

*Reform of
the Bank of England's operations
in the sterling money markets*

A paper by the Bank of England



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REFORM OF THE BANK OF ENGLAND'S OPERATIONS IN THE STERLING MONEY MARKETS

Changes effective from 3 March 1997

This paper sets out the changes the Bank of England is making in its money market operations from 3 March 1997. Technical details of the new arrangements are set out in the Operational Notice, *Bank of England Operations in the Sterling Money Markets*, obtainable from the address below.

Proposals for change were set out in the Bank's consultative paper of December 1996. Responses to that paper indicated positive support for the Bank's proposals across a broad spectrum of market participants. The proposals will therefore be implemented substantially as initially advanced, but some detailed adjustments have been made, and points amplified, in response to helpful comments received.

Further copies of this paper are available from:

The Secretariat
Gilt-Edged and Money Markets Division
Bank of England
Threadneedle Street
London EC2R 8AH

Telephone: 0171 601-3677
Fax: 0171 601-5810

The Bank intends to publish in addition a paper (the "Red Paper") providing a full description of the arrangements for its money market operations, including those aspects which have not been changed. The Bank will keep under review the working of the new arrangements. Any further changes to its money market operations will be announced in Market Notices, as supplements to the Red Paper.

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I Introduction

1 An open trading market in gilt repo began operating at the beginning of 1996. Since then the scale of activity in gilt repo has grown steadily. Details of the market's growth were published in the November 1996 issue of the *Bank of England Quarterly Bulletin* (pages 375-378) and will be updated in the next issue, to be published on 12 February.

2 The Bank believes that the gilt repo market has now developed sufficient scale and depth for it to be appropriate to extend its daily money market operations to include operations in gilt repo. This paper accordingly sets out changes the Bank is introducing in its daily money market operations.

3 The changes will take effect from 3 March 1997.

4 The objectives pursued in the Bank's daily money market operations will remain unchanged. The primary objective is to steer short-term market interest rates to the levels required to implement monetary policy. In doing so, the Bank has regard to the need for the banking system to be able to manage its sterling liquidity effectively; and it also seeks to foster the development of efficient and competitive sterling money markets. The operational changes proposed in this paper are consistent with these objectives.

5 The changes are evolutionary in nature. They retain unchanged the basic structure of the Bank's operating arrangements - daily operations designed to supply, at interest rates determined by the Bank, the liquidity which the banking system as a whole needs to achieve balance by the end of each settlement day, through open market operations conducted on a transparent basis in prime-quality market instruments. In developing the changes, the Bank has sought to avoid creating unnecessary disturbance to the market, while taking account of the development of the gilt repo market and other changes in the pattern of trading in the sterling money markets.

6 Changes are being made in three areas:

(i) **Instruments and the structure of open market operations**

The Bank will extend its daily open market operations to include operations in gilt repo, as well

as continuing to operate in Treasury bills and eligible local authority and bank bills.

(ii) **Counterparties**

In parallel, the Bank will broaden the range of counterparties able to participate in these operations, to include market participants active in the gilt repo and/or bill markets; previously its main counterparties have been the specialist discount houses. There will no longer be any requirement for counterparties to be separately capitalised. In a similar change in the gilt-edged market, the gilt-edged market makers, who are the Bank's counterparties for its gilt funding operations, will also no longer be required to be separately capitalised.

(iii) **Provision of funds late in the day**

The Bank will also implement changes to simplify the arrangements through which it is prepared to provide liquidity at the end of the trading day to adjust for any remaining imbalance in the market.

7 These changes, though evolutionary in character, nonetheless represent a substantial development of the Bank's operations to take account of the changing market environment. They are framed to foster an orderly transition; and, to that end, transitional provisions for discount houses that wish to continue to be counterparties under the new arrangements are set out in section V below. The Bank will monitor carefully the practical effects of the changes and will keep under review the possible need for further adaptation of the structure of its operations in the light of the evolution of the market environment.

