Sterling Monetary Framework Annual Report 2014–15

June 2015

BANK OF ENGLAND

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The Bank reviews its published framework for implementing monetary policy and providing liquidity insurance on an annual basis. The SMF Annual Report is the output of this review process and draws on the views of internal and external stakeholders to identify areas where the SMF works well, and areas where it might be improved.

Contents

Executive summary

In 2014–15, the Bank conducted the second formal annual review of its published operational framework for implementing monetary policy and providing liquidity insurance, known as the Sterling Monetary Framework (SMF). Key changes implemented in 2014–15 are summarised in the box below. This year's review has drawn on views from internal and external stakeholders to help identify where the SMF functions well, and where further work is necessary.

Key changes to the SMF in 2014–15

The Bank introduced a number of structural changes to the SMF in 2014–15 designed to further increase the flexibility of the Bank's ability to provide liquidity insurance. This built on the significant changes introduced in late 2013 and early 2014. Key structural changes introduced in 2014–15 included:

- **Extension of membership to broker-dealers and CCPs.** This was the most significant change to the SMF during 2014–15. The change reflects the Bank's commitment to implement the recommendations of the Winters Review.
- **The intention to introduce a Shari'ah compliant facility.** In October 2014, the Bank announced that it would assess the feasibility of establishing a Shari'ah compliant SMF facility, which would further improve the flexibility with which the Bank is able to provide liquidity insurance.
- **Extension of collateral eligibility criteria.** New sub-classes of collateral, including commercial real estate loans to small and medium-sized enterprises (SMEs) and asset finance leases, were accepted in the SMF for the first time in 2014–15.

Access to the SMF

SMF membership continued to grow in 2014–15, with an additional ten banks and building societies signing up for at least one SMF facility during the year. SMF member banks and building societies account for 98% of total sterling deposits. Membership eligibility was also extended to broker-dealers and central counterparties (CCPs) during the year, with some of these institutions being formally admitted as SMF participants in recent months.

Implementing monetary policy

The Bank's current approach to implementing monetary policy is known as the 'floor' system and involves paying Bank Rate on the full balances held in reserves accounts. This approach remained successful at keeping sterling overnight market rates close to Bank Rate during 2014–15.

Activity in the sterling money markets remained low in 2014–15. In part, this reflects the presence of a floor system alongside a large-scale injection of reserves through Quantitative Easing (QE) which means that there is less need for banks to manage their liquidity actively among themselves. Other factors could potentially have more lasting effects on money market activity, including global liquidity standards and credit risk concerns.

Providing liquidity insurance

Lending via the Bank's liquidity insurance facilities has been lower in recent years than during the financial crisis. Among other things, this reflects the improved financial conditions of banks and building societies and the greater liquidity provided through QE and the Funding for Lending Scheme (FLS).

Improvements to the monthly market-wide Indexed Long-Term Repo (ILTR) auctions introduced in February 2014 have resulted in a greater number of participants using the facility. And the Bank has enhanced its ability to lend cash in the Discount Window Facility (DWF) by bringing the disclosure lag for certain elements of its balance sheet in line with the five-quarter lag for reporting of DWF transactions.

In October 2014, the Bank announced that it would assess the feasibility of establishing a Shari'ah compliant SMF facility, which would further improve the flexibility with which the Bank is able to provide liquidity insurance.

Risk management

The amount of collateral delivered to the Bank for actual or potential use in its facilities (such as the FLS and those within the SMF) continued to increase in 2014–15. The range of eligible collateral continued to widen, both in terms of the range of eligible loan assets and the number of securities deemed eligible. The Bank has also started work to ensure there are no technical obstacles to its ability to accept equities as collateral should the need arise.

Governance

The Governors continue to be fully briefed and engaged in the policy-making around the SMF. And the Monetary Policy Committee (MPC), Financial Policy Committee (FPC) and Prudential Regulation Authority (PRA) Board were actively engaged in the annual review process which has culminated in this Report. The Bank's *Strategic Plan*, published in March 2014, has also established the Independent Evaluation Office (IEO) which provides the Bank's Court of Directors with independent evaluation of the performance of the Bank's policy areas and strategy. The IEO has facilitated Court's oversight of this year's SMF Annual Report. Through the Annual Report process, and in line with its responsibilities, the Bank's Court has reviewed the performance of the SMF over the past year, and considered objectives for the coming year. Court endorses the publication of this Report.

Introduction

The SMF is the published operational framework through which the Bank uses its balance sheet to implement monetary policy and provide liquidity to SMF participants to reduce the cost of disruptions to critical financial services. The objectives of the SMF are to implement the MPC's decisions in order to meet the inflation target, and reduce the cost of disruption to the critical financial services supplied by SMF participants (see box on 'Aims and objectives of the Sterling Monetary Framework'). As such, the SMF underpins the Bank's mission to maintain monetary and financial stability.

