SPECIAL LIQUIDITY SCHEME: INFORMATION

The Bank of England has announced a new Scheme to enable banks and building societies to swap temporarily assets that are currently illiquid in exchange for UK Treasury Bills. This briefing note provides information about the purpose and nature of this initiative, to accompany the Bank's news release.

Addressing the problem

Financial markets are not working normally, which if left unchecked will have an impact on the wider economy. Across the world, there is a lack of confidence in assets created from packages of bank loans, most notably mortgage-backed securities. That lack of confidence was prompted by the downturn in the United States housing market and, in particular, the problems associated with sub-prime mortgages there. The markets that normally trade these assets have, in effect, closed, so it has become very difficult for banks to exchange these assets for cash – the assets are currently 'illiquid'.

As a result, banks in all the major financial centres have on their balance sheets an 'overhang' of these assets, which they cannot readily sell or use to secure borrowing. It is not that banks, at least in the United Kingdom, have made unsustainable losses. But by stretching their balance sheets, this overhang has created uncertainty about the financial position of banks. They have, as a result, been reluctant to lend, even to each other. That reluctance is evident in the interest rates charged on interbank lending, which have risen, even though Bank Rate has fallen. This situation is affecting all banks and building societies and has started to affect their willingness to lend money to individuals and businesses. It had been hoped that these problems would be resolved as markets returned to normal. But it is now clear that there is no immediate prospect that markets in mortgage-backed securities will operate normally. The situation will improve only if the overhang of illiquid assets on banks' balance sheets is dealt with. Only then will banks be willing to lend to each other and, importantly, to the wider economy.

Central bank operations

Banks routinely borrow money from central banks in exchange for assets. They do so to manage their day-to-day cash needs as they lend and borrow funds. In response to the stresses in financial markets, central banks worldwide have extended their lending facilities. Since August, the Bank of England has increased by 42% the amount of central bank money made available to financial institutions. It has increased from 31% to 74% the proportion of its lending to the market that is for a

term of at least three months. Since December, the Bank has also widened the range of high-quality assets accepted in its 3-month lending operations to include mortgage-backed securities. The stock of outstanding lending against that wider range of collateral is £25bn. These changes have aimed to alleviate the problem of financing the large overhang of illiquid assets on banks' balance sheets.

The new Scheme

To tackle this problem decisively, the Bank of England has designed a Special Liquidity Scheme to allow banks and building societies to swap for up to three years some of their illiquid assets for liquid Treasury Bills. The purpose of the Scheme is to finance part of the overhang of currently illiquid assets by exchanging them temporarily with more easily tradable assets. The banks can then use these assets to finance themselves more normally.

All of the banks and building societies that are eligible to sign up for the standing deposit and lending facilities within the Bank's Sterling Monetary Framework will be able to take part in the Scheme.

Usage of the Scheme will depend on market conditions. Discussions with banks suggest that initial use of the Scheme will be around £50bn.

The Scheme will involve the Government, through the Debt Management Office, issuing new Treasury Bills to lend to the Bank of England.

Banks will be required to pay a fee to borrow the Treasury Bills. The fee charged will be the spread between the 3-month London Interbank interest rate (Libor) and the 3-month interest rate for borrowing against the security of government bonds, subject to a floor of 20 basis points.

This Scheme will be completely ring-fenced from, and independent of, the Bank of England's money market operations. So it will not interfere with the Bank's ability to implement monetary policy.

The facility has three important characteristics:

(i) Long-term asset swaps

Banks will be able to enter into new asset swaps at any point during a six-month window, starting today. To provide banks with the certainty about liquidity that is needed to boost confidence, assets will, unless they mature within one year, be swapped for one year and banks will have the opportunity, at the discretion of the Bank of England, to renew these transactions for a total of up to three years. So by October 2011, all assets will have been returned to the banks, all Treasury Bills to the Bank of England, and the Scheme will close. The Scheme is a one-off operation to deal with the existing overhang of assets held by banks.

(ii) Credit risk stays with the banks

Given its scale relative to the size of the Bank of England's balance sheet, the Scheme is indemnified by the Treasury but is designed to avoid the public sector taking on the risk of potential losses. That risk will remain with the banks and their shareholders. The assets are pledged by banks as security against which they will borrow the Treasury bills. When a swap transaction expires, the assets are returned to the banks in exchange for return of the Treasury Bills.

At all times, the banks must provide as security to the Bank of England assets worth significantly more than the Treasury bills they have received in return. If the value of their assets pledged as security falls, the banks must provide more assets to the Bank of England, or return some of their Treasury Bills.

The Bank of England will decide the margin between the value of the Treasury bills borrowed and the value of the assets banks are required to provide as security. For example, if a bank were to provide £100 of AAA-rated UK residential mortgage-backed securities, it would, depending on the specific characteristics of the assets, receive somewhere between £70 and £90 of Treasury Bills. A complete list of margins is included in the market notice.
http://www.bankofengland.co.uk/markets/money/marketnotice080421.pdf

The public sector would be exposed to a loss only in the very unlikely event that a participating bank defaulted and the value of the assets it had placed as security with the Bank of England later proved inadequate to cover the value of the Treasury bills that had been swapped for the assets. This is why the Bank of England will insist that banks provide assets with a value much greater than that of the Treasury bills exchanged. Even if a bank defaults and the public sector is left with illiquid assets,

the Bank of England could choose to hold the assets until they mature, earning the return on them over their lifetime.

(iii) The assets banks can swap

The assets held by financial institutions that can be used in the Scheme are largely the same as those accepted for the Bank of England's recent special three-month lending operations.

The main category of assets will be securities backed by residential mortgages. Securities backed by credit card debt will also be eligible. These assets will be high quality – rated as AAA. If the assets were to be down-rated, banks would need to replace them with AAA assets. The facility will not accept raw mortgages and none of the underlying assets can be derivative products. The Bank of England routinely accepts assets denominated in currencies other than sterling. It will not accept securities backed by US mortgages.

The Scheme is designed to deal with the overhang of existing assets on banks' balance sheets, not to create artificial incentives to undertake new lending. To that end, only securities formed from loans existing before 31 December 2007 will be eligible for use in the Scheme.

Bank of England
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