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Private Secretary to
Michael Howard Esq QC MP
Department of Trade and Industry
1 Victoria Street
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NBPN.

11 December 1986

Dear David

**CONSULTATIVE DOCUMENT ON THE WHOLESALE MARKETS IN STERLING,
BULLION AND FOREIGN EXCHANGE**

The Economic Secretary thought Mr Howard might like to see the final version of this consultative document, which the Treasury and the Bank of England will be publishing jointly on 18 December.

The document fulfils the undertaking the Economic Secretary gave in May to consult on the use the Bank proposes to make, subject to Treasury approval, of the provisions in section 43 of the Financial Services Act which allow for the establishment of what is virtually a non-statutory regime for the supervision of these markets. The document falls into two parts.

First, a paper by the Treasury setting out what the wholesale markets are, why they are to continue to be regulated on a non-statutory basis as Parliament agreed this summer, and how the Bank's supervision will fit in with the Financial Services Act regime. It also seeks comments on the "conditions and arrangements" which the Bank proposes to introduce under section 43.

Second, a paper with annexes by the Bank setting out in detail how it intends, subject to consultations, to supervise these markets (the copy of this paper below is in uncorrected proof form). The Bank's approach is derived from its rules for banking supervision and supervision of the gilts market, ie a "fit and proper" test, capital adequacy rules, and monitoring procedures. In addition, the Bank will require adherence to an extended version of the Code of Conduct which is at present in force in the foreign exchange and the sterling deposit markets.

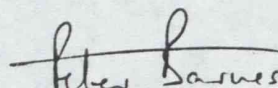
Both parts of the document have benefited from comments by DTI officials on earlier drafts.

Presentation will be low key, emphasising that these are technical proposals setting out in detail arrangements which Parliament has already approved in more general terms in the Financial Services Act. Although the document will not be a Command Paper, the Economic Secretary will make copies available in the Libraries of both Houses and will announce publication through an arranged PQ. The document will not be on public sale, but will be available on demand from the Treasury and the Bank and will be distributed by the Bank to interested parties in the markets in the same way as the Bank's other consultative papers on supervision. Comments are invited by the end of February.

There is one outstanding policy point, not discussed in the document, which the Economic Secretary proposes to consider further during the consultation period. This is whether an appeals system is necessary against decisions of the Bank. The Financial Services Act is silent on this subject. Officials will be in touch with the DTI about this point shortly.

I am sending copies of this letter to David Norgrove (No 10) and John Footman (Governor's Office).

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'Peter Barnes', written over a horizontal line.

P D P BARNES
Private Secretary

The future regulation of the wholesale markets in sterling, foreign exchange and bullion

H M Treasury

**Bank of England
December 1986**

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The future regulation of the wholesale markets in sterling, foreign exchange and bullion

Introduction

1 This paper fulfils the Government's undertaking to issue a Consultative Document on the future regulation of the wholesale markets in sterling, foreign exchange and bullion, given by the Economic Secretary to the Treasury in a Written Answer to the House of Commons on 7 May 1986.

2 Most of these markets have for many years been overseen by the Bank of England on a non-statutory basis. They are recognised as constituting a distinct group of short term markets, whose main participants are professional operators, typically dealing in large amounts. The Government has decided that they should in future be subject to a single system of supervision, for which the Bank should continue to have responsibility, on a non-statutory basis.

3 Some wholesale market transactions come within the definition of investment business in the Financial Services Act: others fall wholly outside it. To reduce the area of supervisory overlap, Section 43 of that Act exempts persons from the requirement to be authorised under the Act in respect of transactions specified in schedule 5 provided that they are on a list to be drawn up by the Bank, on conditions to be approved by the Treasury. The Treasury must also approve the Bank's arrangements for admission to and removal from the list.

4 The rest of this paper describes the scope of the Bank's supervision of the wholesale markets, and the proposed regulatory framework. Central to this will be the list of institutions accepted by the Bank as fit and proper to act either as a principal dealer (including a market maker) or broker in the relevant markets (the term "principal dealer" is used here in the sense of paragraph 17 of Schedule 1 of the Act). It is expected that all major market participants will apply for inclusion on the Bank's list even though some participants may not require exemption under Section 43 of the Financial Services Act. The conditions which the Bank has asked the Treasury to approve for admission to the list, and the arrangements for admission to and removal from the list, are set out in paragraph 24 below. This paper should be read in conjunction with the following paper by the Bank of England, which describes in more detail the factors which the Bank proposes to take into account in determining whether these conditions have been met.

The continuing role of the Bank of England

5 The wholesale markets form a coherent set of markets in which professionals deal in large amounts in a variety of short term instruments. The Bank of England has for many years exercised general oversight over significant parts of these markets. Under the Banking Act 1979 it supervises the banks and other deposit taking institutions that are the main participants in most of these markets. It is itself active in a number of the markets on a day-to-day basis and so has operational experience and understanding. Indeed the Bank was primarily responsible for establishing the Joint Standing Committees in both the sterling and foreign exchange markets which at present serve as a vehicle for self-regulation in these markets. These Committees endeavour to ensure that the highest standards are observed and they were largely responsible for drawing up the Codes of Conduct which the new arrangements will now develop and apply more widely.

6 The Bank's established involvement and expertise make it the natural body to regulate these markets. The Government's view is that initially at least the right way forward is to build on the existing non-statutory regime, and for the Bank to develop and extend its present approach to wholesale market supervision. The Bank's aim will be to ensure that market players pay proper attention to the spirit as well as the letter of the rules. Market participants should have a clear interest in continuing to assist the Bank to make non-statutory regulation effective.

7 The new arrangements will therefore widen the scope of the Bank's supervision to cover the whole of these markets in a consistent manner. The intention is not to change the fundamental principles involved but to ensure that these are universally known and observed. It is in the interests of market users and the financial system generally that institutions operating in professional markets should be fit and proper to do so, observing appropriate standards of prudence and business conduct, so that the markets are "clean", and it is in the national interest that London should maintain its standing as a major financial centre of the highest reputation.

The scope of the Bank's supervision

8 The wholesale markets in sterling, foreign exchange and bullion which the Bank will supervise under the new arrangements are defined in terms of the instruments traded in them, the institutions which do the trading, and the size of transaction usually involved.

(i) Instruments

9 Broadly speaking, the instruments traded on the wholesale markets are short-term in nature and serve what may be termed the "treasury" requirements of market users. As noted above some of these instruments would fall within the definition of "investment" for the purposes of the Financial Services Act. Section 43 of the Act will exempt persons on the Bank's list from the requirement to be authorised in order to conduct wholesale market

business (described in more detail in paragraph 24 below). Business conducted within the limits of such an exemption will therefore be outside the supervisory regime established under the Act but will instead be subject to non-statutory supervision by the Bank. Some instruments traded in the wholesale markets would not fall within the definition of "investment" in the Act. Nevertheless the Bank will expect to see the same standards—in particular, adherence to the relevant Code of Conduct in that market—irrespective of whether particular instruments are inside or outside the scope of the Financial Services Act. And the coverage of the existing Codes of Conduct will be extended and rationalised to cover the whole area.

10 The table below lists the instruments which will be covered by the Bank's wholesale market supervision.

Table I

- | | |
|---|---|
| 1 Sterling wholesale deposits. | 8 Other public sector debt with an original maturity of not more than 1 year (eg Treasury bills, but not gilt-edged securities, for which a separate regulatory regime has already been established). |
| 2 Foreign currency wholesale deposits. | 9 Any certificate (or other instrument) representing the securities covered in 5—8; or rights to, and interests in, these investments. |
| 3 Foreign exchange. | 10 Options or futures contracts on those particular investments; on any currency (including sterling); or on gold or silver. |
| 4 Gold and silver bullion. | 11 Forward rate agreements, or other "contracts for differences" involving arrangements to profit (or avoid loss) by reference to movements in the value of any of these particular investments; or the value of any currency; or in the interest on loans in any currency. These include interest rate and currency swaps. |
| 5 Certificates of deposit (CDs), or other debt instruments issued by institutions authorised under the Banking Act 1979 or by UK building societies, with an original maturity of no more than 5 years. This class of instruments is described in the Financial Services Act by the generic term "debenture". | |
| 6 Other debentures with an original maturity of not more than 1 year. | |
| 7 Local authority debt (bonds, loan stock or other instruments) with an original maturity of no more than 5 years. | |

Note 1 Transactions in these instruments include sale and repurchase agreements ("repos") where the repurchase will take place within twelve months of the sale.