Last year's SMF Annual Report(1) was the output of a new formal annual review process, which was introduced following an assessment of the Bank's framework for liquidity provision, commissioned by the Bank's Court and conducted by Bill Winters during 2012. Last year's Report also reflected the significant reforms to the SMF which resulted from implementing the recommendations of the Winters Review.(2)

The context for this year's SMF Annual Report(3) is different to what might be expected in the medium term. Throughout the year, Bank Rate has remained at exceptionally low levels, with banks and building societies continuing to hold a large stock of central bank reserves. These reserves were created to implement the MPC's programme of large scale asset purchases (also known as QE). The presence of these reserves in the financial system has meant that some parts of the SMF are temporarily suspended or have not been used in size for some time. But the Bank has continued to evolve the SMF further, following the significant changes introduced following the Winters Review, responding to structural developments in financial markets.

The Bank welcomes thoughts or comments from interested parties on this Report or on the SMF more broadly. Details of how to submit views are provided at the end of this Report.

Aims and objectives of the Sterling Monetary Framework

The Bank of England's mission is to promote the good of the people of the United Kingdom by maintaining monetary and financial stability. The Bank's operations in the sterling money markets — known as the SMF — serve that mission. The operations are designed to:

- **Implement the MPC's decisions in order to meet the inflation target.** This is usually achieved by paying interest at Bank Rate on the reserves balances held at the Bank of England by commercial banks, building societies, designated investment firms ('broker-dealers') and CCPs (collectively known as 'SMF participants'). In exceptional circumstances, the Bank may choose to vary the structure of its remuneration on reserves and to supply whatever reserves it deems necessary to meet the MPC's monetary policy objectives, by changing the size or composition of its balance sheet.

- **Reduce the cost of disruption to the critical financial services, including liquidity and payment services, supplied by SMF participants to the UK economy.** The Bank does this by standing ready to provide liquidity in the event of unexpected developments by offering to swap high-quality but less liquid collateral for liquid assets (a so-called 'liquidity upgrade').

I Recent developments in financial markets

The SMF has been reformed extensively in recent years in order to meet its objectives more efficiently. Two broad developments drove these changes. First, financial markets' and institutions' reactions to the crisis, including to the post-crisis package of regulatory reforms aimed at improving the stability of the financial system. Second, the Bank's response to the Winters Review.

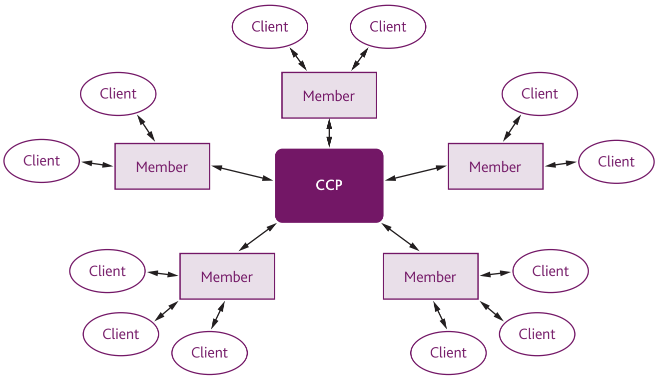
Financial institutions have continued to react to enhanced prudential measures introduced in response to the crisis. Banks in particular have been on a path to greater resilience, and are now held to higher capital and liquidity standards. They now hold significantly larger buffers of liquid assets to meet potential outflows of funding than they did prior to the crisis. And they face larger capital charges on some of their activities. These requirements may affect banks' appetite to transact in money markets that are important for the implementation of monetary policy.

Non-banks have become increasingly important to the financial system since the crisis. Regulatory measures that mandate the clearing of trades in financial instruments through CCPs have reduced interconnectedness between banks and have made CCPs key nodes in the financial system (**Figure 1**). For example, as of January 2015, 50% of the global over-the-counter (OTC) interest rate derivatives market — the largest segment of the OTC derivatives market — is now centrally-cleared, compared with 31% in April 2012.(4)

Broker-dealers have continued to play an important role in financial intermediation in capital markets. The financial crisis

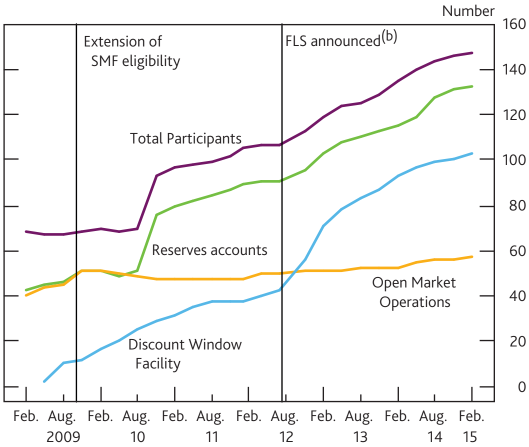
(1) 'Sterling Monetary Framework Annual Report 2013–14', *Bank of England Quarterly Bulletin*, Vol. 54, No. 2, pages 218–25; www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q210.pdf.
(2) See www.bankofengland.co.uk/publications/Documents/news/2012/cr2winters.pdf.
(3) Covering the period from 1 March 2014 to 28 February 2015.
(4) See the *Bank of England's supervision of financial market infrastructures — Annual Report*; www.bankofengland.co.uk/publications/Documents/fmi/annualreport2015.pdf.

Figure 1 CCPs as key nodes in the financial system(a)



(a) For more information about CCPs, see www.bankofengland.co.uk/publications/documents/quarterlybulletin/2013/qb1302ccpsbs.pdf.

