

# Bank of England operations in the sterling money market

## The extension of the Bank of England's dealing relationships in the sterling money market: draft proposals.<sup>(1)</sup>

1 As foreshadowed in the Bank of England's paper 'The future structure of the gilt-edged market', published in April 1985, and in order to ensure continuing competition among its money market dealing counterparties, the Bank is willing to extend the range of counterparties with which it has a dealing relationship in the sterling money market. At present the Bank's money market dealings are conducted with eight discount houses, which act as providers of sterling liquidity to the commercial banks.

2 From the end of October 1988 it will be open to firms which are prepared to accept the commitments described below to apply for a dealing relationship with the Bank in the sterling money market. This paper sets out the Bank's proposals for this extension of its dealing relationships. Section I below sets out the proposed obligations of the Bank's money market dealing counterparties and Section II the proposed criteria for acceptability. The Bank would welcome comments on the proposals by the end of August 1988 and will aim to publish a final version of the paper as soon as possible thereafter.

### I Market making

3 The object of the Bank's daily money market operations is to supply to, or withdraw from, the banking system enough cash to offset the daily flows between the central bank and the commercial banks collectively. In their daily operations the commercial banks individually can meet shortages of funds by drawing down their deposits with discount houses, by borrowing from discount houses or by selling money market instruments to discount houses. If they have surplus funds, the commercial banks individually can use them to increase their deposits with discount houses or to buy additional money market instruments from discount houses. Discount houses can thus intermediate between those commercial banks which are short of funds and those which have surplus funds. In addition, the commercial banks collectively can meet a shortage

of funds by drawing down their deposits with or borrowing from discount houses, or by selling money market instruments to discount houses, and discount houses in turn can raise funds by selling certain money market instruments to the Bank or by borrowing (within pre-set limits) from the Bank. Likewise, when the commercial banks collectively have surplus funds, both banks and discount houses can buy Treasury bills from the Bank. This structure depends on the ability and willingness of discount houses to provide sterling liquidity continuously to the banking system and to assist the commercial banks in managing their day-to-day cash flows, in any trading conditions: this is the basic functional obligation of the Bank's money market dealing counterparties.

4 To assist those participants which are willing to undertake these obligations, which have demonstrated the capacity to do so in terms of capital, of experience and of management and operational resources, and which are prepared to accept the Bank's prudential oversight, the following facilities will be offered:

- (a) a direct dealing relationship with the Bank in eligible bills,<sup>(2)</sup> whenever the Bank, at its discretion, invites offers of eligible bills (either for outright purchase or for purchase and subsequent resale) to relieve a daily cash shortage in the banking system, or invites bids for Treasury bills to absorb a cash surplus;
- (b) borrowing facilities at the Bank against approved collateral up to amounts related to the participant's capital base; and
- (c) facilities to borrow and lend gilt-edged stock through Stock Exchange money brokers.

5 These obligations and facilities are described in more detail below, together with the supervisory arrangements which will apply to firms accorded a dealing relationship with the Bank.

(1) This paper and the annexes that follow were published by the Bank on 29 June 1988.

(2) The Bank is prepared to purchase three types of bills: Treasury bills, eligible bills issued by UK local authorities, and eligible bank bills drawn for commercial purposes and accepted by banks whose acceptances are eligible for discount at the Bank.

**(i) The obligations**

**(a) Taking deposits from banks**

6 The Bank expects its money market dealing counterparties to offer callable deposit facilities to banks, and to non-bank institutions which are members of either the Clearing House Automated Payments System (CHAPS) or the Town Clearing, by quoting rates on a continuous basis in any trading conditions, and to be prepared to pledge as security against the deposits assets which are normally acceptable as collateral in the money market. Moreover, a dealing counterparty of the Bank must keep its asset book, including those assets which can be sold or pledged to the Bank, sufficiently liquid to enable it to put itself in funds by the close of business in any trading conditions.

**(b) Making markets in bills**

7 To enable banks to meet their cash requirements by trading in sterling money market instruments for same-day settlement, the Bank's money market dealing counterparties will be required to make to banks and to non-bank members of either CHAPS or the Town Clearing, on demand and in any trading conditions, and subject to the provisions of paragraph 9 below, continuous and effective two-way prices at which they stand committed to deal in eligible bills for same-day settlement and in marketable amounts. They may of course at their discretion also quote dealing prices to other market participants.

8 Although the Bank would like to encourage market making in as wide a range of sterling money market instruments as possible, the obligation to make markets will be confined to those instruments in which the Bank is usually prepared to conduct its money market operations, namely Treasury bills, eligible local authority bills and eligible bank bills. Within these categories the Bank's money market dealing counterparties will be expected to make prices at all maturities.

9 In the course of their market making activities the Bank's dealing counterparties will incur credit risks. The various market making obligations will all be subject to firms satisfying themselves that each transaction is appropriate in terms of the credit risk arising from it and is consistent with an appropriate policy on large exposures agreed between each firm and the Bank as its supervisory authority.

**(c) Acting as a counterparty to the Bank**

10 Firms accorded a dealing relationship with the Bank will be expected to participate actively in the Bank's operations in the money market.

**(d) Underwriting the weekly Treasury bill tender**

11 At present the discount houses collectively underwrite the weekly Treasury bill tender, regardless of its size. The Bank's money market dealing counterparties will be obliged to participate in this underwriting, tendering each week for at least a minimum proportion of the issue, the proportion being calculated on a basis agreed in advance between the Bank and its counterparties.

**(ii) Structure and prudential supervision**

12 The Bank's paper on 'The future structure of the gilt-edged market' (April 1985) envisaged that successful applicants for a dealing relationship in money market instruments would be required to conduct their dealings in these instruments through separately capitalised entities. These firms would—subject to the agreement of the Bank on a case-by-case basis—be permitted to undertake business other than dealing in sterling money market instruments and taking sterling deposits from banks, on the same basis as existing discount houses.

13 While the Bank's money market dealing counterparties may generally prefer to operate as separately capitalised entities, the Bank is prepared to discuss with applicants the possibility of an existing gilt-edged market maker including, without formal separation of capital, a money market dealing relationship with the Bank among its other activities. These would remain limited to dealing in gilt-edged stock, other sterling debt, sterling money market instruments, and related futures and options. Where this alternative approach was allowed, the Bank would require the same degree of commitment to meeting the obligations described in Section I (i) above, but the supervisory arrangements and the facilities made available would differ slightly, as described below.

14 The main features of the Bank's prudential supervision will be the monitoring of each firm's liquidity and of its capital resources in relation to its exposure to risk. The Bank will liaise as necessary with other supervisory authorities and exchange with them information material to the carrying out of their respective supervisory responsibilities. To facilitate this supervision the Bank will require firms either to be separately capitalised as companies or partnerships in the UK with dedicated sterling capital, or to be part of a gilt-edged market maker which already fulfils this condition.

