Overhauling sterling overnight

Executive summary

- The Bank of England is changing its official operations in the sterling money markets to reduce overnight interest rate volatility.
- This will bring higher overnight rates, which is good for funds with a heavy weighting in these deposits.
- It may also increase liquidity in the overnight market to much later in the trading day, allowing such funds to offer a later cut-off time.
- MMFs will be less prone to arbitage-driven redemptions when overnight rates move.
- The Bank's new system involves allowing banks to average out the sums they hold with it over a maintenance period.
- If overnight rates fall, banks will be able to switch funds to the Bank, causing the overnight rates to rise again, and vice-versa.

The Bank of England has announced plans to change its official operations in the sterling money market and reduce the volatility of overnight interest rates. This will have a number of implications for treasurers and providers of money market funds, says Jonathan Curry.

THE TWIN OBJECTIVES of the Bank of England's sterling money market operations are to implement monetary policy, while meeting the liquidity needs of the banking system. The Bank also wants a system that supports an efficient and competitive money market. In future, it also aims to control overnight market interest rates much more closely. On 14 October 2003, Paul Tucker, Executive Director of the Bank of England Markets Division, announced a review of the Bank's sterling money market operations. "Our aim in reviewing our sterling money market operations is to see whether we can make improvements to ensure that the Bank's operational framework is at the leading edge internationally," he said.

What this means for treasurers

The Bank of England's decision to try to reduce the volatility of the sterling overnight rate has a number of potential implications for treasurers and money market fund (MMF) providers.

One consequence of the change in policy is that, if the Bank is able to reduce volatility, the average overnight rate will be higher than that of the past. This means that MMFs, which typically carry a higher degree of liquidity by having a higher weighting in overnight deposits, will earn a higher yield on those balances. It will no longer be penal for funds to maintain a higher weighting in overnight deposits.

A reduction in volatility may also increase liquidity in the sterling overnight market to later in the trading day. Currently, liquidity in the market begins to dry up by around 11.30am as banks square their books early to avoid being exposed to a volatile and less liquid market later in the morning. Therefore, MMFs that offer a late cut-off time are currently exposed to less liquid market conditions with potentially lower overnight rates available. If the market is more orderly and has a greater degree of liquidity, it may allow funds with earlier cut-off times to move these to later in the day, without compromising the liquidity they offer investors.

Finally, a reduction in sterling overnight market volatility will remove opportunities for investors in MMFs to arbitrage between the yield offered by these funds and the prevailing overnight rate. This will benefit investors in MMFs that do not actively trade in the overnight market, as such funds will no longer be penalised by redemptions should overnight rates rise.

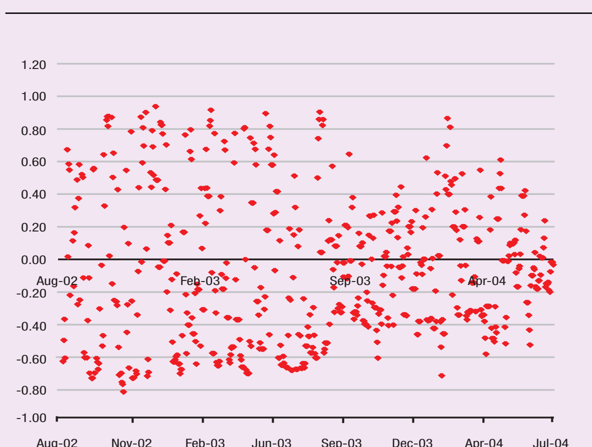
> 'For years the sterling overnight market has been more volatile than desired'

For years the sterling overnight market has been significantly more volatile than desired – considerably more so than the US and euro zone markets. This can be seen in Figures 1, 2 and 3, which show the spread between the overnight interest rates in the UK, US and euro zone, against the target interest rate of the respective central banks over the past two years.

Such volatility has continued in the overnight market for two main reasons. First, the Bank requires settlement banks to maintain a minimum balance of zero on their accounts with it each day – known as the maintenance requirement. The Bank conducts daily open market operations for assets with a maturity of around two weeks to supply the market with the funds it needs to meet the maintenance requirement. However, these overnight operations are not sufficient to make the Bank the rate-setter in the overnight market and this can lead to considerable volatility.

