

# **THE FUTURE OF MONEY MARKET INSTRUMENTS**

## **NEXT STEPS**



**March 2000**

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## A: INTRODUCTION

The findings of the Securities Settlement Priorities Review in September 1998 indicated strong support for the integration of the settlement arrangements for money market instruments (MMIs) into the CREST settlement system<sup>1</sup>. Against this background, the Bank of England's Sterling Money Market Liaison Group (MMLG) asked a Working Group to prepare a report on the future of MMIs.

The Working Group comprised representatives of the Bank of England, CRESTCo, the Association of Corporate Treasurers, APACS, the London Money Market Association, and the UK Debt Management Office (DMO), and experts from Bank of Scotland, Bank One, Barclays Bank, Dresdner Bank, Gerrard & King, HSBC Bank, and Halifax. The London Stock Exchange, the Financial Services Authority, Freshfields, and Travers Smith Braithwaite also took part in some of the discussions; and the Bank also had contact with Treasury Solicitors. HM Treasury was kept informed.

The findings and proposals of the Working Group, as amended in the light of subsequent comments and discussions in the MMLG, were reflected in a consultative paper, *The Future of Money Market Instruments*, issued by the Bank in November 1999. The paper included a consultation from the DMO on the dematerialisation of Treasury bills.

The consultative paper was sent to, amongst others, all members of CREST, the CGO and the CMO; all institutions authorised under the Banking Act 1987 and banks operating in the United Kingdom under the EEA passport; the main market associations; and City legal firms.

The responses have been discussed by the Bank with CRESTCo and the DMO, and this paper reflects these discussions and includes a DMO contribution on Treasury bills (See Section D). The Bank has also discussed the legislative implications with HM Treasury and Treasury Solicitors.

**In summary, the response indicated strong and unanimous support for all the main proposals. This included support for the proposal that Treasury bills should be dematerialised, with no paper option. There were a number of detailed comments on aspects of implementation, including the valuation of MMIs, their grouping for collateral purposes, the relative priority in relation to DVP, the handling of the transition, and the timetable for preparation. In order to**

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<sup>1</sup> Since the Review, CRESTCo has taken over the management of both the CGO and the CMO.

**take this forward, the Bank, together with CRESTCo, propose to convene a new Working Group, with membership broadly similar to last year's Money Market Instrument Reform Working Group, to consider all aspects of preparation and implementation. This will involve the establishment of sub-groups on particular matters.**

The Bank and CRESTCo will issue further reports, and there may be further consultations, including on the timetable for preparation, bearing in mind relative priorities, lead times for preparation by CRESTCo and the market, and the perception of the advantages and risks associated with different implementation schedules. At present, it appears that implementation could begin in the second half of 2001 or the first half of 2002.

It will also be necessary to consider the legislation and the timetable for this. The Bank and CRESTCo will discuss with the HM Treasury and Treasury Solicitors the preparation of the legislation necessary for the settlement of MMIs in CREST. The precise timetable for this will depend on the overall timetable for the start of dematerialised MMIs being settled in CREST and other legislative priorities.

In the meantime if you have any questions on the work programme please contact

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This paper and the November 1999 consultation *The Future of Money Market Instruments* are also available on the Bank's website at [www.bankofengland.co.uk/mmfuture](http://www.bankofengland.co.uk/mmfuture).

## **B: SUMMARY OF PROPOSALS IN THE CONSULTATIVE PAPER**

- (i) **MMIs should be integrated into CREST.** A single system would enable market participants to treat MMIs on the same operational basis in settlement as gilts and equities. A single system could also bring economies of scale and efficiency in back office systems, thereby facilitating straight-through processing.
- (ii) **Existing forms of MMIs should be issued in dematerialised form.** The dematerialisation of MMIs would bring cost savings (no need to print on security paper). The dematerialisation of existing forms of MMIs should not impede the development of new types of MMIs (in either dematerialised or physical form).
- (iii) **Issues of MMIs should be fully dematerialised in CREST.** Issuers could continue to issue MMIs in physical form, but such issues would be wholly separate from dematerialised MMIs in CREST.
- (iv) **CREST records should serve as the definitive record of ownership of dematerialised MMIs.** The records of holdings in CREST are updated in real time and could provide the record of the holder of, and transfer of title to, dematerialised MMIs.
- (v) **The same legal structure should apply to holders of dematerialised MMIs as applies to holders of other dematerialised securities in CREST.** There was no obvious policy case for recommending specific provisions designed to replicate negotiability for dematerialised MMIs. Although it would be undesirable for the strength of title to an MMI to be materially affected by dematerialisation, this should not be the case if MMIs are treated on the same basis as holders of dematerialised securities under the Uncertificated Securities Regulations, particularly once Electronic Transfer of Title is in place.
- (vi) **There should be further discussions on how to take forward the objective that assured payment arrangements (and full Delivery Versus Payment in due course) should be introduced for MMIs.** The dematerialisation (and in some cases simplification) of MMIs should create an environment in which settlement banks could take an adequate charge over MMIs.