15 Separate capitalisation, of either the firm itself or the gilt-edged market maker of which it is a part, need not exclude elements of common management

or staffing with related entities,<sup>(1)</sup> but the Bank would wish to review the organisation of each entity individually. In any event the Bank would expect transactions with related entities normally to be carried out at arm's length and not to represent a disproportionate source of funding or turnover for the Bank's money market dealing counterparty, and will want these connected transactions to be reported to the Bank individually. The Bank will be prepared to exempt from this reporting requirement transactions with a related entity which is acting purely as an agent for unrelated customers, but will wish to discuss the scope of this exemption in each case with the entity concerned.

16 The Bank's money market dealing counterparties should provide an impartial service to other participants in the market and, moreover, their claim to impartiality must be fully credible in the market. Where a successful applicant is part of a group which also contains a bank treasury function the Bank will require there to be arrangements in place which ensure adequate separation between the two operations. These arrangements will be specified on a case-by-case basis, and will involve separate day-to-day management and separate physical location. The Bank's counterparties will not be allowed:

- (i) to acquire or hold the acceptances of fellow group companies, or bills drawn by group companies and accepted by an unrelated eligible bank, unless they carry in addition the endorsement of an independent third party; or
- (ii) to acquire or hold certificates of deposit or other marketable instruments issued by fellow group companies, unless acquired in the course of secondary market trading and then subject to strict limits agreed in advance with the Bank; or
- (iii) to place deposits with, or lend to, fellow group companies unless fully secured by normal money market security, with customary margin and at full market rates; or
- (iv) to become unduly dependent on deposits, placements or turnover from fellow group companies.

17 For a separately capitalised firm structured as in paragraph 12 above, the form of the Bank's proposed prudential supervision, and the information that the Bank will require for this purpose, will be identical to the arrangements currently applied to discount houses.<sup>(2)</sup> These arrangements are described in detail in Annex 1.

18 All existing discount houses are authorised institutions under the Banking Act 1987, which sets out minimum criteria for authorisation. The Bank recognises that it is not strictly necessary for a money market dealing counterparty to be authorised under this Act, since the counterparty could meet its market making obligations without taking deposits from the public (as defined in Section 3 of the Act). Any separately capitalised money market dealing counterparty, whether or not it applied successfully for authorisation under the Banking Act 1987, would be supervised in the same manner as existing discount houses.

19 In the case of a gilt-edged market maker which applied successfully to extend its activities to include a money market dealing relationship with the Bank, as set out in paragraph 13 above, the gilt-edged and money market operations of the firm would be conducted using a common dedicated sterling capital base. The Bank would wish to discuss with such firms the prospective scale of their money market activities and the proportion of their capital which was likely to be required to support them. The Bank would then expect the gilt-edged and related activities of these firms normally to require the support of no more than an agreed proportion of their capital base; the proportion would be determined on a case-by-case basis, but in all cases the Bank would expect these firms to continue to fulfil the full extent of their gilt-edged market making obligations. The form of the Bank's proposed prudential supervision of these firms would represent a slightly modified version of the arrangements currently applied to gilt-edged market makers. The proposed modifications, described in Annex 2, are intended to bring the supervisory treatment of the money market activities of these firms (but not of other gilt-edged market makers) closer to the treatment of discount houses. This does not imply precise equality of treatment, but in practice the remaining differences are unlikely to be of commercial significance. The supervisory treatment of gilt-edged activities would remain unchanged. It is not envisaged that those of the Bank's money market dealing counterparties which are capitalised in this way would have Banking Act authorisation.

### (iii) The facilities

(a) The dealing relationship with the Bank

20 Under the current arrangements introduced in 1981, the Bank conducts its money market operations chiefly through transactions in eligible bills with discount houses. In order to relieve a shortage of funds in the banking system (which has been the typical daily position since the

(1) Related entities include any company with the same ultimate holding company as the firm, including the holding company itself; any company or partnership controlled by partners in the firm; and any associated company.

(2) With the exception that the reporting of individual transactions with related entities will be required, as specified in paragraph 15.

arrangements were introduced) the Bank normally invites discount houses to offer eligible bills to the Bank for sale against same-day settlement, with the invitation either confined to eligible bills for outright sale or, exceptionally, including in addition an invitation to offer eligible bills for sale and subsequent repurchase on a specific future date (or dates). The Bank will choose at its discretion which offers to accept. Discount houses also have the right to offer eligible bills for sale to the Bank at any time at their own initiative; the response to such offers is at the discretion of the Bank and in practice the right has been exercised very rarely. On days when there is a surplus of cash in the banking system the Bank normally invites bids for Treasury bills to be issued for same-day settlement, and chooses at its discretion which bids to accept. Further details of the operational arrangements are set out in Annex 3.

21 Firms accorded a money market dealing relationship with the Bank will be included in all invitations to deal with the Bank, and will be expected to participate actively in the Bank's operations in the money market.

(b) Borrowing facilities at the Bank

22 Discount houses have borrowing facilities at the Bank against approved collateral up to maximum amounts related to their capital bases. These provide them with a supplementary means of balancing their own positions after the Bank's normal bill operations have been concluded. The terms on which these facilities are available on a particular day are at the discretion of the Bank. Borrowing under these facilities usually takes place at 2.45 pm. The Bank may also, at its discretion, invite discount houses wishing to use their borrowing facilities to do so at 2.30 pm; the limits on borrowing by individual discount houses do not apply on such occasions.

23 Firms applying successfully to become money market dealing counterparties of the Bank and choosing to conduct their business as separately capitalised entities will be granted borrowing facilities on the same basis as existing discount houses, with a first tranche of borrowing available up to the value of each firm's capital base and a second tranche of the same amount also available, normally at a higher rate of interest. Gilt-edged market makers which apply successfully to establish a dealing relationship with the Bank within the market maker would be granted borrowing facilities additional to those which they have by virtue of their position in the gilt-edged market; the limits would be determined on a case-by-case basis by the Bank and would be related to the amount of capital

notionally committed to the firm's money market activities on a similar basis to the borrowing facilities granted to separately capitalised entities.

(c) Financing

24 The importance to the banking system of holding secured and callable deposits with the Bank's money market dealing counterparties is reflected in the status granted to such deposits in the Bank's assessment of banks' capital adequacy and liquidity. The arrangements whereby banks whose bills are eligible for discount, or acceptable as security, at the Bank were required to keep a certain proportion of their eligible liabilities in the form of secured deposits with discount houses, gilt-edged jobbers or Stock Exchange money brokers lapsed in September 1986. The Bank's current proposals<sup>(1)</sup> would require all authorised banks to hold a minimum stock of high quality liquid assets. Secured callable deposits held with discount houses, gilt-edged market makers and Stock Exchange money brokers operating in the gilt-edged market would form part of the first tier of high quality sterling liquid assets (together with cash, operational balances held at the Bank, holdings of eligible bills and holdings of gilt-edged stock with a residual maturity of under one year). Moreover, these types of secured money will be assigned a low risk weighting (of 0.1) in the calculation of banks' risk asset ratios for capital adequacy purposes.