Note 2 The exemption covers instruments denominated in foreign currencies as well as in sterling; and transactions by listed institutions will come within the Bank's supervisory framework even if one of the other parties to the transaction is operating abroad.

Note 3 The regulation of deposit-taking under the Banking Act is not affected in any way.

(ii) Institutions

11 As noted above, these are professional markets. Two main categories of institution operate in them. First, *principals* who deal on their own account. Many of these will already be authorised under the Banking Act, because of their deposit-taking activity in other parts of the markets. But some principals are non-banks. Second, specialist *brokers*, who act purely as agents in bringing together two counterparties to a transaction.

12 The definition of "investment business" in the Financial Services Act excludes certain transactions entered into by a person as principal. This exclusion is defined in detail in paragraph 17 of Schedule 1 to the Act. The purpose of the exclusion is, broadly speaking, to catch within the definition of "investment business" those businesses, such as market makers, whose transactions as principal amount to offering an investment service while excluding those who can more properly be regarded as customers of rather than participants in the financial services industry. The Bank too will be primarily concerned with regulating participants in the wholesale money market and not their customers.

13 The activities of listed institutions to which the section 43 exemption will apply are set out in paragraphs 12, 13 and 15 of Schedule 1 of the Act. In brief, these refer to dealing in investments, arranging deals in investments, and advising on investments.

(iii) Size

14 Professionals trading in the wholesale markets usually do so in large amounts. The general principle applied in the Financial Services Act to these markets is to deem as wholesale all transactions which are at or above minimum limits. The purpose of these limits is to ensure that only professional investors or very wealthy individuals who can reasonably be expected to take professional advice will be involved in dealings which meet the size criterion. The minimum size limits are £100,000 (or the equivalent in foreign currency) for debentures, bonds, loan stock and purchase and resale agreements; and an underlying value of £500,000 (or the equivalent in foreign currency) for options, futures and contracts for differences, as these instruments are normally traded on margin and may be traded on a small (or even no) immediate payment.

15 Professionals trading with each other will on occasion trade in smaller amounts than the limits described above. The Act therefore allows for transactions below these limits with established wholesale customers to be engaged in under the exemption provided by section 43.

16 Listed institutions who carry out transactions in the instruments listed in table 1 which are at or above the limits are exempt from the Act, as are transactions

of this size arranged by a listed broker. (The only exception is where transactions are carried out on or under the rules of a Recognised Investment Exchange (RIE) in which case they remain under the Financial Services Act regime whatever their size.)

17 Transactions below the limit are only exempt if one or more of the following conditions are satisfied:

- (a) both counterparties are on the Bank's list under section 43 of the Financial Services Act;
- (b) one of the counterparties is a listed institution and the other is a "wholesale counterparty" (defined below). (This condition applies whether the deal is struck direct or through a listed broker.)
- (c) both counterparties are "wholesale counterparties" and the deal is struck through a listed broker.

18 A "wholesale counterparty" is a person who has entered into a transaction above the minimum limit during the past 18 months. Such a person is, however, a "wholesale counterparty" *only* in relation to the counterparty with which he or she carried out that transaction. For example, investor A carries out a transaction worth £120,000 with listed institution B. For the next 18 months B will be exempt in respect of any further transaction in a relevant instrument with A, regardless of the size of the transaction. But the transaction between A and B will not entitle another listed institution, C, to treat A as a wholesale counterparty.

19 Any listed institution which proposes to enter into a transaction over the minimum limit with a customer who would thereby become a wholesale counterparty in relation to that institution must warn its customer of the consequences in terms of loss of protection before entering into the transaction.

20 It will be open to a listed institution to decide that it will only deal with certain types of wholesale counterparty. It might, for instance, decide as a matter of practice to deal under the limit only with those counterparties whose last transaction over the limit was within the previous year, or some other period of less than eighteen months.

21 The Bank will not generally regulate small transactions or transactions to which neither counterparty is listed, unless arranged by a listed broker. Small transactions which fall within the definition of investments under the Financial Services Act will be regulated under that Act.

22 The Bank's supervision of the wholesale money markets does not extend to transactions on or under the rules of a Recognised Investment Exchange (RIE). An institution on the Bank's list will not be exempt in respect of such transactions, which will continue to be covered by the Financial Services Act.

The Bank of England's list

23 The Bank will supervise all wholesale market institutions who are on a list which it will draw up for that purpose. By virtue of section 43 of the Financial Services Act, inclusion on the Bank's list brings with it exemption from the Financial Services Act in respect of those wholesale market activities which would otherwise have been regulated by the Act. Institutions which hold adequate Financial Services Act authorisation will not legally be required to be on the Bank's list in order to operate in the wholesale markets. Nevertheless, in the interests of the coherent surveillance of these markets, they will be expected to apply for admission to the Bank's list and to accept supervision by the Bank.

24 Section 43 of the Financial Services Act requires the Treasury to approve the conditions which the Bank will impose for admission to the list, and the arrangements it makes for a person's admission to and removal from the list. The conditions and arrangements which the Bank has asked the Treasury to approve are as follows:

An applicant will need to satisfy the Bank that it is "fit and proper", by reason of its capital, managerial and operational resources, its standards of business conduct and its high reputation and standing, to undertake the particular activity. In determining whether an applicant meets this condition, the Bank will therefore take into account the following factors:

- (i) that the financial position of the applicant is sound;*
- (ii) that its ownership structure does not result in any unacceptable conflicts of interest, nor in any other way a source of potential weakness;*
- (iii) that its management and staff are of high quality and experience and that its systems are effective;*
- (iv) that its reputation in the market-place is good; and*
- (v) that it is able and willing to adhere to an undertaking to observe appropriate code(s) of business conduct, specified by the Bank of England from time to time.*

A firm applying for inclusion on the list will be required to submit a business plan setting out the type or types of activity it intends to undertake, including types of instrument in which it intends to trade. Its permitted scope will be limited to those activities agreed with the Bank, subject to review.

Applications should be addressed to the Bank in writing. Applicants should supply any information requested by the Bank which the Bank reasonably requires to form its view on the application.

Applications should in any event include the business plan described above, a description of the applicant's organisation and staff resources, details of ownership, information on directors and managers, and details of internal control systems. Where appropriate, applicants should specify which of their operations are already supervised, and where.

The Bank will also require the applicant's latest audited accounts. Where it would fall to the Bank to assess an applicant's capital adequacy, the applicant will be asked for any additional information necessary to demonstrate its financial soundness.

The Bank will give its decision within three months of receiving an application. Where the Bank is minded to reject an application, it will give the applicant notice of that fact and specify its reasons. The Bank will allow the applicant reasonable opportunity to make representations and will consider any representations made before taking its decision.

The Bank will give notice to any listed institution which it considers should no longer be included in the list, that it may be removed from the list. The Bank will give its reasons for taking that view. The institution will be given reasonable opportunity to make representations as to why it should not be removed from the list and, where relevant, to take remedial action, before the Bank takes its decision.

25 The more detailed factors which the Bank proposes to take into account in determining whether its conditions have been met, and the principles which the Bank proposes to adopt in supervising the markets generally, are set out in a Consultative Paper by the Bank which is published under the same cover as this consultative document. The Bank's paper should therefore be read in conjunction with this document.

Consultation

26 Comments on the proposals in this Consultative Document and in particular on the Bank's proposed conditions and arrangements should be addressed to FIM2 Division of the Treasury to arrive before the end of February 1987. The Treasury will take account of comments received in deciding whether to approve the Bank's proposed conditions and arrangements. Comments on the Bank's paper should be sent to the Head of the Wholesale Markets Supervision Division of the Bank, also before the end of February 1987. The final version of the proposals will be published as soon as practicable once consultations have been completed.