Chart 1 SMF membership(a)



Source: Bank of England.

(a) Quarterly averages.
(b) FLS is the Funding for Lending Scheme, launched on 13 July 2012.

also showed that disruption of broker-dealers' activities can have a severe impact on the financial system. The Winters Review proposed to extend the SMF to some non-bank financial institutions for these reasons. In November 2014, the Bank made broker-dealers and CCPs eligible to apply for SMF access (Section II).

Since the onset of the crisis, there has been a trend towards greater use of secured (as opposed to unsecured) funding by banks, as they reduce their exposures to each other. Market participants have also reduced their exposures through greater collateralisation of trades, in some cases due to regulatory requirements. Together, these changes have increased the demand for high-quality collateral. That may change the nature of secured funding in the future including, possibly, an increase in collateral lending from long-term investors. The Bank is able to support the functioning of collateral markets, most obviously through the routine provision of liquidity against less liquid assets in the monthly Indexed Long-Term Repo operations (see Section V).

II SMF membership

Following the significant reforms to the SMF introduced in October 2013, membership of the SMF has continued to grow. As at the end of February 2015, 149 institutions were signed up to at least one of the facilities that form part of the SMF, up from 139 at February 2014 (**Chart 1**). SMF member banks and building societies account for 98% of total sterling deposits.

Some of the new SMF members in 2014–15 are additional entities within existing banking groups. The ability for banks to access the SMF via multiple group entities was introduced in October 2013 in order to improve the flexibility with which SMF participants can access reserves accounts and the Bank's liquidity facilities.

In addition, a number of existing participants have signed up to additional facilities over 2014–15. The number of reserves account holders has increased by 16, compared to an increase of 11 in 2013–14. There were nine new DWF participants this year, compared to an increase of 21 in the previous year when firms signed up to the DWF as a prerequisite to accessing the FLS.

As discussed in Section I, in November 2014, the Bank widened access to the SMF to broker-dealers(1) and CCPs. This was the most significant change to the SMF in 2014–15. Those broker-dealers deemed critical to the stability of the UK financial system are eligible to apply for the suite of SMF facilities. CCPs operating in UK markets, either authorised under EMIR(2) or recognised by ESMA(3), are eligible to apply for access to reserves accounts and the DWF. Given their systemic importance to the UK economy, the provision of liquidity insurance through the SMF will assist these firms to manage their liquidity in times of market-wide or firm-specific liquidity stress. Work to widen SMF access to these firms has been a significant undertaking and forms part of the Bank's response to the Winters Review. Some of these institutions were formally admitted as SMF participants in recent months.

Direct engagement with SMF participants is vital and the Bank continues to achieve this in a number of ways including:

- **the SMF relationship management framework.** A relationship manager is assigned to each firm. This facilitates contact between SMF participants and the Bank on topics related to SMF access and use, and enables the Bank to gather market intelligence on developments in sterling markets;

(1) The term 'broker-dealers' refers to PRA-designated investment firms, see www.bankofengland.co.uk/pra/Pages/authorisations/designatedfirmslist.aspx.
(2) European Market Infrastructure Regulation.
(3) European Securities and Markets Authority.

- **the risk management framework.** The Bank's risk management team develops and maintains relationships with participants through an annual review cycle, which often includes site visits; and

- **formal committees.** The Money Markets Liaison Committee (MMLC) provides a forum for representatives from sterling money markets and the authorities to discuss structural issues.(1) The Securities Lending and Repo Committee provides a forum for repo and securities lending practitioners and the authorities to discuss structural (including legal) developments.(2)

III Monetary policy implementation

The first objective of the Sterling Monetary Framework is to implement decisions made by the MPC. Since March 2009, when QE was initiated, this has involved maintaining overnight market rates in line with Bank Rate and undertaking large-scale asset purchases financed by the creation of central bank reserves. Bank Rate was maintained at 0.5% throughout the 2014–15 financial year.

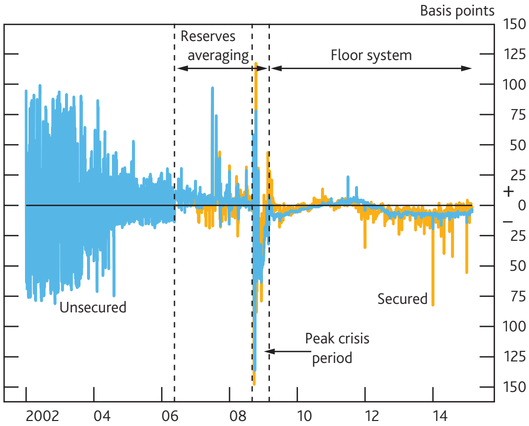
The Bank currently keeps overnight market rates in line with Bank Rate by paying Bank Rate on the full balances held in reserves accounts. This 'floor' system remained effective in keeping market rates close to Bank Rate during 2014–15 (**Chart 2** and **Table A**). Indeed, throughout most of 2014–15, volatility of overnight interest rates remained at historically low levels.

