

Bank of England operations in the sterling money market

The extension of the Bank of England's dealing relationships in the sterling money market⁽¹⁾

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. This paper sets out the Bank's intentions for the extension of its dealing relationships, including the obligations, structure and supervision of the Bank's money market dealing counterparties; the facilities the Bank will offer these counterparties; and the criteria for acceptability. These arrangements have been developed with the help of comments received on the Bank's draft proposals published in June this year. The arrangements will be subject to continuing review and modification in the light of experience.

2 The Bank invites applications, at any time from now, from firms wishing to establish a dealing relationship with the Bank in the sterling money market. The application process is described in Section III below.

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 sterling 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⁽²⁾, 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.

(i) The obligations

- (a) Taking deposits from banks

6 The Bank expects its money market dealing counterparties to offer callable deposit facilities to

(1) This paper and its three annexes were published by the Bank on 24 October 1988 and are a revised version of the consultative paper published by the Bank on 29 June 1988 and reprinted in the August 1988 *Bulletin*, pages 391-409. Annex 3 of the earlier paper has not been revised significantly and is therefore not reprinted here.

(2) The Bank is prepared to purchase three types of sterling 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.

banks, and to non-bank institutions which are members of either the Clearing House Automated Payments System (CHAPS) or the Town Clearing. This involves quoting rates on a continuous basis in any trading conditions, subject to the provisions of paragraph 9 below, and being 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 bid prices and, subject to the availability of paper, offer 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. The Bank recognises that the amounts for which quoted prices and interest rates for same-day settlement are good, and the spreads between bid and offer prices, are likely to depend on the time of day at which the quotations are made.

(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 tender for sterling Treasury bills, 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⁽¹⁾, 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 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 applied to discount houses⁽²⁾. These arrangements, which are described in detail in Annex 1, incorporate some modifications to those set out in the draft paper published in June this year.

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. However, 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 and the Bank will keep these supervisory arrangements under review to ensure that any differences remain small. 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 sterling 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.⁽¹⁾

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⁽²⁾ would require all authorised banks to hold a minimum stock of high quality liquid assets. Callable deposits secured on gilt-edged stock, eligible bills or certificates of deposit and held with discount houses, gilt-edged market makers or 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.

26 Those of the Bank's money market dealing counterparties which are structured as described in

(1) See footnote (1) on page 92.

(2) "Proposals for a stock of high quality liquidity". Bank of England Banking Supervision Division Consultative Paper 2/88, March 1988. (A further version of this paper was published in December 1988.)

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 Applications

39 As indicated in the introduction to this paper, the Bank invites applications from firms wishing to become money market dealing counterparties of the Bank. This procedure will be open-ended: there is no final date by which applications should be submitted. Applications should be addressed to the Head of the Money Market Operations Division at the Bank. The Bank will hold formal discussions with these firms, based on an annotated agenda which will be sent to applicants. The Bank will endeavour to reach a decision on each applicant as soon as possible and will then discuss with each successful applicant the date on which it might become a money market dealing counterparty of the Bank.

Annex 1

Supervisory arrangements for discount houses

1 This annex describes the framework of prudential supervision that the Bank applies to discount houses, including some recent modifications to the risk weighting applied to certain instruments and to the treatment of hedged positions. The framework will be subject to further 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 judgments 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 judgments 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 seven classes. The first gives rise to “basic risk” and the other six classes give rise to “added risk”, which is calculated by multiplying the assets in each class by the appropriate weights. The unadjusted book (the sum of basic risk) plus added risk less liquid asset deductions 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. Even within these limits 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 seven categories of asset. The six "added risk" classes, together with their appropriate risk weights, are given in the final six columns 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
<i>plus</i>	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
<i>minus</i>	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. The Bank is reviewing the treatment of futures positions and will make arrangements to allow for the extent to which the use of futures can reduce the position risk arising from the holding of certain instruments.

