

INTERIM REFORMS TO THE BANK OF ENGLAND'S OPERATIONS IN THE STERLING MONEY MARKETS

NOTICE ISSUED BY THE BANK OF ENGLAND

The Bank of England is today announcing a number of technical changes to its official operations in the sterling money markets. These interim measures are being introduced with the aim of stabilising overnight market interest rates further ahead of the launch of the new fully-reformed framework, as discussed in the second consultative paper on the Bank's reforms published on 25 November 2004.

In that paper, the Bank said it was considering narrowing the 'corridor' between its existing overnight lending and deposit facilities, and indexing the rate charged on the two-week reverse repos undertaken by the Bank in its daily open market operations to the MPC repo rate. Following consultation with its counterparties and other market participants, the Bank has decided to make the following changes. From 14 March 2005:

- 1) The rate on the Bank's overnight (3.30 pm) and late repo (4.20 pm) facilities will be the MPC repo rate plus 25 basis points. The rate on the Bank's overnight (3.30 pm) deposit facility will be the MPC repo rate minus 25 basis points.
- 2) The rate charged on new two-week repos undertaken with the Bank as part of its daily open market operations will be indexed to the MPC repo rate, such that whenever the MPC decides to change its repo rate, the interest rate on those transactions will reset to the new rate for the remaining term of the repo. Indexed repos will not form part of the final framework and so will only be used until the launch of the fully-reformed system.

The Bank expects the narrower corridor between its overnight facilities to contain volatility in short-term market interest rates directly. And, as outlined in the consultative paper, indexing repos to the MPC rate will remove a specific source of market rate volatility, known as 'pivoting'.

Two further changes flow from these measures. The Bank currently conducts its open market operations not only via two-week lending through reverse repo but also via outright purchases of bills with less than 14 days to maturity (Treasury bills and eligible bankers' acceptances). It is not possible to index the rate applying to outright bill purchases, and so from 14 March 2005 the Bank will no longer purchase bills outright in its open market operations. That change would otherwise have been introduced with the launch of the fully-reformed scheme. It is important to note, however, that Treasury bills will continue to be eligible as collateral in the Bank's reverse repo lending.

Finally, the Bank has decided to remove eligible bankers' acceptances from its list of collateral eligible for use in its open market operations and for intra-day liquidity in the RTGS payments system, reflecting the decline in the use of eligible bankers' acceptances to the point where they now form a tiny part of the overall collateral pool.

No further changes are being made to the Bank's operational framework at this time.

There will be transitional arrangements for eligible bankers' acceptances as follows:

- 1) The Bank will continue to take currently outstanding eligible bankers' acceptances as collateral for a six-month period, in operations maturing up to and including 17 August 2005, to allow outstanding acceptances to mature.
- 2) To permit a smooth transition to other forms of finance, any eligible bankers' acceptances issued before 14 March 2005 will also be taken as collateral in operations maturing up to and including 17 August 2005.
- 3) Any acceptances issued on or after 14 March 2005 will be ineligible.

In addition, from 14 March 2005, it will only be possible to use eligible bankers' acceptances as collateral with the Bank via member-to-member deliveries in CREST. They will be removed from the relevant DBV categories for eligible collateral in CREST. These transitional arrangements are also set out in an addendum to the notice on eligible banks and eligible bankers' acceptances originally issued on 27 August 2003, which was published today and is available at www.bankofengland.co.uk/markets/money/eligiblebanks.htm.

An amended Operational Notice that will be effective from 14th March 2005, reflecting these changes to the Bank's open market operations, has been published today, www.bankofengland.co.uk/markets/money/mmopnot.htm.

Notes

1. The Bank published a second consultation paper 'Reform of the Bank of England's Operations in the Sterling Money Markets' on 25 November 2004, www.bankofengland.co.uk/markets/money/smmreform041125.pdf. It outlined the Bank's plans for a new framework based on a system of voluntary remunerated reserves with a period-average maintenance requirement. In addition, standing borrowing and deposit facilities will be available on demand to a wide range of banks and building societies. The Bank's open market operations will move to weekly operations of one-week maturity, with a routine overnight fine-tuning operation on the final day of the maintenance period. The Bank currently envisages that the necessary preparations for the fully-reformed system are unlikely to be completed before the end of 2005.
2. The purpose of the Bank's operations in the sterling money markets is to implement the Monetary Policy Committee's (MPC) interest rate decision while meeting the liquidity needs, and so contributing to the stability, of the banking system as a whole. The Bank currently conducts daily open market operations at a maturity of around two weeks to supply the market with the funds needed by the banking system to meet the requirement for settlement banks to maintain a minimum balance of zero on their accounts at the Bank of England at the end of each day. The Bank's current operational framework is described in the May 2002 paper 'The Bank of England's Operations in the Sterling Money Markets', www.bankofengland.co.uk/markets/money/stermm3.htm.
3. With the current fixed-rate two-week reverse repos, 'pivoting' can occur through a process of normal market arbitrage when the MPC rate is expected to change. Overnight market rates ahead of an MPC meeting adjust to equalise the cost of borrowing from the Bank at two weeks and the expected cost of rolling borrowing in the overnight market over the same period. Thus, overnight rates ahead of the MPC

meeting will tend to fall if overnight market rates following the meeting are expected to rise due to an increase in official rates, and vice versa. Indexing reverse repos means that the interest rate charged on the funds lent to the counterparty will change whenever the MPC rate changes, and so will eliminate this source of market rate volatility.

4. A bankers' acceptance is a two name debt security which is a primary obligation of the accepting bank and a secondary obligation of the firm which borrows money from the bank under the acceptance facility. The bank concerned will typically sell the acceptance in the market. On maturity, the holder looks to the primary issuer, the bank, for repayment. If the bank were to default, the holder may then also look to the secondary issuer for payment. Bills of exchange, including bankers' acceptances, have historically played an important part in the short-term financing of some firms. In recent years, however, and as discussed in recent *Bank of England Quarterly Bulletins*, the role of bill finance has declined markedly as firms developed other sources of borrowing. In late 2004, the size of the eligible acceptance market fell below £1 bn compared with £18 bn in 1998.

Bank of England
11th February 2005