27 The arrangements outlined in this Consultative Document and in the Bank's paper will, of course, be modified from time to time thereafter in the light of experience and the evolution of the market. If it should become necessary, the Government would not hesitate to legislate to improve the system.

HM TREASURY

A draft framework for regulation of the wholesale markets in sterling, foreign exchange and bullion

Introduction

1 The Treasury paper describes the responsibility placed on the Bank for the regulation and supervision of the wholesale markets, and the general framework within which this will be conducted. Central to the framework will be a list of appropriate institutions which the Bank will establish, as set out in the Treasury paper. This companion paper describes in rather more detail the conditions, approved by the Treasury, about which the Bank will need to be satisfied in establishing and maintaining an institution's name on the list.

2 The Bank will wish to include on the list all major market participants which act either as market maker or broker in the wholesale sterling, foreign exchange or bullion markets. The term market maker is used here in the sense of an institution which, as principal, holds itself out as willing to enter into relevant transactions at prices determined by him generally and continuously rather than in respect of each particular transaction; or holds itself out as buying investments with a view to selling them; or regularly solicits members of the public for the purpose of entering into investment transactions.

The Bank's list

3 An applicant will need to satisfy the Bank that it is "fit and proper", by reason of its capital, managerial and operational resources, its standards of business conduct and its high reputation and standing, to undertake the particular activity.

The "fit and proper" test

4 In determining whether an applicant meets this condition, the Bank will therefore take into account the following factors:

- (i) that its financial position is sound;
- (ii) that its ownership structure does not result in any unacceptable conflicts of interest, nor is in any other way a source of potential weakness;
- (iii) that its management and staff are of high quality and experience, and that its systems are effective;
- (iv) that its reputation in the market-place is good; and

- (v) that it is able and willing to observe the appropriate code(s) of business conduct.

5 A firm applying for inclusion on the list will be required to submit a business plan setting out the type or types of activity it intends to undertake, including types of instrument in which it intends to trade. Its permitted scope will be limited to those activities agreed with the Bank, although this will be subject to review on request.

Financial soundness

6 All listed institutions will need to satisfy capital adequacy tests designed to ensure that the risks being taken are not disproportionate to the firm's own resources. It needs to be stressed, however, that no set of supervisory arrangements can remove all risk of default while at the same time allowing a competitive market to function effectively. It must therefore remain the responsibility of all participants in the wholesale markets to satisfy themselves as to the creditworthiness both of those with whom they deal and also the ultimate issuers of any paper traded.

7 In framing its capital adequacy criteria, the Bank will make two important sorts of distinction. One is *institutional*: the Bank will apply its own independent tests (as wholesale market supervisor) to some listed institutions but not to others already supervised by certain other regulatory authorities. The second is a *functional* distinction between firms acting as principal traders (taking positions on their own account) and those acting purely as brokers.

8 Many institutions eligible for inclusion on the Bank's list will already be subject to capital adequacy tests, set by other regulatory authorities either in the UK or overseas. For example, the Bank itself monitors the capital of all institutions authorised under the Banking Act which are incorporated in the UK, as well as the market makers and certain other firms operating in the gilt-edged market. Where the Bank already sets its own capital adequacy tests, these will take into account the capital requirements of the firm's wholesale

market activity, and no separate tests will be applied. In cases where the tests are set by another supervisor, eg the Building Societies Commission in the case of building societies, the Bank will discuss with that other supervisor how best to reduce unnecessary supervisory overlap. In particular, the Bank will investigate on a case-by-case basis whether the monitoring of capital adequacy should be delegated to the other supervisory authority, although the responsibility for ensuring the adequate capitalisation of listed institutions will remain with the Bank. Any such delegation will entail the other supervisor, when assessing capital adequacy, taking into account the risks arising from wholesale market activities.

9 A listed institution operating as a principal in the wholesale markets may be one of three broad types:

- (i) Its business may be confined to the UK wholesale markets. In such a case, the Bank would expect to assess capital adequacy itself as part of its wholesale market regulation (although if the entity concerned was, for instance, a bank or gilt-edged market maker already supervised by the Bank, no additional tests would be necessary).
- (ii) It may be a separately capitalised UK institution with some, perhaps large, part of its business outside the wholesale markets. Examples might include some building societies, or institutions which are also authorised under the Financial Services Act. In such cases the Bank may either assess capital adequacy itself if the scale of the wholesale activity is proportionately large, or delegate the monitoring of capital to another regulatory authority. Close co-operation between the respective supervisors will in any event be required in such cases.
- (iii) It may be an overseas entity operating in the wholesale markets and elsewhere. In such cases, the Bank will either assess capital adequacy itself, by requiring a separately capitalised entity to be established in the UK, or it may rely on the supervision of an overseas authority which regulates the institution in its home country. Where the entity is a branch of an overseas bank authorised under the Banking Act, the Bank will normally take account of the supervision of the home authority, as it does now under the Banking Act. In other cases, such as overseas securities firms, the Bank will discuss the position with the firm in question and, if necessary, with the overseas authority concerned. Where such an institution is also supervised under the Financial Services Act, the Bank will discuss with the UK financial supervisor(s) the best approach to adopt to monitor its capital adequacy.

10 In all cases where the Bank is not directly assessing capital adequacy itself, the Bank will seek to ensure that the standards applied are commensurate with those applied by the Bank in relation to wholesale market trading.

The Bank's Own Capital Adequacy Criteria

11 In assessing capital adequacy, a variety of conflicting objectives have to be reconciled. For instance, the tests should be broadly comparable with those which already exist for banks and gilt-edged market makers, in order to ensure a level playing field amongst all these institutions. The rules should also be relatively simple, yet sufficiently precise to avoid major anomalies.

12 At present the capital adequacy tests applied to banks focus chiefly on credit risk (the risk that on maturity claims on others will not be met in full), while those applied to gilt-edged market makers reflect position risk (the risk that the value of a position will vary as a result, among other factors, of interest rate movements). The Bank is currently undertaking work on position risk, in conjunction with the Securities and Investments Board (SIB), with the intention of developing a system which treats securities in a way which reflects both sets of risk. The task of combining the two approaches is a difficult one, since it involves the categorisation of instruments both by maturity and by issuer/obligor, a problem which is greater than that faced in gilt-edged market supervision which concentrates primarily on the liabilities of one sovereign issuer. Bringing about a reasonably level playing field for all institutions on the list will therefore be a complicated task, and, to be achieved, will require close co-operation between supervisors, not only domestically but also internationally. The construction of suitable capital adequacy tests is made still more difficult by the potential variety of principals on the Bank's list, with some likely to be involved predominantly in credit risk and others, perhaps the majority, more involved in position risk.

13 Many institutions may wish to be subject to a relatively simple set of rules, which are easy to compute and straightforward in application. However, a broadbrush approach inevitably leads to anomalies, which in many cases will tend to penalise an institution undertaking relatively sophisticated operations. A movement towards more complex systems of risk assessment may to some extent be inevitable, particularly to develop appropriate means of dealings with hedges (which often involve off balance sheet positions in derivatives such as futures and options).

14 The Bank will therefore consider whether it is possible to develop two alternative means of assessing capital adequacy. For most institutions a relatively simple set of rules might be applied. For others, with greater expertise and substantial hedging activity, a

more complicated and precise set of rules might be more appropriate. The simple set of rules would inevitably be somewhat more restrictive in some areas than the complicated system. Those firms opting for the more sophisticated system would need to satisfy the Bank that their internal systems were adequate for the complex calculations required.

Capital adequacy tests for principals

15 The capital adequacy tests which the Bank proposes itself to apply are set out in Annex I of this paper. They are based on a categorisation of assets and liabilities principally by maturity and type of issuer, with these being weighted to reflect the risk of loss on such positions. These initial proposals are necessarily highly tentative and the categorisation of assets and in particular the weights shown should be treated as purely illustrative at present. The Bank will welcome comments on the general approach adopted, and will amend the proposals as appropriate. In any event the system will continue to be kept under review after its introduction, with the weights and other details subject to modification in the light of further analysis, and experience of operating the system in practice.