The tendency for unsecured interest rates to trade slightly below Bank Rate throughout 2014–15 reflected the fact that some lenders without reserves accounts at the Bank may be willing to lend cash overnight at below Bank Rate. In addition, reserves account holders are less willing to arbitrage away all of this difference in part because doing so would increase gross balance sheet metrics, including reported leverage ratios.(3)

Secured overnight interest rates continued to fall sharply on the last day of the month throughout the first half of 2014, and again on 31 December 2014. According to market contacts, this continued to reflect the reluctance of financial institutions to take cash on key balance sheet reporting dates, when such borrowing would impact published leverage ratios. As a result, market participants without access to a reserves account at the Bank were able to lend only at reduced rates. Contacts reported that preparation for year-end in 2014 was more extensive than in 2013, with better forward communication between cash borrowers and lenders. But despite some signs of better preparation, market rates did fall notably on 31 December 2014, with RONIA (a secured rate) falling to -0.05%, albeit less sharply than on 31 December 2013, when it fell to -0.32%. SONIA (an unsecured rate) also fell less far, to +0.36%, compared to +0.31% on 31 December 2013. Both RONIA and SONIA recovered to usual levels on the next business day.

The Bank pays close attention to the money markets because they are intimately linked with the SMF: interbank transactions are settled directly or indirectly by transfers between banks' reserves accounts at the Bank. The sterling interbank market is therefore also a market for sterling

Chart 2 Spreads of sterling overnight interest rates to Bank Rate(a)



Sources: Wholesale Markets Brokers' Association (WMBA) and Bank calculations.

(a) In the brokered secured market, interest rates are represented by the repurchase overnight index average (RONIA), which is the daily weighted average interest rate of transactions secured against UK government debt, brokered by members of the WMBA. Interest rates in the brokered unsecured market are represented by the sterling overnight index average (SONIA), which is the daily weighted average interest rate of unsecured overnight transactions brokered by WMBA members. For further details on RONIA and SONIA, see www.wmba.org.uk.

Table A Deviation of sterling overnight rates from Bank Rate(a)

Basis points	Mean		Standard deviation	
	Unsecured	Secured	Unsecured	Secured
Pre-reserves averaging(b)	-4	–	37	–
Reserves averaging:				
to August 2008(c)	6	3	9	11
peak crisis(d)	-27	-19	29	34
Floor system:				
to February 2013(e)	-2	-1	4	5
in 2013/14(f)	-7	-7	1	6
in 2014/15(g)	-7	-5	1	7

Sources: WMBA and Bank calculations.

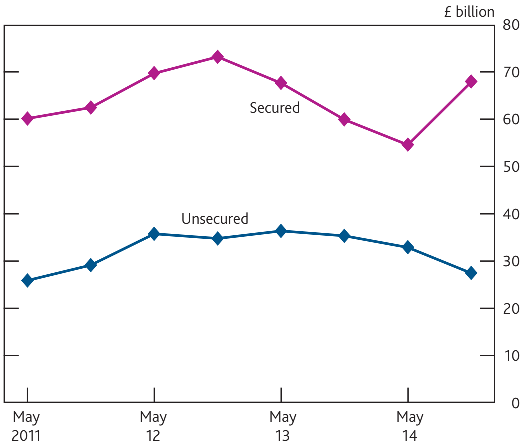
(a) The secured and unsecured rates are RONIA and SONIA respectively, as defined in **Chart 2**. (RONIA data not available before January 2007).
(b) January 2002–May 2006.
(c) May 2006–August 2008.
(d) September 2008–March 2009.
(e) March 2009–February 2013.
(f) March 2013–February 2014.
(g) March 2014–February 2015.

(1) For more information on the Money Markets Liaison Committee, see www.bankofengland.co.uk/markets/Pages/money/smmlg.aspx.
(2) For more information on the Securities Lending and Repo Committee, see www.bankofengland.co.uk/markets/Pages/gilts/slrc.aspx.
(3) For more information, see 'Recent developments in the sterling overnight money market', *Bank of England Quarterly Bulletin*, Vol. 53, No. 3, pages 223–32; www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130304.pdf.

reserves balances. As such, the robustness of overnight rates is important to the ability of the Bank to judge the effectiveness of monetary policy implementation. In August 2014, the Fair and Effective Markets Review made a recommendation to HM Treasury that SONIA and RONIA be brought into the scope of UK legislation originally put in place to regulate LIBOR.(1) This came into force on 1 April 2015.

In the presence of a floor system with a large-scale injection of reserves, there is less need for banks to manage their liquidity actively among themselves. As a result, in the United Kingdom, money market activity has fallen in recent years (**Chart 3**). Overseas money markets, including in the United States and euro area, have also experienced declines in activity.

Chart 3 Sterling overnight money market volumes



Source: MMLC.

According to market participants responding to the November 2014 MMLC Sterling Money Market Survey,(2) activity in the sterling unsecured market — and the interbank market in particular — remained low, with little incentive for banks to trade on an unsecured basis. Instead, many allowed their reserves balances at the Bank to fluctuate in response to daily payment needs. Overall daily activity in the sterling unsecured overnight money market has fallen since 2007–08. According to estimates in the MMLC survey, it has been reasonably stable at around £35 billion over 2012 and 2013, but has since fallen to £27.5 billion in 2014.