8 The plans being drawn up for monetary operations by the future European Central Bank are relevant to any further development of the Bank's operations, whether or not the United Kingdom participates in monetary union: the changes to be implemented from 3 March are consistent with the direction and spirit of the preparatory work for monetary union published by the European Monetary Institute in January - *The Single Monetary Policy in Stage Three: specification of the operational framework*.

II Instruments and the structure of open market operations

9 The money market instruments in which the Bank conducts its open market operations need to fulfil certain requirements. They need to be of prime credit quality; actively traded in a continuous, liquid market; held widely across the financial system for the management of its sterling liquidity; and available in adequate supply.

10 Reflecting these requirements, the Bank has until now conducted its daily open market operations through outright purchases of Treasury bills and eligible local authority and bank bills¹ supplemented on occasion by repos in these instruments and, recently, in floating rate gilts. The bill market has, however, grown relatively slowly in recent years, limiting the supply of paper available for the Bank's operations. In response, the Bank has adapted its operations in a number of ways to avoid placing undue strain on the bill market, in particular by supplementing its daily operations with a twice-monthly gilt repo facility that was introduced in 1994, before the inception of the gilt repo market.

11 The gilt repo market has now, in the Bank's judgment, developed to the point where it meets the requirements for instruments to be used in the Bank's operations. It has become, in essence, a modern form of secured money. The Bank is therefore extending the range of instruments in which it conducts its daily operations to include gilt repo. Alongside the growth of gilt repo, however, Treasury bills and eligible bank bills remain important and useful instruments in the diverse range of sterling money market paper traded in the London markets, and the Bank will therefore continue to include those instruments (and eligible local authority bills) in its daily operations, both for repo, alongside gilts, and for outright sale to the Bank. The Bank will reduce the minimum residual maturity of eligible local authority and bank bills it is prepared to buy outright, from two days to one day, aligning their treatment with that of Treasury bills. The Bank does not purchase gilts outright in its money market operations.

12 In addition, since the Bank already accepts HM Government foreign currency marketable debt

(US dollar, Deutsche Mark and ECU bonds, ECU Notes and ECU Treasury bills) in its twice-monthly repo facility and in its provision of intra-day liquidity in the Real-Time Gross Settlement (RTGS) sterling wholesale payments system, it will accept those instruments in its daily repo operations.

13 In all its repo operations the Bank will require initial margin to be provided and will have the right to call for variation margin. The size of the initial margin will depend on the type of instrument offered.

14 All the sterling and foreign currency assets in which the Bank deals in its money market operations may in principle be included in the quantum of a bank's marketable assets, as monitored by the Bank's banking supervisors for liquidity purposes (under either of the two systems used by the supervisors - the stock liquidity system or the mismatch system). But an asset which is repoed to the Bank (or to any other counterparty) may not be included, because title to the asset passes to the Bank (or other counterparty) for the period of the transaction. Conversely, a bank which has reverse repoed such an asset into its book may count it towards its stock of liquid assets for the period of the transaction, because title has passed to the bank for this period. The same principle applies to other similar transactions where title passes unambiguously to or from a bank for the period of a transaction. But where the asset is pledged as collateral but title has not passed, neither the giver nor the receiver of the collateral may include the asset as a marketable asset for liquidity purposes.

15 The specific arrangements for the Bank's daily operations will be as follows:

- (i) At each of the set times (see below) at which it operates through the day, the Bank will continue, as at present, to publish its forecast of the market's liquidity shortage or surplus for the day.
- (ii) If, as is typically the case, the market's position is one of liquidity shortage, then, if the shortage is large enough to

¹ An eligible bank bill is a bill of exchange accepted by a bank whose acceptances are eligible for discount at the Bank of England. Purchases made by the Bank are with recourse to the seller. Thus eligible bank bills purchased by the Bank from counterparties are three-name paper, the names being those of the drawer, the acceptor and the counterparty. The Bank will not purchase from a counterparty its own acceptances, either on repo or outright.

require it, the Bank will invite a round of open market operations.