Secondly, if the Bank continues to lend every day at the prevailing Monetary Policy Committee (MPC) base rate during a term that spans an MPC meeting, this also creates volatility. If the MPC changes the base rate, outstanding lending is maintained at the previous base rate level until maturity. However, through a process of arbitrage, overnight

Figure 1. Sterling overnight interbank average (Sonia) vs UK base rate



market rates will adjust ahead of the meeting to equalise the cost of borrowing from the Bank for two weeks and the expected cost of rolling borrowing in the overnight market over the same period. Therefore, overnight interest rates will fall ahead of MPC meetings when rates are expected to rise and vice-versa if interest rates are expected to fall at the next meeting. This process brings further volatility to the sterling overnight market.

Most recently, the Bank has reviewed two methods of managing the sterling overnight rate within a narrow band on either side of the prevailing base rate.

In July, after consultation with participants in the sterling overnight market, the Bank announced that it planned to adopt a period-average maintenance requirement in the future (See *News*, page p8, *The Treasurer*, September). Under this method, banks will be able to draw down or build up reserves over the course of a maintenance period, providing their average end-of-day balance over the period equals the required balance; they will also have to maintain a positive balance at the end of each day. Banks, who are members of the scheme, will be able to adjust their balance whenever overnight interest rates in the market diverge from the rate expected at the end of the maintenance period. This means they will be able to draw down balances held with the bank if overnight market rates are higher than the expected rate at the end of the period. They will also be able to increase balances if overnight market rates are lower. This arbitrage, and the subsequent increase or decrease in market liquidity, will ensure the overnight market interest rate at the start of the maintenance period remains close to the expected overnight rate at the end, as withdrawals push rates up and inflows push them back down again.

To ensure that the market overnight rate remains close to the MPC base rate, the following conditions must be met:

- A wide range of banks commit to joining the system;
- the rates available from the Bank have the effect of setting a narrow corridor around the base rate;
- the Bank provides sufficient funds to the market to allow banks to meet the maintenance requirement without recourse to standing facilities; and
- ‘pivoting’ ahead of MPC decisions is eliminated.

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Setting the terms

The Bank’s ability to set the terms on which it lends money or absorbs liquidity, and the terms on which banks hold accounts with it, provides the key to its setting of sterling interest rates. The Bank can create incentives for other banks to manage their account balances consistently with its policy objectives. This can be done via the amount the Bank lends through open market operations, the terms it requires on these accounts, including the frequency it requires banks to balance their books (the maintenance requirement), and on the rates of interest applied to positive and negative balances on these accounts. A maintenance requirement can be daily, with banks required to hold a specific balance at the end of each day – a ‘same-day requirement’. If they fail to hold this specified balance they are charged a penalty rate. A maintenance period can also be averaged out over a period, with banks charged a penalty rate if they fail to hold a specific balance on average over this period of time. Examples of period average systems include those used by the European Central Bank (ECB) and the US Federal Reserve.

Figure 2. Euro overnight interbank average (Eonia) vs ECB repo rate

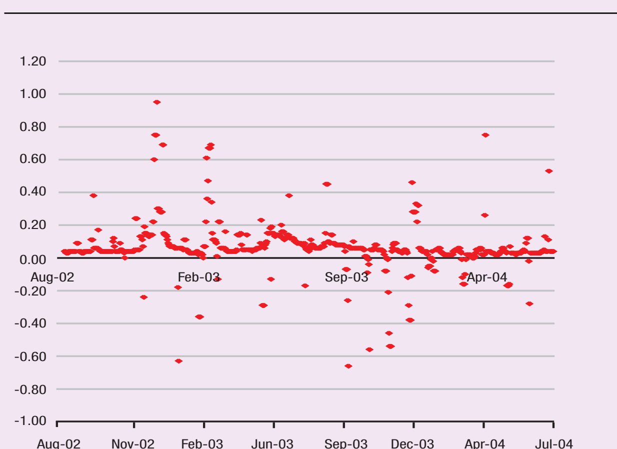

Figure 3. Fed Open vs Fed Funds