Revised supervisory arrangements for the discount market

Supervisory arrangements for the discount market have recently been revised, principally to take account of positions in the futures market and forward commitments, and to give a more accurate reflection of the gradation of risk in short-term paper.

In June 1982, the Bank announced a new set of arrangements for the prudential supervision of the discount houses, which were described in an article in the June 1982 *Bulletin*, page 209. The framework then introduced remains unchanged: an overall multiplier limits the 'adjusted total book' to 40 times a house's capital base, and another, subsidiary, limit restricts the total of 'additions' (a weighted measure of assets in higher risk categories) to 15 times the capital base. On 21 November, however, some changes were made in the detail of the arrangements, and these are set out in this note.

The first set of changes, foreshadowed in the 1982 *Bulletin* article, extends the system to include positions in futures markets, and other forward commitments.[1] Such engagements have a negligible effect on the balance sheet total; for example, taking a position in the financial futures market generally involves making a margin payment that is small in relation to the value of the underlying cash asset. But these engagements do involve risks of a type similar to those in the cash market. For this reason, they are allocated to added risk classes on the same basis as the equivalent cash asset, and consequently have a similar effect on the total of 'additions'. The impact on the 'adjusted total book' is rather less, because the commitments have a negligible effect on the figure for unadjusted assets (as in the example of margin payments described above).

In some cases forward sale commitments and short positions in futures represent a genuine hedge against risk elsewhere in the book. In these instances an offset is allowed against the added risk of the hedged asset for the period after the last date on which the commitment must be taken up, or the short position eliminated. Thus if a house has a futures contract, maturing in two months, to place a £1 million 3-month time deposit, and it also holds £1 million of 5-month CDs, the result for risk weighting purposes is the same as if the house held £1 million of 2-month CDs.

In general it is likely that the first set of changes taken overall will increase the figure for 'total additions', and also that for the 'adjusted total book'.

The second major revision concerns the treatment of certain very short-term sterling assets, set out in detail in the accompanying table. A deduction of two thirds will now be made against holdings of such assets within a week to maturity, and of one third against those with between eight and thirty-three days still to run; these deductions are used to reduce the reported figure for unadjusted assets. This change will result in a more accurate reflection of the gradation of risk in short-term paper, and is consistent with the proposed draft arrangements for participants in the new gilt-edged market.[2] It will also offset in part the effect of the first set of changes on the 'adjusted total book', although not on the figure for 'total additions'.

Finally, a number of minor changes have been made over the last two years, so as to incorporate other assets such as leases into the supervisory arrangements. These changes are set out in broad terms in the risk classifications contained in the accompanying table.

(1) Including deals done, but not yet settled, calls outstanding on partly-paid gilts and sale commitments.
(2) See pages 513 – 540.

Risk classification of assets

No added risk	Added risk classes			
	Added risk weight = 1	*Added risk weight = 2*	*Added risk weight = 4*	*Added risk weight = 5*
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(a)	Trade bills 3–6 months(a)	Trade bills over 6 months(a)		
	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	
Loans to banks, LDTs and building societies up to 3 months	Loans to banks, LDTs and building societies 3–12 months	Loans to banks, LDTs and building societies 1–3 years	Loans to banks, LDTs and building societies over 3 years	
Other loans to next business day	Other loans longer than to next business day			
Fixed-rate BGS up to 3 months	Fixed-rate BGS 3–18 months (or short positions in such stocks)(b)	Fixed-rate BGS $1\frac{1}{2}$–5 years (or short positions in such stocks)(b)	Fixed-rate BGS over 5 years (or short positions in such stocks)(b)	
Variable-rate assets issued by local authorities or government-guaranteed borrowers, where rate is fixed for 3 months or less	Variable-rate assets issued by local authorities or government-guaranteed borrowers, where rate is fixed for 3–6 months	Variable-rate assets issued by local authorities or government-guaranteed borrowers, where rate is fixed for more than 6 months		
	Other variable-rate assets where rate is fixed for 3 months or less (including leases)	Other variable-rate assets where rate is fixed for 3–6 months (including leases)	Other variable-rate assets where rate is fixed for more than 6 months (including leases)	
Fixed-rate quoted assets up to 3 months	Fixed-rate quoted assets 3–12 months	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	
	Fixed-rate leases up to 3 months	Fixed-rate leases 3–6 months	Fixed-rate leases 6–18 months	Fixed-rate leases over 18 months
Futures positions and forward commitments in gilts(c) up to 3 months	Futures positions and forward commitments in gilts(c) 3–18 months	Futures positions and forward commitments in gilts(c) $1\frac{1}{2}$–5 years	Futures positions and forward commitments in gilts(c) over 5 years	
Other forward commitments(c) up to 3 months	Other forward commitments(c) 3–12 months	Other forward commitments(c) 1–3 years	Other forward commitments(c) over 3 years	
		Open position in foreign currency		
			Equity investments (including preference shares)	
Deductions	*Deduction*	*Deduction*	*Deduction*	
$\frac{2}{3}$ specified sterling assets(d) 0–7 days	Fixed money 3–12 months	Fixed money 1–3 years	Fixed money over 3 years	
$\frac{1}{3}$ specified sterling assets(d) 8–33 days				
Short or long position in BGS (whichever is the smaller)				

(a) Trade bills which are drawn and accepted by independent names, or bear one public sector name, or are insured.

(b) Where short positions in assets within a certain class exceed long positions, the added risk weight is to be applied to the short position.

(c) For futures and forward commitments to purchase assets at an agreed price, the duration of the investment is taken as the period until the commitment falls due, plus the maturity of the deliverable asset. For all other purchase commitments, the duration is taken as that of the deliverable asset only. Where a short position in futures (or a sale commitment) represents a genuine hedge against an asset already held, it will be assumed to offset the added risk from that asset for the period after the delivery date falls due. No such offset will be allowed where the price of the sale commitment is not already determined.

(d) Specified sterling assets are eligible bills, government securities, CDs, deposits with and loans to banks, LDTs and building societies, and sums due on margin account from LIFFE.