BANK OF ENGLAND

News release

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Central bank policy on collateral - paper by Paul Fisher

In a paper summarising recent discussions with a range of market contacts, Paul Fisher - Executive Director Markets, member of the Monetary Policy Committee and member of the interim Financial Policy Committee - sets outs the Bank of England's approach to collateral policy, which is driven by a combination of monetary and financial policy objectives and the need to protect the Bank's balance sheet.

The Bank expanded significantly the scale of lending and range of collateral acceptable in its sterling market operations in the face of the financial crisis. But central banks, like any other business, need to protect their balance sheet. To that end, Paul Fisher identifies three principles that central banks should look to observe, reflecting: the prospective solvency of creditors; the quality of collateral; and the achievement of public policy objectives. Those principles in turn require decisions about collateral eligibility, valuation, haircuts and exposure limits. He says: "These are important questions for the banking system as a whole, and have presented new and complex risk management challenges for central banks over the past few years."

Reflecting on these challenges, Paul Fisher says the financial crisis proved a "game changer" for the Bank and its Sterling Monetary Framework. Following the introduction of the Special Liquidity Scheme and extension of its Long-Term Repo operations (eLTRs), the Bank revised its operational toolkit, introducing the Discount Window Facility (DWF) and replacing eLTRs with Indexed Long-Term Repo operations. He says that in designing these new liquidity insurance facilities "...the Bank was very mindful of the need to balance the benefits to systemic stability, the incentives for banks to manage liquidity risk prudently, and the need to minimise the risk taken onto the Bank's balance sheet. In particular, the aim of the Bank has been to leave the credit and market risks associated with collateral with the counterparty, so that we only provide the intended liquidity insurance and not any official underwriting of the underlying risks."

The Bank has recently decided to allow counterparties to use 'raw' loans as collateral in the DWF, expanding both the range of assets and institutions that have the potential to use the facility in times of stress. And steps to increase ABS transparency have also been formalised, which is expected to deliver benefits to both the Bank and the wider market.

Paul Fisher concludes by considering some of the future issues facing the Bank and its collateral management ahead, most immediately the winding down of the SLS by January 2012. He says: "The banks have made good, early progress in reducing their use of the Scheme, unwinding the collateral swaps ahead of their contractual maturities." And given the improvement in secondary and repo markets for RMBS and mortgage-backed securities, it is his expectation that "...the banks will be able to generate liquidity using their mortgage assets in the private market or by raising funding through other markets".

Key Resources

Central bank policy on collateral – Full speech