Annual Report on the Bank's official market operations 2017–18

June 2018

BANK OF ENGLAND

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The Bank has changed its approach to reviewing its published framework for implementing monetary policy and providing liquidity insurance. The Bank will conduct a more in-depth review every three years, and publish a factual report, covering key developments and usage, on an annual basis. This is the first such report.

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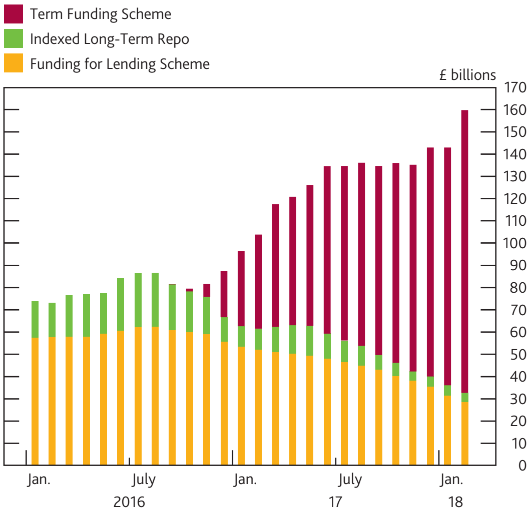
Executive summary

The Bank conducts a range of operations in the sterling money markets. These operations are conducted either on the Bank's balance sheet, through the Sterling Monetary Framework (SMF) or as a standalone facilities, or through the Asset Purchase Facility (APF), which is a subsidiary of the Bank.

The year has seen the ongoing operation of the Bank's regular liquidity insurance facilities and the closure of two of the Bank's funding schemes, the Funding for Lending Scheme (FLS) and Term Funding Scheme (TFS).

There was limited use of the Bank's liquidity insurance facilities, such as the Indexed Long-Term Repo, over the year. This was partly due to the ongoing presence of the TFS, which offered eligible participants access to funding for a four-year term and meant that the total amount lent by the Bank through its official operations was higher than in the previous year (**Chart 1**).

Chart 1 Outstanding amounts lent in SMF liquidity facilities, the FLS and TFS 2016–18



Source: Bank of England.

This year has also seen the first increase in Bank Rate in over 10 years, with the Monetary Policy Committee (MPC) announcing an increase to Bank Rate from 0.25% to 0.5% on 2 November 2017. This Bank Rate change was passed on smoothly to both unsecured and secured money market rates. The Bank's Independent Evaluation Office (IEO) completed a report on the Bank's approach to providing sterling liquidity, published in January 2018. The report concluded that the reforms undertaken by the Bank in recent years have been effectively implemented and positive progress made in a number of areas. The Bank is now working to implement a number of recommendations made by the IEO.

Introduction

The SMF is the published operational framework (outlined in the Red Book[1]) through which the Bank implements monetary policy and provides liquidity insurance to commercial banks, building societies, designated investment firms ('broker-dealers') and central counterparties (CCPs) — collectively known as SMF participants.

The Bank also runs a number of different facilities outside the SMF, which support the Bank's broader monetary policy and financial stability objectives.

The Bank's operations serve the Bank's mission to promote the good of the people of the United Kingdom by maintaining monetary and financial stability.

These operations are designed to:

1. Implement the MPC's decisions 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 SMF participants.

2. Reduce the cost of disruption to 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').

This report covers the period from 1 March 2017 to 28 February 2018, and focuses on the Bank's official market operations during that period.

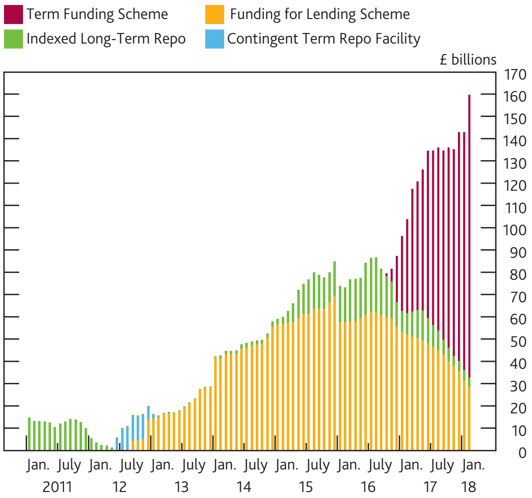
The Bank welcomes thoughts or comments from interested parties on this report or on the Bank's official operations more broadly. Details of how to submit views are provided on page 7.