- (iii) Open market operations will generally be conducted at a fixed rate, but the Bank may, on occasion, choose to operate on a variable-rate basis through a tender. In the normal case of a fixed-rate tender the Bank will state, when it invites each round of operations, the repo rate at which it is prepared to operate. If the Bank were to conduct a variable-rate tender, the form of the tender would be announced at the time or in advance.
- (iv) For fixed-rate operations, in each round of operations the Bank will invite counterparties to state the total amount of funds each wishes to obtain in that round and, within that, the amount of funds wanted through repo and the amount wanted through outright sales to the Bank. An individual counterparty will not be permitted to bid for more than the total amount of the forecast remaining shortage at each round. In providing funds, the Bank will normally treat repos and outright sales on the same basis and make no distinction between the two types of transaction. But on occasion the Bank may wish to give priority to one type of transaction over the other, for example allocating funds through repo ahead of funds through outright sales to the Bank, or vice versa; in that event, the Bank will indicate in advance which type of transaction is to be given priority. In announcing the result of each round, the Bank will publish the amount of funds provided through repo and the amount provided through outright sales to the Bank.
- (v) As at present, in each round the Bank may supply funds for part, or all of, but not normally more than, the forecast remaining shortage. If, in a fixed-rate operation, aggregate bids for funds exceed the amount the Bank wishes to allot in any round of operations, the Bank will pro-rate bids, normally without regard to the specific type of transaction

(ie repo or outright) offered, unless, as outlined in the previous sub-paragraph, it has already announced that it will give priority to one type of transaction over the other. In any event, within each type of transaction (ie repo or outright), the Bank will make no distinction between different types of paper offered².

- (vi) In each round, counterparties will have five minutes in which to make their bids, after the Bank has published its invitation. The Bank will announce the result within 15 minutes of the start of the round.
- (vii) When the Bank is operating at a fixed rate, counterparties will not be required to state the interest rate at which they seek funds, and the present practice of giving priority to bids for funds at a higher rate will cease. Funds to be provided through repo will be provided at the Bank's stated repo rate. Funds provided through outright purchases of bills will be provided at discount rates, varying as necessary with the maturity of the bills, and set so that their yield equivalents are as close as possible to the Bank's repo rate. Discount rates to be applied in outright purchases will be published on the Bank's pages on screen services.

16 The maturity of funds provided through the Bank's daily open market operations has up to now been set in terms of maturity bands: the Bank has offered to buy outright bills whose residual maturity falls in Band 1 (1-14 days) and Band 2 (15-33 days), though it could extend its operations to Band 3 (34-63 days) and Band 4 (64-91 days). Operating in maturity ranges in this way has been necessary for outright purchases because if the Bank had specified a single maturity date, the market might have had difficulty mobilising at short notice sufficient paper maturing on that specific date. In repo operations, no such constraints exist, since funds can be provided against any acceptable security with a maturity longer than that of the repo.

17 In practice, the maturity of the funds the Bank has been providing in recent years has been on

² This means that in providing funds through repo, the Bank will make no distinction between repo of gilts, repo of bills and repo of HM Government foreign currency marketable debt; and in providing funds through outright purchases, the Bank will make no distinction between outright purchases of Treasury bills, eligible local authority bills and eligible bank bills.

average around two weeks. The Bank will retain approximately this maturity for its dealing operations in repo, though with minor variations possible from day to day in order to smooth the future pattern of forecast daily shortages/surpluses. Thus, when the Bank operates to supply funds, it will normally invite repos to any or all of three dates - the two week forward date and the working days either side of that forward date. The particular combination of these maturities at which the Bank is prepared to operate will be specified in advance on each occasion. Repos to additional dates may also be invited on occasion if necessary to smooth the future pattern of forecast daily shortages/surpluses. On each occasion, offers for outright sales to the Bank will be invited of bills with a residual maturity up to the longest-dated repo invited; but the Bank will not buy outright bank bills within seven days of their date of acceptance. Counterparties will not be able to exercise any choice among the repo maturities specified by the Bank. The Bank will normally allocate the funds it is prepared to provide through repo in each round equally across the specified maturities, though it may on occasion adopt a differential allocation across the maturities if necessary to smooth the future pattern of forecast daily shortages/surpluses, in which case this will be announced in advance.