16 The approach adopted in assessing capital adequacy will be based on limits on the level of acceptable risk exposure as a multiple of capital base. It is intended that in cases where the balance-sheet consists of short term assets with little credit risk, relatively high levels of gearing will be allowed. By contrast where assets are of longer maturity and reflect exposures to the non-supervised private sector, a principal will be able to gear up less on its capital. The risk weights have been designed with this end in mind. The Bank is considering whether it should supplement the system by an additional requirement, set either in absolute terms or based on a turnover and/or expenses criterion.

17 The Bank will require positions to be marked to market daily, with any gains or losses taken to capital base immediately. It will also expect all principals to observe the limits on risk exposure in relation to capital base continuously. If the capital base falls for any reason, risk exposure should be reduced immediately, so that it remains within the maximum risk: capital ratio allowed. Although the Bank will only require returns from each principal at the end of each month on a regular basis, it reserves the right to call for additional returns at any time. Persistent breaches of the risk: capital ratio, or evidence that it is only being observed on regular reporting dates, will cause the Bank to consider whether the firm should be removed from its list.

Capital adequacy for agents and brokers

18 In the traditional wholesale markets, brokers do not carry out transactions on a 'matched principal' (or

'blind broking') basis, but instead act purely as the arrangers of deals, passing the names of the principal counterparties. As a result, settlement is effected directly between the two principals involved, and the broker is at risk principally for differences arising due to errors or omissions on his part.

19 In general, the Bank wishes to maintain this clear distinction between the functions of brokers and principals in these markets and the capital requirements in Annex II are established on this basis. Nevertheless in some of the newer instruments different conventions might be appropriate. The Bank will consider whether to allow in some specific areas matched principal transactions, if it can be established that there is a genuine market demand for this form of broking. In that case more stringent capital requirements would be established, to reflect the risk that a broker might be left with an unintended open position. In any event, because the monitoring of a broker's capital adequacy cannot easily be applied if a firm also operates in other markets, including markets overseas, the Bank will require a broker to be a separately capitalised entity incorporated in the United Kingdom.

20 There will be no minimum capital requirement for a broker, although the firm will need to maintain sufficient liquid capital to cover a minimum of two months' expenditure [and/or a minimum of 'n' weeks' turnover]. The broker will thus be cushioned from the risk that turnover and income may suddenly decline, leading to losses unless overhead costs can be commensurately reduced. In addition, a broker may be held responsible for errors in a deal which the firm has arranged, and so be required to meet any resulting differences. It may be possible to arrange appropriate insurance (such as fidelity and errors and omissions insurance) to cover such risks, in which case less demanding capital adequacy tests may be set.

Reporting requirements for capital adequacy

21 The Bank's supervision of capital adequacy for both principals and brokers will be based on end-month returns of the capital resources available from which to meet losses, together with the figures for risk exposure. These tests will form the starting point for the assessment of capital adequacy, which will be developed further by means of regular quarterly bilateral meetings with each institution. Where the Bank already undertakes supervision of an institution under the Banking Act it is not envisaged that additional interviews will be required, but instead questions relating to wholesale market transactions will normally be subsumed within the existing supervisory arrangements. The same will be true for market makers, money brokers and inter-dealer brokers in the gilt-edged market, where the Gilt-Edged Division of the Bank will carry out the supervision. In

cases where the Bank has delegated the monitoring of capital adequacy to another supervisory authority, it will wish to discuss with that authority the arrangements most appropriate for dealing with matters associated with the supervision of the wholesale markets.

22 The Bank may carry out spot checks and/or ask for additional returns at any time, to ensure that the capital adequacy tests are being applied continuously by all institutions, and that the regular end-month reports form a representative picture of an institution's business. In this context it will wish to explore the possibility of co-operation with the accountancy profession, along the lines of the proposals recently published in the new Banking Bill.

Adequacy of management and operational resources

23 The Bank will wish to satisfy itself that a listed firm has sufficient managerial resources to conduct effectively the activities proposed in the firm's business plan, and that its directors and managers have the knowledge, experience and good reputation necessary for their intended responsibilities. Similarly, the Bank will wish to ensure that the numbers of skilled and experienced staff are sufficient for the firm's intended scale of operations.

Systems

24 To enable the firm's management to exercise their function effectively, and in particular to assess on a continuing basis the financial soundness of the firm, adequate control systems and accounting records must be maintained. These should also be sufficient to allow the firm to satisfy all the Bank's data requirements, in all respects.

Reputation

25 Listed institutions will be expected to have a good reputation and be of good standing in the market: they will need to carry on their business with the highest degree of honesty and integrity. Where a firm is already authorised under the Banking Act (by the Bank), the Building Societies Act (by the Commission) or the Financial Services Act, [by the SIB or a Self-Regulating Organisation (SRO)], the Bank will start from the presumption that this condition is satisfied. Where applicants to the list are seeking authorisation simultaneously from the SIB or an SRO, the Bank will co-operate with the relevant organisation. For a firm not already authorised or supervised elsewhere, the Bank will require further information and may take confidential soundings in the market from established market practitioners to satisfy itself about the firm's good standing. In addition a broker will be required to demonstrate in its business plan that there is likely to be a broadly-based market demand for its services.

Ownership

26 The Bank will be concerned to ensure that the ownership of listed firms does not represent a source of potential financial weakness nor give rise to unacceptable conflicts of interest, and firms will be required to satisfy the Bank in these respects. The Bank may also seek assurances from substantial shareholders in listed firms that they accept ultimate responsibility for the liabilities of the listed firm.

27 Until recently under the Bank's arrangements for the foreign exchange and currency deposit markets, no principal was allowed to own a stake of 10% or more in a broker. This rule, which ensured the independence of principal and broker, has never been applied in the sterling markets. The Bank has announced the withdrawal of this particular rule and its replacement by a rule preventing brokers in the foreign exchange and currency deposit markets from arranging deals with related counterparties (still using the 10% equity stake limit). The Bank will wish to discuss the application of this rule to *all* wholesale money market instruments and will in any case wish it to apply in the *traditional* sterling deposit market as well as in the foreign exchange and currency deposit markets.

Business Conduct

28 All listed firms must agree to observe the Code of Conduct for wholesale market activity currently in force. All those involved in dealings in the markets should be aware of its provisions. The Code establishes general principles of good market conduct in all the areas embraced by the Bank's regulation. It also sets out a number of conventions, in respect for example of market definitions and terminology, which differ from market to market, although these are inevitably not entirely comprehensive. The distinct responsibilities of principals and brokers are separately identified. A draft Code is set out in Annex III.

29 The Bank stands ready to receive complaints from any party to a transaction where it is alleged that a breach in the Code may have occurred. The Bank will investigate such complaints, drawing on whatever advice and expertise from market practitioners that it feels appropriate. During this investigation the Bank will discuss the nature of the allegations with those involved and will establish appropriate internal arrangements to assess, and review, all such cases.

30 Where a breach of the Code is established, and depending on how serious it is, the Bank may publicly reprimand individuals or firms, restrict a firm's activities or, if the breach is sufficiently serious to cast doubt on the competence of the firm, or on its integrity, suspend or ultimately remove the offending firm from the list. The Bank will promulgate its decisions as widely as it considers appropriate, but in any case to the SIB and other relevant regulatory authorities whether in the UK or abroad.

31 There will be no compensation fund for listed institutions *per se*, either to compensate counterparties in the event of a listed institution failing or as a result of an institution breaching the Code, but if any breaches of the Code are found to have occurred, the offending institution(s) will be expected to make redress to the damaged party(ies).

London Instruments

32 Although the Bank's regulatory regime relates to secondary market activity, the Bank believes that homogeneity of the primary instruments in issue helps to avoid investor confusion and facilitates market trading. The Bank will therefore wish to consider with market participants the possibility of extending the distinction at present adopted in the CD market between London and non-London certificates, to other instruments, with London paper conforming to uniform guidelines and standards.