Lending operations

The Bank's lending operations are predominantly available to provide liquidity support to SMF participants. There are also facilities in place designed to assist the pass-through of monetary policy and boost lending to the real economy. This section looks at each facility over the period 2017–18. **Chart 2** below shows the total amount lent by the Bank since January 2011.

(1) See www.bankofengland.co.uk/markets/the-sterling-monetary-framework.

Chart 2 Outstanding amounts lent in SMF liquidity facilities, the FLS and TFS 2011–18



Source: Bank of England.

Operational Standing Facilities

Operational Standing Facilities (OSFs) allow SMF participants to deposit reserves with or borrow reserves directly from the Bank throughout each business day.

Between March 2009 and November 2017, the rate paid on the Operational Standing Deposit Facility was zero. Following the 25 basis point increase in Bank Rate on 2 November 2017, the rate paid on the Operational Standing Deposit Facility increased to 0.25%, 25 basis points below Bank Rate. As all reserves account balances are remunerated at Bank Rate, there remains little incentive for reserves account holders to use the deposit facility. Reflecting this, there was no use of the deposit facility over 2017–18.

The rate charged on the Operational Standing Lending Facility remained at 25 basis points above Bank Rate. However, given the large aggregate supply of reserves, there was no demand from market participants to use the lending facility, and so no use of it during 2017–18.

Indexed Long-Term Repo operations

The market-wide Indexed Long-Term Repo (ILTR) operations offered routinely each month are aimed at institutions with a predictable need for liquid assets. They allow participants to bid for reserves against the full set of eligible collateral which ranges from Level A collateral — highly liquid, high-quality sovereign securities — to Level C collateral — less liquid securities and portfolios of loans.

The Bank ran 12 ILTR operations during 2017–18, over which there was a net fall in ILTR balances of £5.2 billion, with £18.1 billion of ILTRs maturing and £12.9 billion of new ILTRs allocated. ILTR usage by SMF participants has been at lower levels than in the recent past, partly due to the availability of term funding to banks and building societies through the Term Funding Scheme.

During 2017–18, 27.7% of drawings were made against Level A collateral, 10.7% against Level B and 61.5% against Level C. This is a marked shift in the type of collateral used, since at end-February 2017 almost 75% of the stock of ILTR borrowing was against Level A collateral compared to 32.4% at end-February 2018.

Feedback from participants suggests that this reflects lower demand to use the ILTR as a means of converting UK Treasury bills borrowed under the FLS into central bank reserves following the introduction of the TFS, which lends reserves directly.

In response to the IEO review, the Bank is keen to ensure that enough information is provided to SMF participants to ensure they have a comprehensive understanding of the SMF facilities. The Bank has therefore put in place an education programme, hosting ILTR familiarisation sessions with participants.

Contingent Term Repo Facility

The Contingent Term Repo Facility (CTRF) is a contingent liquidity facility that the Bank can activate in response to actual or prospective market-wide stress of an exceptional nature. The Bank reserves the right to activate the facility as it deems appropriate. Throughout the review period, the Bank judged that CTRF auctions were not required.

Discount Window Facility

The Discount Window Facility (DWF) is a bilateral on-demand facility provided to institutions experiencing a firm-specific or market-wide liquidity shock. It allows participants to borrow gilts in return for less liquid collateral in potentially large size and for a variable term. The Bank may lend sterling cash instead of gilts to smaller participants or if, for example, government bond repo markets fail to function properly.

The Bank publishes quarterly data of DWF usage with a five-quarter lag. There was no DWF usage recorded up to the most recent DWF disclosure period (the three months to 31 December 2016). However, the Bank undertakes a programme of small-sized test trades with DWF participants and applicants in order to ensure operational readiness and resilience.

Term Funding Scheme

The TFS was part of the MPC's package of stimulus measures launched in August 2016. The TFS provided four-year term funding to banks at rates close to Bank Rate, to reinforce the transmission of Bank Rate cuts to those interest rates faced by householders and businesses in the United Kingdom.

The drawdown period ran from 19 September 2016 to 28 February 2018. During the drawdown period, 62 bank and building society groups joined the Scheme and the total amount of loans made through the TFS at the end of the drawdown period was £127 billion, of which £84.8 billion was made in 2017–18.

Funding for Lending Scheme

The Funding for Lending Scheme (FLS) was launched by the Bank and HM Treasury on 13 July 2012. The FLS was designed to encourage banks and building societies to lend more to businesses and households. The quantity and price of funding was linked to participants' lending performance. The Scheme's initial drawdown period ran until 31 January 2014. The drawdown period for the FLS extension opened on 3 February 2014 and was extended several times. It closed on 31 January 2018.

