BANK OF ENGLAND STERLING MONEY MARKETS LIAISON GROUP
Meeting at 3pm on Tuesday 1 October

Paul Tucker (Chairman)	Bank of England
David Rule	Bank of England
John Rippon	Bank of England
Kieren Wright	Bank of England
David Sawyer	Bank of England
Andrew Grice	Bank of England
Adrian Gray	APACS Liquidity Managers Group (Citibank)
Antony Littleton	Association for Payment Clearing Services
David Morrison	Royal Bank of Scotland
Ian Firth	LloydsTSB Bank
Ian Mair	London Money Market Association
Peter Martin	Chartered Institute of Public Finance and Accountancy
John Burke	London Clearing House
Jonathan Wood	HSBC
Lindsay MacKay	Bank of Scotland
Jo Whelan	UK Debt Management Office
Nigel Dawes	Prebon Marshall Yamane
Peter Fingland	Association of Foreign Banks (Bankgesellschaft Berlin)
Stewart Devine	Financial Services Authority
Mike Beales	Wholesale Markets Brokers' Association
Toby Davies	CrestCo

Apologies

Brian Morrison	Abbey National Treasury Services
Richard Pattinson	Barclays Bank
Amanda Sudworth	LIFFE

Agenda Item 1 – Introduction by Chairman

1 Paul Tucker, the Bank's new Markets Director, introduced the agenda.

Agenda Item 2 – Current developments in sterling money markets

2 David Rule (Bank of England) invited the group for its views on five topics: the continued strong relationship between equity market movements and changes in money and bond yields; whether market conditions had remained orderly and whether there had been any signs of flight to quality in the face of equity market falls, heightened price volatility across a range of markets and greater uncertainty; the recent growth of money market funds in the UK; the recent growth of interbank deposits relative to CD issuance; and the pattern of short-dated unsecured rates since the previous meeting.

3 On the first point, one member thought the close correlation between movements in short sterling futures and equity markets had been surprising. Global equity markets had been highly correlated, which was not easy to explain since many of the underlying factors seemed to be more US-specific, and it was even less obvious why these should have affected UK market interest rates, especially at longer maturities. Another member thought the close correlation was explained by changing views about future growth prospects, which affected both equity and bond markets. It was noted that in the late 1990s, the correlation had not been as strong.

4 The Chairman asked members how the relationship between equity movements and changes in longer-term market interest rates implied by bond yields could be explained? One member thought that a factor had been asset reallocations out of equities into bonds by some institutional investors. Such funds were expected to have a lower equity weighting in the future.

5 Members of the Committee said that sterling markets had remained orderly.

6 On CD issuance, one member said that issuance of longer-dated CDs had declined, with banks increasingly using Medium Term Notes for longer-term funding needs. Another suggested that the secondary market in CDs had all but dried up, with only a few tens of banks now issuing in the primary market. There had, however, been quite a lot of interest from end-investors in structured transactions with embedded interest rate options. These were typically private placements.

7 On sterling money market funds, one member suggested they had grown ten-fold since 1999 and now had assets in excess of £20bn. They had a number of attractions for corporates and institutional investors: many funds were AAA rated because of the class of assets in which they invested, whereas most banks had lower ratings; funds often offered higher interest rates than the banks; and institutions were, in effect, able to outsource their back office functions by investing through funds rather than depositing with a range of banks themselves. Some investors attempted to arbitrage funds by switching money into the overnight market when rates were tight but some funds sought to deter such behaviour. Most of the major banks now managed such funds. One member thought their growth might encourage a transfer of liquidity from the overnight

cash market into longer-dated Certificates of Deposit and Commercial Paper. But, at present, the trend was in the opposite direction.

8 Finally, members said that the pattern of short-dated interest rates appeared to be more unpredictable now. Banks were not running large asset books with the money market yield curve flat.

Agenda Item 3 – Discussion of early days of Continuous Link Settlement (CLS) and impact on gilt repo market of gilts in London Clearing House (LCH) RepoClear

9 David Sawyer (Bank of England) reported that CLS had gone live on 9 September. The process had been very smooth. Certain controls remained on volumes but the robustness of the system meant these might be lifted soon, probably in mid-October. [The inputting of trades for unrestricted settlement began on 14 October.] In the first two weeks of CLS, 1,500 to 2,700 trades had been settled per day. In the last week of September, there had been around 5,000 trades settled per day. Inside/outside swaps, designed to reduce pay-in requirements and make these easier to fund, had worked well. The outlook was for volumes and values to increase sharply in mid-October, and then more gradually as further settlement members joined and third-party business started to be brought into the system. Members said that the start of CLS had been smooth from their perspectives too, with no significant problems in sterling liquidity management. One suggested that the potential for liquidity imbalances would decline as more banks joined. So far as members were aware, there had been no perceived impact so far on trading or liquidity in the foreign exchange market.

