BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

24 January 2013

Remarks to the London Money Market Association Executive Committee Meeting – Chris Salmon

In remarks delivered to the London Money Market Association Executive Committee, Chris Salmon, Executive Director for Banking Services and Chief Cashier, provides a progress report on some of the key changes the Bank has been promoting in the payment, settlement and clearing infrastructure for the unsecured and secured money markets. He also offers some comments on the nascent offshore RMB market in London.

Chris Salmon begins by noting that the series of reforms initiated in the mid-1990s helped to create a strong infrastructure for the UK core unsecured and secured sterling money markets. But developments in market infrastructure never reach an end point and the Bank is working with market participants to address a number of tail risks which remain or have emerged.

In terms of payment arrangements for the unsecured money market, the Bank's focus has been on strengthening the operation of the core high value payments system, CHAPS. Following up on a speech from July 2011, Chris Salmon reiterates the Bank's efforts in encouraging greater direct membership of CHAPS over the past few years. "As of end-2008 there were just 14 CHAPS banks. Since then, four banks have joined CHAPS and two others have formally committed themselves to join over the next year or so. A small number of other banks continue to deliberate their next steps. I hope they too conclude that membership is in their own interest...If all of the banks we have been in discussions with were to join the scheme, the number of direct members would have increased by around a half compared with 2008." He concludes that "...assuming the progress we expect over the next year occurs, the Bank's concerns about tiering risks within CHAPS will have been materially reduced."

Salmon goes on to say that a renewed, and appropriate, focus on liquidity regulation has led to changes in payments behaviour, increasing the incentive for banks to make their payments late in the day. To address the risks associated with these changes, the Bank is pursuing a two pronged strategy: first, the Bank will introduce a Liquidity Saving Mechanism into CHAPS this Spring. This will have the effect of making CHAPS inherently more liquidity efficient, reducing the incentive to economise on liquidity uncooperatively. Second, the Bank is working with the CHAPS Scheme to reform the rules guiding "throughput" behaviour. The expectation is that this work should be substantively completed by the end of this year. These initiatives will reduce credit, liquidity and operational risks associated with the settlement of cash transactions.

Turning to the secured money market, Chris Salmon states that the Bank's key objective in this area has been to reform how the Delivery-By-Value (DBV) market works. DBV gilt repo has become the mainstay of the secured sterling market and is used by all major participants. The key weakness, however, is that any DBV transaction, whatever its underlying economic term, is implemented as if it were a series of overnight transactions. This results in a cycle of unwinding and re-inputting trades each day until the underlying transaction matures. Salmon notes that this complicated method of term lending introduces operational and liquidity risks. These are tail risks, but would be very costly should they materialise. As such, for several years the Bank has believed that the market would be well served if the term transactions currently conducted on an overnight DBV basis moved to a term DBV basis. Salmon refers to an announcement made this morning, that the Money Market Liaison Group has agreed to establish a steering committee with membership from the Bank, EUI, LCH and the LMMA to facilitate the adoption of Term DBV as the default method for gilt repo transactions. Salmon states: "Hopefully, this joint commitment by all the key parties in the sterling money market, along with the establishment of the steering committee, will overcome the collective action problem, paving the way for the orderly adoption of term DBV."

Finally, Chris Salmon touches on the development of the nascent offshore RMB market. He states that the Bank would welcome the development of the offshore RMB market and notes that the Bank has engaged with the City of London initiative on London as a centre for renminbi business. He suggests that: "the growth of the market will depend on the success of market participants in matching incipient demand and supply for RMB denominated products". However, for the removal of any residual uncertainty about the Bank's attitude, he concludes that: "the Bank is ready in principle to agree a swap line with the PBOC, assuming a mutually agreeable format can be identified."

ENDS

Notes to Editors

1. A copy of Chris Salmon's speech *The case for more CHAPS settlement banks* from 5 July 2011 can be found on the Bank of England website: http://www.bankofengland.co.uk/publications/Pages/speeches/2011/508.aspx

2. News release – Joint initiative to introduce a cleared term delivery-by-value service – 24 January 2013: http://www.bankofengland.co.uk/publications/Pages/news/2013/022.aspx
3. CHAPS and CREST are both high value payment systems. The CHAPS payment system is designed to make instant, high-value sterling transfers. Typically, members of the public will initiate payment using CHAPS only rarely, for example when buying a house. Financial institutions will

make many large CHAPS transactions daily, regularly settling inter-bank loans worth hundreds of millions of pounds. The CREST system plays an equivalent role for securities transactions and is used intensively by financial institutions for the exchange of loaned funds and associated collateral.

4. Liquidity Saving Mechanisms can reduce the amount of liquidity members will use during the day to make a given level of payments by allowing those payments that are earmarked by CHAPS banks to be matched against incoming payments and settled simultaneously (taken from page 4 of the speech).

5. According to the current framework, a bank is deemed to have met its throughput target so long as it had sufficient liquidity available to make any payments which were in fact made late. But these guidelines were designed before the boost to commercial bank reserves from quantitative easing and have become ineffectual in the current environment. We expect new rules which will focus only on the timing of payments to be agreed soon. Given that in some cases 'lateness' may be a natural artefact of a bank's business model, rather than a strategic choice, the new rules will work on the basis that banks must 'comply or explain' to the CHAPS Scheme, rather than anything more automatic (taken from page 4 of the speech).