

# **BANK OF ENGLAND STERLING MONEY MARKETS LIAISON GROUP**

**Monday 30 October 2006**

**Bank of England**

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## **MINUTES**

### **Attendees**

Ronny Maiti (A)	Abbey / LMMA
Mark Griffin (A)	Alliance and Leicester
Cliff Broadhurst	APACS LMG
Antony Littleton	APACS
Richard Pattinson	Barclays
Steve Nichols	Britannia Building Society
John Ewan	British Bankers Association
Alex Merriman	British Bankers Association
Richard Turrell	CrestCo
David Wyatt	CrestCo
David Nicholls	Deutsche
Joanne Perez (A)	DMO
Douglas Hull	FSA
Ian Fox	HBOS
Jon Wood	HSBC
Danny Corrigan	ICAP
Jonathan Curry	Institutional Money Market Funds Association / BGI
Dave Lally	JP Morgan
Nigel Bradley (A)	LCH
Richard Stevens (A)	LIFFE
Clive Jones (A)	Lloyds
Graham Niblock	RBOS

### **Bank of England**

Paul Tucker (Chairman)  
Simon Wells (Secretary)  
David Rule  
Sarah Breeden  
Peter Andrews  
Toby Davies  
Victoria Cleland  
John Rippon  
Stephen Denby

### **Apologies**

Peter Fingland	Association of Foreign Bankers / Bankgesellschaft Berlin
David McFarlane	CHAPS

## **1. Introduction**

- 1.1 As part of the Bank's review of MMLG membership to ensure that all types of participant in its new monetary operational framework were represented, Paul Tucker welcomed Steve Nichols (Britannia Building Society) to the group. Paul Tucker also welcomed another new member, Danny Corrigan (ICAP).

## **BANK OF ENGLAND ITEMS**

### **2. Volatility in the overnight gilt repo market on 31 July**

2.1 David Rule summarised the Bank's understanding of events in the overnight gilt repo market on 31 July, when an apparent scarcity of gilt collateral had driven repo rates close to zero and caused spreads between secured and unsecured overnight interest rates to widen significantly. Bank contacts had suggested a range of factors had contributed to the sharp swings in repo rates. These had included gilts being used to collateralise borrowing of equities (although the amounts did not seem unusually large); month-end balance sheet constraints limiting some banks' ability to trade the widening in spreads; and a number of experienced dealers being absent from the market that day. David Rule asked members for suggestions on how a repeat of such an event could be avoided.

2.2 Several members thought that gilt lenders accepting more types of collateral, in particular cash and European government bonds, would make it easier to borrow gilts later in the day for same-day settlement. Currently, if a market participant needs to borrow gilts in the afternoon, many lenders will take only other gilts as collateral. But it was pointed out that cash collateral would need to be reinvested by the lender.

2.3 It was generally seen as less likely that such sharp swings would occur in future. In part, this was because participants had adjusted their behaviour at month-ends, running smaller positions and trading earlier in the day. Since 31 July a quarter-end and two month-ends had passed without significant volatility.

2.4 One member said that there were fewer reasons for the large UK banks to hold collateral surplus to their liquidity needs in the new system, so they had a reduced ability to lend collateral into low repo rates. On 31 July, some banks had lent

additional collateral into the market, but regulatory and internal liquidity ratios had limited their ability to do so.

2.5 Group members welcomed the Bank's move to extend the deadline for its counterparties to substitute euro-denominated for gilt collateral in its operations. David Rule said that, following feedback from market participants, the Bank was exploring how it might lend gilts following its planned outright bond purchase programme (see item 4).

### **3 CREST / SSE problems and knock on to monetary policy implementation and money markets**

3.1 David Wyatt explained that the recent problems experienced by CREST could be split into several categories. The communication issues between CREST and Euroclear's Single Settlement Engine (SSE) in late August, which had delayed gilt DBV settlement, should not happen again. Also, additional flexibility was being created to keep US dollar DBVs open later, as an additional financing option, by separating the US dollar and euro currency deadlines. This had followed a few occasions when US dollar settlement (linked to euro in CREST) had had to be closed before DBVs could be issued, because of the 'hard' TARGET deadline for euro.

3.2 The longest running problem had been the DBV collateral settlement period at the end-of-day. Initially there had been considerable difficulties in completing DBVs within the normal period, and for the first two weeks of September this had been resolved by agreeing with banks a half-hour extension as routine. Since mid-September, the timetable had returned to normal as a result of an initial set of improvements, though customer-led settlement extensions had occurred on some occasions. There had also been problems processing DBVs involving large numbers of lines of stock, which CREST planned to fix shortly. CREST acknowledged that further improvement to the DBV process was required.

3.3 To address the outstanding issues, CREST were in the process of implementing a package of changes designed to improve performance. Paul Tucker said that, given its importance in the infrastructure underpinning the Bank's implementation of monetary policy and management of banking system liquidity, the Bank hoped CREST would communicate a clear timetable to the market. Several members

agreed this was important, noting that delays to DBV had knock-on effects to CHAPS and access to the Bank's standing facilities, so it was not just an issue for the securities market. This called for a clear communication strategy, including regular dialogue with the settlement banks. One member was concerned for stability ahead of the dividend season, when equity repo volumes typically rise, and suggested that stock lenders should be alerted to potential delays.