Regular Monitoring and Supervision of Listed Institutions

33 Once established, a listed institution will need to continue to satisfy the Bank that it should remain on the list. As noted above this will involve, where appropriate, regular monitoring of capital adequacy and prior notification of other relevant information. In undertaking the continuous monitoring process, the Bank will bear in mind information received from other regulatory authorities, and by itself in respect of institutions whose activities extend beyond the wholesale market area.

Right to remove names

34 If the Bank judges that a listed institution no longer meets the approved criteria, it will draw its misgivings to the attention of that institution and may ultimately remove its name from the list.

35 Any complaints that the Code has been breached in any respect will be fully investigated. An institution could be removed from the list if a serious breach were established.

36 If a listed institution which is also authorised under the Banking Act, Building Societies Act or Financial Services Act has that authorisation terminated, there must be a presumption that it will also lose its listed status, unless it can show good cause why this should not be so.

37 Before a listed institution experiences a change in ownership or controlling interest (defined as a shareholding of 15% or more), prior notification must be given, to allow the Bank to satisfy itself that this will not become a source of weakness. Failure to do so could lead to removal from the list.

Arrangements for establishing and subsequently amending the list

38 Applications to become listed institutions will initially be invited, in writing, at any time within two months after the publication date of the final version of these papers. Applicants should provide sufficient information as the Bank may reasonably require in order for it to make a judgment on whether the institution should become listed, in the light of the conditions described in this paper. Applicants will need to include a business plan; details of the internal organisation of their activity and staff numbers involved; adequate details of ownership; the names and background of those involved at managerial and directorial level in the firm; adequate information on control systems; and details of any aspects of their activity which are supervised elsewhere and the nature of such supervision. The latest audited accounts should also be provided unless already previously made available to the Bank. Those institutions for which the Bank will be assessing capital adequacy will also need to demonstrate their financial soundness, in the sense used in this paper.

39 The Bank will consider each application, discuss it with the institution concerned and form its judgment within three months. It will communicate its decision then to the relevant institution, specifying where relevant its reasons for rejecting an application. Those rejected will be allowed reasonable opportunity to make representations to the Bank.

40 A list will be published around end-August 1987. Thereafter at any time applications may be made to become listed institutions; and the list will be periodically brought up-to-date. The Bank will provide a certified copy of the list for the time being in force at the request of any person wishing to refer to it in legal proceedings.

41 When considering whether an institution no longer meets the approved criteria, the Bank will give notice to that institution that it may be removed from the list, and explain the reasons why such action may be taken. The institution concerned will be given every reasonable opportunity to express its viewpoint, and in some circumstances may be able to take remedial action to satisfy the Bank that it should remain on the list.

Consultation

42 The Bank would welcome comments on this paper and the detailed Annexes before end-February 1987, addressed in writing to the Head of the Wholesale Markets Supervision Division.

BANK OF ENGLAND

Annex I

Capital adequacy tests to be applied to non-bank principals

1 The general principles underlying the assessment of capital adequacy and its application to principals on the Bank's list are set out in the main paper. This annex gives a more detailed indication of the tests which might be applied where alternative means of monitoring capital adequacy have not been agreed (ie where other regulatory bodies are not responsible for the assessment of capital adequacy).

2 The Bank will welcome comments on the general approach outlined in this annex, and in particular on the appropriate trade off in approach between relative simplicity and relative precision. All figures should be treated as purely illustrative.

Measurement of capital base

3 For a separately capitalised institution which is a limited company, the capital base will be defined as follows:

	amount paid up on ordinary share capital
plus	amount paid up on non-redeemable preference shares
	share premium account
	revaluation reserves
	other reserves (to be specified), [but excluding provision for deferred tax]
	profit and loss account as in last audited accounts
	profit/loss since date of last audited accounts, including unrealised appreciation/depreciation, but net of tax payable (calculated at the current corporation tax rate) and dividends proposed
	subordinated loan capital, subject to the Bank's agreement as to amount and terms
minus	net book value of fixed assets (deducting only 20% of value of freehold and leasehold property)
	goodwill and other intangibles
	book value of interests in subsidiaries and associated companies (whether in form of share capital or loans)
	unsecured loans to parent company or fellow subsidiaries (in some circumstances, secured loans will not be treated in this fashion, but will instead be treated as adding risk to the book in accordance with the assets against which the loan is secured).

In cases where the principal is not a limited company, the Bank will discuss the definition of the capital base with those concerned.

4 This definition of the capital base is broadly in line with that used in assessing the capital adequacy of gilt-edged market makers and banks. However in the former case deductions are also made for some forms of unconnected non-marketable unsecured loans, to ensure that gilt-edged market makers do not become too involved in areas unrelated to the gilt-edged market. By contrast, by no means all unsecured intra-group loans made by banks are deducted from the capital base. Nevertheless, the intention is that the proposed definition of the capital base should mean that principals on the Bank's list will be treated broadly on a par with those institutions already supervised by the Bank.

5 Positions taken by a principal should be marked to market at the close of each business day, with the consequent profit or loss taken to capital base immediately. Although regular returns will be required only at the end of each month, the Bank may undertake spot checks or call for additional returns on other days at its discretion. The Bank will set a maximum risk: capital ratio, thereby limiting the extent to which a principal can gear up (in risk-adjusted terms) on its capital, and will consider whether it is also necessary to set an additional requirement, set either in absolute terms or related to turnover and/or expenses.

Types of risk

6 There are three main types of risk inherent in the assets held by wholesale market principals, and a fourth in the trading of such assets. These are as follows:

- (i) credit risk = risk of default by issuer or borrower
- (ii) position risk = risk of changes in the market value of assets (which will, of course, include the risk that prices might change because of an altered perception of the creditworthiness of the borrower)
- (iii) as part of (ii), forced sale risk = risk of additional loss above that implied by the quoted market price, resulting from being forced to sell a greater volume of assets than that for which quoted bid prices refer. This is likely to be of greatest concern in cases where the market for the asset is narrow.

- (iv) settlement risk, where a counterparty fails to complete a transaction which has previously been agreed. Two types of settlement risk can be identified. The most serious is where payment is made for an asset which is never delivered, or where no payment is received for an asset which is delivered. An assured payments system can help meet this problem, but cannot solve the situation where a delivery fails, (with no transfer of cash or asset taking place) but where loss nevertheless results because of an adverse price movement in the asset which was to have been bought or sold

7 Settlement risk is not easy to incorporate into a set of weights, when these are related to a principal's balance-sheet. The Bank has considered whether to ask for reports on the levels of transactions which have yet to be settled, and in particular those for which no assured payments system (such as the Central Gilts Office) currently exists. It has concluded that asking for such information would be burdensome and might serve little purpose, given that most of this risk takes the form of 'daylight' exposure and that by the time an unsettled transaction was reported, it might already represent a "problem" exposure. Instead the Bank will discuss with all principals the control systems they have in place to minimise these risks. Moreover, when calculating risk exposure, an asset which has been sold, but is yet to settle, will not be considered as entirely riskless, although it will be given a lower weight than if no sale had been agreed. Where the deal has remained unsettled for an unusually long period, the Bank would expect to be informed, and may amend the treatment of the position accordingly.

8 The other elements of risk are capable of being analysed independently, and then combined so as to produce a single set of weights to be applied to positions run by a principal. In so doing, the Bank proposes to make use of certain simplifying assumptions. So far as *credit risk* is concerned, the Bank considers that exposures to banks and other supervised institutions should normally be ranked above those to other private sector entities, but below sovereign debt. *Position risk* is influenced by many factors, amongst which residual maturity is one of the most important, while some of the other influences are inevitably difficult to incorporate into a relatively simple weighting system. Finally, *forced sale* risk can only be assessed by type of instrument, and an analysis of the depth of the relevant market. Other things being equal, it will tend to be greatest in markets with low turnover, sometimes (but by no means invariably) where these are in relatively new areas with few regular market makers.

Risk weights for open positions

9 Table A below sets out some illustrative weights which might be applied to positions held by principals in the wholesale markets. As indicated in paragraph 15 of the main paper they are intended to provide a starting point for discussion, rather than a fully articulated set of proposals. The Bank hopes to be able to incorporate the results of further research being carried out on the past price history of various instruments, when this becomes available, and will in any case continue to keep the weights chosen under review.