18 On days when the market is forecast to be in surplus, the Bank will operate, as in the past, to "mop" the surplus, by offering outright sales of short-dated Treasury bills to its counterparties in its open market operations.

19 The Bank's daily open market operations have until now been conducted at 12.00 noon and 2.00 pm, with an additional early round of operations undertaken at 9.45 am if the forecast daily shortage is large. 9.45 am (if needed) and 12.00 noon continue to be appropriate times for the Bank to operate, but in recent years the need for market participants to be active in managing their liquidity right up until market trading ends for the day suggests that 2.00 pm is earlier than desirable for the Bank's final round of open market operations. One result has been increased use of the Bank's late lending facility from 2.45 pm, which has at times tended to take on the character of a further round of open market operations.

20 The Bank's final round of open market operations will therefore be undertaken at 2.30 pm,

which consultation with the market has suggested is the latest time in the day feasible under the timetables of the relevant sterling payment and settlement systems. Thus the Bank's daily operations will be at 9.45 am (if needed), 12.00 noon and 2.30 pm. Consequent changes to simplify the Bank's provision of funds later in the trading day are set out in section IV below.

21 Once these changes are in operation the Bank expects that its twice-monthly gilt repo facility will not need to be used on a regular basis. But the facility will continue for the time being, to facilitate the transition to the new arrangements, and thereafter will be retained in abeyance for future use if necessary.

22 To avoid a possible clash in time between the Bank's 9.45 am round of open market operations in the money market and gilt-edged auctions, in which the deadline for bids has until now been 10.00 am, the Bank has decided to alter the deadline for bids at gilt-edged auctions to 10.30 am. This change will be effective from the auction to be held on 26 March 1997.

23 Full technical details of the Bank's operations in the sterling money markets and of related settlement procedures are given in an Operational Notice, copies of which can be obtained from the Bank's Gilt-Edged and Money Markets Division (see the address, telephone and fax numbers given on page 3).

III Counterparties

24 To facilitate its operations, and in particular to ensure that access to the liquidity provided by the Bank is available as smoothly as possible to all market participants, the Bank will stand ready to deal in its daily operations with a wide range of financial institutions active in the gilt repo and/or bill markets.

25 The Bank will need to be satisfied that counterparties are subject to appropriate prudential supervision and it will wish to sign legal agreements with counterparties, governing their transactions with the Bank, in a form acceptable to the Bank. But subject to these conditions, the Bank will be prepared to conduct operations with market participants who meet the functional requirements for its operations set out below. The Bank will not establish any fixed list of official counterparties.

26 In particular, the Bank will be prepared to sign legal agreements with banks, building societies and securities firms, supervised by the Bank of England, the Building Societies Commission, the Securities and Futures Authority or a competent authority in the European Economic Area, who satisfy the Bank that they meet the following functional criteria:

- (i) Counterparties must have the technical capability to respond quickly and efficiently to the Bank's daily rounds of open market operations. This means in particular that counterparties must be able to execute dealing operations with the Bank, in its daily rounds of open market operations, and complete all subsequent settlement activities, in accordance with the timeframes given in the Operational Notice referred to in paragraph 23. To assist this process, the Bank will be prepared to give each counterparty access to its dealing room via a direct telephone line.
- (ii) Counterparties must maintain an active presence in the gilt repo and/or the bill markets. This means that counterparties will be expected to be trading in the gilt repo and/or bill markets on a reasonably continuous basis, with a range of unrelated counterparties, on a scale that

would enable them to contribute in a material way to distributing around the system the liquidity provided by the Bank in its rounds of operations with its counterparties. A counterparty whose operations are limited to managing its own liquidity requirements may not fulfil this criterion.

