Supervision of the wholesale money markets

In a speech[1] to market practitioners, Mr John Townend, Head of the Bank's Wholesale Markets Supervision Division, explains the objectives and rationale of the Bank's proposed regulation of the wholesale money markets and describes the principal features of the new regime. He then goes on to discuss and, where possible, clarify some of the outstanding issues of principle and interpretation that have been causing concern among participants in the markets, and outlines the next steps in the introduction of the new system.

The Bank's Wholesale Markets Supervision Division was established in late November 1986, in order to effect the task given to the Bank, under Section 43 of the Financial Services Act, to administer the arrangements for disapplying the provisions of that Act from the wholesale markets in sterling, foreign exchange and bullion. As such, it is quite distinct from our now long-established Banking Supervision Division, which carries out the statutory responsibilities given to the Bank under the Banking Act 1987 and reports to a different Executive Director. While I recognise that this may be somewhat confusing to the outside world, it is important to understand this distinction in the internal organisation of the Bank: not only because banks which are supervised by both areas will need to come to terms with it when our regime becomes operational, but also because it highlights the different nature of the supervision in which we are engaged.

Banking Supervision Division is primarily concerned with the protection of depositors, and with institutions for which lending (and the associated credit risk) has traditionally predominated, although the evolution of banking has inevitably and increasingly drawn them into securities business and its risks. In contrast, our concern in the Wholesale Markets Supervision Division relates much more to the functioning and integrity of the markets themselves and to firms for which day-to-day position-taking in these markets is a prime source of the risks to which they are exposed. To understand that business properly, and to set the standards to which it should be conducted, we need to maintain close contacts with those markets. That is why we are part of the markets area of the Bank and why the supervision of the discount market—which has come under my wing—has never been part of BSD's work.

Objectives of the Bank's regulation

I will try to explain as briefly as I can what we are trying to achieve in regulating the wholesale money markets and describe in particular the form of the regulation which we are preparing to establish in this area. But let me begin with an obvious question, since the answer to it will I hope set the scene and give an insight to the fundamental approach we are adopting to regulation in these particular wholesale markets. The question, or rather series of questions, is: why bother? Why are these markets being singled out for special treatment? Why not just leave them within the scope of the Financial Services Act? Are we not introducing a further and unnecessary complication into a framework which is already extremely complex and hard to come to terms with?

I will readily concede that the wholesale markets regime is undoubtedly an added legislative complication. But its very purpose is to allow the wholesale money markets—which exclusively serve professionals—to continue to operate outside the full rigour of the Financial Services Act and to ensure that those markets which are outside the Act's scope are not split apart from those within it. Had some wholesale market activity been left subject to the Act, it would have been difficult to design a *special* regime for it—and even more difficult, if not impossible, to design an *appropriate* regime. Yet without such special provision, the efficient functioning of all these markets could have been seriously impaired, to the detriment of those very investors whom the Act was intended to protect.

Our hope is that at least some operators—not just principals, whether banks or discount houses, but also the specialist money brokers—may, if they confine their activity to banking or wholesale market dealing, be able by this means to avoid altogether the need for authorisation under the Financial Services Act. Even if the numbers in this category are rather small, there will be many others who, while needing authorisation anyway for their non-exempt investment activity, will nevertheless benefit from the wholesale markets regime in that it will be a less intrusive form of regulation, tailor-made for these markets, and that it will apply equally to others not involved with the Act. This will help to ensure that the wholesale money markets remain a coherent whole.

That said, an inevitable corollary of taking this activity outside the scope of the Act is that these markets must accept some regulation on a more formal basis than

(1) At the BBA Conference on the Financial Services Act, on 9 November 1987.

hitherto. Those who choose to apply to the Bank for exemption under Section 43 will have to accept the Bank's regulation of their capital adequacy and abide by the London Codes of Conduct—codes prepared by the Bank, drawing on the best advice of market practitioners and their associations.

Before saying more about these aspects of our regime, it is perhaps worth asking first: why the Bank? Even if it is accepted that special treatment for these markets is appropriate, why is the Bank the appropriate regulator? You will see that I take nothing for granted, even though I am aware that some believe that the Bank should have been given even wider responsibilities for the supervision of investment activity, in preference to the complicated framework which is currently being established under the Financial Services Act. Leaving that on one side, however, I hope you will agree that the Bank's long-standing involvement, experience, understanding and operational role in many of the wholesale money markets combine to make us the natural regulatory authority for them. Much of our understanding of these markets of course stems directly from that operational role, and our new regime is just as much a natural extension as was our involvement in banking supervision, which itself evolved from our day-to-day market activity.

