



BANK OF ENGLAND

The Bank of England's response to the Independent Evaluation Office's evaluation of its approach to providing sterling liquidity

January 2018

1 Introduction

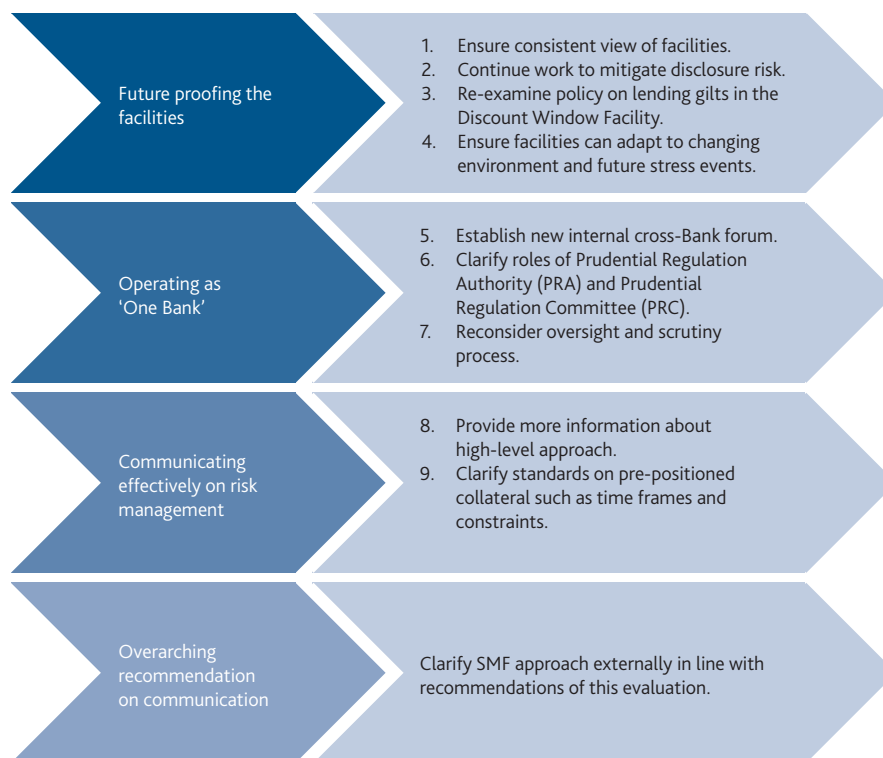
1.1 The Bank of England (Bank) welcomes the Independent Evaluation Office's (IEO's) evaluation of the effectiveness of its approach to providing sterling liquidity insurance through its published market facilities⁽¹⁾ (known as the Sterling Monetary Framework or 'SMF'). The Bank's liquidity facilities have undergone material change over the past few years, in particular in response to the 2012 Court-commissioned Winters Review,⁽²⁾ and the Bank is reassured that the IEO found 'clear evidence of the positive impact of recent reforms'.

1.2 The IEO report recommends a number of ways in which the Bank can further enhance the effectiveness of its liquidity operations. The Bank is committed to implementing all of these recommendations.

2 The IEO's recommendations and the Bank's response

2.1 The IEO has set out recommendations in four main areas, summarised in **Figure 1**.⁽³⁾

Figure 1 Summary of recommendations



2.2 The IEO report rightly emphasises the need to future proof the Bank's facilities. The Bank has a wide range of liquidity facilities available in its published toolkit. These facilities already provide flexibility for banks, building societies and other SMF participants⁽⁴⁾ in managing their liquidity needs, and allow those firms and the Bank to plan for, and respond to, a wide variety of stress events. But there is further to go, and the IEO helpfully highlights a number of specific areas where the Bank may be able to take steps to further strengthen its approach.

2.3 The IEO notes that the risk that use of central bank facilities will be disclosed is a key concern for market participants, and could potentially act as a barrier to approaching the Bank for bilateral support. The Bank recognises this concern and will continue to prioritise mitigation of disclosure issues relating to the use of its facilities. In light of the IEO's recommendations, in 2018 the Bank will:

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

(2) Available at www.bankofengland.co.uk/-/media/boe/files/news/2012/november/the-banks-framework-for-providing-liquidity-to-the-banking.

(3) A summary of the Bank's response to each recommendation is available in the annex.

(4) Referred to collectively as 'firms' throughout this document.

- Consider what further work can be done with participants and other authorities regarding the need to disclose usage of the Bank's liquidity facilities.
- Re-examine the limitations around lending gilts in the Discount Window Facility (DWF) as a means of mitigating disclosure risks for large-scale drawings.