(d) Lending and borrowing of gilt-edged stock

25 It is envisaged that those of the Bank's money market dealing counterparties which are structured as described in paragraph 12 may, under the new arrangements, be both approved lenders of gilt-edged stock, and approved borrowers of gilt-edged stock with up to seven years to maturity for the purpose of hedging the interest rate risk of holdings of bills. At present the Inland Revenue does not treat the loan and recovery of gilt-edged stock as a disposal and acquisition for tax purposes if the lender is an approved lender, the borrower is an approved borrower and the loan is arranged by an approved Stock Exchange money broker. These arrangements are currently governed by Extra-Statutory Concession B15, under which discount houses are approved borrowers and lenders of gilt-edged stock. It is the intention that this treatment will be continued under the regulations that the Government propose to introduce under Section 129 of the Income and Corporation Taxes Act 1988, which provides a new statutory framework for the treatment of stock lending and borrowing.

(1) 'Proposals for a stock of high quality liquidity'. Bank of England Banking Supervision Division Consultative Paper 2/88, March 1988.

26 Those of the Bank's money market dealing counterparties which are structured as described in paragraph 13 may already be both approved lenders and approved borrowers of gilt-edged stock of all maturities.

## II Criteria for acceptability

27 The Bank will not accept any applicant as a money market dealing counterparty unless the applicant is able to demonstrate that it meets the minimum conditions set out below, and will expect its money market dealing counterparties to meet conditions (i)-(v) below continuously.

### (i) Capital adequacy

28 Applicants must satisfy the Bank that their capitalisation is adequate in relation to the Bank's tests, given the type and scale of business they propose to undertake.

### (ii) Adequacy of management and operational resources

29 Applicants should have sufficient managerial resources to conduct their proposed activities effectively; and their directors and managers should have the knowledge, experience, integrity and good reputation necessary for their intended responsibilities. Similarly, the numbers of skilled and experienced staff must be sufficient for the intended scale of operations.

### (iii) Systems

30 To enable management to exercise its function effectively, and in particular to assess continuously the financial soundness of the firm, adequate control systems and accounting records must be maintained. These should also be sufficient to enable the firm to satisfy the Bank's reporting requirements in all respects. The Bank will discuss systems and controls with each applicant in the light of its particular circumstances.

### (iv) Ownership

31 The Bank's money market dealing counterparties will be required to satisfy the Bank that their ownership does not represent a source of potential financial weakness nor give rise to unacceptable conflicts of interest and, where appropriate, that the necessary arrangements for separation of the business from other parts of this group are in place. The Bank will also seek assurances from substantial shareholders that they accept ultimate responsibility for the liabilities of the firm.

32 In general, and having regard to European Community obligations, the Bank will not make a distinction between domestic and foreign firms,

except that, in the case of firms with substantial foreign ownership, the Bank will have regard to the extent to which British-owned firms can in practice undertake money market activities in the home countries of the owners.

### (v) Separation of function

33 Applicants must satisfy the Bank that their proposed physical and operational structure will achieve the objective of providing an impartial service to other participants in the money market.

### (vi) Authorisation under the Banking Act 1987

34 Applicants intending to establish separately capitalised firms for their money market activities and intending in addition to apply for authorisation under the Banking Act 1987 should give careful consideration to the statutory requirements of that Act, including the minimum criteria for authorisation set out in Schedule 3 to the Act. These criteria are described more fully in the Act under six headings:

- Directors etc to be fit and proper persons
- Business to be directed by at least two individuals
- Composition of the board of directors
- Business to be conducted in a prudent manner
- Integrity and skill
- Minimum net assets (of £1 million)

### (vii) Track record

35 The Bank will expect prospective counterparties to have demonstrated a capacity to fulfil the main functional obligations of firms accorded a dealing relationship with the Bank over a period of at least a year and, depending on the scale of their business, normally longer. The Bank recognises that it will be difficult to infer this capacity from the behaviour of an entity which does not have access to all the facilities currently made available to existing discount houses, but the Bank nevertheless intends to assess the extent to which prospective counterparties are providing liquidity to the banking system, in particular through the taking of secured and callable deposits, and dealing in sterling money market instruments for same-day settlement.

36 This assessment will be based upon:

- the liability structure of the money market book of a prospective counterparty, including its overall size, the proportion accounted for by secured and callable deposits, and the range of its bank counterparties;
- the extent to which a prospective counterparty has been making a market or trading in short-term sterling instruments,

particularly eligible bills, for same-day settlement; and

— views expressed by banks on the usefulness of the role undertaken by the prospective counterparty.

37 There will be no formal regular reporting requirements for prospective counterparties in respect of this assessment, but the track record will need to have been established before a prospective counterparty applies formally to the Bank. It will not be necessary for applicants to implement their chosen structural arrangements before the Bank approves them as a counterparty.

38 Should a disagreement arise over questions of principle relating to the application of the arrangements described in this paper, the Bank would be prepared to have the matter reviewed by a suitable independent person(s) appointed by the

Bank for that purpose, and would take full account of the outcome of the review.

### **III Next steps**

39 As indicated in the introduction to this paper, the Bank would welcome comments on the above proposals, including the proposals in the Annexes, by the end of August 1988. Such comments should please be addressed to the Head of the Money Market Operations Division at the Bank.

40 In the light of these responses the Bank will publish its definitive proposals as soon as possible thereafter, and will invite applications from the end of October 1988 from firms wishing to establish a dealing relationship with the Bank in money market instruments. The Bank will hold formal discussions with these firms, based on an annotated agenda which will be sent to applicants.

## Annex 1

### Current supervisory arrangements for discount houses

1 This annex describes the framework of prudential supervision that the Bank applies to discount houses. The framework will be subject to modification in the light of experience.

2 Risk taking is an essential part of a discount house's function, and the effective working of the market requires that discount houses should be as free as possible to make their own judgements about the positions they wish to run. The aim of the Bank's supervision will be, within this framework, to ensure as far as possible that such judgements do not result in risks being taken which are disproportionate to the discount house's own funds, and which would endanger its ability to meet its obligations to its counterparties. No supervisory arrangements can wholly exclude the risk of default, however, and it must remain the responsibility of the counterparties to satisfy themselves as to the integrity of a discount house with whom they deal.

3 The Bank requires discount houses to be separately capitalised in the UK. In addition it seeks assurances from substantial shareholders that they accept ultimate responsibility for the liabilities of the discount house. The Bank's prudential supervision is based upon close familiarity with the management and business of each discount house, developed through quarterly bilateral discussions. It is supported by continuous assessment of the discount house's risk exposure in relation to the capital resources that it has freely available to meet losses, taking as a starting point the detailed guidelines set out in Sections A and B below. The Bank's assessment of discount houses' financial performance and balance sheets will not, however, be based mechanically on these guidelines, which it regards as simply a starting point for such assessment.

