances will be for a 30-day term maturity, although the Bank will have discretion to extend the maturity.

Counterparties will be able to bring to the Discount Window Facilities any collateral from a well-defined list. This will include both public and private securities. They will be classified into four groups, or levels, from high-quality sovereign bonds to own name instruments. Highly-rated mortgage bonds that are not trading in liquid markets will be eligible. The Bank will include on the list only assets that it is able to value and whose risks it is able to manage in the event of a counterparty defaulting.

A transaction of this form will have no impact on the net supply of reserves, and so will not necessitate any offsetting adjustment in the Bank's other monetary operations. And in order to avoid counter-productive speculation over the use of the facility, disclosure about its use will be low. In particular, average use of the Discount Window Facility over a quarter will be disclosed at the end of the subsequent quarter.

Long-term repo operations

As part of its existing Red Book framework, the Bank has for some years conducted long-term repo operations each month, lending at three, six, nine and twelve month maturities. Since December 2007, and especially since September 2008, the Bank has increased the amount and frequency of its three-month lending and has expanded the range of collateral eligible in those operations to include, amongst other things, some asset-backed securities and covered bonds.

By shifting the composition of its open market lending away from the one-week maturity and towards the three-month maturity, the Bank has helped to provide time for banks to address the problems underlying market stress. And by extending the range of collateral eligible in its three-month repos, the Bank has assisted commercial banks in financing assets that had suddenly become illiquid.

The Bank now proposes to widen permanently the range of collateral eligible in its routine monthly long-term repo operations. In order to meet its objectives, it intends also to modify their operational design. The Bank is minded, therefore, to introduce an auction mechanism under which counterparties would be asked to bid separately to borrow against different types of collateral. The Bank will consult on this.

By providing liquidity insurance, the central bank effectively provides time for banks and others to address the problems created by the stress. Such insurance is not and cannot be a source of longer-term funding to the banking system.

Bank of England
16 October 2008

Appendix: the Bank's existing framework for market operations

The Bank's market operations have two objectives.

(i) To implement monetary policy by maintaining overnight market interest rates in line with Bank Rate, so that there is a flat risk-free money market yield curve to the next MPC decision date, and there is very little day-to-day or intraday volatility in market interest rates at maturities out to that horizon.

(ii) To reduce the cost of disruptions to the liquidity and payments services supplied by commercial banks. The Bank does this by balancing the provision of liquidity insurance against the costs of creating incentives for banks to take greater risks, and subject to the need to avoid taking risk onto its balance sheet.

The three main elements of the Sterling Monetary Framework introduced in May 2006 are reserves, standing facilities and open market operations. Banks that are members of the reserves scheme set targets for their average holdings of reserves over each period between monthly MPC decisions. Provided that a bank's actual average holding of reserves is within the specified range around its target, those reserves are remunerated at Bank Rate.

For the rate-setting objective to be met, the Bank needs to ensure that its (net) supply of reserves is in line with demand. If the Bank supplies less money than banks demand, market interest rates would rise other things being equal, and vice-versa if it supplies too much money. That entails ensuring that banks in aggregate are in the region where their reserves will be remunerated at Bank Rate so that the arbitrage with and between market rates can work correctly. The Bank uses its Open Market Operations (OMOs) to achieve this, relying on the sterling money markets to provide an efficient mechanism for distributing reserves to where they are demanded.

The framework's Standing Facilities enable banks to borrow from and deposit with the Bank in unlimited amounts throughout the day, every day. These facilities were designed to stabilise expectations, throughout the maintenance period, of the overnight rate on the final day in line with Bank Rate. They also give banks a source of insurance against payments shocks that could otherwise take their reserves accounts below zero.