(vii) **The following simplifications to bills of exchange were proposed:**

- The abolition of the Bank of England's underlying transaction requirements for eligible bills;
- The abolition of the Bank of England's clausing requirements; and
- The abolition of endorsement (as evidenced in use of the 'e-field' in CMO) for dematerialised MMIs (this would not preclude bilateral arrangements between market participants). This form of endorsement is almost never used for bills in CMO. Without extra distinguishing features, like endorsement, bills with identical economic characteristics (the same drawer, acceptor, and maturity date) could be grouped into fungible issues. The abolition of endorsement would have little impact on current market practice and would assist the integration of bills into CREST.

**NOTE:** *The abolition of the underlying transaction and clausing requirements was announced on 1 March 2000, in advance of the other MMI reforms, and took effect on 6 March 2000.*

- (viii) **MMIs should be issued as 'issues' (rather than as separate physical instruments).** An issue would represent all instruments with the *same* features. For discount instruments an issue would include all instruments with the same issuer and maturity date. For coupon bearing instruments an issue would include all instruments by the same issuer possessing the same coupon, coupon payment dates, and maturity (including accrued interest as necessary).
- (ix) **Issues of MMIs should be identified by ISINs.** The Working Group considered ISINs to be the most appropriate identifier for MMIs as they are the internationally recognised standard numbering system for securities, and are used for all securities in CREST. In addition, identifying MMIs by ISIN should assist greater efficiency in back office systems (most of which are based on ISINs).
- (x) **Issuers (or their issuing agents) should be able to input new issues of MMIs directly into CREST.** This should enable new issues to be input into CREST quickly, thus making them available for rapid distribution to the market.

- (xi) **Issues of dematerialised MMIs should be fungible.** This would allow holdings of the same issue to be interchanged and divided into smaller holdings. Fungible MMIs could also bring benefits for the wider market including:
- A deeper and more liquid market, which in turn could bring cheaper issuance, and better prices; and
  - A reduction in the number of identifiers which settlement banks would need to track collateral. This could thereby help to facilitate the introduction of assured payment.
- (xii) **Dematerialised MMIs should be denominated in units of one penny,** as small multiples provide maximum flexibility. This would not affect market practices or conventions dealing with minimum transaction sizes.
- (xiii) **Where these changes require legislative amendments, they should be implemented, as far as practicable, using section 207 of the Companies Act 1989.**

## **C: RESPONSES**

### **General**

There was strong and unanimous support from all respondents for the main proposals in the consultative paper.

### **Paper option and paper interface**

Some respondents were content for there to be no paper option, but others wanted this possibility to remain. There was, however, no obvious demand expressed for a paper interface in CREST.

One respondent agreed that CREST did not need to provide facilities to accept or create physical instruments. But they felt that an option to re-materialise should be made available; and that Issuing and Paying Agents should be able to provide the necessary link here. They viewed their proposed solution as a matter for the commercial decision by the banks able to provide the service, and one which would not require additional facilities to be built into the CREST system.

One bank argued that the cost saving to the market on security printing should not be overstated, given that CDs are already dematerialised.

### **Valuation and collateral grouping of MMIs**

There was general recognition that a lot of work remains to be done in underpinning the move of MMIs into CREST eg establishing a valuation method, haircuts and collateral groupings.

One respondent commented that valuation of instruments needed to be simple and standard across all sectors of the market; and that individual organisations own internal requirements should be catered for locally. Another said that a compromise may have to be found between comprehensive coverage between and within the various different instruments and a simple approach which seeks to include as many instrument types within wide bands.

One bank argued for yield based pricing of MMIs. Another thought it possible to use the yield curve minus a number of basis points by instrument; or to use an Index as a performance benchmark.

One respondent said that it may be operationally desirable to adopt a simple categorisation process, but that this ran the risk of excluding MMIs from secured debit caps (either explicitly or by settlement banks setting punitive haircuts).