Secured money market functioning also deteriorated during 2014–15, according to responses to the MMLC survey. Although overall functioning was considered fair on balance, contacts noted that market conditions were poor at longer maturities. Secured trades make up around three quarters of the money market turnover reported in the November 2014 MMLC survey, up from two thirds in the May 2014 survey. Market contacts suggested that the preference for secured trading reflected liquidity regulations and a continued aversion to lending unsecured to other banks. Secured trading volumes increased by around 10% in the six months to November 2014, with contacts suggesting this represents a shift from unsecured to secured activity, rather than new business.

Some of the factors restricting money market activity are temporary — most notably the impact of QE — while others are likely to have more lasting effects — for example the introduction of global liquidity standards through the Basel III framework, which includes the Liquidity Coverage Ratio. MMLC survey respondents commented that regulatory liquidity ratios had reduced participants' appetite to participate in the secured market and had impacted turnover in the unsecured markets.

As outlined earlier, the current system used to implement the MPC's interest rate decision is known as a 'floor' system. In the minutes of the August 2014 meeting, the MPC noted that the 'floor' system could be used to implement the Committee's decisions on Bank Rate in the near term, and that the framework will be reviewed alongside decisions about the future of the Asset Purchase Facility (APF).(3) The MPC had already noted, in the February and May 2014 *Inflation Reports*,(4) that it intends to maintain the stock of assets purchased, including reinvesting the cash flows associated with all maturing gilts held in the APF, at least until Bank Rate has been raised from its current rate of 0.5%, and that sales of assets from the APF are likely to be deferred at least until Bank Rate has reached a level from which it could be cut materially. That means the quantity of reserves created through the APF is likely to remain above what banks would demand in the absence of the APF. Therefore, it is likely that the 'floor' system will be retained as the method the Bank uses to implement monetary policy for some time after Bank Rate is increased from its current level.

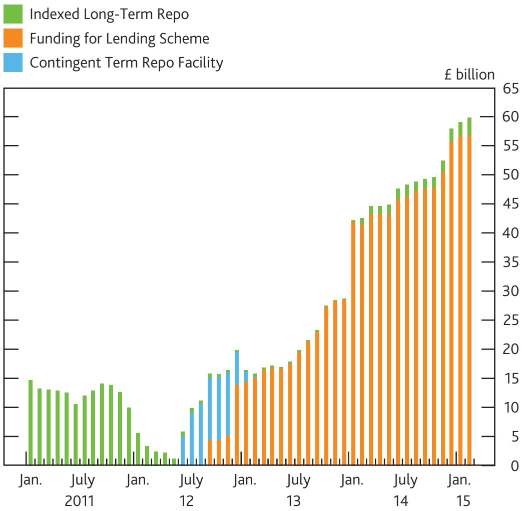
The Bank has also considered its approach in the event that the spread between overnight interest rates and Bank Rate widened to the extent that the MPC believed there was a risk of monetary policy implementation becoming impaired. In 2014, the Bank discussed potential approaches to mitigate this risk with a range of SMF participants. One option could be to drain reserves from the system, which would put upward pressure on market rates, to reinforce the floor. If that was deemed necessary, the Bank is prepared to drain reserves by issuing Bank of England bills, with a maturity of up to one week. Bank of England bills were used to drain excess reserves in 2008–09.(5)

(1) See www.bankofengland.co.uk/markets/Documents/femraug2014.pdf.
(2) See www.bankofengland.co.uk/publications/Documents/other/markets/mmlg/smms2014h2.pdf.
(3) See paragraph 41, www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2014/mpc1408.pdf.
(4) See www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.
(5) See 'Markets and operations', *Bank of England Quarterly Bulletin*, Vol. 48, No. 4, Page 377, www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb0804.pdf.

IV Liquidity insurance

The liquidity insurance facilities provided by the Bank were used extensively during the financial crisis. But lending via these facilities has been lower in recent years reflecting, *inter alia*, the improved financial positions of banks and building societies, and the greater liquidity provided by the Bank through QE and, more recently, the FLS. As a result, the Bank's liquidity insurance facilities continued to see relatively modest use in 2014–15 (**Chart 4**, further details are provided in the Annex).

Chart 4 Outstanding amounts lent in SMF liquidity facilities and the FLS[a]



Source: Bank of England.

(a) Prior to January 2014, the CTRF was called the Extended Collateral Term Repo facility. The FLS (including the two FLS extensions) lies outside the SMF and is not a liquidity insurance facility, but has the result of providing liquidity to the banking sector. There has been no Discount Window Facility usage up to the most recent disclosure point (as specified in the Red Book).

The monthly market-wide ILTR auctions were made more flexible in February 2014, with reduced prices, a longer maturity, a wider range of eligible collateral and built-in flexibility for the quantity of liquidity provided to vary in response to market conditions. The majority of usage in these operations in 2014–15 has been as a means of converting Treasury bills borrowed under the FLS into central bank reserves or participants testing their ability to convert less liquid collateral into reserves.

