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Yale Program on Financial Stability-Request for review of draft case studies

Bahaj, Saleem <s.bahaj@ucl.ac.uk> Wed, Feb 8, 2023 at 6:37 PM
To: "Wiggins, Rosalind" <rosalind.wiggins@yale.edu>
Cc: "Feldberg, Greg" <greg.feldberg@yale.edu>, "Swaminathan, Lakshimi" <lakshimi.swaminathan@yale.edu>

Hi Rosalind,

Many apologies, I am normally reliable with these things, but I have been too busy to get around to this request.

I don't know the answer to the first question unfortunately. Broad brush, I would expect the swap line to be covered by the provisions of the Bank of England act related to foreign exchange interventions and open market operations but exactly what provisions apply I wouldn't be able to say as I don't have legal training.

On you second question, my short answer is that I don't think there is a legal definition, but I would interpret activation as there being a readiness to draw funds.

Let me elaborate on this. A swap line agreement in many cases is initially only an agreement in principle between the two central banks and some terms (e.g. the interest rate, the exact maturity of lent and the purpose) may not be decided upon when the agreement is reached. E.g. The Bank of Canada has an agreement in principle that it can swap CAD for JPY with the Bank of Japan if needed but exactly how those drawings would be structured is not known. Activation is when the borrowing central bank tells the lending central bank that it wants to start using the facility so let's agree the terms so that drawings can start taking place. Some swap lines are agreed and are immediately active, this is typically in a crisis such as the 2010 BoE-ECB agreement or the new lines from the Fed during the pandemic.

In a one-off transaction either for an FX intervention or more generally, (e.g., in the case of Chang Mai or Argentina borrowing from the PBoC) there is not much of a distinction between activating the line and drawing on the line. The terms are finalised (activation) and then the borrowing central bank draws on at the line (i.e., the money changes hands) at an agreed date. I can see a case where the central banks first use the activation to signal to market participants that they are ready to intervene before doing so but I cannot think of a case of that happening.

However, if the borrowing central bank is planning on running liquidity facility things are slightly different. Take LiFE as an example. Activating the line means that the BoE and the ECB have agreed that the swap line can be drawn on an ongoing basis to fund the liquidity facility. The actual drawings take place whenever the BoE conducts a Euro operation with positive demand for Euros from UK banks. It turned out that there were only a few test cases where UK banks borrowed what looks like the minimum amount of Eur5mn, so the demand was effectively zero. As a result, while the BoE did draw from the line it was only on a few occasions and in tiny amounts. So, drawings were nil most of the time that the line was active. In a counterfactual world where UK banks suddenly had difficulty funding themselves in Euros, the actual drawings could have been much higher, but the line would be active in either case.

I also wanted to flag that in most swap agreements the lending central bank can always say no to any drawing. The BoE was not free to draw on the line at any time, it required the ECB to authorise the drawing. So activation can also be interpreted as the lending central bank saying at this time drawings are authorised at these terms. The lending central bank can also deactivate the line any time it wishes although there may be a reputational cost to doing so. Moreover, the terms for subsequent drawing can be changed while the line is still active – indeed, legally the terms are drawing specific.

However, it is not practical to renegotiate terms repeatedly and these changes are rare (e.g. the Fed has only changed the spread it adds to the swap line interest rate twice in the past 15 years).

I also wanted to send over a link to a paper Ricardo and I prepared last year summarising these operational aspects: https://cepr.org/publications/dp17096

While composing this email. I also took the opportunity to read your case studies. I don't have much in the way of major comments, they seem very thoroughly researched. A few quick remarks:

- (BoE/ECB/CBI 2010) The details of the arrangements between the CBI and the ECB will be part of the Eurosystem framework for managing liquidity arrangements within the Euroarea. Banks within the Euro Area always borrow from their own national central bank who administers liquidity operations on behalf of the ECB. There is a mutualisation of losses under the Eurosystem although I can't say whether it applied in the case of the CBI (if you know it would be great to find out).
- (BoE/ECB/CBI 2010) On your point regarding why the BoE communicated differently to the ECB: in most swap lines between central banks in developed economics, it is the borrowing central bank that determines how to funnel the liquidity to where it is needed within its banking system. So the ECB determines which of its counterparties can access the facility (although, the BoE can refuse to activate the line if it disagrees with the policy). From a communication perspective, it is appropriate for the ECB to explain which of its counterparties will get the money and not for the BoE to do it or to impose stipulations publicly even when they may exist in the background.
- (BoE/ECB 2019) This webpage has a link to a spreadsheet to the results of BoE operations under LiFE. https://www.bankofengland.co.uk/markets/bank-of-england-market-operations-guide/results-and-usage-data
- (BoE/ECB 2019) The MPC would be the relevant decision-making body for the BoE since these are monetary operations.
- (BoE/ECB 2019) Banks that are members of the Sterling Monetary Framework are not UK banks in an ownership sense. They include the UK based branches and subsidiaries of international banks. The eligibility for the LiFE facility is based on the sterling monetary framework and is in line with the BoE's GBP/USD repo facilities. Hence, broker-dealers can also access the facility. And the point about CCPs not being able to borrow euros is slightly odd. The decision not to make CCPs eligible was taken by the BoE not the ECB as the borrowing central bank picks the counterparties and bears the credit risk. I think Draghi was saying that there was a small gap for CCPs due to how the BoE did things but the ECB would not fill it unilaterally/directly.
- (BoE/ECB 2019) I was under the impression that the BoE paid the ECB its policy rate + 50bps but if you cannot find a public statement of this then do not make the claim.
- (BoE/ECB 2019) I agree with your formal statement regarding the exit strategy. But de facto the line has been deactivated and the BoE would need to activate it again at potentially different terms to restart the facility.

All the best,

Saleem

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From: Wiggins, Rosalind <rosalind.wiggins@yale.edu>
Sent: Wednesday, February 8, 2023 3:38:29 PM
To: Bahaj, Saleem <s.bahaj@ucl.ac.uk>
Cc: Feldberg, Greg <greg.feldberg@yale.edu>; Swaminathan, Lakshimi <lakshimi.swaminathan@yale.edu>
Subject: RE: Yale Program on Financial Stability-Request for review of draft case studies

Hi Saleem,

I hope that the new year is off to a good start for you.

I assume that you have been too busy to review our two cases, which I understand. I wonder though if you can answer a couple quick questions for us:

1. Can you point us to which section of the British laws authorizes the Bank of England to enter into foreign currency swaps? We are having bit of trouble penning this down as the UK laws go back quite a long way.

2. We would also appreciate your thoughts on the use of the term “activate” with regard a swap arrangements. Central banks use the term “activate” variously when discussing swap arrangements, yet, we have not discerned a clear meaning for this term. For example, in 2019 with respect to Brexit:

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