2.4 The Bank also agrees with the IEO's view that there is merit in further consideration of the factors that might determine how it would respond to future stress events. The Bank will undertake analysis with the aim of promoting a shared understanding between staff of how relevant factors might be taken into account in the Bank's response. This work will consolidate learning from previous episodes, but not be prescriptive, recognising that flexibility needs to be retained to tailor any response to the specific circumstances faced at the time. The Bank will also look to extend its programme of regular internal test exercises to incorporate such decision-making in order to help embed an understanding of these issues across a wide range of Bank staff.

2.5 It is also important that market participants understand how the Bank's facilities operate, and are confident they can access them effectively when required. The IEO report notes some confusion among firms about the operation of some of the Bank's facilities, in particular the Indexed Long-Term Repo operations. To respond to this, the Bank will put in place an ongoing education programme for counterparties by 2018 H2, to ensure there is appropriate understanding of the Bank's facilities.

2.6 In considering how the SMF is operated within the Bank, the IEO notes that it observed 'multiple instances of positive evidence of cross-Bank collaboration to help deliver SMF liquidity insurance goals', citing several examples including the contingency planning that took place in the run-up to the EU referendum. But the report also notes that many issues in relation to the SMF cut across a number of its policy objectives, and there is more that could be done to set SMF strategy as a single institution.

2.7 The Bank will take forward the IEO's recommendation to establish a senior cross-Bank forum to discuss strategic questions related to the positioning of the Bank's facilities, in particular where they touch on the objectives of different areas of the Bank. The forum will be chaired by the Deputy Governor for Markets and Banking, and will include representatives from the monetary policy, and macro and microprudential areas of the Bank. It will meet for the first time in early 2018.

2.8 Given the focus of this review on the Bank's liquidity insurance facilities, the IEO report specifically highlights the various interlinkages between the Bank's facilities and microprudential liquidity supervision. For example, central bank reserves form part of firms' Liquid Asset Buffers, and the Bank's liquidity insurance facilities provide tools that can be used alongside those buffers, to help firms manage liquidity shocks. The Bank agrees with the IEO that it is important that these interlinkages are fully understood, that there is a consistent view of the Bank's facilities across the institution, and that staff across the Bank have a clear understanding of their role in relation to the Bank's facilities.

2.9 To address the IEO's recommendations in relation to the interaction of the facilities with microprudential objectives, the Bank will take forward three actions:

- Agree with the Prudential Regulation Committee (PRC) a framework to guide its engagement on issues that are relevant to both the PRC's microprudential responsibilities and to the operation of the Bank's facilities.
- Work to promote a consistent view about the appropriate usage of the Bank's facilities, and how any usage may interact with the use of individual firms' liquidity buffers in a stress scenario. This will include clarifying relevant aspects of its risk management approach internally, focusing on the 'presumption of access' to the Bank's facilities and the extent to which that is built into some firms recovery plans appropriately. Staff will also consider the best way to ensure this knowledge is kept up to date across the institution and communicated externally.
- Document, at a high level, how supervisory staff and those responsible for the operation of the Bank's facilities should work together to maximise the effectiveness of the Bank's facilities.

2.10 It is important to note that appropriate use of the Bank's liquidity facilities will vary according to the circumstances of individual firms and in light of the broader market context; there is unlikely to be a one size fits all approach. But, in taking the above steps, the Bank hopes to ensure that firms are given a clear and consistent message about the types of circumstances in which the Bank might anticipate its facilities being used in order that they can plan appropriately. This, in turn will help to ensure the facilities are as effective as possible, particularly in times of stress.

2.11 The IEO report also recommends the Bank reconsider the way the SMF is reviewed. The Bank is committed to ensuring an effective review and challenge process in relation to its liquidity facilities. But, as the report notes, the current annual review is both time consuming to undertake and has become somewhat formulaic, mainly because the facilities do not change sufficiently to justify a full review every year. Consistent with the IEO's recommendation, the Bank will move to a mixed review model: undertaking an in-depth review at least once every three years and light-touch reviews in other years. The Bank will publish a factual report, documenting the usage of the facilities and key developments annually, and the key findings from the periodic in-depth reviews.

2.12 The IEO Report notes the importance of clear communication around the Bank's liquidity operations, including in relation to its risk management practices, and suggests several areas when communications could be improved. Specifically:

- At various times over the past ten years the Bank has had to act outside of its published framework to support longer-term funding markets. The Bank accepts that a more clearly articulated approach would be helpful and will therefore seek to clarify the Bank's role in this respect.
- Building on the example of existing guidance for new banks, the Bank will produce a new guide setting out further information on the collateral prepositioning process for existing and prospective counterparties in the Bank's operations. This will include explanations of the time frames involved, the level of due diligence the Bank conducts, the trade-offs the Bank faces when trying to meet the system's needs for collateral prepositioning to meet liquidity insurance needs as a whole and the mechanisms for escalating any issues if necessary.