10 John Burke (LCH) described LCH's RepoClear fixed income clearing service. Gilts had been added to RepoClear on 5 August, and represented approximately 10% of RepoClear's repo turnover. Practically all of the major gilt trading firms were either already using RepoClear or in the process of implementing the service within their firms. The system also enabled screen-based brokers to offer anonymous trading. Gilt settlements were "netted" prior to submission to CREST, potentially reducing participants' settlement costs and also flows through the settlement system. As a result of LCH becoming a central counterparty in this part of the interbank market, banks could net their gilt repo exposures on their balance sheets. Of the gilt trades cleared

through RepoClear, about 30% to 40% originated from voice-brokers while the remainder came from automated trading systems. The proportion of voice-brokered trades for gilts was higher than in the other markets using RepoClear.

11 Partly related to the introduction of gilts in RepoClear, the DMO had recently given BrokerTec (which is owned by a consortium of 14 investment banks) inter-dealer broker status in gilts, having taken the view that while LCH provided a clearing service for the market, BrokerTec could be viewed as providing the equivalent of a matched principal service.

12 The RepoClear system had been modified to accept gilt repo trades with same day value, reflecting market practice of T+0 settlement. Over time, LCH expected other European bond markets to mirror the gilt market and offer same day settlement.

13 The one gap in RepoClear's product offering at present was that of gilt "delivery-by-value", whereby gilts were lent overnight in bundles of a value agreed beforehand, rather than the lending of individual bonds. LCH was looking to set up a design team for that product and would consider how such a product could coexist with the standard Repoclear service.

14 Mr Burke also mentioned that LCH SwapClear (a central counterparty netting service for interest rate swaps) had now signed up to nineteen participants. Comments suggested that it was regarded as a significant addition to the market infrastructure.

Agenda Item 4 – Progress on dematerialisation of money market instruments

15 Mr Rippon (Bank of England) noted that preparatory work for the issuance of non–material money market securities into CREST was continuing; and that the aim was for non-material issuance to begin in about July 2003, with the Central Moneymarkets Office closing towards the end of that year. At present sterling money market securities (eg. CDs and bankers' acceptances) are negotiable paper instruments. Non-material securities will be economically the same but have similar legal characteristics to other securities issued into CREST, as registered securities fungible within the same issue.

16 The Treasury had issued a consultation document in September, which included draft legislation; and they were looking for responses by 6 December. CREST had been discussing with its market group the other, practical aspects of preparation, and would shortly be publishing the results of the recent work. There were still some matters that needed further consideration by CREST and the market, including aspects of the transition. The Bank was also about to reconvene the Next Steps Group of market representatives to consider the remaining preparatory work, including any issues not covered by the Treasury and CREST. This would include in particular the draft standard terms of issuance for non–material securities, which were necessary to enable the non–material securities to be constituted and issued into CREST.

17 The Bank currently envisaged that a single set of basic draft terms, amended as necessary, might be applied to all non–material securities (eg. commercial paper, bankers' acceptances and CDs), although this would need further discussion. The Bank had prepared some draft standard terms, with the assistance of its legal advisers and CREST, and these would be shown to the Next Steps Group. Once this Group had given its initial reactions, it was envisaged that it would set up a specialist sub–group, including some lawyers, to take forward the further development of the terms; and the drafts would be posted on the Bank's website. The Bank hoped to have a revised draft ready by Christmas in time for a second stage consultation; and the aim was to have final terms agreed by the market by March 2003, so the market would be familiar with them well in advance of the start of issuance.

18 Mr Rippon emphasised the importance of all in the market, including front, middle and back offices, as well as market participants' customers, being familiar with all the preparatory work, so that everyone was ready by mid–2003.

19 The Chairman noted that the dematerialisation of money market instruments was a precondition for moving to settlement arrangements which did not carry the exposures entailed at present. The initiative was also, therefore, a welcome step to strengthen the resilience of the system.

