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Mr David Rule
Head of Sterling Money Markets
Bank of England
Threadneedle Street
London, EC2R 8AH

11 June 2004

Re: Reform of the Bank of England's Operations in the Sterling Money Markets

Dear David

The Bond Market Association (the "Association")¹ welcomes this opportunity to respond to the Bank of England's (the "Bank") consultative paper dated May 2004 reviewing the objectives and broad framework of the Bank's operations in the Sterling money markets (the "Paper"). Please note that the views expressed herein are based on input received from a broad range of member firms that are active, or are considering becoming more active, in the Sterling money markets. This letter comments on the Bank's proposal in general terms and does not explicitly respond to each question set out in the Paper.

1. The Bank's Objectives

The Association understands that the Bank's primary objective is to align the Sterling overnight interest rates to the Monetary Policy Committee's ("MPC") repo rate, leading to an essentially flat money market curve out to the next MPC decision date, with very limited day-to-day or intra-day volatility in market interest rates. Second, the Bank is seeking to promote a more efficient and safe framework for banking system liquidity management that relies on both competitive money markets and, where necessary, central bank money. Third, the Bank intends to create a simple and straightforward operational framework thereby facilitating more competitive and transparent Sterling money markets, to the benefit of both end-users and intermediaries.

2. Executive Summary

The Bank's policy objectives are both laudable and achievable. While the Association would like to offer some suggestions regarding how the Bank might best achieve its stated objectives, we are very supportive of the Bank's overall efforts to

¹ The Bond Market Association is an international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities internationally. More information about the BMA and its members and activities is available on its website www.bondmarkets.com.



stabilise the short term interest rates and enhance transparency and predictability in the Sterling money markets. In general, the Association's comments can be summarised as follows:

- While the proposed changes should lead to the reduction of volatility in short-term market interest rates, it is unclear whether the proposed framework would retain adequate incentives for settlement banks to manage their own liquidity needs without excessive reliance on borrowings from or reserves maintained at the Bank.
- Reduced volatility is likely to attract additional market participants who will welcome a more transparent and predictable market. However, these improvements also raise some risk that the key liquidity providers will begin to commit less capital to Sterling money market operations and thereby potentially leave the market susceptible to liquidity shortages (absent injections of central bank money or new participants) especially in market stress situations.
- Achieving the Bank's policy objectives under the proposed framework requires that more foreign banks (including some of the Bank's current counter-parties for its open market operations ("OMOs")) bank with the Bank or otherwise structure their U.K. operations to better avail themselves of any new lending facility.
- Day-to-day usage of the new lending facility should be encouraged and available to as many market participants as possible thereby eliminating any potential stigma for firms that choose to borrow from the Bank.
- Our members are interested in potentially engaging in indexed-linked repos with the Bank as part of its OMOs. The Association would, therefore, be happy to assist the Bank in obtaining more detailed feedback from market participants that are not currently OMO counter-parties on the ideal structure and the term of any such repos (i.e., overnight, one-week or two-weeks).
- The Bank's policy objectives may be more easily achieved by engaging each day in one-week term repos at a fixed tender rather than the current two-week maturities while preserving the Bank's ability to conduct "fine tuning" operations at the end of the day.
- The new framework appears to unduly emphasise remuneration of reserves and the introduction of an enhanced overnight deposit and lending facility to stabilise short term rates.

3. Discussion

3.1. The Association Supports the Bank's Efforts to Reduce Volatility in Short Term Sterling Interest Rates

The Association supports the Bank's overall objectives of encouraging greater stability in short term Sterling interest rates. However, as noted below, we feel that the Bank is more likely to successfully achieve its objectives if it incorporates certain changes outlined below into the new framework.



Unlike other major money markets, a very large portion of the U.K. money markets are currently dominated by a number of relatively large players. These firms are able to exert more influence over the structure of short term rates and, thus, the Bank's OMOs have arguably become more concentrated.