(d) Options

12 Discount houses which are active in options markets are required to calculate the "delta value"⁽¹⁾ of each individual option. These delta values are aggregated for particular instruments and contract maturities and treated as a single position in the asset underlying the option contract. This position is reported and assigned an appropriate added risk weight. The difficulty of summarising position risk exposure in a single figure is particularly acute where options are involved and for that reason the Bank will look particularly closely at the detail of discount houses' positions in options and assess the extent of their exposure to price movements in either direction. Discount houses are also required to report the margin on their combined futures and options positions.

(e) Foreign currency assets

13 Since open positions in foreign currency can expose a discount house to exchange risk, these are included in the framework of added risk classes⁽²⁾.

B Large exposures

14 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).

(1) The amount of the underlying instrument that the option carries the right to buy or sell multiplied by the probability of the option being exercised.

(2) Where such open positions are defined as the aggregate of net short open positions across all currencies, including sterling.

Exposures under category (c) (largely to the non-bank private sector), or under category (b) (largely banks) if more than a year in maturity, must be reported to the Bank if they exceed 10% of capital base and no such exposures in excess of 25% of capital base may be taken on without the Bank's prior permission, which will generally be forthcoming only in the particular circumstances defined in paragraph 16 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⁽¹⁾.

15 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.

16 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 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

17 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.

18 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.

19 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.

20 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.

(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.

Table 1
Risk classification of assets

	Nil	Added risk classes					5
		½	1	1½	2	4	
Cash at bankers							
Deposits with Bank of England							
UK treasury bills up to 3 months		3-9 months	9-12 months				
Other eligible bills up to 3 months		3-6 months					
Ineligible bank bills							
Trade bills (a)		3-6 months	6-12 months				
Other trade bills							
Commercial paper (b)		up to 3 months	3-6 months	over 6 months			
CDs							
up to 3 months		3-9 months	9-18 months	1½-5 years			
Loans to banks and building societies up to 1 month		1-3 months	3-6 months	6-12 months	1-3 years	over 3 years	
Other loans to next business day			1 day to 1 month		1-3 months		
Leases			up to 1 month		1-3 months	3-18 months	over 18 months
Fixed-rate gilts (long or short positions) (c) up to 3 months		3-9 months	9-18 months	1½-5 years	5-10 years	over 10 years	
Other fixed-rate quoted assets up to 3 months		3-9 months	9-18 months	1½-5 years	5-10 years	over 10 years	
Fixed-rate unquoted assets			up to 1 month	1-6 months	6-18 months	over 18 months	
Variable-rate assets issued by local authorities or government- guaranteed borrowers where rate is fixed for up to 3 months		3-6 months	over 6 months				
Other variable-rate assets where rate is fixed for			up to 3 months		3-6 months	over 6 months	
Futures positions and forward commitments (d) up to 3 months		3-9 months	9-18 months	1½-5 years	5-10 years	over 10 years	
					Aggregate net short open foreign exchange position		
						Equity investments (including preference shares)	
Deductions (e)		Fixed money 3-9 months	9-18 months	1½-5 years	5-10 years	over 10 years	

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

(b) The Bank may impose a higher weight depending on the creditworthiness of the issuer.

(c) Where short positions in assets within a certain class exceed long positions the added risk weight is to be applied to the short position and vice versa.

(d) 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. See paragraphs 11-12 regarding the use of futures (and also options) in hedging.

(e) In addition, in calculating *basic risk*, deductions are allowed for ½ specified sterling assets (eligible bills, government securities, CDs, deposits with and loans to banks and building societies, and sums due on margin account from LIFFE) of maturity 0-33 days; and in the case of gilts, only the difference between the long and short positions attracts *basic risk*.

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 holdings 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 In addition to the current supervisory reports received through the computer linked reporting system for gilt-edged market makers, the Bank would require some additional reports from gilt-edged market makers with which it had established a money market dealing relationship. The reports would include a breakdown of money market instruments by maturity band, turnover in money market instruments, details of money market transactions with related entities and the profits and losses of the money market trading operations. These reports would initially be required in paper form and mostly on a fortnightly basis.