- (iii) Counterparties will be expected to participate regularly in the Bank's daily rounds of open market operations. This does not mean that counterparties are obliged to take part in the operations every day or in every round on any one day. But the Bank does expect them to participate on most occasions and, on average over time, on a reasonable scale. The Bank will monitor the performance of counterparties in participating in its operations and will notify a counterparty, with a view to reassessing its dealing relationship, if the counterparty's participation is judged to be falling short of the Bank's requirements. Such reassessment may lead the Bank to cease dealing with a counterparty if performance continues to be inadequate.
- (iv) The Bank will look to its counterparties to provide useful information on a regular basis on market conditions and developments in the sterling money markets. This would normally be on an informal ad hoc basis and principally through counterparties' day-to-day contact with the Bank's dealers and the working liaison the Bank maintains with market participants. Counterparties, alongside other market participants, are also asked to contribute to the Bank's quarterly statistical survey of the gilt repo market.

27 Firms which believe they meet the requirements and wish to become counterparties of the Bank are invited to contact the Head of the Gilt-Edged and Money Markets Division of the Bank at the address given on page 3. Copies of the Bank's legal agreement for these operations can be

obtained from the same address. The Bank is ready to accept counterparties not incorporated in the United Kingdom which meet the functional, supervisory and legal requirements, but the Bank will need to be given a legal opinion on the operation of any foreign system of law under which a counterparty is incorporated; details of the matters to be covered in such an opinion are also obtainable from the Gilt-Edged and Money Markets Division.

28 The Bank will expect all its requirements to be met on a continuous basis. Thus the Bank will want to be satisfied that the legal agreements it signs with counterparties are, and remain at all times, fully valid and robust. It will also want to be satisfied that counterparties continue to meet the prudential and other requirements of their relevant supervisory body. There will be no requirement for counterparties to be separately capitalised or specialised entities and there will be no special supervisory arrangements for counterparties per se; prudential oversight of their activities as a whole will remain with their existing supervisor.

29 The Bank will also expect the functional requirements set out above to be fulfilled on a continuous basis. The Bank reserves the right to cease dealing, temporarily or for longer periods, with any counterparty at its own discretion. The Bank will publish no list of firms with which it has signed legal agreements.

30 Since the Bank's counterparties in the money market will no longer need to be specialist entities, the Bank will similarly no longer require gilt-edged market makers to be separately capitalised firms. This change will take effect from 3 March 1997. The Bank will publish a paper (the "Blue Book") setting out full details of its counterparty relationship with the gilt-edged market makers, in the light of these changes, (and the arrangements for the operations of the gilt-edged inter-dealer brokers, which remain unchanged for the time being).

31 As a consequence of the widening of the range of the Bank's counterparties, the requirement for the members of the London Discount Market Association to underwrite the weekly sterling Treasury bill tender will cease to apply. Given the widespread demand for Treasury bills, the Bank does not consider it necessary to put substitute arrangements in place for formal underwriting, but given the importance of weekly Treasury bill

tenders in the management of the money market, it will look to counterparties to participate actively over time in the weekly tenders; the Bank would not necessarily expect counterparties to feel obliged to do so every week, but would expect counterparties to do so on most occasions, and on sufficient scale to ensure that the tender is adequately covered.

IV Late repo facility for settlement banks³

32 The Bank has until now made available a facility for secured lending, within limits, to the discount houses (from 2.45 pm to 3.30 pm), and a similar facility to the gilt-edged market makers (at 2.45 pm), as well as standing ready to purchase Treasury bills from the settlement banks up to 3.00 pm. The purpose of these facilities has been to enable market participants to adjust to any end-of-day imbalance in the market.

33 Moving the Bank's final round of open market operations from 2.00 pm to 2.30 pm should substantially relieve the need for late access to liquidity from the Bank. The Bank would expect market participants to ensure that their daily liquidity needs are addressed as early as possible in the day; and the Bank will aim to provide sufficient liquidity to square the system by the end of its 2.30 pm round, so that residual needs arising late in the day should be capable of being satisfied either at the 2.30 pm round or in the market.