The outstanding stock of FLS drawings was £31.4 billion at the closure of the scheme, having fallen by £23.6 billion in 2017–18 and significantly down from its peak of £70 billion in December 2015. This was due to maturities, repayments and refinancing into the TFS.

US dollar repo operations

There was no use of the weekly maturity US dollar operations which the Bank continued to run in concert with other major central banks throughout the period.

Asset purchase operations

The Bank purchases assets to implement monetary policy as set by the MPC. These purchase operations are conducted through a subsidiary of the Bank, the Asset Purchase Facility (APF), which is also the entity through which the TFS operates. The Bank also separately purchases assets to invest cash ratio deposits and the Bank's free capital and reserves (see Box 1 for further information).

Gilt purchases

The purpose of purchases of UK government bonds, financed by central bank reserves, is to impart monetary stimulus, by lowering the cost of borrowing for households and companies and by triggering portfolio re-balancing into other assets by sellers of gilts.

On 28 February 2018, the stock of purchases of UK government bonds was at its target of £435 billion. The Bank conducts periodic operations to purchase additional gilts to replace those which have matured; these operations accounted for the purchase of £13.2 billion of gilts in 2017–18.

Corporate Bond Purchase Scheme

The Corporate Bond Purchase Scheme (CBPS) was launched as part of the August 2016 monetary policy package. In April 2017, the Bank completed the operations necessary to achieve the current target for corporate bond purchases of £10 billion, with £2.6 billion purchased in March and April 2017. No other operations were held in the review period. The stock of corporate bonds held by the APF at 28 February 2018, valued at initial purchase price and net of sales and redemptions was £9.9 billion. The article in the 2017 Q3 *Quarterly Bulletin*, 'Corporate Bond Purchase Scheme: design, operation and impact', provides further details.[1]

(1) See www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2017/cbps-design-operation-and-impact.pdf.

Box 1
Sterling Bond Portfolio

The Sterling Bond Portfolio[1] is the means by which the Bank's free capital and reserves (FCR) and cash ratio deposits (CRDs) are invested.

Under the CRD scheme, deposit-taking financial institutions over a certain size place non-interest bearing deposits at the Bank. The Bank invests these deposits in financial instruments, and the income earned on these investments is used to fund the costs of the Bank's monetary policy and financial stability operations. The FCR portion of the portfolio is invested in order to grow the Bank's capital base.

Under the Bank of England Act 1998, HM Treasury is required to undertake a review of the Bank's CRD scheme once every five years. The last review in February 2018 was open to public consultation.

The consultation document set out a number of the government's proposals on the CRD scheme, which came into force on 1 June 2018. These include:

1 A move from a fixed ratio to a ratio that is indexed to yields on a portfolio of gilts and is calculated every six months.

2 All other parameters of the scheme remain unchanged. The threshold for firms to place a CRD remains at Eligible Liabilities (a rough proxy for a firm's sterling liabilities) of over £600 million.

3 Continuing to monitor the effectiveness of the CRD scheme, conducting a further formal review within five years and publishing a report in respect of that review.

The revised scheme, incorporating these changes, came into effect from 1 June 2018. The CRD ratio as at 1 June 2018 was 0.288%.

(1) See www.bankofengland.co.uk/markets/the-sterling-bond-portfolio.

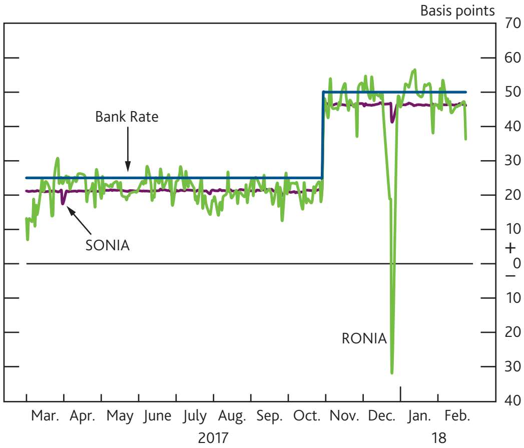
Reserves accounts

Reserves accounts are effectively sterling current accounts for SMF participants. Reserves balances can be varied freely to meet day-to-day liquidity needs. Reserves accounts also can be used by SMF members for settlement of obligations arising as a result of direct participation in UK payment systems.

As a result of the Bank's asset purchase operations, the total amount of reserves increased from £410.9 billion to £492.2 billion over the year. This was mainly driven by an increase in TFS drawings of £84.1 billion, among other autonomous factors, which was slightly offset by a reduction in outstanding ILTR drawings of £5.2 billion (see **Chart 1**). Additional reserves were also injected into the system through the purchase of £2.6 billion of corporate bonds, completing the £10 billion CBPS announced in August 2016.