10 The weights set out in Table A are related not only to the inherent price volatility of each group of assets, but also reflect an assessment of the risk that a borrower or issuer might default on its obligations. Thus the rows of the matrix classify positions by issuer (and thereby reflect credit, and to some extent forced sale, risk) while the columns refer to maturity (an important element in position risk). In drawing up its proposals, the Bank has been guided by a desire to produce a relatively simple system, which is broadly consistent with the weights applied to similar positions run by banks and/or gilt-edged market makers. This is not an easy task, since the weights applied in the first case chiefly reflect credit risk factors, while in the latter case they capture position risk. Nevertheless, the weights shown represent a first attempt at synthesising these two approaches, on the basis of the *a priori* assumptions spelt out in paragraph 8 of this annex. Positions are categorised under very broad headings, and it may be necessary to make further distinctions between instruments when the final set of proposals are produced.

11 Offsets between positions will only be allowed where these have been defined as matched positions (see paragraphs 19 to 22 of this annex). All other positions, whether 'long' or 'short', will therefore be summed together regardless of sign, once they have been appropriately weighted.⁽¹⁾ In line with the principles underlying the assessment of the capital base, the Bank will require all positions to be valued on the basis of current market prices, and it will expect this to be done daily, in a way which is sufficient to ensure that risk exposure is not excessive in comparison with the capital resources which are available to meet losses resulting from position-taking.

12 The maximum permissible risk: capital ratio allowed will be 100 (see paragraph 23). On the basis of the figures in Table A, this means that the largest position which a principal can run in certain instruments is as follows: equivalent figures are also shown for institutions already supervised by the Bank.

(1) There is a somewhat different treatment of money market liabilities, which will be identified separately, rather than as a 'short' position to the lender in question

- (a) 3 month eligible bill 33.3 (Discount house 40)
- (b) 15 year gilt 10 (Gilt-Edged market maker 11.8)
- (c) Loan to personal sector (where rate fixed for 3 months or less) 8.3 (Bank 8.3, for target risk asset ratio of 12)

13 In general, therefore, the capital requirements are a little stiffer than those applied to discount houses, and gilt-edged market makers, in their area of particular expertise. This is intentional, with discount houses and gilt-edged market makers being specialists in these areas and taking on certain market making obligations which are of a more onerous nature than those undertaken by principals on the Bank's list. The specialist intermediaries also have certain privileges, such as access to last resort borrowing facilities at the Bank.

14 All positions shown in Table A are classified by *residual* maturity, except for those at floating rates of interest which will be assessed instead according to the frequency with which the interest rate is set.⁽¹⁾ This is because it is residual maturity which is the more relevant concept for price volatility, while for the purposes of defining the wholesale markets, original maturity is the more useful, allowing, for instance, a distinction to be drawn between Treasury bills and gilts.

15 All foreign currency instruments should be converted into sterling at the current spot rate and weighted according to the figures given in the table. To the extent that a firm is running an open position in foreign currency, this will be given an *additional* weight.

16 The range of instruments covered by the risk-weighting system will be wider than those included in the wholesale markets, since the assessment of capital adequacy will need to be carried out on an entity-wide basis, whether the Bank is acting as sole supervisor, or as a lead regulator for others. Thus any position in, for instance, gilts will be included in the assessment of capital adequacy of a wholesale market principal.

17 The Bank will include positions in off balance sheet instruments in its assessment of risk exposure. For futures and FRAs, the weightings applied will be the same as for the equivalent cash position, since price movements in the two markets are broadly similar. For simplicity, the Bank will also treat positions in options in this fashion, but it appreciates that such an approach will exaggerate the risk exposure of the principal concerned. For those for whom positions in options

are large in relation to the overall scale of their business, therefore, the Bank will discuss alternative means of assessing risk exposure, on a bilateral basis.

18 The Bank will also consider other forms of forward commitment in its assessment of risk, including assets repoed off the book and other commitments to purchase assets (including deals done but not yet settled). In general, it will treat such commitments as giving rise to an exposure in the same way as if the position itself was held on the balance sheet. In this context, the Bank will wish to discuss the appropriate treatment of swaps and underwriting commitments with those who are undertaking such activities, and will seek to establish whether any modification in the risk weightings is appropriate in such cases.

Treatment of matched positions

19 Table A sets out—in very general terms—the risk weights to be applied to 'open' positions run by a principal. However, many principals will expect to run large cross-books, with risks incurred in one part of the book being offset in part by opposite positions elsewhere. In such a case, four alternatives are available to the supervisor.

- (a) To allow no offset, and to weight both halves of the transaction. For instance, the risk on a position in equities may not be substantially reduced by funding it with two year money, and indeed there are many circumstances in which the principal may lose money on *both* positions.
- (b) To allow no offset, but to weight only one side of the transaction. This is in many ways a special case of the following category.
- (c) To allow a partial offset from a hedge, for instance where a position in a one year CD is funded with one year money. Here interest rate risk is hedged, but losses could still result from other factors (eg a changed perception of the credit risk on the CD).
- (d) To allow a total offset from a hedge. Since this allows positions of this type to be held without limit, it is not a concession which is given very often or very willingly by supervisory authorities.

20 Listed overleaf are certain examples of positions for which it might be appropriate to grant some type of concession.

⁽¹⁾ For these purposes only loans linked to base rate or another administered rate will be taken as having a maturity of one month.

- (i) Where a fixed rate asset of over three months is financed by a liability of similar maturity (eg one which falls in the same maturity band).
- (ii) Where a principal is running long and short positions in the traded paper of the same issuer (eg gilts), particularly where these fall into the same maturity band.
- (iii) Where a position in a futures contract, FRA or (less straightforwardly) an option is taken against an opposite position, either in the cash market or in a derivative instrument. The case will be particularly strong if both halves of the position are in the same maturity band and relate to the same type of asset.⁽¹⁾
- (v) Where a commitment exists at an already-determined price to close a position (eg by selling an asset, or closing a bear position). Deals done, but not yet settled, would be included within this category, unless the deal had remained unsettled for an unusually long period, and there were indications that it might not settle.

21 In each of these cases the principal would achieve a good degree of protection against interest rate risk, although the protection against credit risk would vary, being greatest under (ii) and (iv). There remains the question as to how matched positions should in general be assessed for capital adequacy purposes. One approach would be to weight only *one* half of the transaction, perhaps that half which carried the greatest credit risk, on the basis of the weight applied to a [one] month position in such an instrument. Even this very general rule, however, would require modification in the case of positions in foreign exchange and bullion, particularly those which fell into category (iv), where many would argue that a total offset would be more appropriate than a weight of 12, since in effect all that was being measured was settlement risk.

22 The approach outlined above does not deal well with more partial hedges, where (for instance) the positions fall into different maturity bands. In order to

keep the system simple the Bank is minded to disallow such hedges, and to weight both halves of the hedged transaction in its assessment of risk exposure. While this rather arbitrary approach may be suitable for some of the principals on the Bank's list, it may not be appropriate for all. The Bank is therefore prepared to discuss this matter further with those who wish to submit to a more rigorous yet complex assessment of capital adequacy.

The Relationship between Risk Exposure and Capital Base

23 The Bank will expect a principal to limit its risk exposure, assessed on the basis of the guidelines set out above, to no more than 100 times capital base. Although regular reports will be completed only monthly, the 100 times limit should be observed continuously, and the Bank reserves the right to call for additional reports from any principal at any time. The 100 times limit should not be breached without very good reason and without due explanation being provided promptly in each case to the Bank. Persistent infringements of this limit, or evidence that it is observed only on regular reporting dates, would make the firm concerned liable to suspension or removal from the Bank's list.

