

Supervision of the markets in money, foreign exchange, currency deposits and gold

1 This paper describes the Bank's rôle in supervising three groups of markets: the sterling money markets, which deal in sterling deposits and a wide range of short-term public and private sector instruments; the foreign exchange and currency deposit markets, the former dealing both spot and forward in foreign exchange and the latter being the pre-eminent international market for inter-bank foreign currency deposits; and the gold market.

The Bank's rôle

2 The Bank exercise a supervisory rôle in regulating these markets not only because their good health and operational efficiency are important to the soundness of the UK financial system as a whole and in particular to the continued standing of London as a major international centre, but also because of their importance as the field in which the Bank's policy objectives are effected. For example, the Bank operate in the foreign exchange market as agents for HM Treasury in managing the Exchange Equalisation Account. Similarly, in the domestic field the Bank conduct money-market operations through the secondary market in Treasury bills and certain other short-term instruments.

3 The Bank have, for the most part, encouraged the participants in the various markets to organise their own institutional framework, within which soundings may be taken and matters of day-to-day management disposed of, the better to assist the Bank in monitoring and controlling developments. The Bank's aim is to procure the efficiency and integrity of the markets to a degree which will maintain and enhance the international reputation and standing of the London market.

4 There are several aspects of integrity in the operation of financial markets. It is particularly important that participants in money markets should be able to rely absolutely on the good faith of their counterparty, especially where most bargains are concluded by word of mouth, and that acceptable arbitration procedures are available to resolve misunderstandings. Secondly, the quality of the instruments in which the markets trade must be maintained at appropriate standards. Lastly, of course, venality should be prevented or eliminated and suitable disciplinary procedures be available to deal with any lapses. In order to maintain high standards, the markets need effective conventions or codes of practice and conduct. While the basic principles underlying them remain unchanged, individual conventions are likely to require amendment or interpretation to take account of new developments or, especially in the EEC context, to reconcile differences between market practices in London and other major financial centres.

5 The Bank have established and developed these conventions in close consultation with banking and other market associations. Such associations have proved both the most convenient channel of communication and the most effective means of ensuring that conventions, once agreed, are duly observed. The largest and most comprehensive of these associations in the context of money markets as a whole is the British Bankers' Association (BBA), which was reconstituted in 1972, with the Bank's encouragement, to represent comprehensively the interests of all banks operating in the United Kingdom. The BBA, in its turn, has formed a series of

committees which keep all aspects of money-market activity under review. To enable it effectively to take account of varying views within the BBA in the regulation of the market, the Bank participate in many of these committees.

6 The interests of particular groups within the banking market are represented by a number of sectoral banking associations (the Committee of London Clearing Bankers, the Committee of Scottish Clearing Bankers, the Accepting Houses Committee, the London Discount Market Association, the Foreign Banks and Affiliates Association, the British Overseas and Commonwealth Banks' Association, the American Banks' Association of London, the representatives of Japanese banks in London and the Association of Consortium Banks), which have been established at various times, in a number of cases with the direct encouragement of the Bank. Non-banking associations such as the Foreign Exchange and Currency Deposit Brokers' Association and the International Certificate of Deposit Market Association have also been formed. The Bank maintain links of varying degrees of closeness with all these associations and they each approach the Bank directly on subjects of concern to their members. These associations also provide the channel through which practical issues which affect the efficiency of the markets can be discussed and resolved.

7 The following paragraphs outline briefly the institutional arrangements which exist in the three groups of markets and the relationships which the Bank have developed with the participants. They do not purport to present an exhaustive survey of all the Bank's activity in this field.

Sterling money markets

8 There are two main domestic money markets, which to some extent overlap. The traditional secured money market is made primarily by the members of the London Discount Market Association (LDMA). This comprises the eleven houses who hold a discount account at the Bank, who alone have the right of access to the Bank's lender of last resort facility and through whom the Bank conduct the bulk of their open money-market operations. The discount houses borrow sterling, either overnight, at call or for a fixed period, mainly from banks but also from other financial institutions and commercial companies. Their borrowings are normally secured on collateral comprising the short-term instruments (e.g. Treasury bills, local authority bills, bank bills, sterling certificates of deposit and short-dated British government securities) which they acquire with the money they have borrowed. This activity enables them to play a large or predominant part in the secondary market in most of the assets in which they deal.

9 The Bank's regular contacts with the LDMA and its members are extremely close. The chairman and deputy chairman of the Association attend weekly on the Governor to discuss matters affecting the market, and there is daily contact at various levels which may relate to any aspect of the operations of the market. In such an environment any development in market practice or proposals for new instruments to be traded in the market are always fully discussed with the Bank.

10 Since the early 1960s a second sterling market has developed, mainly in inter-bank unsecured deposits (again either overnight, at call or for a fixed term) but also, to a significant extent latterly, in sterling certificates of deposit (CDs). Unlike in the foreign exchange markets, however, participants are not restricted to banks and include local authorities, building societies and other financial institutions and many other commercial and industrial companies. This market is sometimes thought of as a series of discrete markets, e.g. an inter-bank market where banks lend to banks, an inter-company market where companies lend to companies, a local authority market where funds are lent to local authorities and a CD market where CDs are traded. Such distinctions may help in describing differences in interest rates applicable to different types of borrower or instrument within the market, but the market is essentially a unitary unsecured sterling money market.

11 Many of the transactions in this market are negotiated through brokers, who provide similar facilities to participants in this market to those provided by the foreign exchange brokers described in paragraph 13 below. In the wake of the losses which some participants, and notably the Scottish Wholesale Co-operative Society, incurred as a result of transactions in this market in the early 1970s, a working party was set up by the Bank in 1974 to examine the institutional framework of the market. Following the report of this working party, which revealed certain shortcomings in market practice, it was decided, in order to assist the Bank in regulating the market, that a code of practice to govern transactions in this market should be drafted and a Sterling Brokers' Association formed, very much on the lines of the Foreign Exchange and Currency Deposit Brokers' Association (described in paragraph 14 below). Discussions to these ends, which have been proceeding under the aegis of the Bank, are very far advanced.