3.4 It was also noted that traders in London tended to operate slightly differently from traders in continental Europe. In particular, there had been a tendency to execute more 'last minute' DBV trades in London, typically associated with the financing of client's equity positions. CREST's link to the SSE meant that transactions now take slightly longer to reach settlement, so that market participants had greater uncertainty very near the deadlines. Some changes in business practices might be required.

#### **4 Outright bond purchases and electronic bidding**

4.1 Sarah Breeden said that the Bank had published, in July, a consultation paper on the proposed outright bond purchases. The paper had set out the background to the Bank's plans and described the principles that will govern the management of the resulting bond portfolio. It had asked for comment on a number of specific issues related to the mechanics of tenders and sought feedback on a proposal that the Bank should move to electronic bidding for all of its open market operations.

4.2 A short document describing the Bank's proposed design for tenders would be published as soon as possible and the Bank will invite OMO counterparties to a seminar in November to discuss and review the proposed bidding system. Sarah Breeden also underlined that the Bank was keen to engage counterparties' IT departments and back offices in the process of system design.

4.3 Trialling was expected to begin next summer so the first tender would be no earlier than next autumn. The roll-out was expected to occur in stages, with electronic bidding in bond purchase OMOs and electronic bidding in repo OMOs being phased in over a period of months.

#### **5 Technical changes to the Bank's operations**

5.1 David Rule reminded the group that the Bank was taking steps to eliminate its unsecured intraday exposure to accrued interest on term DBV gilt repos. Following consultation with OMO counterparties, the Bank had decided that the most straightforward approach was to require collateralisation of all future interest on repos. This would have a material effect on the economics of the Bank's long-term repos. But the Bank was a price taker in those OMOs and so counterparties could adjust bids to take account of any additional costs incurred. The Bank intended to grandfather outstanding long-term repos. The Bank would speak to counterparties about how much notice they would need before implementing this change.

5.2 David Rule reported that the Bank would be implementing the removal of the one-day grace period for breaches of its collateral concentration limits at the end of November. At the same time, the Bank would make explicit provision in its documentation for the use of standing facilities to roll intra-day credit overnight in the event of an infrastructure failure, and for the later deadlines for collateral substitutions.

5.3 David Rule also updated the group on the Bank's exploration of whether it could accept delivery of euro-denominated government bond collateral using Euroclear and Clearstream 'links' into national central securities depositories (CSDs).

## **6 Proposed survey of money market participants, including end users**

6.1 David Rule thanked members for their feedback on the proposed survey. Where necessary, the survey would be sent to several parts of individual institutions, in order to cover as wide a cross section of the market as possible. The survey would be conducted in 2007Q1 and would be web-based.

## **7 Contingency planning**

7.1 Richard Pattinson outlined the objectives and scope of the proposed sterling market contingency exercise. The aim was to move large parts of the sterling market to backup sites, with a skeleton team left at primary sites to be called upon in the event of any problems. A test on this scale had not been conducted elsewhere and it was agreed that such a test would be useful. Participation would be voluntary, although all reserve scheme banks and OMO counterparties would

be encouraged to take part. It was hoped that the exercise would be the first of a number of tests, designed to assess thoroughly the resilience of the sterling markets.

7.2 A few members raised concerns about potential knock-on effects to other parts of their business. For example, it might be problematic to conduct all sterling business at a different site to foreign exchange business. In addition, systems tended moved completely or not at all. This meant that leaving a back-up team at primary sites may not be straightforward. Care would be needed when planning and carrying out the exercise. The next stage was to write to all potential participants and to establish a steering group to plan the exercise. David Rule said that the intention was to uncover issues in the planning rather than on the day if possible.

7.3 Simon Wells thanked members for taking part in the test of the conference call facility, conducted in July. All bar three members successfully dialled in. Updated contact cards would be posted immediately after the meeting.

## **WIDER MARKET ISSUES**

### **8 Reports from:**

#### **8.1 LCH plans for netting of gilt DBV repos**

- Nigel Bradley updated the group on LCH's initiative to develop central clearing of gilt repos using CREST's delivery-by-value (DBV) service. The product had been successfully tested by LCH members. The launch had been put back owing to the problems experienced by CREST discussed under item 2. The product would now be launched as soon as there was a sustained period of CREST stability.

#### **8.2 BBA LIBOR business continuity proposals**

- John Ewan presented the BBA's updated proposals for how LIBOR would be fixed in exceptional circumstances. Following comments at the previous MMLG meeting, the BBA had consulted a wide range of market users, including derivatives traders. This had resulted in a few small changes. The group approved the updated proposals.

## **9 Gilt repo code**

9.1 David Rule had written to the Bank's OMO counterparties seeking views on whether the code should be updated. Feedback so far suggested the market was fairly evenly split on the issue. A full update would be provided at the next MMLG meeting.

## **10 AOB**

### **10.1 Market-wide contingency exercise**

Richard Pattinson reminded the MMLG that the Operations sub-group was participating in, and offering advice on, the market-wide flu pandemic exercise. This involved responding to the weekly inject of 'news' and responding on behalf of the MMLG.

### **10.2 Italian government bonds and Bank of England eligible collateral**

Paul Tucker said that some counterparties had asked how the Bank would respond in the event of further credit rating downgrades to Italian government debt making it ineligible as collateral for use in the Bank's operations. (The Bank accepts euro-denominated securities issued by EEA central governments, central banks and major international institutions where the issuing entity is rated Aa3 or higher by two of the three major ratings agencies.) Depending on the precise circumstances, the Bank envisaged that counterparties would substitute other collateral for Italian debt on the following day.

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