Chris Salmon: Remarks on the Sterling Monetary Framework (SMF) Annual Report

Remarks by Mr Chris Salmon, Executive Director for Markets of the Bank of England, at the Money Markets Liaison Committee meeting, London, 13 July 2015.

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I would like to thank Eleanor Broughton, Ronnie Driver, Sarah John, Ben Martin and Ben Morley for their comments and contributions.

The Bank will hold an Open Forum this autumn. The Forum will facilitate an open debate about the role of markets in society, and provide an opportunity to review how key financial markets are functioning. The Bank's own mechanism for interacting with markets, when implementing monetary policy and providing liquidity insurance, is set out in the Sterling Monetary Framework (SMF). Markets work more effectively when participants are open and transparent about their activities, and the Bank aspires to meet that standard in relation to its own market operations, including through publishing an annual report on the effectiveness of the SMF.

This Committee brings together key participants in sterling money markets and is a natural venue to discuss the operation of SMF. As such, today I want to summarise the key themes that were covered in our most recent annual reports and to sketch out some of the issues that the Bank is likely to confront in coming years. These are areas where your future feedback will be essential as we work to maintain the effectiveness of the SMF.

Liquidity insurance

We have made a number of significant changes to the way the Bank offers liquidity provision through the SMF. As the Governor has remarked, these changes have been aimed at providing more liquidity, at longer terms, at cheaper rates, and to a wider range of counterparties with the objective of ensuring that the Bank of England is "open for business".

As discussed in the SMF annual report, the main highlights over the past couple of years have included the extension of SMF membership to broker-dealers and central counterparties (CCPs), and the expansion of the monthly indexed long term repo (ILTR) operations.

The extension of the SMF to broker-dealers and CCPs gives non-banks access to the Bank of England's balance sheet for the first time. Non-banks are becoming increasingly important to the financial system. The Bank considered three key themes before widening SMF membership: whether the non-bank institutions were systemically important, whether they were exposed to sterling liquidity risk, and whether they were appropriately prudentially regulated so that usage of the facilities remained appropriate. In light of this, the Bank announced in November 2014 that broker-dealers and CCPs would be eligible to apply for access to the SMF. And some of these institutions have indeed formally signed up in recent months.

Another recent, major change to the SMF was the reform to the Bank's ILTR operations in February 2014. These auctions offer reserves at lower prices and for a longer maturity against a wider range of collateral than had been the case previously. And the auctions are responsive to market conditions, with the amount of liquidity available rising automatically if there is greater demand. Reflecting the improved financial positions of banks and building societies, and the liquidity provided to the market through QE, the Bank's liquidity insurance facilities saw relatively modest usage over the year covered by the most recent annual report. More recently, however, usage has increased, as banks sought to make use of the liquidity insurance provision on offer by pre-emptively securing term funding ahead of a period of potential uncertainty around key events, such as the UK general election, and Greece. This pattern of usage is encouraging and welcome, as it demonstrates that banks are prudently managing their liquidity position ahead of potential risks, and that the ILTR is an active part of their liquidity management. Despite the increase, however, demand has remained relatively low, with just over £4 billion allocated in the May operation: a high water mark for the expanded ILTR operation.

Looking back to 2007, before the crisis, the cumulative changes we have made to the SMF have been transformative. The SMF now has 164 members, more than double the number signed up in 2007, with banks and building society SMF members accounting for 98% of total sterling deposits. The drawable value of collateral delivered to the Bank for actual or potential use in the Bank's facilities has increased dramatically, and stood at £327.4 billion at end-June 2015. And the Bank now has a comprehensive set of market wide and bilateral facilities. These developments give the Bank tremendous flexibility to support financial institutions during periods of stress. As you will see from the FPC's published record, it was in that context that the Bank decided to announce two additional ILTR operations in the event of a "yes" vote in the referendum on Scottish Independence, as a precautionary measure to backstop sterling market liquidity. As part of its contingency planning, the Bank assessed its ability to provide liquidity support to the banking system should it become necessary and concluded that the range of tools within the existing framework offered sufficient flexibility to respond.

But the Bank is not standing still; we are continuing to develop our liquidity insurance framework to ensure that it can react to a wide range of liquidity challenges.

First, as part of the strategy to broaden liquidity provision, the Bank has committed to consider the feasibility of offering Shari'ah compliant facilities. All banks must hold an adequate stock of liquid assets to meet prudential regulations and, as the most liquid assets in the economy are the reserves held by banks and building societies on account at the Bank, it would be beneficial to Shari'ah compliant banks to have access to our balance sheet. There are significant challenges to this work: for example, in designing a Shar'iah compliant deposit account which has similar economic properties to interest-paying reserve accounts and in identifying sufficient Shari'ah compliant collateral to support lending facilities. But the Bank is now actively working on these issues and I am hopeful that we will be able to release further details as early as the turn of the year.