4 The remainder of this annex is arranged as follows. Section A describes how the capital adequacy of discount houses is measured and evaluated. Section B sets out how their large exposures are supervised, and Section C describes the reporting and monitoring arrangements for discount houses.

#### A Capital adequacy

5 The capital adequacy of discount houses is assessed by comparing the assets of each discount house—measured in risk-adjusted terms—with its capital base. For measurement purposes, assets are

divided into five classes. Four of these classes are treated as giving rise to 'added risk', which is calculated by multiplying the assets in each class by the appropriate weights. The added risk and the actual total book together comprise the adjusted total book, which must not exceed 80 times the capital base. In addition, added risk alone must not exceed 25 times capital base. These limits are absolute maxima, and even within these the Bank reserves the right to disallow unbalanced books, but has had occasion to do so only rarely, conscious of the general objective of unfettered competition.

#### (a) Risk classification and valuation of assets

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

- (i) *Credit risk*—ie the risk that one or more entities will fail to discharge their liabilities, thereby impairing the value of the asset.
- (ii) *Position risk*—ie the risk of a change in the market value of the asset for other reasons, eg a change in interest rates.
- (iii) As part of (ii), *forced sale risk*—ie the risk of additional loss if a supervised entity is forced to sell at short notice an asset in which the market is narrow.
- (iv) *Settlement risk*—ie the risk that the process of exchanging money for assets will not be completed smoothly and the supervised entity will suffer some loss of value.

The assets held by discount houses carry principally risk of types (ii) and (iii) but there is also some element of credit risk in assets such as trade bills or unsecured loans. Historical experience suggests that position 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 marketable holdings of comparable maturity. Some degree of settlement risk is involved in all exchanges of money for assets: it may be greatly reduced by the use of assured payment systems.

7 Table 1 shows the five categories of asset. The four 'added risk' classes, together with their appropriate risk weights, are given in columns 2, 3, 4 and 5 of the table. The assets which do not attract an added risk weight are for completeness shown in the first column.

8 For certain very short-term sterling assets a more favourable treatment is allowed. A deduction of  $\frac{1}{2}$  is made against holdings of such assets with 33 days or less to run. This treatment is confined to eligible bills, government securities, CDs, deposits with and loans to banks and building societies, and sums due on margin account from LIFFE.

9 Assets are measured at market values, consistent with the definition of capital base.

**(b) Definition of capital base**

10 The capital base is defined in the way that best measures a discount house's ability to absorb losses and includes the following elements:

- 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)
- subordinated loan capital, subject to the Bank's agreement as to amount and terms
- minus* net book value of fixed assets (deducting only 20% of the value of freehold and leasehold property)
- goodwill
- book value of interests 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 loans are secured).

Unsecured loans required to support activities conducted in a separate group company are therefore excluded from the capital base supporting the money market activity. Where a discount house has subsidiaries, they are consolidated with their discount house parent for the purpose of these measurements. The proportion of capital that may be in the form of subordinated debt is subject to limit, discussed on a case-by-case basis, and monitored continuously. The loan must be provided by a related company and the Bank requires the opportunity to consider its documentation beforehand. Repayment of a loan before its final maturity date (if any) is allowed only with the prior permission of the Bank.

**(c) Matched liabilities and short positions**

11 The Bank allows a reduction in any added risk required because of the maturity of an asset if it is matched by certain liabilities of comparable term. Longer-term money liabilities which are totally fixed qualify for this treatment, as do short positions in the gilt market. 'Matched' long and short positions in gilts may thus be netted out in the reported assets where the relevant maturity dates are within 3 months of each other for stocks within 18 months of maturity, or within 12 months for longer stocks. Where short positions are not allowed as hedges, the added risk weighting in each risk class is applied to whichever is the larger of the long positions and the short positions in that class.

**(d) Foreign currency assets**

12 Since an unmatched foreign currency position can expose a discount house to exchange risk, open positions in foreign currency are included in the framework of added risk classes.

**B Large exposures**

13 As required under the Banking Act 1987, each discount house must set out in writing to the Bank its policy for the monitoring of exposures to individual borrowers: this statement should normally be adopted by its board. Any subsequent changes should be discussed with the Bank before implementation. Exposures should be grouped into one of three categories (see Table 2 for details). All exposures in excess of 10% of capital base must be reported to the Bank where they are exposures under category (c) (largely to the non-bank private sector), or under category (b) (largely banks) if more than a year in maturity. No exposures in excess of 25% of capital base under either of these categories may be taken on without the Bank's prior permission, which will generally be forthcoming only in the particular circumstances defined in paragraph 15 below, or otherwise in exceptional situations. In assessing 'exposures', account should be taken not only of direct claims on the borrower, but also of all contingent liabilities; and exposures to different companies in the same group should for these purposes be regarded as to a single borrower.<sup>(1)</sup>

14 The Bank reserves the right in some circumstances to deduct part or all of such large exposures from the capital base or to apply higher risk weights, though it would not normally expect to do so for exposures of less than 25% of capital base.

15 The Bank is prepared to tolerate exposures in excess of 25% of capital base if:

- (i) the discount house is a subsidiary either of another institution authorised under the Banking Act, or of an overseas bank, and if

(1) In cases where a consolidated approach has been used in assessing capital adequacy—eg for a leasing subsidiary—all exposures will also be considered on a consolidated basis.

there are arrangements acceptable to the Bank under which the parent bank will take over the whole exposure if problems occur or will make up any resultant deficiency in the discount house's capital; or

- (ii) the discount house is carrying out a lead-management function in underwriting an issue, where special arrangements may be agreed; or
- (iii) proper security is taken which fully covers the exposure and is in the form of British Government Stock, eligible bills or deposits held with the lender over which there is a legal right of set-off.

### **C Reporting and monitoring**

16 The Bank expects discount houses to monitor their positions continuously, marking to market daily and updating the capital base to reflect any profit or loss, *even if unrealised*, that this revaluation shows. The multiplier limits must be observed continuously.

17 Regular returns are required showing the capital base and adjusted book as at close of business on the third Wednesday and last working day of every month, which must be submitted to the Bank within seven days of the reporting date. The Bank may also ask for additional returns at any time, to ensure that the multiplier limits are being observed. Large exposures returns must also be submitted on these dates.

18 The returns form the basis of the supervisory process, which includes regular interviews with senior management to discuss all aspects of the discount houses' business. Discount houses are expected to provide the Bank with any information it may reasonably require in carrying out its supervision.

19 In addition, discount houses are required to complete a number of other returns to assist the Bank in its calculation of monetary and other aggregates, on weekly, monthly or quarterly bases.

