

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