However, any new framework also needs to continue to encourage active participation by the largest liquidity providers and create economic incentives for banks to actively speculate in and make two-sided markets in short term interest rates. The Association further cautions that the larger gilt edged market makers, and other large liquidity providers may elect to commit less capital under the new regime to their Sterling money market operations, thereby potentially leaving the market susceptible to liquidity shortages (absent injections of central bank money) especially in market stress situations.² The Bank's success at reducing volatility in short term interest rates may ultimately depend upon the Bank's ability to convince additional foreign banks to become settlement banks or more active in these markets.

3.2. Successful Implementation of the Proposed New Framework Depends Upon More Firms Choosing to Become Settlement Banks

The Bank has obviously had some previous success reducing volatility in short term rates such as in 2001 when it introduced an overnight deposit facility to put a floor under overnight interest rates. However, the Association is concerned that direct access to any new deposit or lending facility at the Bank under the new framework may, in practice, be limited to too few firms. Based on discussions with our members, it appears that most firms have no interest in becoming settlement banks as a result of the proposed reform because of substantial infrastructure cost and the requirement for expensive additional collateral. We also believe that many of the firms that are the Bank's current OMO counter-parties but not RTGS banks are unlikely to be interested in participating directly in a secured lending facility being enhanced under the framework.

3.3. The Association Supports Revising the Account Maintenance Requirements for Settlement Banks And Increasing Access To The Lending Facility

The Association supports a modification to the account maintenance requirements for settlement banks. The Association equally welcomes the Bank's proposal to implement a periodic requirement that requires an average amount of reserves to be maintained over the maintenance period (i.e., from one MPC decision to the next MPC decision). In particular, because of a wider available access to central bank money and the ability of banks to balance out their reserve averages over time, the period-average scheme is preferable and should contribute to reduced volatility in short-term interest rates. We also support a requirement whereby a settlement bank is required to fund its reserve balance back to zero or higher by the end of the business

² Moreover, the Bank argues in its Paper that volatility in the U.K. money markets should more closely mirror the US and Euro markets. While there is some merit to this argument, the Association questions whether those markets are in fact completely comparable since all three markets have a different investor base and are influenced by completely different market dynamics.



day.³

However, some of our member firms are structured in a manner such that in managing their short term liquidity needs borrowings from the Bank against high quality collateral is preferable to the expense of becoming a settlement bank that can draw down remunerated reserves. Therefore, we urge the Bank not to unduly rely on account maintenance requirements in seeking to stabilise short term interest rates, but instead adopt a framework that allows somewhat more equal access to central bank credit by both OMO counter-parties and RTGS settlement banks.

3.4. The Association Supports an Enhanced Lending & Borrowing Facility for Settlement Banks

While it appears that the proposed new overnight lending and borrowing facilities may not be available to certain of the Bank's current OMO counter-parties (i.e., those that do not have, and have no intention to establish, a banking relationship with the Bank under the new framework), the Association nevertheless supports the creation of a new enhanced lending and borrowing facility at the Bank. The Bank should use the new facility to borrow from (or lend to) a broader range of market participants than the Bank does currently.⁴

3.5. Open Market Operations Should Occur Daily Under the New Framework With an Emphasis On Overnight to 1-Week Maturities

The Association believes that OMOs should continue to be an integral part of the Bank's management of short term interest rates under the new framework. It is our understanding that the Bank is considering reducing the frequency of OMOs under the new framework such that it only engages in a single round of OMO each day as compared to currently four rounds each day. While introduction of a periodic maintenance requirement and new liquidity facilities will naturally lead to the need for less frequent OMOs, the Bank's should not diminished its commitment to engage in daily OMOs with its counter-parties.