Exposures to Individual Borrowers

24 The Bank will ask for reports of all exposures to individual customers which are greater than 10% of capital base, and will require prior notification of any exposure of this type in excess of 25% of capital base. It will consider whether additional capital requirements are appropriate, to take account of the concentration of credit risk implied by exposures in excess of 10% of capital base. Exposures with a maturity of no more than a year to banks, gilt-edged market makers and and Stock Exchange money brokers need not be reported under this heading. For these purposes, all entities whose liabilities are directly or indirectly the responsibility of a central entity will be regarded as a single borrower.

⁽¹⁾ For these purposes, the maturity of a futures/FRA position should be taken as equivalent to the period until delivery of the contract plus the life of the underlying asset.

Table A

Illustrative weights for non-bank principals*

	Residual maturity					
	0-7 days	7 days- 1 month	1-3 months	3 months- 1 year	1-5 years	over 5 years or no maturity
Exposure to UK [or overseas] central government (including Treasury bills, gilt-edged stock, [US Treasury bonds] and any other obligation to central government)	0	1	2	3	6	9
Money market liabilities (eg borrowing from banks)	0	0	0	3	6	9
Exposure to local government and other public sector	1	2	3	4	7	10
Exposure to banks or building societies etc. (including deposits, loans, CDs and bank bills, but excluding any obligation with an original maturity of more than five years)	1	2	3	5	8	n/a
Other marketable instruments (eg trade bills, commercial paper, equities, FRNs or eurobonds)	6	6	6	8	11	12
Other forms of exposure to non-supervised private sector	12	12	12	14	17	18
Net open bullion positions			All 15			
Open foreign exchange positions			All 12			

*See paragraph 15, main text. The categorisation adopted and the weights shown are for discussion purposes only. Floating rate instruments will be assessed on the basis of the frequency with which the rate is set, and not with reference to residual maturity.

Annex II

Capital adequacy tests to be applied to brokers and agents

The general principles underlying the assessment of capital adequacy and its application to brokers on the Bank's list are set out in the main paper. This annex contains the details of the tests to be applied where no alternative means of monitoring capital adequacy has been agreed (ie where other regulatory bodies are not responsible for the assessment of capital adequacy). All brokers on the Bank's list are likely to be required to be separately capitalised entities incorporated in the UK, since the means of determining capital adequacy is not one which will easily be applied to an institution operating in other markets overseas.

Measurement of capital base

For a limited company, the capital base will be defined as set out in Annex I for principals, with the following exceptions:

- (a) The entire value of freehold and leasehold property will be deducted from the capital base, not just the 20% figure applied in the case of principals. The latter treatment, identical to that applied to gilt-edged market makers and discount houses, is also similar in effect to that used for the risk asset ratio of banks. However, it is not appropriate for brokers, to whom an expenses criterion will be applied in the assessment of capital adequacy. This is because such a criterion is designed to ensure that a firm can continue to trade for a period while generating no income. If capital resources are represented only by premises (or other property) it may not be possible to meet overhead costs in this way, unless the firm concerned can use the buildings as collateral for a loan.
- (b) In order to ensure that capital is sufficiently liquid to meet running costs, the Bank will require it to be held in the form of 'approved' relatively low risk assets. All other assets will be deducted from the capital base, as for property. The precise definition of 'approved' assets will be discussed with market practitioners, but is likely to include gilt-edged stock with a year or less to run, Treasury, local authority and eligible bank bills and CDs with three months or less to maturity, deposits with banks, Ldts or building societies repayable within a month and all net debtor balances in respect of commission payable. In cases where such balances have been outstanding for more than 30 calendar days

from the date on which the brokerage statement was submitted, or there are any other indications that payment may not be made, these will *not* count as 'approved' assets. In cases where the Bank has agreed that broking may take place on a matched principal basis (ie where this is allowed outside the traditional markets) the definition of approved assets will be altered as appropriate.

The Bank will expect returns for the capital base to be submitted monthly, but reserves the right to carry out spot checks or to call for further returns from any broker whenever it considers it necessary. Figures for the capital base should be updated daily to reflect the institution's current liquid resources from which to meet losses.

Types of risk

There are four main sources of potential loss for a broker in the wholesale markets.

- (i) Running expenses (if turnover and therefore income were suddenly to fall sharply).
- (ii) Differences, in cases where the broker has to pay compensation for errors as a result of which a customer suffers loss.
- (iii) Own funds, where losses are sustained as a result of movements in the value of those assets in which the capital of the broker is invested. This risk is akin to that run by principals (on a much larger scale) in their day-to-day business.
- (iv) Customer failure: in the case of a broker in the traditional markets this would relate to losses resulting from non-payment of commission due.

Risk Exposure

The Bank will require brokers to maintain a capital base equivalent to at least two months of annual audited expenditure. This is less than the three month's expenses figure recently adopted by the Stock Exchange and reflects the fact that brokers in these markets act as pure agents, rather than as matched principals. If the Bank has in specific areas (outside the traditional markets) agreed to allow a firm to act as a matched principal, the minimum capital requirement will be raised accordingly. It is hoped that the expenses

requirement will be sufficient to cushion the broker from any likely scale of 'running expenses' loss.

'Differences' risk is by nature difficult to assess, although it is probably related to turnover (both in terms of the number of transactions, and their amount). So too, is commission payable, and thus potential loss from customer default. Turnover is only very approximately measured by the expenses criterion, which should therefore be taken only as a rough first guide to the risk incurred by a broker. It should in no circumstances be regarded as sufficient in itself either by the broker or the customers with whom he does business. With this point in mind, the Bank will consider whether to set a second capital requirement related to turnover. In any event, it will ask for returns from each broker setting out differences paid away each month, and over the preceding year, and also for information on turnover on a monthly basis.

Some brokers may wish to take out fidelity and/or errors and omissions insurance as a protection against losses arising from differences payable. The Bank

would welcome such steps, and will consider whether the insurance obtained is sufficient to allow it to set a lower capital requirement for the broker. Although the capital requirement may be reduced, however, it will still need to be set at a level sufficient to meet potential losses from other forms of risk.

The Bank may call at any time for a special meeting with a listed broker, and will do so if the capital requirement falls below the minimum which has been agreed. Having discussed the position with the broker, the Bank may require it to increase its capital over a period of time. Alternatively, it may examine whether the scale of the broker's activities should be curtailed, and its running expenses consequently reduced. In coming to its decision, the Bank will pay particular attention to the causes of the losses suffered by the broker, and to what extent these reflect losses from differences, or the investment of own funds. In some cases, it will be the nature as well as the scale of the loss which will lead the Bank to consider whether a listed broker, in failing to meet its capital adequacy requirement, is still 'fit and proper' to do such business.

Annex III

The London Code of Conduct

A guide to accepted practice in the wholesale money, foreign exchange and bullion markets.

Introduction

1 The London financial markets have an enviable reputation for their high degree of professionalism and the maintenance of the highest standards of business conduct. All those operating in these markets in any capacity share a common interest in their health and have a duty to maintain the established exacting standards. The Bank's aim in promulgating this Code is to ensure that the highest standards of integrity and fair dealing are observed throughout these markets. All those on the Bank's list of institutions deemed fit and proper to transact in the wholesale markets will be required to abide by the Code in all relevant respects.

2 The Code will be in three (or more) parts. The first attached here is based on the existing Codes in place in the sterling and foreign exchange markets, themselves drawn up and revised over time with the aid of market practitioners. The second part will deal with the instruments and markets in London which have more recently developed, including interest rate and currency swaps and forward rate agreements, which are distinguished from the traditional markets in particular by the heterogeneity (or tailor-made nature) of the instruments involved. This part of the Code will be drawn up in consultation with market practitioners. The third which will relate specifically to the gold and silver bullion markets will also be established by the Bank with the aid of market practitioners.

3 The aim of this Code in its entirety is not to establish over-burdensome regulation, nor to impair the efficient functioning of these markets. It is intended as an explicit statement of the principles which are expected to govern market conduct in dealings in all relevant instruments, as an aid to ensuring that listed institutions act with due skill, care and diligence.

4 The first part of the Code is itself divided into a number of parts. The general principles governing the conduct of business in all these wholesale markets are first set out. There are sections on confidentiality; general procedural rules for transactions in these markets; dealing policy; and on gifts and entertainment. At the end there are a number of schedules defining market terminology and practice appropriate for each of the traditional markets covered by the Bank's regulatory responsibility.

