Prudential arrangements for the discount market

This note describes new arrangements for the prudential supervision of the discount market. A fuller description of the arrangements was issued by the Bank on 3 June.[1]

For many years, the discount houses have observed some simple multipliers relating their trading activities to their capital resources. The multipliers have served two purposes: they have defined the basis of competition among the discount houses, and they have provided the focus for prudential supervision of the houses by the Bank. The principal multiplier provided a guideline of 30 times its 'resources' as the maximum size of a house's total book. A subsidiary multiplier of 8 times resources was applied to the house's bond book.

From time to time there have been other multipliers or controls. Thus, the credit control arrangements which applied between July 1973 and August 1981 embodied a limit on the houses' holdings of assets other than defined short-term public sector debt. Also, principally to conserve their capacity to operate in the sterling market, a limit of 3 times resources was applied to their book in foreign currency assets.

Tests have recently been developed for prudential supervision of banks, including a measure of their capital adequacy. This measure takes account of the different risks associated with various banking assets. It is constructed by multiplying holdings of assets by weights which reflect their risks, and the total of weighted assets is compared with a bank's capital funds available to absorb losses. The measure devised for banks is not in a form suitable for discount houses, because it emphasises credit risks, which are present in the houses' business only to a very modest extent. But the same general approach can be used to relate the capital needs of a discount house to the size and composition of its balance sheet, and discussions with the London Discount Market Association revealed ready acceptance of this principle.

The relative weights appropriate to different assets depend on the volatility of their prices. It was uncertain whether the introduction of the new monetary control arrangements in August 1981 might produce somewhat greater volatility in some asset prices; so discussion with the London Discount Market Association of the detailed form of the new multipliers began only towards the end of 1981. Arrangements have now been introduced which reflect the outcome of that discussion.

There follows a summary of the main features. The new system will be reviewed in the light of experience and developed as necessary to encompass new activities, for example trading in the futures markets.

Risk classification of assets and measurement of added risk

There are three main types of risk inherent in any assets held:

- credit risk = default risk
- investment risk = risk that the market value of the asset will fall
- forced sale risk = the risk of loss (additional to investment risk) if the holder is forced to sell at short notice assets in which the market is narrow.

The assets held by discount houses carry mainly investment and forced sale risks, but there is also some element of credit risk (eg in trade bills or unsecured loans). Experience suggests that investment risk increases with the term to maturity of the asset and that forced sale risk is less for holdings of gilt-edged stocks than for other assets of comparable maturity.

Assets have been allocated to one of four classes and a single risk weight is applied to all assets within each class (see appendix). The least risky assets are cash and paper maturing within three months. Such paper is widely traded and its investment risk is limited by the short maturity. Other assets are more risky than these, so, to the extent that a house holds them, it has 'added risk' to its book.

The lowest class of added risk assets includes bank bills and CDs of between three months and one year to maturity, other bills and assets of fairly short maturity (mostly 3-6 months); also gilts of between 3 and 18 months to maturity. Assets in this class have an added risk weight of one, so the total added risk for this class is the value of these assets held.

The second added risk class includes bills of longer maturity than the lowest added risk class, CDs of between 1 and 3 years to maturity, gilts of between $1\frac{1}{2}$ and 5 years to maturity, and certain other assets listed in the appendix (including open positions in foreign currencies). It has a

(1) Copies are available from the Money Markets Division of the Bank.

How the new arrangements might operate

Suppose a house's book consisted of the following assets:

Assets	Total	Risk classes: No added risk		Added risk weight 1		Added risk weight 2		Added risk weight 4	
Eligible bank bills	150	Under 3 months	100	Over 3 months	50				
Sterling CDs	100	Under 3 months	80	3–12 months	20	1–3 years	—	Over 3 years	—
Fixed rate gilts	20	Under 3 months	3	3–18 months	10	1½–5 years	5	Over 5 years	2
Total	**270**		**183**		**80**		**5**		**2**
Deduction									
Fixed money				3–12 months	10	1–3 years	—	Over 3 years	—
Added risk class totals					**70**		**5**		**2**
Net additions (added risk class total multiplied by class weight)	**88**			*Weight 1*	70	*Weight 2*	10	*Weight 4*	8
Adjusted total book	**358**								

If the house's capital base were 10 units, then the multipliers would produce the following limits:

	Actual	Maximum
Adjusted total book	358	400
Net additions	88	150

weight of two, so its contribution to added risk is twice the value of assets held in this class.