We have for many years exercised general oversight over significant parts of these markets. Indeed, the Bank was primarily responsible for establishing Joint Standing Committees in both the sterling and foreign exchange markets which have served as a vehicle for their self-regulation for quite some time. So it is appropriate, I think, that the supervision of those wishing to take advantage of the Section 43 exemption should fall to the Bank. And the scope of the exemption reflects in large measure the traditional ambit of the Bank: the wholesale sterling money markets, the forex market and—to a lesser extent—gold and silver bullion.

We very much hope that the net effect of the wholesale markets regime will be to produce a considerable operational simplification for those acting in the money markets. That is our purpose and objective, and we will be doing all that we can to see that it is achieved.

The Grey Paper describing our intentions and arrangements is admittedly yet another rule book for you to master and may be viewed by some of you in the same light as the other rule books with which you are wrestling. There are, I freely admit, many rough edges still to be smoothed away—especially at the jagged and uncertain boundary between our regime and the Financial Services Act—and I shall say more about this shortly. But that is inevitable at this stage in our preparations. For the moment I hope you will agree that, despite the detailed technical questions still to be resolved, our regime is in broad outline not too far wide of the mark. From the number of institutions which have already applied to become listed money-market institutions, we believe that we have indeed met a need, and that we are establishing a useful and appropriate regime. To date we have received some 350 applications, of which about 250 are banks, about 15 are discount houses or gilt-edged market makers, about 35 are non-bank principals and the rest wholesale market brokers. Given that these institutions could have chosen to remain entirely within the scope of the Financial Services Act, and not exempt their money-market activity from its provisions and rules, this suggests a fair measure of support for our regime.

The new regulatory regime

Let me turn now to some of its details. First let me define its scope, in case this is unfamiliar to some of you. The boundaries of the money markets are defined in terms of a three-fold classification: the institutions involved; the instruments in which they are dealing or arranging deals; and the size of their transactions. The first and last of these are I think the most straightforward. To benefit from the exemption, an institution has to appear on the list of 'fit and proper' money-market institutions which we are currently drawing up. As our Grey Paper describes, we propose to list two broad types of firm: first, those who act as principals in a market-making capacity; and second, those acting as brokers, arranging deals between counterparty principals. We do not intend to list those who, even though they may be very active in the markets, are more appropriately thought of as end-users or customers of the markets.

In addition, deals with unlisted institutions or individuals in instruments falling within the scope of the Financial Services Act must be above certain size limits to become exempt, since we are interested exclusively in the *wholesale* markets and with participants who should be sufficiently experienced to be expected in large measure to protect their own interests without needing the help of the Act: only cash transactions of £100,000 or more and margin transactions involving a principal sum of £500,000 or more qualify for exemption. But there is an important proviso here: once one such deal has been undertaken, any further transactions—regardless of size—by that customer with the same listed institution over the following eighteen months will also be exempt.

Lastly, the markets with which we are concerned are those for short-term instruments which broadly serve the 'treasury' requirements of market users. Hardly surprisingly, these do not naturally conform with the definition of investments under the Financial Services Act: indeed, many transactions in instruments which form the core of money-market activity—like sterling and currency wholesale deposits, commercial bills and ordinary foreign exchange and bullion transactions—lie outside its scope, but will nevertheless be embraced consistently within the Bank's wholesale market regime.

So much for the basic definition of our scope: you will not be surprised to learn that there are some difficulties at the boundary, and I will deal with these shortly. Before doing so, however, let me refer to another basic feature of our regime. It is important to keep firmly in mind that it has two distinct aspects: a capital adequacy test (in fact, two: one for principals, and one for brokers); and codes of conduct for the various wholesale markets. I make this distinction because of the confusion which may so easily arise in discussions on lead regulation about what lead regulation actually implies for our regime.

We have made clear that banks which also become listed institutions under our regime will not be subject to capital adequacy tests beyond those applied by the banking supervisors, though that supervision will itself take into account the risks involved in money-market activity. Thus the Wholesale Markets Supervision Division will not be *directly* involved in monitoring the capital adequacy of listed banks (with the exception, of course, of the discount houses—which are in any case treated rather differently). For all banks, whether listed or non-listed, the terms of the Memorandum of Understanding between the Bank and the SIB will apply. This memorandum will govern the division between them of responsibility for capital adequacy testing for those banks which are also authorised for investment business under the Financial Services Act. In the markets area, we also hope to reach similar arrangements for the supervision of discount houses; the gilt-edged market makers, Stock Exchange money brokers and inter-dealer brokers; and other listed money-market institutions. Thus for those entities for whom their predominant activity, assessed on a range of criteria including the balance of risks in the business, is in the money as opposed to the securities markets, the Bank would act as lead regulator; but where the predominant activity is non-exempt investment business under the Financial Services Act, the lead will be taken by the relevant securities regulator. This may well be the situation for many of our *non-bank* listed wholesale market firms.

