

**BANK OF ENGLAND STERLING MONEY MARKETS LIAISON GROUP
MEETING AT 2.30 PM ON THURSDAY 20 JUNE**

David Rule (Chairman)	Bank of England
Paul Mikhailoff (Secretary)	Bank of England
John Rippon	Bank of England
Eric Edmond	Bank of England
Mike Beales	WMBA
Toby Davies	CRESTCo
Nigel Dawes	Prebon Marshall
Stewart Devine	FSA
Peter Fingland	Bankgesellschaft Berlin AG
Barry Holland	London Investment Banking Association
Graham Forster	LloydsTSB
Anthony Littleton	Association for Payment Clearing Services
Lindsay Mackay	HBOS
Ronnie Maiti	London Money Market Association
Peter Martin	CIPFA
David Morrison	Royal Bank of Scotland
Richard Pattinson	Barclays
Lesley Poltock	JP Morgan
Amanda Sudworth	LIFFE
Mike Williams	DMO
Jonathan Wood	HSBC

Agenda Item 1 – Introduction

- 1 David Rule introduced the agenda and explained that he was chairing the meeting on behalf of Paul Tucker, the Bank's new Markets Director, who would chair future meetings.

Agenda Item 2 – Current developments in sterling money Markets

- 2 David Rule (Bank of England) invited the group for its views on four topics: the recent apparently strong correlation between equity market movements and changes in money and bond market yields and how this could be explained; trends in the overnight rate, the period of more random distribution around the repo rate that was seen earlier in the year seemingly having been followed by a pattern of greater serial correlation of SONIAs; comparative liquidity in derivative and cash money market instruments (which was later discussed under agenda item 3); and the expected effect of the extension of LCH's Repoclear service to the gilt repo market, planned in August.
- 3 On the first point, one member suggested that in 1999 equity and bond price changes had been positively correlated, suggesting a focus on productivity gains affecting the supply side of the economy, whereas the current strong negative correlation might suggest particular concerns about demand, with

equity prices seen as an indicator. Others pointed out that the second round effect of falling equity values on wealth and consumption had in the past been important in the United States. One member suggested that, although the UK personal sector was generally considered to be more influenced by property prices, the effect of falling equity markets on pension and endowment might now be more visible, with a potential effect on consumption. Members believed UK pension funds and life insurers had again been selling equities and purchasing bonds, especially corporate bonds.

- 4 Members agreed that the overnight rate had recently demonstrated greater serial correlation, with periods of softness punctuated by shorter periods of tightness. Some suggested that counterparties were getting used to the deposit facility and concentration rules put in place in 2001. It was also pointed out that counterparties' positions, changing over time from being long or short of assets requiring very short term financing, in part determined whether it was advantageous to them to have funding costs at a certain level. Some thought that more participants were getting involved in OMOs and that this was a factor. It was remarked that the concentration limits could make counterparties more cautious on days of very large shortages. One member referred to what he felt to be a weakness of the operational technique in that a daily shortage was relieved by two-week assistance.
- 5 The extension of Repoclear to gilt repo was expected to expand the market. LCH will be central counterparty and netting will reduce the use of capital. One member noted how the UK money market had historically focused on names: Repoclear, combined with use of electronic trading platforms, will encourage dealing on prices and liquidity.

Agenda Item 3 – Market Liquidity

- 6 Peter Fingland described the results of a recent FBSA questionnaire asking for views on liquidity in cash interbank markets up to and beyond 90 days. 80% of respondents felt that liquidity beyond 90 days had reduced and that the average maturity of their interbank liabilities had decreased but fewer, 35%, had noticed a reduction in liquidity at shorter maturities. Beyond one month, it was said that CDs had replaced interbank deposits as the preferred sterling funding tool and only some 16 names were freely tradable. Lower market liquidity at longer maturities was attributed to mergers and increased use of off-balance sheet products to take rate or curve views.
- 7 The view was expressed that on-balance sheet funding had shifted to shorter maturities and, therefore, that the overnight rate and any volatility in it had acquired a greater influence on funding costs. Longer-term assets were more likely to be funded in the medium-term note market, which might increase funding costs. However, others thought that this was simply the price of longer-term liquidity. Funding costs related to the creditworthiness of the bank (increasingly based on ratings) and to the term of the borrowing.

Agenda Item 4 – Dematerialisation of Money Market Instruments

- 8 John Rippon (Bank of England) introduced the Bank's paper of 20 June on the state of play of preparation for the issuance of non-material money market securities and on further work. The aim was for the issuance of such securities into CREST to begin in the second half of 2003 and for CMO to close by the end of that year.
- 9 HM Treasury were working on a consultation document and draft legislation, which they were proposing to issue for comment before October 2002. CRESTCo were in the meantime continuing technical work with the market looking at matters such as the role of IPAs, the handling of maturities, the enhancement of stock selection functionality, and the transition. In addition, the Bank would be reconvening the *Next Steps Group* to consider the overarching issues and issues not covered in other fora, including in particular the preparation of some standard terms of issuance for each of the main types of security, eg CDs, CP and bankers' acceptances. The Bank was working on some preliminary drafts of such terms, which it would issue for comment to the *Next Steps Group*, probably later this summer. Mike Williams noted that the Treasury Bill Memorandum and Regulations governed the issuance terms for Treasury bills; these would be reviewed in parallel as necessary.
- 10 John Rippon said it was likely that the amendments to the Uncertificated Securities Regulations 2001 (USRs) would not distinguish different types of money market security; and indeed the intention was to cover non-material equivalents of all negotiable debt securities, including those with longer maturities than those of money market securities. The current terminology being followed, and reflected in the Bank's paper, was 'eligible debt securities'. He emphasised that the term 'eligible' related only to eligibility for issuance into CREST of such wholly dematerialised securities, and was not related to eligibility as collateral for the Bank's money market operations.