The Bank implements the MPC's interest rates decisions by paying Bank Rate, on reserves. This keeps short-term market interest rates in line with Bank Rate. The Bank currently pays Bank Rate on all reserves balances for banks, building societies and broker-dealers. CCPs, however, are required to hold a target average daily balance to receive Bank Rate.

Chart 3 Sterling overnight interest rates



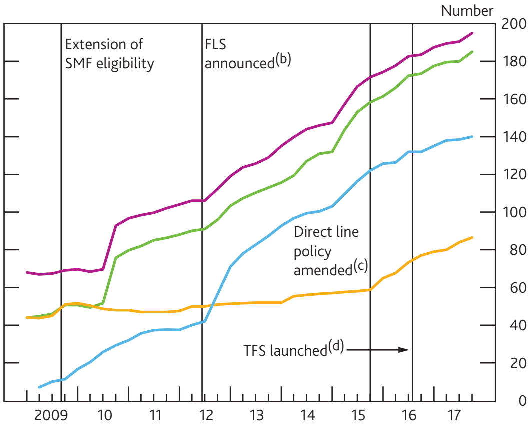
Sources: Bank of England and EVIA (formerly WMBA).

On 2 November 2017 the MPC announced an increase Bank Rate from 0.25% to 0.5%, the first increase in Bank Rate since 2007. The Bank monitors both secured and unsecured rates to assess the effectiveness of monetary policy implementation. Both secured and unsecured rates responded to the increase in Bank Rate (**Chart 3**).

SMF membership

SMF membership gradually increased in 2017–18 from 189 to 198 participants. In addition, 19 existing participants signed up for additional facilities.

Chart 4 SMF membership[(a)]



(a) Quarterly averages.
(b) FLS is the Funding for Lending Scheme, launched on 13 July 2012.
(c) From November 2015, smaller firms have been able to access Open Market Operations without installing a direct telephone line.
(d) TFS is the Term Funding Scheme, launched in August 2016.

Interest in joining the SMF or applying for access to a wider range of facilities largely continues to come from smaller firms and, in particular, newly authorised banks. This, in part, reflects the work to reduce barriers to SMF entry in previous years (**Chart 4**).

The Bank has continued to review SMF access policy in that vein and has made a change to policy in the past year. Some smaller firms are now able to apply for a reserves account without access to Operational Standing Facilities under certain, strictly limited circumstances. This further reduces the barriers to entry for smaller firms.

The Bank has also worked with the larger UK banks throughout 2017–18 on the impact of ring-fencing on their SMF operations. This was primarily to ensure that firms have appropriate membership of SMF facilities either side of the ring-fence, in line with SMF access policy.

Progress in establishing a Shari'ah compliant central bank deposit facility

Work continued throughout the review period on establishing a Shari'ah compliant central bank deposit facility. Once launched, this facility will enable UK Islamic banks to place deposits directly with the Bank, providing them with greater flexibility in managing their liquidity and meeting the Liquidity Coverage Ratio requirement in a Shari'ah compliant manner.

The Bank selected a fund based deposit structure as its preferred model following extensive analysis and a consultation paper in April 2017, which provides further details.[(1)] The Bank remains committed to establishing this facility, and has opted to take a staged approach to the

(1) www.bankofengland.co.uk/paper/2017/shariah-compliant-liquidity-facilities-consultation-paper.

implementation to ensure sound delivery. The focus during the coming months will be on the policy and legal aspects of the facility's development, including drafting the necessary contractual documentation. Work on the Bank's systems will begin at a later date.

Risk management

There is a presumption of access to the SMF for firms that meet the Prudential Regulation Authority's (PRA) supervisory threshold conditions and which are not failing or likely to fail. A firm's SMF eligibility is subject to a regular and independent review of their creditworthiness by the Bank's financial risk management function. The due diligence process includes a regular review of the firm's business viability and strategy, asset quality, funding and liquidity, and both current and prospective capital position. The resulting firm rating enables the Bank to monitor its risk and exposures by the underlying riskiness of its counterparties across multiple operations. To produce credit assessments, data and information are sourced from both PRA supervisory colleagues and the member firms themselves, including through on-site interviews with the firm's executive management where appropriate.