These arrangements, however, relate *only* to capital adequacy testing and to the regular statistical reporting which that will entail. *We* in Wholesale Markets Supervision Division will retain responsibility for ensuring that *all* listed institutions—banks, non-banks and brokers—observe our Codes of Conduct in all respects. Thus we will investigate any complaints which may arise about listed institutions' behaviour in relation to the codes (although we hope that these will not be too frequent). But the point I would stress is that this task falls solely to the Bank's Wholesale Markets Supervision Division, not to whoever happens to be the designated lead regulator for a particular firm. The distinction is, I think, a straightforward one and should not cause complications. It is all part of ensuring a consistent and coherent approach to breaches of accepted standards in the wholesale markets, which—as is evident from the origins of our supervision—is one of our key concerns.

Some outstanding problems

It would be wrong of me to pretend that our wholesale regime is wholly free of problems, even now. From the comments we have received since the publication of our revised Grey Paper in July, it is quite evident not only that a number of misconceptions persist but also, and more seriously, that there are one or two awkward issues of principle which are causing concern. The latter have their basis largely in the Financial Services Act itself, but are nonetheless very relevant to our wholesale regime.

Let me deal first with one or two of the less serious difficulties before tackling the more substantive issues. First, we have found that the market-making criterion is a source of some confusion. It should not be. The requirement that a firm should be a market maker in one of the instruments covered by our regime is designed to limit the list to the most active players in the wholesale markets: those which, in effect, determine standards in those markets and are the key to their efficient and orderly operation. As such it is merely a *qualifying* criterion and is not intended to *restrict* listed—or unlisted—firms' activities. A listed institution will not be precluded in any way from dealing in other instruments within the exempt area—provided those dealings are consistent with the business plan we will have agreed with each firm—and any deals done in these other instruments which meet the size criterion will be exempt from the Act. To take a concrete example: there are banks whose market-making activity is largely confined to the foreign exchange market and to particular currencies there. So long as their activity in this area is sufficient to satisfy the Bank that they are indeed carrying out a market-making function in that market, and the other qualifying criteria are met, these banks will become listed. Regardless of the fact that this market-making activity is outside the scope of the Financial Services Act, as a listed institution *all* their wholesale transactions in the defined money-market area under schedule 5 of the FSA will be exempt from the Act. This of course means that, when assessing the fitness of applicants for listing, we must have regard not only to their market-making activities but also to any other business—especially in the money market—which they may do. We will certainly wish to be informed by a listed institution if it intends to add to the range or scope of its activities (or, for that matter, to restrict them), because involvement of that kind can only be undertaken safely if adequate systems are in place and the firm's staff have the required expertise. So we would need to assure ourselves in such cases that the expansion was justified. But that is a prudential concern, and one which will be shared by all responsible firms themselves.

When it comes to the list itself, we have yet to decide whether to identify explicitly the *instruments* in which the firms are acting as market makers. Although this is a superficially attractive idea, and would provide some useful information to counterparties, it would be an added complication (for many firms are market makers in a range of instruments) and it might only serve to confuse because, as I have just said, firms are not restricted only to those areas in which they are making markets. Equally, they are not *committed* to deal in the way that, for example, the gilt-edged market makers are. Listed firms undertake to observe the codes of conduct in *all* their dealings, and will be supervised for capital adequacy purposes on their whole book. So, to the extent that recognition is being given to them by their inclusion on the list, it is a general, not a specific, recognition.

Another area of apparent difficulty is the *wholesale counterparty* concept, and the reports we will require on small deals with such counterparties. The concept is drawn from the Financial Services Act itself, and is the shorthand way of referring to counterparties who, by virtue of a single transaction at or above the minimum limit (prescribed in the Act) in one of the relevant FSA instruments with a listed institution, lose the protection of the Act for all further transactions in the exempt area with that institution—whether above or below the limits.