**Table 1**  
**Risk classification of assets**

<b>No added risk</b>	<b>Added risk classes</b> 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) Other trade bills up to 3 months	Trade bills over 6 months (a) 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 and building societies up to 3 months	Loans to banks and building societies 3-12 months	Loans to banks and building societies 1-3 years	Loans to banks and building societies over 3 years	
Other loans to next business day	Other loans longer than to next business day			
Fixed-rate gilts up to 3 months	Fixed-rate gilts 3-18 months (or short positions in such stocks)(b)	Fixed-rate gilts 1½-5 years (or short positions in such stocks)(b)	Fixed-rate gilts 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 up to 3 months	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 up to 3 months (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 up to 3 months (c)	Futures positions and forward commitments in gilts 3-18 months (c)	Futures positions and forward commitments in gilts 1½-5 years (c)	Futures positions and forward commitments in gilts over 5 years (c)	
Other forward commitments up to 3 months (c)	Other forward commitments 3-12 months (c)	Other forward commitments 1-3 years (c) Open position in foreign currency	Other forward commitments over 3 years (c) Equity investments (including preference shares)	
<b>Deduction</b>	<b>Deduction</b>	<b>Deduction</b>	<b>Deduction</b>	
½ Specified sterling assets 0-33 days (d)	Fixed money 3-12 months	Fixed money 1-3 years	Fixed money over 3 years	

Short or long position in gilts (whichever is the smaller)(e)

(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 and building societies, and sums due on margin account from LIFFE.

(e) See paragraph 11.

**Table 2**

**Large exposures**

Exposures should be grouped into three categories:

- (a) Central government and specified international institutions; central banks and public sector bodies with an unconditional central government guarantee.
- (b) (i) Institutions authorised under the Banking Act; overseas banks.  
(ii) Building societies.  
(iii) Stock Exchange money brokers and gilt-edged market makers.  
(iv) Contingent exposures to insurers of credit risk.
- (c) All other counterparties.

## Annex 2

### Supervisory arrangements for gilt-edged market makers which have a dealing relationship with the Bank of England in money market instruments

1 As stated in paragraph 13 of the main paper, the Bank is prepared to discuss with applicants the possibility of a money market dealing relationship with the Bank being established from within a gilt-edged market maker, rather than in a separately capitalised money market dealing counterparty. This annex sets out the supervisory arrangements which would apply to any gilt-edged market makers which were permitted to adopt this approach.

2 The framework for the prudential supervision which the Bank applies to gilt-edged market makers is set out in Annex 1 of the Bank's paper 'The future structure of the gilt-edged market', dated April 1985. This framework has been modified by the issue of market notices and is subject to continuing review in the light of experience. Apart from the differences outlined below, the prudential supervision of gilt-edged market makers which had a money market dealing relationship with the Bank would be the same as that of other gilt-edged market makers.

3 The risk weights applied to positions held by gilt-edged market makers are, at present, broadly similar to those applied to discount houses, taking into account the different nature of the two supervisory systems. In recognition of the role of discount houses as market makers in bills, however, the weights applied to holdings of money market instruments with up to three months to maturity are

lower for them than for gilt-edged market makers. Accordingly, for gilt-edged market makers which had a money market dealing relationship with the Bank, the additional risk weight of  $\frac{1}{2}$  currently imposed on holding of money market instruments of maturities less than three months would be reduced to  $\frac{1}{4}$ . This means that the weight applied to holdings of these instruments would be broadly the same for all the Bank's money market dealing counterparties.

4 The Bank would expect the gilt-edged activities of a gilt-edged market maker which had a money market dealing relationship with the Bank normally to require the support of no more than an agreed proportion of its total capital base, to ensure the availability of capital to support its money market activities. The Bank would wish to discuss with individual prospective counterparties the determination and application of this proportion.

5 The Bank would require additional supervisory reports from gilt-edged market makers with which it had established a money market dealing relationship, to enable it to monitor their volume of money market business. These would include more detailed reports of positions in money market instruments, turnover in money market instruments and transactions with related entities in money market instruments. Provision would be made for these additional reports to be included in gilt-edged market makers' current reporting package. Further details will be provided in due course.

## Annex 3

### Bank of England dealings in the sterling money market: operational arrangements

1 The purpose of this annex is to describe the arrangements for the day-to-day operations of the Bank of England in the sterling money market.<sup>(1)</sup> Few changes have been made to the arrangements since they were introduced in 1981, though they are nevertheless subject to continuing review and modification in the light of experience. The expansion of the range of the Bank's money market dealing counterparties will not affect the arrangements, except that invitations to deal which are currently extended to discount houses will be extended to all of the Bank's money market dealing counterparties.

#### A The purpose of the Bank's operations

2 The United Kingdom has a highly centralised banking mechanism for central government receipts and payments: the Bank acts as the main banker to the Government, maintaining a major group of official accounts. The Government does not hold balances, other than working amounts, with other banks. This centralised system enables the Bank to minimise government non-interest-bearing balances by employing any surplus cash to reduce the amount of official debt outstanding or to acquire short-term assets, thus avoiding unnecessary loss of interest to the Government.

3 The final daily cash settlements within the commercial banking system, and between the commercial banking system (reflecting the position of almost the entire private sector) and the Bank (embracing the Government), take place principally across a small number of accounts—those of the banks which are members of the Town Clearing—at the Bank. These banks are obliged to keep their operational accounts with the Bank in credit, and to cover themselves against the uncertainties in their daily cash flows. Each bank specifies a target balance at which it will aim; the banks advise the Bank of their target balances to assist the Bank in its daily forecasts of the money market's cash position. The Bank maintains accounts for other customers too—including, for instance, other domestic banks and overseas central banks—but these normally play only a minor part in determining the daily flow of funds between the Bank and the banking system.

4 As banker to the Government and to the clearing banks, the Bank is necessarily involved in the day-to-day transactions between these parties. Government transactions with the rest of the economy are on average very large—totalling several hundred million pounds or more in each direction each day—and they fluctuate widely. Substantial daily net flows between the clearing banks and the Bank can result. A net flow of funds to the Government would, in the absence of intervention by the Bank, be reflected in a drain on the balances held by the clearing banks at the Bank; a net flow from the Government would result in an accumulation of them. In its money market operations, the Bank aims to offset these net flows, and the terms on which it does so are likely to have general implications for interest rates.

5 In undertaking these operations (and in particular when relieving a shortage of funds in the banking system) the Bank deals mainly with discount houses and only to a very limited extent directly with commercial banks. Banks typically hold some liquidity in the form of secured and callable or very short-term deposits with discount houses, which can be used to meet cash needs; and they can sell sterling money market instruments to discount houses to raise cash. Discount houses, in turn, may expect to balance their position, if short of funds, either by selling eligible bills to the Bank or by borrowing from the Bank against collateral, during the Bank's normal money market operations.