This analysis is reviewed regularly to ensure it still holds and provided the firm still meets threshold conditions and is not failing or likely to fail, then there is a presumption that the Bank will lend. Any lending is secured against collateral. Collateral haircuts are set to protect the Bank's balance sheet in a severe stress to avoid being procyclical — the intention is that haircuts would not need to be increased when lending is required. The Bank in principle accepts as eligible collateral any asset it judges it can effectively and efficiently risk manage. It does this to enable a broad range of counterparties to have access to SMF facilities. The eligible collateral list is very broad, including a wide range of securities and portfolios of residential mortgage loans, asset finance, consumer, auto, corporate, SME, PFI and social housing loans.

Haircuts for SMF collateral start at 0.5% for sovereign securities, 12% for residential mortgage-backed securities or covered bonds, and 30% for portfolios of senior corporate bonds. Loan pool haircuts across all collateral types are 14%–52%. Residential mortgage collateral continues to make up the majority of collateral delivered to the Bank.

The total amount the Bank could lend through its SMF market operations based on the amount of collateral available stood at £295 billion on 28 February 2018.

About this report

Changes to the SMF Annual Report and Review process

The Bank has undertaken an annual review of the SMF since 2014, based on outreach to a range of key stakeholders. The results of this review were then published in an annual report. However, the Bank has opted to alter the way we conduct this annual review. This followed a recommendation from the IEO in its wider assessment of the Bank's approach to providing sterling liquidity.

The IEO noted that the annual review process had, in recent years, become resource intensive for the Bank and somewhat formulaic. They also considered there might be benefits to conducting a more detailed review over a longer time period than a single year. The Bank accepted this recommendation, and has committed to undertake a more in-depth review of the SMF every three years. However, to maintain transparency around the framework, the Bank will continue to publish a factual report covering key developments in the facilities and their usage on an annual basis. This is the first such report.

The IEO made a number of other recommendations,(1) which the Bank has also undertaken to implement.

Feedback

The Bank welcomes ongoing feedback from interested parties on any aspect of this report. 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.

(1) www.bankofengland.co.uk/news/2018/january/ieo-evaluation-of-the-boe-approach-to-providing-sterling-liquidity.

Annex

Table A.1 Results of operations, FLS and TFS drawings

£ millions	Total stock outstanding[(a)] Feb. 2017	Mar. 17	2017 Q2 Apr.	2017 Q2 May	2017 Q2 June	2017 Q3 July	2017 Q3 Aug.	2017 Q3 Sep.	2017 Q4 Oct.	2017 Q4 Nov.	2017 Q4 Dec.	2018 Q1 Jan.	2018 Q1 Feb.	Total stock outstanding[(b)] Feb. 2018
SMF														
OSF	**0**	0	0	0	0	0	0	0	0	0	0	0	0	**0**
ILTR	**9,355**	2,600	1,520	2,145	1,290	367	855	395	1,015	150	1,635	610	310	**4,115**
Level A	**6,955**	55	40	1,590	430	85	40	40	520	0	375	400	0	**1,335**
Level B	**780**	275	105	0	100	82	300	0	0	15	55	150	300	**520**
Level C	**1,620**	2,270	1,375	555	760	200	515	355	495	135	1,205	60	10	**2,260**
CTRF[(c)]	**0**	0	0	0	0	0	0	0	0	0	0	0	0	**0**
FLS[(d)]	**52,185**	-1,126			-2,987			-4,986			-7,491		-6,998	**28,598**
TFS[(e)]	**42,254**	12,824			20,197			9,715			17,959		24,068	**127,016**

Note: FLS/TFS data taken from website publication.

(a) Aggregate drawings outstanding as at 28 February 2017.
(b) Aggregate drawings outstanding as at 28 February 2018.
(c) The CTRF was not activated during this period.
(d) FLS and FLS Extension, drawdowns for each period (drawdowns less repayments and maturities).
(e) TFS, Net drawdowns for each period (drawdowns less repayments).

Table A.2 Balances held in reserves accounts

£ millions	Total[(a)] Feb. 2017	Mar. 17	2017 Q2 Apr.	2017 Q2 May	2017 Q2 June	2017 Q3 July	2017 Q3 Aug.	2017 Q3 Sep.	2017 Q4 Oct.	2017 Q4 Nov.	2017 Q4 Dec.	2018 Q1 Jan.	2018 Q1 Feb.	Total[(b)] Feb. 2018
Reserves account balances[(c)]	**406,088**	427,580	–	439,012	444,473	–	445,379	452,616	–	457,529	467,427	–	479,515	**492,226**

(a) Total reserves balances as at 28 February 2017.
(b) Total reserves balances as at 28 February 2018.
(c) Monthly reserves balances are averages for maintenance periods (the period between MPC meetings).