Agenda Item 5 – Contingency planning a year on from 11TH September 2001

20 Kieren Wright (Bank of England) said that the FSA had published a couple of further papers since the previous MMLG, which were available on the Bank/Financial Services Authority/HM Treasury joint website at www.financialsectorcontinuity.gov.uk. The first was a consultative paper called "Operational risk, systems and controls". It had a section on business continuity and included some draft guidance for market participants. The deadline for comments was 31 October. The second was a review of the contingency arrangements of a wide range of financial institutions. The report included some examples of good practice but it was not a formal consultation document and did not represent formal guidance.

21 More generally the Bank/FSA/HMT tripartite subgroup on business continuity management had been reviewing current legislation for declaring emergency bank holidays. Also, the Foreign Exchange Joint Standing Committee operations sub-group had continued its work on contingency planning and should be ready to make further proposals soon.

22 David Rule (Bank of England) noted the importance of industry conference calls in the US markets following 11 September and asked the Group whether it would be helpful for it to rehearse such a call. Members thought this was a good idea. Mr Rule said the Bank would contact members to make arrangements for such a call to take place before the next meeting.

Agenda Item 6 – The Rates Sub-Group

23 The group was formed by MMLG at its March 2002 meeting to propose non-binding guidelines for the 'fall back' interest rates that might be applied to unexpected long and short balances in the event of a major market disruption or infrastructure failure. In the Sub-Group Chairman Richard Pattinson's absence, David Rule (Bank of England) introduced the draft paper and asked the Group to approve it. Group members did so and the final paper is appended to these minutes. The Group then discussed how the paper should be promulgated. It was agreed that the various trade organisations (BBA, LIBA, WMBA, AFB) would be asked to disseminate the report through the markets and the Bank would publish the report on its website and perhaps in its Quarterly Bulletin.

Agenda Item 7 – Association Cambiste Internationale (ACI) consultation on short-term securities market in Europe

24 Mr Rippon noted the recently issued consultation by the ACI (a foreign exchange dealers' association) on the development of an integrated CP market in Europe; and added that the ECB had been following this work closely. The proposals included the harmonisation of CP Information Memoranda, filing of copies at the ECB, more statistics, the creation of a primary index on CP issues (maintained by the ECB), possible inclusion in Tier 1 collateral for ESCB operations, improved settlement arrangements in due course, a common legal treatment in national legislation, and the liberalisation of the Undertakings for Collective Investment Transferable Securities directive to allow greater purchases by a money fund in one member state of CP issued in other member states. The focus of the consultation seemed to be on domestic CP markets in the eurozone, but it seemed that they could also be relevant to the international ECP markets and markets in member states generally. The Bank would be interested to learn of the market's reaction to the proposals once they had been digested. One member noted that IPMA would respond to the consultation in detail.

Agenda Item 8 – Any other business

25 **Undisclosed principal trading** - Andrew Grice (Bank of England) reported that major participants in the foreign exchange markets in London had proposed a change to the **N**on-**I**nvestment **P**roduct**s** Code to address the practice of trading with undisclosed principals. This occurred when a fund manager acted as an agent for a client (the principal), which did not want its identity disclosed to a third party (usually a bank) with which the fund manager was trading on its behalf. The Foreign Exchange Joint Standing Committee (FX JSC) had agreed that revised wording to the NIPs code should go out to market consultation. The Bank's understanding was that the vast majority of undisclosed principal trading occurred in the foreign exchange markets. However, because the MMLG, FX JSC and LBMA 'coordinate' the NIPs code, the FX JSC was asking for its agreement to release the consultation. This was granted.

Next meeting: 17 December 2002

Action points:
(1) Bank to arrange a rehearsal of a conference call between MMLG members.
(2) Bank to ask trade associations if they would be prepared to disseminate the Rates Sub-Group paper amongst their members.

APPENDIX

STERLING MONEY MARKETS LIAISON GROUP CONTINGENCY PLANNING RATES SUB-GROUP – BACKGROUND AND RECOMMENDATIONS

Terms of reference

The sub-group had the following terms of reference:

"To propose to MMLG non-binding guidelines for the interest rates that might be applied to unexpected long and short balances in the event of major market disruption or infrastructure failure.

The proposals might be in the form of various options with pros and cons in different circumstances.

The sub-group might helpfully review practice in other markets and note relevant past events in the sterling market.

Background: relevant section of the NIPS code." (Paragraph 106 gives the Bank of England discretion to determine and publish the rate(s) to be applied in such circumstances.)