#### B Bank of England forecasts of the daily position

6 In order to plan and to undertake its operations efficiently, the Bank maintains running forecasts of the cash position of the banking system—daily for several weeks ahead, and on a weekly or monthly basis over a longer horizon. As part of the same exercise, the Bank also forecasts changes in the stock of assistance (if the Government had net short-term debt outstanding, the same procedure would enable the Bank to forecast the amount of Treasury bills that would need to be outstanding in the market).

(1) This annex updates some parts of the article 'The role of the Bank of England in the money market' published in the *Bank of England Quarterly Bulletin*, March 1982; but the descriptions of the historical background and of the discussions leading to the changes introduced in 1981 are not repeated here.

7 There is considerable unavoidable uncertainty in such forecasts. The factors which contribute to the market's position are known with varying degrees of certainty at varying stages in advance. By the morning of a particular day, the picture for that day is usually as follows:

- (i) The Bank has an estimate, obtained from various government sources, and confirmed in advance in some instances by the receiving or paying banks, of the flows to and from the banking system in respect of the various government accounts at the Bank. These flows include tax receipts, government spending, national savings and certificates of tax deposit. Some uncertainties remain, however—for example, over the timing of the clearing of expected tax payments—and these may sometimes result in very large swings in the estimate during the day. The picture can never be complete until the outcome of the Town Clearing is known, which is after the conclusion of normal business. Other customers of the Bank, such as overseas central banks, assist by giving advance notice, where possible, of likely movements on their accounts.
- (ii) The Bank also has an estimate, based on banks' declared requirements and on past experience of daily and seasonal patterns, of the net change in the circulation of bank notes for the day, which is matched by movements on the clearers' balances at the Bank. The clearing banks may adjust their note movements during the day, so the initial estimate is subject to revision.
- (iii) The impact of the sterling settlement of any foreign exchange transactions by the Bank, arising from its management of the Exchange Equalisation Account as agent for the Government, is usually known, since most such transactions are settled two business days later. Likewise, the impact of official dealings in the gilt-edged market can usually be predicted with reasonable accuracy, since these are normally settled on the next business day after the transaction. New issues by tender are an exception: payment in full or in part is lodged with applications and the extent to which the issues are subscribed, and how much of the payments will be cleared that day, are known with certainty only in the course of the day. Redemptions also create some uncertainty, because it is not possible to predict exactly when recipients will present their redemption warrants.
- (iv) The day's take-up of Treasury bills tendered for the previous week, and maturities of

Treasury bills in market hands, are known. So too is the value of any local authority or commercial bills maturing in the Bank's portfolio, or of any bills due for resale to the market, which give rise to cash flows from the market to the Bank. Any repayment to the Bank of earlier assistance to the market in the form of lending is also known.

### C Instruments in which the Bank conducts its money market operations

8 Most of the Bank's money market operations are conducted in eligible bills, comprising Treasury bills, eligible local authority bills and eligible bank bills.

9 The Treasury bill is a bearer government security, representing a charge on the Consolidated Fund of the United Kingdom, payable on or after a certain date and issued at a discount to its face value. Treasury bills are issued to the public in two ways: by allotment to the highest bidder at a weekly tender (paragraph 28 below describes the procedures of the tender); and by allotment to the highest bidder in response to an invitation from the Bank to discount houses and clearing banks to bid for Treasury bills to absorb a money market surplus on a particular day. In addition, Treasury bills may be issued at any time to government departments and the Issue Department of the Bank; these 'tap' bills are issued at a rate of discount fixed by the Treasury. The Treasury Bills Act 1877 provided for Treasury bills to be issued for any period not exceeding twelve months, but after 1917 bills offered at the tenders were for three calendar months and since 1950 for 91 days (or sometimes for one or two days more or less to take account of public and bank holidays), except for temporary use of shorter-dated bills on specific occasions to smooth money market flows.

10 Local authorities are empowered under Schedule 13 (5) of the Local Government Act 1972, as amended by Schedule 70 of the Local Government Act 1985, to issue bills with a maturity of up to twelve months, for the purpose of defraying expenses pending the receipt of revenue. These powers are restricted to authorities of a certain size (on the basis of their rate income) and the amount of bills issued by each local authority is limited to a proportion of its rate income. Local authority bills are eligible for discount at the Bank only if:

- (i) these statutory requirements are met;
- (ii) the original maturity of the bills is no more than 187 days;
- (iii) specific details of each issue are supplied to the Bank at the time of issue, including the due date(s), the amount(s) allotted, the average rate for each maturity and the total

amount of bills outstanding following the issue; and

- (iv) the Treasurer of the issuing local authority provides the Bank annually with a statement certifying that its issues of bills during the previous financial year have complied with the statutory and other requirements on bill issues in force during that period.

11 Eligible bank bills comprise those commercial bills which are accepted by a bank and which meet a number of criteria, relating to the purpose for which the bill is drawn, the clausing and maturity of the bill and the eligibility of the accepting bank. In particular, such bills should:

- (i) identify the underlying transaction for which this form of financing is being arranged, which should be short-term, self-liquidating and not for capital purposes;
- (ii) be drawn in sterling for an original maturity of no more than 187 days;
- (iii) not be payable outside the UK; and
- (iv) not be drawn on, or accepted by, a bank which has a shareholding link with the drawer.

12 The Bank maintains a published list of institutions whose acceptances are eligible for discount at the Bank. The Bank is prepared to admit applicants as eligible where they have, in the Bank's judgement, a substantial and broadly-based existing sterling acceptance business in the United Kingdom and where they can command the finest rates in the market for ineligible bills, provided, in the case of a foreign or foreign-owned institution, that British banks enjoy comparable opportunities in its domestic market. The list published on 3 March 1988 included 153 banks.

13 The Bank does not impose any direct limit for monetary control purposes on the volume of acceptance business written by eligible institutions. However, for reasons of equity and prudence, it does set limits for internal purposes on the proportion of its own portfolio for which an individual acceptor's paper may account.

14 During periods of acute cash shortages in the banking system, such as in the main tax-paying periods, the Bank may undertake operations in instruments other than eligible bills. In particular, the Bank may purchase gilt-edged stock and certain other assets directly from banks for resale to them at a future date. On such occasions the Bank announces in advance that it is offering temporary facilities to banks to take effect from a certain date until a specified future date. The operation offers facilities to each member of the monetary sector

with eligible liabilities in excess of a specified minimum figure for an amount up to a specified percentage of its eligible liabilities (although for practical reasons the Bank imposes a minimum size on individual transactions). The facilities are normally for the sale to the Bank and subsequent repurchase of gilt-edged stock and for the provision of finance against promissory notes in relation to holdings of sterling export credit and shipbuilding paper guaranteed by the Export Credits Guarantee Department and the Department of Trade and Industry respectively.