Second, the Bank has also started work to ensure there are no technical obstacles to our ability to accept equities as collateral should the need arise. At present, the Bank accepts a very broad range of collateral, including government bonds, asset backed securities and pools of "raw" loans. But the Bank can further bolster its flexibility by removing any technical obstacles to accepting equities as collateral, should the need arise. Given the complexities involved, the project will take some time to deliver, and we currently anticipate that work to remove technical obstacles will continue throughout 2015 and 2016.

Finally, as noted in the Open Forum paper[1] published in June, the Bank stands ready in principle to support core markets directly through "Market Maker of Last Resort" (MMLR) actions. Such action would probably only be contemplated if the illiquidity in particular markets was judged to pose a threat to financial stability, or was judged to be important to the transmission mechanism of monetary policy. However, MMLR remains a relatively untested tool, and the Bank's ability and willingness to act as a MMLR could be a fruitful topic to discuss at the forthcoming Open Forum.

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[1] Open Forum: Building Real Markets for the Good of the People.

Monetary policy

The task of evolving our liquidity insurance framework will not end, but given the substantial reforms made to it over recent years, it is likely that the focus will shift to monetary policy implementation, as and when the MPC decides to move policy away from its current settings.

As the head of the Markets Directorate it is not my role to speculate when the policy setting might change, but it is my job to ensure that decisions of the MPC are implemented effectively. That involves, in particular, ensuring that we have the tools needed for ***effective*** monetary control; that is, keeping overnight market interest rates in line with Bank Rate.

The Bank's current approach is to pay Bank Rate on the full balances held in reserves accounts. This is known as the "floor" system. As set out in the SMF Annual Report, this approach remained successful at keeping sterling overnight market rates close to Bank Rate during 2014–15, with the "wedge" between policy rates and market rates relatively small over the past year. But over the year, activity in the sterling money markets remained low as the floor system, alongside a large-scale injection of reserves through QE, reduced the need for banks to transact in money markets.

In the near-term, I expect that this system will remain effective at moving market rates in line with any change made to policy rates by the MPC. Nevertheless, in the spirit of being prepared, and drawing on feedback from previous meetings of this committee[2], staff have developed plans should market rates persistently settle below Bank Rate, to such an extent that the Bank decided it was necessary to intervene in support of monetary control. In such a scenario, the presumption is that the Bank would issue one-week Bank of England bills, draining reserves from the system. That would tend to put upward pressure on market rates, reducing the wedge that had opened up and tightening the link between policy and markets rates. The Bank has a history of issuing these instruments successfully: Bank of England bills were first issued in 2008, to drain excess reserves following the increased size of long-term repo operations. And Bank of England bills also have the advantages of being widely tradable, offering a close substitute to deposits for most participants in the money markets, and of providing additional supply of high quality collateral.

I have no particular expectation that the Bank will need to issue Bills in the foreseeable future, but the tool is ready if required.

The move to the current floor regime was prompted by the MPC's policy decisions to cut Bank Rate to the effective lower bound and its subsequent decision to loosen monetary conditions via asset purchases. It is unlikely that the regime would have been adopted without these developments and so as and when the MPC starts to "normalise" the level of Bank Rate, the Bank is likely to review whether to retain the current "floor" system indefinitely or whether it should move to a different medium-term operating framework.

One obvious option would be to return to the framework used before the introduction of QE – which was known as "reserves averaging". That operating regime was introduced after a careful review of alternative regimes open to the Bank in the mid-2000s. But the world has changed markedly since that review was undertaken. Banks have structurally higher demand for central bank reserves than they did before the crisis, reflecting in part liquidity regulations, and as I noted earlier, a far wider range of institutions can directly access our balance sheet than was the case a decade ago. Moreover, the structure of money markets has evolved considerably over this period as banks have responded to lessons learned during the crisis and the impact of post-crisis regulation.

These changes have been sufficiently profound that the Bank no longer maintains a presumption that it will return to a version of reserves averaging that existed prior to 2009.

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[2] See 3.1-3.4 of the September 2014 MMLG Minutes http://www.bankofengland.co.uk/markets/Documents/money/mmlgsep14.pdf.

While such a decision remains possible, the choice of medium-term operating framework is now a genuinely open question and is likely to be become a key issue for the Bank as it considers the future design of the SMF.

Whatever decision the Bank makes about its medium-term monetary policy framework it is likely that the floor system will be retained for some time after Bank Rate is increased from its current level.

Conclusion

The SMF defines how the Bank interacts with markets, when implementing monetary policy and providing liquidity insurance. It is important that we are open and accountable for the operation of the SMF. The MMLC itself and the new SMF annual review process help us achieve that aim. In recent years we have transformed the SMF, and we believe for the better. But reform of the SMF is an on-going process. As my remarks today have made clear, that process is incomplete: further changes to support liquidity insurance are in the pipeline and the Bank needs to keep under review its tools for implementing monetary policy. The Bank is both open for business *and* open to outside views, and we always welcome feedback from MMLC members or other interested parties on any aspect of the SMF, including at the forthcoming Open Forum.