One bank suggested that valuation and grouping may be tackled best by mandating a sub-group comprised of the Bank, CRESTCo, LMMA and APACS 'to formulate a proposal based on empirical analysis of MMI volatility (including credit rating), but recognising design complexity and settlement efficiency and where possible establishing a market norm for pricing bills'.

### **Assured payment and DVP**

One bank commented that it would wish to see the simultaneous development of full DVP and the dematerialisation of MMIs although several banks stressed that they did not want the timing of a move of MMIs into an assured payments environment to jeopardise the introduction of full DVP.

### **ISINs**

There was general recognition that ISINs would need to be allocated very quickly to allow for the creation of a large number of issues at short notice - which could then be traded and settled on the same day.

One bank noted that some MMIs held in CMO may also settle across another clearing system which had already established a cross border ISIN number for the tranche.

### **Fungibility and the liquidity and depth of the market**

There were mixed views on this. One bank thought that, although fungibility would be useful for the market, the additional depth and liquidity this would provide would be marginal. Another, in contrast, felt this part of the proposal will have the benefit of significantly increasing the depth of the bill market. One market organisation considered the proposed development will improve the liquidity and depth of the market generally.

Another market organisation said that to advance fungibility, encouragement should be given to the issuance of CDs on a discounted basis, and that more work should be done on this.

## **Certainty of transfer in CREST**

A number of parties stressed the great importance of certainty of title.

## **Scope for dematerialisation of other instruments: letters of credit**

There were mixed views on the dematerialisation of letters of credit. One bank flagged its uncertainty over the practicability and cost of covering other instruments, like letters of credit. But one market organisation, in contrast, welcomed wider dematerialisation saying it 'would be of great benefit to lenders and would effectively mean the full range of short term sterling instruments used for collateral purposes would then be covered by an assured payment system'.

## **Disclosure of information on outstandings**

One market organisation argued for greater disclosure here for the 'longer term'. Other respondents, however, were opposed to making this information generally available.

## **Dematerialised MMIs denominated in units of one penny**

This was generally supported.

## **Transition**

The Working Group considered it might be best to have a period of transition followed by a 'big bang'.

There were various views on this. Some favoured a transition of dual running followed by a 'big bang'; one argued for a 'big bang' alone; and several saw merit in a 'big bang' or 'mini-bangs' by instrument. One noted the need to avoid running a 'legacy' system for a small number of instruments.

## **Change planning**

One bank argued for establishing a 'Roadmap' for the preparation for dematerialisation of MMIs, setting out the main stages and the timetable. It also noted the current pressures on market participants in dealing with T+3 standard settlement for equities and corporate debt, the CREST/CGO merger, Model 1 DVP, and central counterparty and international developments. Another factor to be considered was the timing of the introduction of the CLS Bank.

## **D: TREASURY BILLS**

Respondents welcomed the proposal to dematerialise Treasury bills.

### **Demand for physical Treasury bills**

The majority of respondents indicated that they had no need for physical instruments. However, two respondents indicated that a demand for physical MMIs might remain.

### **Interface**

There was no demand from respondents for an interface between physical and dematerialised Treasury bills.

### **Implementation**

Several respondents noted that changes should be implemented in 2001; although one bank said that dematerialisation of MMIs should not delay the introduction of DVP, another respondent mentioned their concern about the simultaneous introduction of DVP and dematerialisation of MMIs.

### **Transitional issues**

Some respondents noted that dematerialisation of MMIs could be achieved in a series of 'mini-bangs' by instrument. One respondent noted that legal complexities should not delay the dematerialisation of 'easier instruments' such as Treasury bills.

As a result of comments received, the DMO will issue dematerialised Treasury bills as soon as the necessary legislative changes have been made, and the other preparatory measures have been taken. This may or may not be at the same time as other MMIs. As some respondents have noted, MMIs could be dematerialised on an instrument by instrument basis. In such an eventuality, the DMO would hope that Treasury bills would be one of the first instruments to be dematerialised.

Dematerialised issues will be fungible and could be reopened.

Once Treasury bills have been dematerialised, the DMO does not expect to issue any physical securities; however, the DMO would retain the option to do so should circumstances necessitate it.

### **Further work**

The DMO believes that a period of transition, which would allow existing physical Treasury bills to mature and new issues to be issued in a dematerialised environment, would be appropriate. This transitional period would be followed by a ‘mini-bang’ where any outstanding physical Treasury bills would be dematerialised. However, the DMO is happy to take advice from the Working Group on this issue.