## D Techniques

### (i) Bill operations

15 In order to relieve a shortage of funds in the banking system, the Bank normally invites discount houses to offer eligible bills to the Bank for outright sale (though with recourse to the seller—see paragraph 17 below) against same-day settlement. The invitation usually makes no distinction among Treasury, eligible local authority and eligible bank bills, but it may do so and may also be confined to certain maturity bands. These bands are defined in terms of the remaining, not the original, maturity of the bills and comprise:

band 1:	1-14 days
band 2:	15-33 days
band 3:	34-63 days
band 4:	64-91 days

The Bank does not usually purchase outright bills with more than three months remaining to maturity or, in the case of eligible bank bills, within seven days of their date of acceptance.

16 In response to an invitation from the Bank, each discount house may make offers of eligible bills to the Bank. Each offer must specify:

- (i) the amount of bills being offered (face value);
- (ii) whether the bills are Treasury, local authority or eligible bank bills;
- (iii) the maturity band of the bills (as set out in paragraph 15); and
- (iv) the discount rate at which the bills are being offered.

The Bank decides at its discretion which offers to accept, and normally buys paper, up to the amount of the shortage as estimated by the Bank, at the best acceptable rates offered within each combination of instrument and band in which the Bank chooses to deal. If offers of bills exceed the amount of the shortage, the Bank normally accepts offers of shorter rather than longer bills and of bills at higher rather than lower discount rates. The Bank may also

distinguish among types of bills: its practice is to accept offers of Treasury bills in preference to local authority bills, and of local authority bills in preference to eligible bank bills. The lowest rate at which the Bank buys bills outright (the 'stop rate') may differ for different maturity bands and different types of bill. The Bank may buy an amount of bills lower than the estimated shortage, for instance if insufficient bills have been offered at acceptable rates.

17 Although the purchase of eligible bills through the technique described above is commonly referred to as an 'outright' purchase, these purchases are with recourse to the seller: eligible bank bills purchased by the Bank from discount houses are regarded by the Bank as three-name paper (the three names being those of the drawer, the acceptor and the discount house).

18 In addition to responding to invitations from the Bank to offer eligible bills, discount houses also have the right to offer eligible bills for sale to the Bank at any time at their own initiative. The response to such offers is at the discretion of the Bank, which may quote a discount rate of its own choosing at which it would be prepared to accept the offer. In practice, operations at the initiative of the Bank provide ample opportunity for discount houses to sell eligible bills to the Bank, while borrowing facilities are a convenient means of relieving a shortage late in the day. This right has therefore been exercised very rarely in recent years: it represents the continuation of the long-standing facility available to discount houses to offer bills for rediscount at the Bank.

19 The clearing banks are not normally given a specific invitation to offer bills to the Bank to help relieve a market shortage; but they have a general invitation to do so which they may activate, in respect of Treasury bills and local authority bills only, at the times of day when the Bank is inviting offers from the discount houses. They may also offer bills of these types to the Bank after the Bank's normal bill operations have been concluded, but before 3 pm; but in this case the banks do not propose the rate at which they wish to sell, rather the Bank sets the rate at which it will buy, which is never below and will typically be above the rate at which the Bank purchased similar bills in its earlier operations.

20 As a further technique, the Bank may invite discount houses to offer eligible bills for sale to the Bank, with an agreement to repurchase them later. The Bank specifies a terminal date (or dates) for the repurchase by discount houses and the rate of discount at which the proceeds of the sale of all bills to the Bank under the agreement (regardless of type

and maturity band) will be calculated; discount houses then submit offers of bills (the offers do not need to differentiate between types of bill), at rates of interest which they are prepared to pay on the proceeds for the specified period. The Bank responds to the bids in the same way as with outright operations.

21 The Bank retains the discretion to impose restrictions on which eligible bills may be offered for sale and repurchase (for example only bills with more than 91 days to maturity, or only those eligible bills which are not available for outright sale on a particular day), but it may also invite offers on an unrestricted basis. In this case any eligible bills, including those with more than 91 days to maturity and eligible bank bills accepted within the previous seven days, may be offered for sale and repurchase, provided that they do not mature before the repurchase date. The Bank is thus able to undertake its operations in a wider range of eligible bills than those in the maturities it is normally willing to purchase outright.

22 The rate of discount used to calculate the proceeds of bills sold to the Bank under the sale and purchase agreement is chosen by the Bank at its discretion and is normally set at least as high as the highest 'stop rate' prevailing in the Bank's outright bill operations. Meanwhile, the rate of interest at which bills are offered by discount houses is quoted on a yield basis and the Bank will not normally accept offers at rates which are lower than the yield at which the Bank would be prepared to purchase outright bills maturing on the terminal date of the sale and repurchase agreement. The Bank will normally choose as the terminal dates of sale and repurchase agreements days when there would otherwise be a surplus of funds in the banking system, or a relatively small shortage.

23 The proceeds of sales of bills to the Bank are credited to the seller's account with the Bank. Bills held by the Bank under sale and repurchase agreements are released to the original seller on the agreed date of repurchase in exchange for a cheque drawn on the seller's account with the Bank for the proceeds plus interest.

24 The techniques described above are employed when the banking system is short of funds on a particular day; in the event of a surplus the Bank may, at its discretion, invite both discount houses and clearing banks to bid for Treasury bills of one or more specified maturities for same-day settlement. The inclusion of banks in the invitation is necessary because they could otherwise be at a substantial disadvantage late in the trading day *vis-à-vis* discount houses in finding an outlet for surplus funds. In these operations the Bank at its discretion

normally accepts the bids at the lowest rates for the bills it wishes to sell, and issues bills to successful bidders in exchange for cheques drawn on their accounts with the Bank.

## (ii) Lending

25 Discount houses have borrowing facilities at the Bank against approved collateral up to maximum amounts related to the capital base of each house. These provide discount houses with a supplementary means of balancing their positions after the Bank's main operations in eligible bills have been concluded. Collateral acceptable to the Bank as security against this lending comprises eligible bills due after the maturity of the loan and gilt-edged stock with a residual maturity of up to five years. Collateral of 105% in the form of eligible bills or gilt-edged stock with up to five years to maturity is required against lending; bills are valued at face value, and gilt-edged stock is valued at the Central Gilts Office reference price. Interest is deducted from the amount advanced, which is credited to the borrower's account with the Bank. Upon maturity of the loan the collateral is returned to the borrower in exchange for a cheque drawn on its account with the Bank.

26 Each discount house's facility is in two tranches, each for an amount equal to the capital base of the discount house. Facilities are adjusted quarterly in line with changes in the capital base of each discount house or, exceptionally, within a quarter to take account of a large specific change in capital base. Drawings on the second tranche will normally bear a higher rate of interest than those on the first tranche. The terms on which these facilities are available on a particular day are at the discretion of the Bank. The facility may be activated by personal application to the Head of the Money Market Operations Division at the Bank. Prospective borrowers are invited to state the amount they wish to borrow before being told the terms on which the funds will be made available.

27 Borrowing facilities are also available to gilt-edged market makers and to Stock Exchange money brokers operating in the gilt-edged market, though the tranches represent a lower proportion of each institution's capital base.