The FLS, launched in July 2012, is designed to incentivise banks and building societies to boost their net lending to the UK real economy by providing funding (in the form of UK Treasury Bills) for a four-year term. While the FLS sits outside the SMF, there are important interlinkages: all banks and building societies with DWF access are eligible to participate in the FLS; eligible collateral for the FLS consists of all collateral eligible in the SMF; and, like SMF operations, the FLS provides a liquidity upgrade for participants. FLS usage has grown substantially in recent years. On 2 December 2014, the Bank announced that it was extending the drawdown period for one year, to end-January 2016, and focusing the incentives of the scheme on lending to SMEs in 2015.[1]

As discussed above, the Bank has widened access to the SMF this year to include broker-dealers and CCPs. The business models, balance sheets, and liquidity risk of CCPs and broker-dealers differ to those of banks. Consequently, the Bank has provided the appropriate facilities to these institutions. Broker-dealers will be able to access the full suite of SMF facilities. CCPs face different liquidity risks and will have access to reserves accounts, Operational Standing Facilities (OSFs) and the DWF. Since the principle of 'eligible liabilities' does not apply to broker-dealers and CCPs, it cannot be used as a basis for pricing DWF drawings by these institutions in the same way that it is used for banks and building societies. As such, for broker-dealers and CCPs, DWF fees will be agreed on a bilateral basis at the time of a drawing.

The Bank has said previously that, for banks and building societies, it stands ready to provide DWF liquidity in the form of cash, as well as gilts. Cash lending may be necessary in a scenario where government bond repo markets are not functioning properly, or in order to provide liquidity to a smaller institution that does not have access to the repo market. DWF liquidity will also be available in the same way to broker-dealers, while CCPs would be lent cash as standard. The Bank has also enhanced its ability to lend cash in the DWF by changing the way that it publishes its balance sheet, by bringing the disclosure lag for certain elements of its balance sheet in line with the five-quarter lag for reporting of DWF transactions.[2]

During September 2014 there was intense focus in financial markets on the referendum on Scottish independence. As noted in the record of the FPC's meeting on 26 September 2014, the impact of a 'yes' vote on regulated firms would likely have been varied, but 'there could have been significant effects for those major UK banks and insurers which were domiciled in Scotland or had substantial Scottish assets and liabilities'.[3] As part of its contingency planning, the Bank assessed its ability to provide liquidity support to the banking system should it become necessary, concluding that the range of tools within the existing framework offered sufficient flexibility to respond. As previously disclosed in the FPC Record, in the event of a 'yes' vote, the Bank intended to announce two additional liquidity operations immediately as a bridge to the next scheduled ILTR operation.

(1) See www.bankofengland.co.uk/markets/Pages/FLS/notices.aspx.
(2) This is explained in further detail in 'Changes to the Bank's weekly reporting regime', *Bank of England Quarterly Bulletin*, Vol. 54, No. 3, pages 338–43; www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q309.pdf.
(3) See www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1410.pdf.

Market commentary at the time correctly suggested the Bank could activate its Contingent Term Repo Facility (CTRF). But a wider range of options was available, including more frequent ILTR operations. The Bank is therefore making some minor amendments to the drafting of the Red Book alongside the release of this Report to clarify the full flexibility that it has in such circumstances.

Finally, in October 2014, the Bank announced that it would assess the feasibility of establishing a Shari'ah compliant SMF facility, which would further increase the flexibility with which the Bank can provide liquidity insurance.(1) There are significant challenges inherent in this work, since some of the fundamental features of the SMF would, at present, not be compliant. For instance, the interest rate paid on reserves accounts is the first stage of the monetary transmission mechanism. Work on assessing the feasibility of establishing a Shari'ah compliant facility will be undertaken in the second half of 2015.

V Risk management

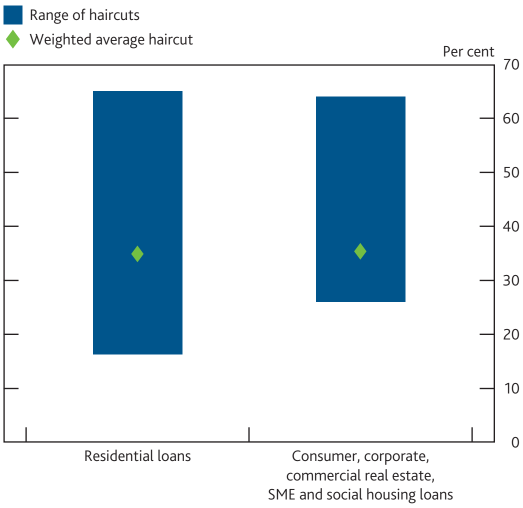
To support wider policy objectives, the Bank encourages SMF participants to pre-position eligible collateral at all times, to ensure that they are able to draw quickly and smoothly via SMF facilities should the need arise. This element of the SMF framework reduces operational and financial risk, improving the efficiency with which the Bank is able to provide liquidity insurance.

Three different sets of collateral are eligible in the Bank's operations. In its intraday and short-term monetary policy operations, the Bank only lends against Level A collateral, comprising certain high-quality sovereign securities that are liquid in all but the most extreme circumstances. In its liquidity insurance operations, which provide an effective liquidity insurance mechanism to the financial system, the Bank also lends against Level B collateral, comprising high-quality liquid collateral, including private sector securities that normally trade in liquid markets, and Level C collateral, comprising less liquid securities and portfolios of loans.