2.13 More generally, the Bank will review its communication strategy for the SMF, with the aim of providing a clearer and more accessible explanation of the objectives and functioning of the framework and the Bank's high-level approach towards risk management. The updated communications will incorporate any changes made as a result of this evaluation.

3 Conclusion

3.1 The Bank welcomes the IEO's evaluation, which it considers a balanced and informative assessment of its approach to providing sterling liquidity insurance. The Bank is reassured that the IEO has found positive evidence of the reforms of its facilities in recent years, and will look to take forward the report's recommendations to further strengthen the effectiveness of its operations in future.

Annex

Summary of the Bank's response

Recommendations	Actions proposed
<p>Future proofing the facilities</p> <p>1 Ensure consistent view of facilities.</p> <p>2 Continue work to mitigate disclosure risk; and</p> <p>3 Re-examine policy on bilateral gilt lending in the DWF.</p> <p>4 Ensure facilities can adapt to changing environment and future stress events.</p>	<p>Staff in Markets, Banking and the PRA will work to promote a consistent view about the appropriate usage of the Bank's facilities, and how any usage may interact with the use of individual firms' liquidity buffers in a stress scenario. Staff will also consider the best way to ensure this knowledge is kept up to date across the institution and communicated externally. A proposed approach will be taken to the new cross-Bank forum (see recommendation 5) in 2018 H1.</p> <p>The Bank will continue to prioritise mitigation of disclosure issues relating to the use of its facilities. In 2018, the Bank will:</p> <ul style="list-style-type: none"> • Consider what further work can be done with participants and other authorities regarding the need to disclose usage of the Bank's liquidity facilities. • Re-examine the limitations around lending gilts in the DWF as a means of mitigating disclosure risks for large-scale drawings. <p>Staff will consider what further steps can be taken to ensure the facilities are well placed to respond to future stress events. This will include:</p> <ul style="list-style-type: none"> • Facilitating a discussion at the new cross-Bank forum in 2018 H1 about the factors that bear upon the appropriate response by the Bank to different types of stress event. • Considering how its programme of liquidity support test exercises, which to date have tended to focus on the provision of Emergency Liquidity Assistance (ELA), can most effectively be extended to capture lending via the Bank's other facilities, by the end of 2018. • Putting in place an ongoing education programme for counterparties by 2018 H2, to ensure there is appropriate understanding of the Bank's facilities. A specific area of focus will be explaining the operation of the Indexed Long-Term Repos. <p>The Bank will seek to clarify its role in supporting longer-term funding markets, recognising that it has acted to do this at various times over the past ten years.</p>
<p>Operating as 'One Bank'</p> <p>5 Establish new internal cross-Bank forum.</p> <p>6 Clarify roles of PRA and PRC.</p> <p>7 Reconsider oversight and scrutiny process.</p>	<p>The Bank will establish a senior forum, chaired by the Deputy Governor for Markets and Banking, drawing representatives from the monetary policy, and macro and microprudential areas of the Bank. This forum will provide a means for in-depth discussion of strategic questions related to the positioning of the Bank's facilities, in particular where they touch on the objectives of different areas of the Bank. The forum will meet for the first time in early 2018.</p> <p>Staff will agree with the PRC a framework to guide its engagement on issues which bear both upon the PRC's responsibilities and on the operation of the SMF. Staff will also document, at a high level, how supervisory staff and those responsible for the operation of the Bank's facilities should work together to maximise the effectiveness of the Bank's facilities. Both of these exercises will be completed before end-2018.</p> <p>The Bank will move to a mixed review model: undertaking an in-depth review at least once every three years and light-touch reviews in other years. The Bank will publish a factual report, documenting the usage of the facilities and key developments annually and the key findings from the periodic in-depth reviews.</p>
<p>Communicating effectively on risk management</p> <p>8 Provide more information about high-level approach.</p> <p>9 Clarify standards on pre-positioned collateral such as time frames and constraints.</p>	<p>In 2018, the Bank will clarify relevant aspects of its risk management approach internally, focusing on the 'presumption of access' to the Bank's facilities and the extent to which that is built into some firms recovery plans appropriately. The Bank will also provide more high-level messages on the Bank's approach to risk management externally.</p> <p>Building on the example of existing guidance for new banks, the Bank will produce in 2018 a new guide setting out further information on the collateral prepositioning process for existing and prospective counterparties in the Bank's operations.</p>
<p>Clarify SMF approach externally in line with recommendations of this evaluation</p>	<p>The Bank will review its communication strategy for the SMF, with the aim of providing a clearer and more accessible explanation of the objectives and functioning of the framework. The updated communications will incorporate any changes made as a result of this evaluation. The revised approach to communications will be initiated by end-2018.</p>