## (iii) Treasury bill tender

28 Weekly Treasury bill tenders are held on Fridays (or the last business day of the week); the Bank announces the amount and maturity of Treasury bills to be offered a week in advance when announcing the result of the previous week's tender. The bills on offer normally mature 91 days after their date of issue but, as noted in paragraph 9

above, the Treasury Bills Act 1877 allows any maturity up to twelve months, and on occasions the Bank has offered bills with a shorter maturity than 91 days. The bills are for issue and payment on any business day in the following week, at the option of each successful tenderer. Each tender must be for an amount not less than £50,000 and must specify the date on which the bills required are to be dated, and the net amount per cent (being a multiple of half of one penny) which will be given for the amount applied for. Separate tenders must be lodged for bills of different dates. There is no restriction on who may tender for Treasury bills. Accepted tenders are allocated at the price bid. The Bank may allot less than the amount announced the previous Friday without giving any prior notice, but may not allot more than the previously announced amount.

29 Even if a sizable cash shortage is in prospect for the following week (as is normally the case), some Treasury bills will be offered, other than in exceptional circumstances, so as to preserve a market in these bills. During a period of substantial surpluses (or in order to alleviate a future period of large prospective shortages) the weekly Treasury bill tender may be increased in size.

30 Irrespective of its size, the Treasury bill tender is underwritten each week by the discount houses collectively. This ensures that the tender is covered, but there is no minimum price agreed in advance between the Bank and the discount houses, and the discount houses receive no fee for undertaking the underwriting. The basis for calculating the minimum proportion of each issue for which each discount house will tender is agreed in advance between the Bank and the discount houses, taking into account the capital base of each discount house.

## (iv) Special deposits

31 Under the current monetary control provisions, monetary sector institutions with eligible liabilities of £10 million or more may be called upon to place special deposits with the Bank. Such deposits would normally earn a rate of interest close to the equivalent of the average rate of discount at the most recent Treasury bill tender and would be called in amounts set as a percentage of eligible liabilities. Although this scheme has not been activated since December 1979 it remains available as a means of withdrawing cash from the banking system. Since a call for, or repayment of, special deposits requires a period of notice, the scheme is best suited to occasions when there is the prospect of a protracted period of surplus cash which the Bank wishes to offset. Once special deposits have been called, their release can be timed to suit the expected pattern of market flows—in particular, to match an expected shortage.

## **E Daily procedures**

32 On the basis of the information available, the Bank makes known to the market, at about 9.45 am, its forecast of the day's position. This estimate is published on the financial news screens, with an overall figure (rounded to the nearest £50 million) and a summary of the main contributory factors, including maturing assistance, net Exchequer transactions, the increase or decrease in note issue and the divergence of clearing banks' operational balances at the Bank from their target level the previous evening.

33 The Bank may, at its discretion, at this stage invite by telephone an 'early round' of eligible bill offers from discount houses (for outright sale to the Bank or, in addition, also for subsequent resale). Normally, an early round of invitations is extended only if a very large shortage is forecast. Having decided which offers, if any, to accept, the Bank publishes the results of its operation, disclosing the amount and types of bills purchased in each maturity band and the spread of discount rates at which it has dealt in each band. If applicable, the Bank will also disclose the amount of bills it has bought for later resale, and the spread of interest rates at which it has bought them. The Bank's responses to individual houses' offers are communicated by telephone after the results of the operation have been published.

34 If the forecast has changed significantly by noon the Bank publishes a revised figure, but does not publish the factors responsible for the revision. The Bank does not base its operational decisions during the day solely on its own estimates of the market's position, but takes account also of reports from discount houses on their positions, indications from the major banks, and the state of the market as evidenced by the behaviour of short-term interest rates. Having considered these factors, the Bank decides shortly after midday whether it is then prepared to operate in the money market.

35 Conventionally, banks withdraw any callable funds which they require from discount houses before noon, but they may offer surplus funds to the houses right up to the close of business in the afternoon. It follows that any shortage in the system as a whole can be expected to show in the discount houses' position by noon; indeed, because banks often withdraw money from discount houses in the morning in amounts which prove later to be surplus to their needs later in the day, the discount houses may report a shortage larger than the Bank's own forecast. But an overall surplus is unlikely to show fully at this time. Thus at this stage the Bank normally acts, if at all, only to relieve a shortage.

36 At noon the Bank may, at its discretion, invite a round of eligible bill offers. The procedure is as

described in paragraph 33 above. However, whereas the early round of offers is normally invited only when a particularly large shortage is forecast, the noon round usually takes place unless the forecast shortage is very small. In any round of invitations for eligible bill offers (including the early round) the Bank may conduct the round sequentially, for example by first inviting offers of bills for outright sale and second, having decided which bills to accept for outright purchase, inviting offers of bills for sale and subsequent repurchase.

37 At 2 pm the Bank normally publishes any further significant revision to its estimate of the market's position for the day. Once again, the Bank considers its forecast together with other indicators in deciding whether to invite business with discount houses. This may be in addition to dealings transacted at earlier sessions and the Bank again publishes the details of the market operations it conducts. The Bank need not repeat the terms of invitations made earlier in the day at later sessions; and need not accept offers at later sessions at the same rates as it accepted offers earlier in the day.

38 If the forecast is of an insignificant shortage or surplus the Bank need not invite business at any time during the day.

39 If a surplus is forecast, then unless it is very large the Bank usually acts only in the afternoon session to absorb it, for the reasons given above. To do so, at 2 pm the Bank invites discount houses and clearing banks to bid for Treasury bills of one or more specified maturities.

40 If a discount house finds itself short of funds after the Bank's main bill business has been concluded, a director of the discount house may attend the Bank in person at 2.45 pm to request to borrow on a secured basis under its facilities. The Bank publishes the total amount of this late assistance provided to discount houses, gilt-edged market makers and Stock Exchange money brokers, but not the terms. Thereafter, these entities may seek by telephone application to borrow further, but such transactions are at the discretion of the Bank and usually attract increasing rates of interest.

41 Transactions within the banking system may continue until dealing is effectively terminated by the need to present items at the Town Clearing. Only when the outcome of this clearing is known will the net money market position for the day, and the final position of the clearing banks individually at the Bank, be apparent.

42 The procedures described above comprise the operations which the Bank normally undertakes. On particular occasions, however, the Bank may choose to alter its arrangements, for example to deal with

exceptional money flows or to give a signal to the market about interest rates.

43 For example, the Bank may publish an announcement that discount houses wishing to use their borrowing facilities are invited to do so at 2.30 pm; on such occasions the interest rate at which the loans are made is usually published. The limits on

the size of borrowing facilities are suspended for 2.30 pm lending, and the amount outstanding over the duration of the lending does not count against each discount house's borrowing facilities for late assistance on subsequent days. Or (as on 14 January 1985), the Bank may announce a Minimum Lending Rate, which, for a short period ahead, it will apply in any lending to discount houses.