Currently, the Bank engages in multiple rounds of operations each day, generally for a term of two weeks. In order to limit the degree of "pivoting" that takes place the week before an MPC meeting and reduce volatility, the Bank is considering several reasonable policy options. The various changes being contemplated (remuneration of reserves, an enhanced borrowing facility etc.) will help contribute to the Bank's overall policy objectives. However, we also recommend that the Bank makes daily fixed rate tenders with a maturity of 1-week or less the cornerstone of its OMOs operations with such tenders solicited around 10:00 a.m. As part of this new OMO structure, the Bank should continue to conduct a late day round for purposes of facilitating balancing. In order to maximise transparency for all market participants, the late day round should also be fixed rate. Many of our members indicated a willingness to engage in 1-week fixed rate tenders with the Bank under the new

³ However, as noted above, the Association remains concerned that the ability to tap reserves would not be available to a broad enough range of banks including certain of the Bank's current OMO counterparties.

⁴ In this context, the Association also supports the widening of the list of acceptable collateral.



regime.

Finally, in the Paper the Bank acknowledges that its current end-of-day arrangements are too complicated. The Association agrees. However, since the Bank recognises that errors in the Bank's liquidity forecast are still likely to occur from time to time under any new regime, the Association supports continued usage by the Bank of end-of-day "fine-tuning" operations directly to offset any forecast errors.

3.6. The Bank Should Study The Feasibility Of Utilising Index-Linked Repos ("ILRs") In Its Open Market Operations

In its Paper, the Bank requests feedback on whether it should consider undertaking ILRs as part of its OMOs under the new framework. We understand that under such ILRs the interest rate on any outstanding OMO transactions would reset to a new rate whenever the MPC decided to change its repo rate and such new rate would apply for the remaining term of the transaction.

Our members were generally sceptical about the viability of such transactions becoming an integral part of the Bank's OMOs with its counter-parties.⁵ While the Bank might wish to explore using ILRs occasionally in its OMOs, our members identified several barriers to the Bank's successful engagement in such transactions on a regular basis. For instance with ILRs of longer than two weeks maturity our members expressed concern about the ability to readily transfer (lay-off) their exposure if market sentiment shifted due to the subsequent release of new key economic data.

While several of our members were critical of the market's ability to support an active ILR market away from the Bank, ILRs may be viewed by the Bank as a useful "feedback" mechanism for the MPC to evaluate market participants' future expectations regarding the changes in the MPC rate. The Association would, therefore, be happy to assist the Bank in obtaining more detailed feedback on the ideal structure and the term of any such repos (i.e. overnight, one-week or two-weeks).

3.7. The Association Supports Longer Maturity Open Market Operations Using Variable Rate Tenders

The Paper notes that the Bank is also considering lending through the usage of longer-maturity (6, 9 or 12 months) repos at market rates through the solicitation of variable rate tenders. Our member firms would find the ability to obtain liquidity from the Bank at such longer maturities valuable although we do not expect that there will be a significant demand for engaging in such longer-maturity repos with the Bank. Willingness for participation will obviously depend on the nature of the applicable haircuts by the Bank and whether competitive haircuts are likely. If such longer-maturity repos were introduced, regular public tenders of this type would help to encourage liquidity at longer maturities in the gilt repo market and in other parts of the Sterling money markets.

⁵ However, several of our members expressed an interest in entering into such repo transactions with the Bank provided the term of the transaction was 1-week or less.



In closing, the Association and its membership sincerely appreciate the opportunity to comment on the Bank's Paper, and look forward to a continuing dialogue with the Bank as its review of its operations in the Sterling money markets progresses. Please do not hesitate to contact Eric Lindh Foster, Associate General Counsel or the undersigned should you have any questions or wish to discuss any of the industry's concerns in greater detail.

Yours sincerely,

A handwritten signature in black ink, appearing to read "M. Sgouridis", followed by a period.

Markus Sgouridis
European Legal Counsel

cc: International Repo Committee
International Repo Legal Advisory Committee
Funding Division Executive Committee
Funding Division Legal Advisory Committee
BMA Legal & Professional Staff