The third class, which comprises all other assets, has an added risk weight of four, so the value of assets in the class is multiplied by four to give its contribution to added risk.

When a house takes a fixed deposit with a maturity broadly similar to that of added risk assets, the risks of holding the assets are reduced; the house is protected against changes in interest rates by the matching of maturities on the two sides of its balance sheet. In calculating the added risk in each class a house can therefore deduct the amount of fixed-term deposits of appropriate maturity from the value of assets in that class. The appropriate maturities are given in the appendix; to qualify, these deposits must be irrevocably fixed (ie not callable fixtures).

Measurement of the capital base

The capital base is intended to be a measure of a house's ability to absorb losses in its discount market operations. Any capital required to support other activities—whether or not they are conducted in a separate company, eg a subsidiary—cannot be counted a second time as part of the capital base in the discount market. Subsidiaries should be adequately capitalised in their own right (or may in appropriate cases be consolidated with their discount house parent).

The definition of the capital base is:

amount paid up on ordinary share capital
plus amount paid up on non-redeemable preference shares
share premium account
capital reserves
general reserves
profit and loss account
contingency and other reserves (including provision for deferred tax)
profit/loss in current year to date including unrealised appreciation/depreciation (net of tax payable in respect of current year)
minus net book value of fixed assets (deducting only 20% of value of freehold and leasehold property)
goodwill
book value of interest in subsidiaries and associated companies (share capital and loans)
unsecured loans to parent company or fellow subsidiaries (secured loans would be treated as adding risk to the book in accordance with the assets against which the loan is secured).

(References to share capital, reserves etc relate only to the discount house and not to any holding company or subsidiaries.)

Multipliers

Two multipliers have been set in relation to each house's capital base. The first limits its adjusted total book to a maximum of forty times its capital base, where the adjusted total book is the total value of assets held *plus* total net additions. Net additions are the total, for the three classes of added risk, of the product of a risk weight times the value of assets (net of deductions) in the class. The second, subsidiary limit, restricts net additions to fifteen times the capital base.

The effect of these arrangements is that a house whose book consists almost exclusively of low risk assets may hold a larger total book than one whose book contains higher risk assets. The Bank will retain a degree of flexibility in administering the new system so as to allow exceptions which are perfectly prudent (eg taking short-dated 'mop-up' Treasury bills even if it means exceeding the forty times limit), and to disallow unbalanced structures that are permitted by the simple arithmetic; but it recognises that in exercising such flexibility it must not disturb the basis of competition within the market.

Appendix
Risk classification of assets

No added risk	Added risk classes: *Added risk weight = 1*	*Added risk weight = 2*	*Added risk weight = 4*
Cash at bankers			
Deposits with Bank of England			
Eligible bills up to 3 months	Eligible bills 3–6 months		
Ineligible bank bills up to 3 months	Ineligible bank bills 3–12 months	Ineligible bank bills over 1 year	
Trade bills up to 3 months(1)	Trade bills 3–6 months(1)	Trade bills over 6 months(1)	
	Other trade bills up to 3 months	Other trade bills over 3 months	
£/$ CDs up to 3 months	£/$ CDs 3–12 months	£/$ CDs 1–3 years	£/$ CDs over 3 years
Fixed rate BGS up to 3 months	Fixed rate BGS 3–18 months (or short positions in such stocks)(2)	Fixed rate BGS $1\frac{1}{2}$–5 years (or short positions in such stocks)(2)	Fixed rate BGS over 5 years (or short positions in such stocks)(2)
Variable rate assets where rate fixed for 3 months or less	Variable rate assets where rate fixed for 3–6 months	Variable rate assets where rate fixed for more than 6 months	
Fixed rate quoted assets up to 3 months	Fixed rate quoted assets 3 months–1 year	Fixed rate quoted assets 1–3 years	Fixed rate quoted assets over 3 years
Fixed rate unquoted assets up to 3 months	Fixed rate unquoted assets 3–6 months	Fixed rate unquoted assets 6–18 months	Fixed rate unquoted assets over 18 months
Loans to next business day	Loans longer than to next business day		
		Open position in foreign currency	
			Equity investments (including preference shares)
	Deductions	*Deductions*	*Deductions*
	Fixed money 3–12 months	Fixed money 1–3 years	Fixed money over 3 years

(1) Trade bills which are drawn and accepted by independent names, or bear one public sector name, or are insured.
(2) Where short positions in assets within a certain class exceed long positions, the added risk weight is to be applied to the short position.