Background

1. Previous disruptions in UK markets included the 1987 hurricane and a CGO interruption in early 1990. On both those occasions a rate which was in practice equal to the official policy rate had been recommended for application to consequential overdrafts and credit balances. A more recent occasion in April 2002 had been an interruption to settlement of DBVs in CREST, preventing settlement of some repo, but not unsecured, transactions. It was questionable whether this had been an event of sufficient scale to be covered by the sub-group's terms of reference but on that occasion the Bank of England had applied the day's high and low to any settlement bank overdrafts and credit balances respectively.

2. On 11 September 2001, New York markets followed long-established New York Clearing House guidelines to apply the effective Fed funds rate (plus an

administration fee) for any displaced balances. In its operations the Fed switched from lending sufficient funds for banks to meet reserve balance targets to lending as much as counterparties wanted: for one week after the disaster open market operations were in overnight repo. The Fed encouraged counterparties to make all their payments and give customers liquidity.

3. In the euro area the Federation Bancaire has agreed that EONIA +/- 25 basis points should be applied to compensation claims in respect of ordinary business. No such ground rules for compensation exist in sterling markets, but in any case the purpose of the sub-group was not to discuss undue enrichment in a day-to-day context.

4. In the Pan-EU TARGET system for euro payments a compensation scheme based on the ECB's main refinancing rate has been in operation for use when payments remain unprocessed at the end of a business day because of a malfunction (for whatever reason) of a TARGET component. The scheme is based on the principle of no undue enrichment and is cost-neutral for NCBs. There are, however, current discussions as to whether the compensation rate should be based on a market rate such as EONIA.

Discussion

5. The consensus among sub-group members was that the approaches adopted in other international markets, although of interest, were probably of more relevance in their respective domestic contexts given different money market structures and operational techniques.

6. The sub-group considered a range of scenarios – an event causing physical or electronic disruption to a significant number of key market participants or infrastructure providers, a CREST problem, a CHAPS problem or a SWIFT problem. It concluded there need be no difference between the approach applied in these various possible situations – long and short positions would result because of an inability to complete the day's business in one or more of the settlement and payment systems. The key point was that this should have market-wide consequences rather than affecting the business of one or two market participants only.

7. The view of the sub-group was that a single rate should be applied to both long and short positions arising from a large-scale disruption. Long and short positions arising from a disruption would not be deliberate, so any penalties would be arbitrary. It was also not obvious how a fair spread could be determined. The sub-group also saw no justification for the application of administration fees, it being unclear what the concept meant in this context. And in any event administration costs tended to net out between parties.

8. The minutes of the sub-group's meeting describe the various arguments for and against applying a rate based on what may have already taken place in the market prior to any disruption. In the event of a large scale shock, it may prove to be impossible to establish any middle market rate which would be generally

acceptable. The use of a SONIA-type average rate, reflecting business successfully conducted before the event, was considered but ruled out on the grounds that it was open to challenge and would probably take too long to determine, or perhaps not be possible to determine at all. The use of the previous day's SONIA was also considered as was a long run average of it, but these too were thought inappropriate. A rate based on quotes collected from a BBA-type panel of banks was another idea but this also was thought to be likely to take too long and again be open to challenge. The prevailing Bank of England official repo rate was on the other hand neutral and, of course, known to all in the market. Use of the Bank`s official repo rate would give rapid certainty and transparency.

Recommendations

- Following an event causing market-wide disruption to settlement of sterling money market transactions, unintended long balances should be remunerated and unintended overdrafts charged at the current Bank of England official repo rate.

- The rate to be applied to balances should be the official repo rate most recently announced by the Bank of England's Monetary Policy Committee at the close of business on the day of a disruption, following any changes announced on that day.

- Transactions agreed before any disruption occurred, including on that day, should stand at the rates at which they were struck.

- Maturing transactions, if extended because of the inability to return funds, should run on at the Bank`s repo rate, not the rate applicable to the original transaction.

- Notwithstanding the sub-group's recommendations and as reflected in the NIPS code, the Bank of England would continue to have discretion to determine and publish a rate following a market-wide event of this kind. It was important to retain this flexibility given the impossibility of forecasting the circumstances at the time.

- Members of the APACS End Of Day Transfer Scheme have agreed to use the rate of interest published by the Bank for loans between members on the day of a disruption.

- The Wholesale Markets Brokers` Association has agreed to use the rate of interest published by the Bank as the fixing of the Sterling Overnight Index Average (SONIA) on the day of a disruption.

October 2002