The intention of the drafters of the Act was that only professional investors would become wholesale counterparties: it was certainly not their intention that small investors should lose the protection of the Act. But it is clearly possible—if unlikely—that some investors, in no real sense professional, could become wholesale counterparties by virtue of one or two untypically large transactions and then deal almost exclusively in small amounts. The Act, I should add, gives listed institutions no discretion in determining who is a wholesale counterparty: it is an *inevitable* result of carrying out a qualifying transaction. That is why we have included in our regime a requirement that firms warn customers of the consequences (in terms of loss of protection under the Act) *before* entering into the qualifying transaction; why we will require that firms keep proper records of the names of wholesale counterparties and of correspondence with them about its implications; and why we will require that small transactions in a limited number of the instruments with such customers are reported regularly to us. By these means, we hope to ensure that no customer is unaware of the consequences of his actions; and that firms do not seek to take advantage of customers who generally deal in small amounts and from whom the protection of the Act was not intended to be withdrawn.

Let me stress that the reporting requirement for small deals will relate *only* to those instruments falling within our regime that are also investments within the terms of the Financial Services Act; and, even of those, will not cover off-exchange options or futures, forward rate agreements or repos. We will *not* require reporting of small deals in deposits or foreign exchange, where the number of such transactions may be considerable. We believe that the number of small deals likely to be caught by our reporting requirement is therefore already very small. Moreover, any bank is of course quite free to decide, as a matter of practice, to deal only with certain types of wholesale counterparty or to deal in the relevant instruments only in amounts which exceed the qualifying limit. For example, those discount houses whose activity is confined to the exempt instruments have told us that they will no longer undertake small deals in these instruments, to ensure that they do not need authorisation. Whatever firms decide, however, we are sure that it is right for us to seek to ensure that inexperienced investors are not disadvantaged by becoming wholesale counterparties.

Issues of interpretation

I would like now to turn to a rather different problem which I know is causing considerable difficulty for practitioners and their legal advisers, but where I am not sure I can offer much comfort. This is the confusion and uncertainty which seems to be arising because of the rather obscure terms in which parts of the Financial Services Act are drafted. It is all too clear from the comments we have received, especially from banks and the relevant associations, that the Act presents some difficult problems of interpretation, especially with regard to the definitions of what is, or is not, an investment, but also who can benefit from the terms of the so-called 'own-account' exemption.

We have seen a number of legal opinions on some of the most uncertain of these definitions of investments, opinions which do not always agree even among themselves—still less with the original intentions of the Act's drafters—as to what should be caught by it. I have heard it cogently argued that bank loans are debentures within the meaning of the Act. I have also seen it argued that swaps are not 'contracts for differences' under paragraph 9 of schedule 1, as I believe was originally intended, but debentures under paragraph 2: as such they would still fall under the Act but would then not be eligible for exemption under the Section 43 regime where over one year in maturity. This is all most unsatisfactory, and understandably worrying for practitioners wishing to protect themselves against inadvertently committing an offence.

The sorts of difficulty I have in mind are also exemplified by the Act's definition of forward foreign exchange (and, indeed, bullion) transactions. I am sure that those responsible for the drafting of the Act did their very best and were trying to achieve a workable solution, but I fear that this has not been successful. The Act makes the distinction between contracts undertaken for 'commercial' and for 'investment' purposes, with the intention of bringing futures within its scope whilst allowing forwards to be excluded. Yet only 'indications' are provided to help draw the distinction and these are creating considerable uncertainty. I am told that this particular distinction was necessary because legally watertight definitions of forwards and futures cannot be constructed, even though we can all tell Stork from butter: it seems to be a case of 'I cannot describe it, but I know it when I taste it'. In the face of this unworkable distinction, it is quite natural that the legal advice firms are being given is for caution, to err on the safe side and therefore to seek authorisation under the Act for *all* this activity, alone if necessary, and to apply the full rigour of the FSA regime to all such forward transactions. I can understand this, but it cannot be a *sensible* solution. We have been urging that a more helpful answer be found and I am hopeful that there may be some progress here soon.

I also mentioned the 'own account' exemption. This seems to be causing uncertainty because one of the ways in which investment business (that is, business caught by the Act) is defined is as a person 'holding himself out as engaging in the business of buying investments with a view to selling them'. This, it appears, may well apply to activities which are, in fact, at the sole discretion of the firm concerned and not for clients nor in any way market making. Again this cannot be sensible, nor what was intended.

I have much sympathy with those who have sought guidance on these sorts of point and we have taken up a number of the more obvious difficulties in interpreting the language used in the Act. It would clearly be of enormous help if it were possible for there to be some interpretative statements or more formal clarification in the form of amendments to schedule 1. It has been disappointing that it has not yet proved possible to achieve this, so that, as things stand, those of you with difficulties must continue to take legal advice and to look too at Hansards' record of the parliamentary debates on the Act, which in some areas may help to clarify its underlying intentions. But we will continue to do what we can to secure firmer guidance.