All lending in the SMF facilities is collateralised, and the Bank manages the risk to its balance sheet by performing due diligence on all SMF counterparties and applying suitable 'haircuts' on the collateral delivered to it. Haircuts account for extremely stressful conditions, thereby reducing the risk of procyclicality, so that they do not vary with the economic cycle (**Chart 5**).

Both the level of pre-positioning and the number of counterparties with collateral pre-positioned at the Bank have continued to increase during 2014–15. The market value of collateral delivered to the Bank for actual or potential use in the Bank's facilities (such as the FLS and those within the SMF)

Chart 5 Haircuts applied to loan portfolios delivered to the Bank



Source: Bank of England.

has increased substantially over recent years, and stood at £469 billion at end-February 2015. After valuation and haircuts, this provided banks and building societies with a total drawable value of around £315 billion in the Bank's facilities. This is compared with £444 billion and £277 billion respectively at the end of February 2014.

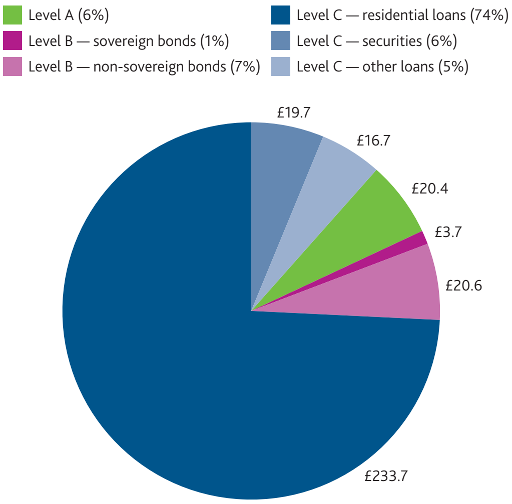
New sub-classes of collateral, including SME commercial real estate loans and asset finance leases, were accepted in the SMF for the first time in 2014–15. As at end-February 2015, over 80 banks and building societies had securities and/or loans pre-positioned with the Bank for potential or actual drawings. More than 200 loan portfolios were pre-positioned with the Bank at end-February 2015.

The bulk of loans currently pre-positioned are residential mortgages, reflecting their prominence on UK banks' and building societies' balance sheets (**Chart 6**). But the Bank has actively sought to extend the range of eligible collateral, now accepting asset finance, personal loans, auto loans, corporate loans, SME loans and revolving credit facilities. This enables a broader range of banks to have access to liquidity insurance, whilst supporting established lenders in managing their balance sheet with greater flexibility. The Bank has made it clear that the list of eligible assets extends in principle to any asset that the Bank judges it can effectively and efficiently risk manage.

Firms can also borrow from the Bank's facilities against securities collateral. Haircuts on securities assets typically depend on their liquidity, historical price volatility and underlying credit risk. Haircuts start at 0.5% for government securities and 12% for retail mortgage-backed securities

(1) See www.bankofengland.co.uk/markets/Pages/sterlingoperations/shariah-compliant-facilities.aspx.

Chart 6 Collateral delivered to the Bank at drawable value (£ billions)



Source: Bank of England.

(RMBS) and covered bonds.(1) The Bank has continued to review the eligibility of securities submitted by SMF participants, and has deemed over 1,600 eligible outside of the narrow list of 'Level A' collateral as published on the Bank's website.(2)

The trend of widening the set of eligible securities reflects the increased number of Bank counterparties, increasing market issuance and an increased number of securities meeting transparency requirements. Minimum transparency requirements for marketable securities (such as RMBS) ensure that the Bank, as well as other market participants, has sufficient information to appropriately risk manage these assets.

Looking ahead, the Bank will continue to review the breadth of collateral eligible for use in its facilities. Most notably, work is underway to ensure that there are no technical obstacles to the Bank's ability to accept equities as collateral should the need arise.

Haircut methodologies are reviewed on a regular basis, and the Bank aims to avoid any unnecessary risk to its balance sheet by ensuring haircut valuations are suitably conservative. In addition to ongoing haircut reviews, the Bank will continue to work with counterparties to ensure the effectiveness of the collateral pre-positioning process.

SMF counterparties also continue to access the FLS with aggregate outstanding drawings increasing to £57.3 billion by end-March 2015. The Bank monitors its lending in the FLS very closely as the four-year exposure (compared to a maximum of six months in SMF facilities) exposes the Bank to longer-term risk.

In 2014, the Bank moved to a Single Collateral Pool (SCP) model to increase efficiencies and reduce operational risk within the SMF, enabling participants to pool collateral across all SMF facilities. The SCP allows participants' collateral to be rolled-over between maturing and new operations and to be pooled across different operational exposures (see box on page 11).

VI Governance

Governance of the SMF was substantially reformed following the Winters Review, which recommended that: (i) the formal arrangements around governance of the SMF should be clarified; (ii) Court should oversee regular reviews of the SMF and ensure the necessary communication and co-ordination channels are in place; (iii) there should be regular consultation with key stakeholders; (iv) the role of the MPC and FPC should be clarified.

Frameworks for engagement with both the MPC and the FPC on the SMF were set out in concordats published in 2013.(3) A key aspect of these frameworks is the annual review process, which has culminated in this Report, and in which the MPC, FPC and the PRA Board have been engaged.