The DMO would like to see Treasury bills become part of the general pool of collateral available to market participants and, in particular, for them to be used as flexibly as gilts for DBVs and other repo transactions. Therefore, the DMO will be interested in the outcome of the work on issues of classification and valuation of MMIs to be undertaken by the Working Group. In particular, the DMO would favour Treasury bills being capable of being grouped with instruments of similar credit quality, but recognises that further work needs to be done to identify the best DBV grouping.

## **E: ELIGIBLE BILLS**

There was no support for having the equivalent of the CMO 'e-field' (which allows electronic endorsement) in CREST once MMIs are settled in that system. Some respondents, however, said that they would continue to look for bilateral endorsement from counterparties.

There was full support for the proposal to end the underlying transaction and clausing requirements. This change was announced on 1 March 2000, in advance of the other MMI reforms, becoming effective on 6 March 2000. Copies of the Notice on requirements for eligible bills are available on the Bank's website at [www.bankofengland.co.uk/publica.htm#eligbanks](http://www.bankofengland.co.uk/publica.htm#eligbanks).

## **F: FURTHER WORK**

### **Recommendations for further work in consultative paper**

- (i) The **method of valuation** of MMIs in CREST requires further discussion. This will be a key issue for settlement banks and for any assured payment arrangements introduced before dematerialisation. It will be necessary to consider what reference prices should be used - a price source, a simple discount to maturity, or an accrued interest approach with a haircut?
- (ii) **How should MMIs in CREST be grouped for collateral purposes**, specifically for the categories used for DBVs and floating charges? There is a trade-off between the desire for numerous categories in order to assign appropriate haircuts to different instruments, and the need to keep the approach to categories for MMI collateral relatively simple.
- (iii) **Issuing** MMIs (with the option to re-open an issue) directly into CREST will be a significant change from current practice for CREST. This will have systems implications for CREST, and require an agreed contractual and legal underpinning. CRESTCo and market participants (issuers and their issuing agents) need to consider this further.
- (iv) If MMIs are integrated into CREST, how should the **transition** work? The period of transition could involve some MMIs being issued under the proposals outlined in this paper whilst other (existing) MMIs continued as physical, bearer instruments within CMO. The Working Group concluded that transitional issues should be considered further, but suggested a few preliminary recommendations:
  - All MMIs should be covered by the same transitional arrangements (rather than a series of separate transitions for different types of MMIs).
  - It may be best to have a period of transition, followed by a 'big bang' when remaining physical MMIs are dematerialised at the same time (or preceded by a 'big bang' for MMIs with an outstanding maturity longer than the transitional period). This would allow a large number of MMIs to mature, and any outstanding MMIs could be dealt with in a 'big bang' which should be more manageable for a smaller number of MMIs. There would be a number of issues concerning a 'big bang' that would require further consideration (for example, should dematerialisation be automatic, or should it involve prior consent?).

- Many **legal and legislative issues** will require further detailed work. Treasury Solicitors need to consider the legislative changes. CRESTCo and its members and settlement banks would also need to consider their relationships and, for example, on the exact legal provisions for the transfer of title to MMIs in CREST.
- (v) CRESTCo and market participants will need to consider their **preferred timetable** for the integration of MMIs in CREST. This will depend on the legislative timetable, but will also relate to other priorities and available resources.
- (vi) There are also some general **tax points** that will need to be agreed with the Inland Revenue.
- (vii) Progress towards the dematerialisation of MMIs may also prompt moves **to dematerialise other instruments**.

## Next Steps

The consultation showed widespread support for this work programme. As the next step the Bank, together with CRESTCo, will be convening a further Working Group of market participants to consider outstanding issues relating to preparation and the timetable for implementation. The Bank and CRESTCo will issue further reports in the light of the Group's work. The Group, assisted by sub-groups, will consider, in particular, matters relating to the issuance of MMIs (including the allocation of ISINs); the valuation of MMIs and grouping for collateral purposes; legal issues; and transitional arrangements. It will also consider relative priorities in the market's overall work programme and the target date(s) for implementation.

The aim is for the Group to meet before Easter to establish its work programme. The membership of the group, chaired by Peter Andrews, will be broadly similar to that of the 1999 MMI Reform Working Group.

In addition, the Bank, CRESTCo and the DMO will be discussing further the necessary legislation with HM Treasury and Treasury Solicitors.

The Bank will also be considering, in the forum of the MMLG, issues arising relating to the structure of the money market, in the light of MMI reform, and to the legal agreements used in the market.