A different and more general area of concern, which some have expressed quite forcefully, is that of the effect on the competitive position of banks of the differing standards which will be applied by the various regulators of securities business. The main banking supervisors are, as you know, making good progress towards the laudable objective of common supervisory standards and this naturally encourages the expectation that securities supervisors too should make similar efforts to adopt common standards—both among themselves and, where their interests overlap those of banking supervisors, with them too. Seeing that standards at present differ, apparently to their disadvantage, banks are prompted to ask why they should be penalised in this way.

I can understand this perception, and that this may be how it looks. But the playing field *should* be more level than this implies. We as regulators have had to come to terms with the multi-functional nature of financial businesses and this, of itself, requires a matrix, functional form of supervision. But so long as the lead monitoring arrangements are successful, these should help to iron out the bumps or at least reduce them to manageable proportions. We cannot of course claim that we are there yet. But we are all sensitive to the issue and are trying to do what we can. I am hopeful that we will achieve the desired end-result, even if this requires a little patience.

Codes of conduct

Having dealt with these areas of difficulty let me move on finally to the Codes of Conduct we are establishing for the money markets, since it is this part of our regime which is of the greatest direct relevance to banks. As I have already indicated, the codes are an attempt primarily not to *change* the way in which trading is carried out but to *describe*, with assistance from practitioners, current best market practice and promulgate it as widely as possible. London has long benefited from the generally high standards adopted as a matter of course by the main participants in its markets, and our intention is only that those high standards should be observed throughout the markets—especially by those who may be less familiar with the way business is conducted here, or those who may—for whatever reason—be tempted now and again to cut corners. By and large, the codes concentrate on working practices and the like: they do not place a responsibility on market makers for best execution, but we would expect them to stand by prices they have quoted as firm for a reasonable period. And, unlike the rules which will be put in place by the various SROs, our codes are not legally enforceable: the concerns which have been voiced about Section 62 of the Financial Services Act have no bearing on our regime. But we will want to see the *spirit* of the codes, not just their letter, observed. We will investigate complaints by anyone against a listed institution and will be prepared to arbitrate in unresolved disputes. Serious or persistent breaches of the rules would call into question a firm's fitness to be listed.

Timetable

Let me conclude with a few words on our timetable. As you know, the regulatory aspects of the Financial Services Act will not now come into effect until next April, so our regime too cannot operate fully until then. But we asked firms to apply to us by the end of September so that we could decide whether or not they would qualify for listing well before the deadline for applications to the SROs: so-called 'P-day'. That was to ensure that those who do not meet our criteria in some way—and that may well, I should add, be nothing to do with doubts about their competence or probity—have sufficient time if needs be to apply to an SRO instead. Many of our applicants, of course, already intend to apply also to one or more SROs because some of their business falls outside the exempt areas. But some will only need to take that step if they are not listed, and we will make every effort to make sure that they know they must do so in good time.

We hope to publish a preliminary list of those who meet our criteria early next year, though that list will not become operationally significant until the parallel Financial Services Act requirements come into force. Our purpose in doing that is to give ample notice to market participants who will of course need to develop systems—as part of the process of being able to comply with the Financial Services Act and with our wholesale regime—which can distinguish between different types of counterparty. (This will be necessary because of the different rules which apply to dealing with each.) We remain willing to consider new applicants for listing, but we cannot now commit ourselves to have processed their applications in time for that preliminary list.

Conclusion

I hope you all now have a rather clearer picture of what we, the Wholesale Markets Supervision Division of the Bank, are about and that I have clarified some of the points which we know from experience are causing you, as practitioners, the most difficulty. Some of your problems are not, I am afraid, within our competence to resolve—though we are doing what we can. Inevitably, however, we will not smooth off all the rough edges by next April. Experience of the regime in operation, and how it works alongside our banking supervision and the activities of the SROs, will undoubtedly be an educative experience for all of us and it is only through discussion based on such practical experience that we will be able to make improvements, where improvements are shown to be needed.

We at the Bank do not claim a monopoly of knowledge and will continue to value your comments. I hope you will find us not only sympathetic but also able to respond flexibly: that is one of the benefits of a non-statutory regime. But whatever direction the development of our regime may take, you can be assured that our prime objective will remain the same: the maintenance of conditions in which the business of London's traditional wholesale markets can continue to be honestly conducted among firms of sound reputation and adequate resources, with a minimum of unnecessary interference from supervisors. I am sure that is an objective we all share.