Internal governance of the SMF has been further enhanced in 2014–15. The launch of the Bank's *Strategic Plan* in March 2014(4) led to a change in the Bank's internal committee structure. Key decisions around SMF strategy are now discussed among the Governors in the first instance. And Court's oversight of the annual review process has been further strengthened through the involvement of the Bank's new IEO, which assists Court in overseeing key aspects of the Bank's performance.

The Bank has also sought views on the functioning of the SMF from large and small SMF counterparties. There was broad-based confidence that the SMF facilities provided adequate liquidity insurance, when needed.

Through the Annual Report process, and in line with its responsibilities,(5) the Bank's Court has reviewed the performance of the SMF over the past year, and considered objectives for the coming year. Court endorses the publication of this Report.

(1) A summary table of haircuts for Bank lending operations is available at www.bankofengland.co.uk/markets/Documents/money/publications/summary_haircuts.pdf.
(2) A list of Level A collateral eligible securities is available at www.bankofengland.co.uk/markets/Documents/money/publications/levelacollateral.pdf.
(3) The MPC Concordat is available at www.bankofengland.co.uk/about/Documents/legislation/mpcconcordat.pdf. The FPC Concordat is available at www.bankofengland.co.uk/about/Documents/legislation/fpcconcordat.pdf.
(4) See www.bankofengland.co.uk/about/Pages/strategicplan/default.aspx.
(5) For more detail on matters reserved to Court, see www.bankofengland.co.uk/about/Documents/matters122014.pdf.

Single collateral pool

In October 2014, the Bank introduced a collateral pooling model for its SMF operations under which each participant maintains a pool of securities with the Bank. This is used by the Bank to collateralise the participant's current and potential exposures.

Unlike the repo or asset swap structure used previously, collateral is not earmarked against individual transactions. Instead, the aggregate value of the Bank's exposure to the participant under all the facilities covered by the relevant pool is compared to the aggregate value of the collateral held in that pool. Action is only required where the aggregate exposure exceeds the aggregate collateral value; in this case the Bank would call margin. This contrasts with the previous arrangement, where collateral was held against each individual transaction and was managed on a transaction by transaction basis.

The collateral pooling model has been used for several years by a number of other central banks. The Bank's pooling model takes into account differing collateral eligibility by operation, only allowing participants to use collateral of the minimum level (or above) to collateralise an exposure. Excess collateral held in a pool can be used to absorb day to day fluctuations in valuation and to cover any new exposures. For RTGS settlement banks, excess Level A securities held in the main pool can also be used to provide intraday liquidity in RTGS.

Collateral pooling is more efficient than a repo/asset swap based model. Security movements are reduced to those instances where a participant needs to supply more collateral to cover the Bank's aggregate exposure to them, or where the participant requests the return of individual securities. If a transaction is rolled, no specific collateral movements are required. Pooling also represents the most efficient use of collateral for the participant; collateral of the appropriate level is automatically used to cover relevant exposures, maximising the amount of collateral excess.

The introduction of collateral pooling required only minor changes to operating procedures. A change to the legal agreements underlying the Bank's operations was necessary, however; operations previously conducted under a repo agreement are now conducted via a collateralised loan structure with securities provided by way of outright title transfer. In principle this means that all securities now delivered by SMF participants are owned by the Bank, whether drawn against or not, though in practice there is no change to the Bank's treatment of beneficial owner events (eg coupon payments still flow through to the participant).

More information is available on the Bank's SMF collateral management page:
www.bankofengland.co.uk/markets/Pages/money/Single-Collateral-Pool-Implementation.aspx.

The Bank welcomes ongoing feedback from interested parties on any aspect of this Report or the SMF. Comments can be sent to:

Head of Sterling Markets Division
Bank of England
Threadneedle Street
London, EC2R 8AH

or by email to: SMFfeedback@bankofengland.co.uk.

Annex

Table A.1 Results of SMF operations, FLS drawings and reserves balances

(£ million)	2014 Q1	2014 Q2			2014 Q3			2014 Q4			2015 Q1		Total stock outstanding Feb. 2015
	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	
SMF													
OSF	0	0	0	0	0	0	0	0	0	0	0	0	**0**
ILTR	203	200	160	435	219	345	299	288	317	830	260	1,000	**2,994**
Level A	148	125	110	140	134	240	245	250	205	310	215	240	**1,465**
Level B	25	20	50	40	30	10	49	33	87	60	0	5	**234**
Level C	30	55	0	255	55	95	5	5	25	460	45	755	**1,295**
CTRF[a]	–	–	–	–	–	–	–	–	–	–	–	–	**–**
FLS[b]	2,012			3,243			1,957			8,441			**57,287**[c]
Reserves balances[d]	298,138	301,601	304,675	303,602	303,378	302,828	292,412	302,284	303,967	300,062	303,333	306,450	**306,418**[e]

(a) The CTRF was not activated during this period.
(b) FLS Extension, net drawdowns for each quarter (drawdowns less repayments).
(c) Aggregate outstanding FLS drawings as at 31 March 2015.
(d) Monthly reserves balances are averages for Maintenance Periods (the period between MPC meetings).
(e) Aggregate reserves as at 28 February 2015.