12 In addition to these institutional links, the Bank have for many years entered the markets in bank bills and, to a lesser extent, in trade bills to sample the quality of paper in circulation. By refusing to discount at their prime rate any bills in a sample which do not conform to the highest quality, the Bank are able to demonstrate to participants the standards which they expect them to maintain.

Foreign exchange and currency deposit markets

13 Only banks which are authorised under the Exchange Control Act 1947 to deal in foreign exchange are permitted to participate as principals in the London foreign exchange market. These banks mostly employ the services of broking intermediaries, both to identify willing counterparties to transactions and to obtain up-to-the-minute information on the rates being quoted, both spot and forward, for all major and most minor currencies. The brokers have combined to form an association called the Foreign Exchange and Currency Deposit Brokers' Association (FECDBA). Those banks that wish to employ the services of a broker are required as far as their dealings with other banks in London are concerned, to operate exclusively through members of the FECDBA (with an exception for *de minimis* amounts in which they may deal directly between each other).

14 These arrangements stem from events which occurred prior to the Second World War, when there were a large number of small broking firms in the market and some unsatisfactory commercial practices developed. With the Bank's

encouragement a Foreign Exchange Brokers' Association was then formed with membership criteria which included sponsorship from the banks themselves, and an agreed code of conduct. In their turn banks employing a broker were required to pass their London inter-bank foreign exchange business through members of the Association. After an interval covering the war years and those immediately succeeding it, these arrangements were reactivated in 1951 when the exchange market was reopened. They have been reviewed and revised under the supervision of the Bank on a number of subsequent occasions, notably in 1967 when negotiations were begun to enlarge the Brokers' Association to encompass the growing market in currency deposits and, most recently, in 1975 when the trading arrangements and the code of practice required by the Bank were restated in a letter sent to all members of the BBA by its president, Lord O'Brien. The working of these arrangements is kept under regular review by a Joint Standing Committee, chaired by a Bank of England official, on which banks and brokers are equally represented. The Committee reports back to the Council of the FECDBA and the Foreign Exchange Sub-Committee of the BBA (which is also the body consulted by the Exchange Control Department of the Bank on exchange control matters affecting banks). The Joint Standing Committee also acts as arbitrator in the event of disputes arising out of foreign exchange and currency deposit transactions completed in the London market.

15 Dollar certificates of deposit issued by London banks have become the most important negotiable instrument traded in the currency deposit markets. The first issues were made in 1966, when the Bank had been satisfied that the banks generally felt that such instruments would constitute a useful addition to their range of liabilities and that a viable secondary market would develop. Because the CD (whether dollar or sterling) is a bearer instrument, exchange control consent is required by anyone proposing to make an issue. Such consent has, in practice, only been granted to authorised banks and is subject to the condition that the term to maturity of the CDs should not exceed five years. The Bank have also imposed certain non-statutory requirements on the market to reinforce the quality of the instrument traded in London, including that the secondary market in dollar CDs shall be confined to CDs issued by London banks, and that CDs may not be denominated in currencies the responsible monetary authorities for which are known to be anxious to discourage the use of their currency in this way (e.g. deutschmarks and Swiss francs).

16 The Bank regulate the foreign currency and currency deposit markets in a number of ways additional to the arrangements described in paragraph 14. Although these other arrangements are mainly directed to balance of payments considerations or the prudential supervision of individual banks, they also effectively supplement the Bank's knowledge of and control over the markets as a whole. Under exchange control rules all banks operating in the United Kingdom are obliged to maintain on a daily basis a very closely matched position between their aggregate spot and forward liabilities in foreign currencies against sterling and their corresponding claims. This strictly limits the extent to which UK banks are able to take positions in foreign currencies (either in favour of or against sterling). The banks also report on a monthly basis their positions in respect of one foreign currency against another and these positions, which do not, of course, affect their overall foreign currency/sterling position, are monitored to

ensure that individual banks do not enter into imprudent exposures on individual currencies. Further, the Bank regularly review the euro-currency positions of banks, individually and in aggregate, to ensure that the degree of maturity mismatch between their currency deposit liabilities and claims is maintained at prudent levels. Finally, the Bank take a close interest, mainly in the course of their prudential supervision of individual banks, in the internal control systems operated by banks which enable bank managements to monitor the activities of their foreign exchange dealers, particularly in the forward markets. Following a number of incidents involving apparent failures of such control in several international centres, the Bank wrote in 1974 to all banks operating in London reminding them of the need to impose proper controls and listing the main points which such a system should encompass.

Gold market

17 The London gold market, which is rivalled in importance only by that of Zurich, comprises five authorised dealers in gold, of which three are authorised banks and of the other two

one is wholly-owned and the other majority-owned by an authorised bank. Until 1968 the Bank were regular participants in the daily gold fixings. While there is now no longer any operational requirement for the Bank to be involved on a regular basis, contact between the Bank and the members of the gold market remains very close, and all substantive developments are discussed by the market members with the Bank.

Conclusion

18 The Bank conduct their supervision of the various money markets by establishing and monitoring a series of conventions, some involving the participation of market members themselves through associations and some imposed more directly by the Bank. All contribute, each in its different style, to the Bank's ability to control these markets generally. In either case, however, the Bank seek to ensure that the participants in the markets concerned both understand the reasons which underlie the conventions which are thus established and acknowledge the philosophy of the arrangements with which they are required to comply.