Agenda Item 5 – Contingency Planning

- 11 Paul Mikhailoff (Bank of England), before describing MMLG's progress, outlined recent work under the auspices of the tripartite committee and said he hoped that at MMLG's next meeting Will Parry (Bank of England) would be able to provide more information. The public version of the Business Continuity Management (BCM) website was launched at the end of April. The FSA has published a working paper aiming to capture current thinking about contingency planning among major financial groups. A BCM matrix has been published in order to capture good practice which, it is hoped, will be completed by major financial services firms by end-July. A group of the financial and telecoms authorities and providers has been established to look at financial sector infrastructure. The website will soon include summaries of meetings of the various market committees.
- 12 Paul Mikhailoff then reported that the directory of MMLG members, alternates, mobile numbers and contingency site details had been established and circulated. There will be a quarterly update ahead of each MMLG meeting.

- 13 He then drew attention to the minutes of the rates sub-group of MMLG, circulated to the full MMLG membership (attached to these minutes), and ran through its recommendations. The group had been asked to propose non-binding guidelines for the rate or rates that might be applied to unexpected long and short balances in the event of a major market disruption or infrastructure failure. Under the NIPs code the Bank has discretion to determine and publish such a rate, the purpose of this work by MMLG was to establish the market's views on how such a rate might be set.
- 14 The rate under consideration was in no way related to any rate that might be applied in respect of compensation claims following misplaced balances in the course of normal business.
- 15 The sub-group thought that a single rate was appropriate rather than a spread of rates. They thought that in the event of a major disruption the distribution of long and short positions would be arbitrary and that a spread was inappropriate. Nor did the group think that any administration fee should be imposed, as was the case for some compensation claims in the euro-area.
- 16 The same approach was recommended to be followed whatever the nature of the market-wide disruption, eg whether a financial or other infrastructure failure, a disaster or problems affecting one or more settlement banks.
- 17 The minutes of the sub-group set out the various arguments relating to the single rate the group thought should be used. The choice of the Bank of England repo rate in force at the time of the disruption was virtually unanimous. Any attempt to establish and announce a middle rate reflecting business already transacted on the day of any event was thought to be problematic, to take too long and in any event would find fault with some. The Bank's repo rate would already be known and its application could be announced rapidly, if necessary, giving the market early certainty and guidance.
- 18 The sub-group had recommended that any trades already entered into before the announcement should stand at the rates at which they were struck even if they had not been settled. One member wondered if this was right, but others said that there was no alternative and that this was the approach applied to any failed trade. To unscramble business when the market was recovering from a major shock would probably be impossible anyway.
- 19 In respect of any maturing trades that could not be settled and had to be extended to a future settlement date, Richard Pattinson (Chairman of the Sub-group) said that a compensation payment would probably arise based on the repo rate.
- 20 David Rule pointed out that the recommendation would not be binding – the NIPs code would continue to give the Bank discretion to determine and publish a rate given that it was impossible to foresee all possible extreme circumstances. But there would certainly be a bias towards it. He asked MMLG again if they were sure the repo rate would be preferable to the level of the overnight on the day in question in all circumstances. For example,

what if an event occurred in the afternoon, when the majority of overnight trading had already been done? Would those that had already traded, perhaps at a less advantageous rate to them than the repo rate, feel disadvantaged? MMLG confirmed the sub-group's recommendation, believing that the advantages of clarity and simplicity carried more weight.

- 21 David Rule referred to the CREST disruption on 18 April on which day the Bank had remunerated settlement bank credit balances at the low of the day, 3 3/16%, and charged the high of the day, 3 1/2%, on any settlement bank overdrafts. Some had suggested that this decision had not been communicated within or beyond the settlement banks to all those that had been affected. Any rates applied by commercial banks would of course depend on the terms of customer accounts but the Bank's decision might be helpful to any looking for guidance.

Agenda Item 6 – Money Market Spreads

- 22 Eric Edmond (Bank of England) asked the group for its views on why the spread between secured and unsecured rates in the US and UK was wider than that in Europe. It was suggested that one possible reason might be the lower credit ratings given to some euro government debt and, possibly, that European banks accepted a lower return on capital.
- 23 The group was then asked why the secured/unsecured spreads in sterling and the US markets were so close given the relative abundance of collateral in the US. The view was put forward that the US market was highly differentiated according to creditworthiness, largely based on ratings. Repo was preferred for much inter-bank business.

Agenda Item 7 – Any Other Business

- 24 Mike Williams (DMO) reminded the group that the UK Government had issued some £4 bn gilts, which will be held on the Debt Management Account for use solely as collateral (initially DBV only) by the DMO to facilitate its cash management operations.