34 Nonetheless, some form of late access to liquidity is necessary because late imbalances can inevitably arise, for example because of a late change in the Bank's money market forecast or unforeseen variations in market participants' positions. But with the Bank operating in the open market as late as 2.30 pm, the need for late access to the Bank arises only for the settlement banks, who provide wholesale payments services to the rest of the market and need to balance their settlement accounts at the Bank of England at the end of each day. The arrangements for late access to liquidity can accordingly be simplified.

35 The Bank will therefore be prepared to make available, to the settlement banks only, between 3.50 pm and 3.55 pm a late repo facility at a rate 1/4% above the repo rate applied in the Bank's open market operations. The Bank will be prepared to provide liquidity, normally up to the amount of any late swing it identifies in the system's need for liquidity, to any settlement bank, whether or not it is one of the Bank's counterparties in the open market operations. An individual settlement bank will not be permitted to apply for more than the total of the forecast shortage remaining at that stage, but the Bank will not otherwise place any

predetermined limits on individual banks' access to this facility. It is intended that the facility should normally be utilised only for shortages unforeseen at the time of the Bank's 2.30 pm operations and arising unexpectedly thereafter. It would be withdrawn from any settlement bank seeking to use it other than for its intended purpose, in which case the charge on any resulting shortfall in the settlement bank's settlement account at the close of business would be more heavily penal.

36 The operation will be conducted in the form of repo, and normally with an overnight maturity as at present, unless the Bank specifies otherwise. Paper eligible for use in this facility will be the same as for the Bank's open market operations. The Bank will publish shortly before 3.50 pm its latest estimate of the day's shortage and whether the facility is to be made available that day. The Bank will pro-rate bids for funds from the settlement banks if they exceed the amount it considers necessary to provide.

37 Late access to liquidity will also be available to discount houses during a transitional period (see paragraph 38 (v)).

³ Settlement members of the Clearing House Automated Payment System (CHAPS) other than the Bank itself.

V Transitional provisions for discount houses

38 Up to now, a number of special provisions have applied to the business of discount houses, in recognition of the role they have played in the Bank's money market operations and the associated obligations they have undertaken. To facilitate the process of transition to the new arrangements, the Bank is prepared to continue to make available, to any discount house that wishes to continue to be a counterparty of the Bank under the new arrangements and is accepted by the Bank for that purpose, a number of these provisions for a transitional period which would not extend beyond a maximum of two years. The transitional arrangements will be as follows:-

- (i) The provisions will be available only to discount houses which remain specialist, separately capitalised counterparties, subject to "appropriate business" rules which place restrictions on the types of business which they may undertake. Such houses will continue to be supervised by the Bank under the special arrangements for discount houses.
- (ii) Clearing bank secured deposits (overnight or at call) with such houses will continue to count as primary liquidity for these banks.
- (iii) Banks' secured deposits with such houses will continue, as now, to attract a risk weighting of 10%.
- (iv) Deposits which such houses take from UK banks (including via repo transactions) will continue to be excluded from the calculation of these houses' eligible liabilities, including for the purposes of calculating cash ratio deposits.
- (v) From 2.45 pm, after completion of the Bank's final round of open market operations, the Bank will continue to make available to such houses late access to liquidity from the Bank on broadly the same terms as in their present facility. Thus houses will continue to be able to apply for late liquidity from the Bank, by way of repo, in amounts up to twice their

capital. The Bank will have complete discretion on how to respond to such applications and will not normally supply more than its estimate of any remaining shortage in the market as a whole. Applications for liquidity will be pro-rated if necessary. The amount provided under this facility will be published. The amount provided before 3.00 pm will be published shortly after that time and the total amount provided will be published shortly after 3.20 pm.

Banks will be given the information they need to implement items (ii) and (iii) above.

39 Discount houses which wish to participate in the Bank's open market operations without taking advantage of these transitional provisions will, if accepted by the Bank as meeting the functional criteria, not be required to be separately capitalised, will not be subject to "appropriate business" rules and will be supervised under the prudential arrangements applied to other firms conducting similar business. The same will apply to houses which initially use the transitional provisions, when they cease to do so.