Part 1 — The traditional markets

5 This part of the Code applies to those areas which have in practice been governed by the Codes of Conduct established by the Joint Standing Committee for principals and brokers in the sterling deposit market and the Joint Standing Committee in the foreign exchange and currency deposit market.

London Instruments

6 Although this Code defines best current practice for secondary market transactions in traditional sterling and foreign exchange instruments, the Bank believes that as great a degree of homogeneity as possible at the primary *issuing* stage assists good order in the market. It reduces the scope for investor confusion about the nature of the instruments being traded and facilitates market trading itself. Such homogeneity is achieved in the CD market by the Bank's guidelines for CDs issued and payable in the United Kingdom and by the BBA standards for 'London good delivery'. These allow London CDs to be clearly identified and distinguished from non-London CDs. The BBA has also issued recommended terms and conditions for dealing in foreign currency options, FRAs and interest rate swaps. The Bank believes that in principle it could be beneficial to establish comparable standards for other instruments similarly issued and payable in the UK, to allow a distinction in the secondary market between such paper and other, non-London, paper. The Bank will wish to explore this possibility with market participants.

General

7 All principals and brokers participating in these markets must abide by the spirit as well as the letter of the Code, uphold it at all times, and ensure to the best of their ability that all parties act in a manner in keeping with the maintenance of the highest reputation for these markets in London.

Standards

Brokers

8 When a broker establishes a relationship with a principal, he must ensure:

- (i) that the principal understands the limitations of the broker's responsibilities for business conducted;

- (ii) in particular that the principal understands that the ultimate responsibility for assessing the credit-worthiness of a counterparty must rest with the principal himself;
- (iii) that all its principals understand that they are required to conform, where appropriate, to the Code of Conduct and market practice;
- (iv) that its staff carrying out transactions on behalf of principals are adequately trained in the practices of the market-place, in the firm's responsibilities to principals, and in the need to adhere to the Code of Conduct and other guidelines that may be issued from time to time.

9 It should be understood that, in these markets, where names are passed on the conclusion of a deal, brokers act purely as the arrangers of deals, bringing together the counterparties on mutually acceptable terms, with payment only in the form of brokerage for this function. Matched principal transactions, or blind broking, in which a broker does not pass names but interposes himself in a deal so that settlement takes place, however fleetingly, through his own books, are not permitted. When investing own funds, brokers must make clear to the relevant counterparties that they are acting as principals in these deals. Brokers will not be allowed to deal with *related* principals even on a principal to principal basis, nor to acquire the liability (eg a CD) of a related party. If such an asset were to be bought by accident, the Bank will expect it to be sold as soon as possible.

Principals

10 It is the responsibility of the management of all principals to exercise full control over the activities of their dealers and to ensure that they act within the provisions of this Code and other guidelines as may from time to time be issued.

11 Principals shall not place any orders with brokers with the intention of ascertaining the name of a counterparty, who can be immediately contacted directly with a view to concluding such deals for a further amount.

Confidentiality

12 In these markets, confidentiality is important for the preservation of a reputable and efficient market-place. Principals and brokers have a common interest in preserving the anonymity of the market and share equal responsibility for maintaining confidentiality. The standing of the market and the mutual trust on which it rests, outweigh any transient gain to which a breach of confidentiality might give rise. Neither principals nor brokers shall therefore disclose or discuss any confidential information relating to business which has been transacted in these markets, except to those parties directly involved in a transaction, who should only be given those details

necessary to conclude the transaction. It follows that the exchange of confidential information, in any setting whatsoever, and in whatever direction it flows, is not in the market's interest.

13 A dealer representing a principal shall not apply pressure on a broker to pass information which it would be improper for the broker to pass. Pressure shall include (without prejudice to the generality of the foregoing) any statement to the effect, or which could be taken as implying, that a failure to co-operate would lead to a reduction in the business given by the principal or by other principals to the broker. Respect for confidentiality is in the interests of all market participants and any attempt to induce a breach is strongly condemned: it is a responsibility of management to ensure that all relevant personnel are aware, and observe, this fundamental principle.

14 In the traditional sterling and currency deposit markets the name of a borrower (or issuer in respect of certificates of deposit) shall be disclosed only when a broker has established that the potential lender (or buyer in respect of CDs) seriously intends to do business. Once a lender (or buyer) has asked the key question "who pays" or "whose paper is it", he is considered committed to do business at the price quoted with a name acceptable to him. If this is not the particular borrower or issuer in question, this applies to an alternative acceptable name, provided this alternative name is immediately given to him by the broker.

15 Similarly the name of a lender (or buyer in respect of certificates of deposit) shall be disclosed only after the borrower's (or issuer's) name has been accepted by the lender (or buyer); and the borrower or issuer shall have the right to refuse the particular lender (or buyer), provided that he is prepared to accept up to the same amount at the same price from an alternative acceptable name provided immediately by the broker.

16 Additionally in the case of forward dealings in certificates of deposit, the name of the seller shall be disclosed only when the broker has ascertained that the potential buyer seriously intends to do business. Once a buyer asks "who sells", he is considered committed to do business at the price quoted with a name acceptable to him, and if not with the particular seller in question, then with an alternative acceptable name, so long as this name is immediately shown to him by the broker. Similarly, the name of a buyer shall be disclosed only after the seller's name has been accepted by the buyer. The seller has the right to refuse the particular buyer, so long as he is prepared to accept at that time sums up to the same amount, and at the same price, from an alternative acceptable name immediately shown to him by the broker.

17 Where a bank's name proves unacceptable to another name and the broker quite properly declines

to say by whom it was refused, the bank may sometimes feel that the broker has in fact quoted a price which cannot be substantiated. In such cases, the management of the broking firm concerned may ask the Bank to obtain the reluctant counterparty's confirmation that he did have business to do at the quoted price and to assure the aggrieved party that this was so without, of course, revealing the reluctant Party's name.

18 In order to facilitate the smooth operation of these markets, and to minimise frustration on all sides, principals may wish to give brokers prior indication of those with whom they would be unwilling to do business (referring as necessary to particular markets or instruments). The right of a bank to turn down a name includes the taking of deposits (this most often applies with short dates) and could therefore require predisclosure of the name before closing the deal.

19 Improving technology has led in recent years to the widespread introduction of loudspeakers in both brokers' offices and principals' dealing rooms. While such innovations are to be welcomed for their contribution to the increased efficiency of the market, clearly where two-way loudspeakers are in operation and open at all times, breaches of confidentiality can occur.

20 Dealers employed by principals or brokers shall not visit each others' dealing rooms except at the express invitation of the management or directors of both parties. In particular a principal's dealer shall at no time deal from within the offices of a broker, and vice versa.

21 All firms, whether acting as principals or brokers, will be held responsible for the actions of their dealers. They have a duty to ensure that all dealers who commit the firm to a transaction are authorised to do so.

Risk of Counterparty Confusion

22 In order to minimise the risk of counterparty confusion in circumstances where a dealer, acting for a principal or broker, is dealing in one or more products for more than one company, he must make absolutely clear, at the outset of any deal, on behalf of which company he is dealing.

Conflicts of Interest

23 The Bank for many years maintained restrictions on shareholding links between brokers in foreign exchange and currency deposits "recognised" by the Bank and principals in these markets. These arrangements were contained in the "O'Brien Letters". No such restriction in the relationship between brokers and principals was ever applied in the sterling markets, although a restriction effectively operated where a broker had both sterling and foreign currency business. With markets becoming more closely

integrated, the Bank has decided that it is no longer appropriate to maintain distinct arrangements in the foreign exchange and currency deposit markets. As a result the Bank has announced the withdrawal of this particular rule, so that there are now no restrictions on shareholding connections between a recognised broker and any bank or other active principal in these markets. In order to preserve the neutrality of the broking system in the foreign exchange and currency deposit markets, the Bank now requires that a broker may not undertake business in these or foreign exchange instruments on behalf of a principal where there is a connection of 10% or more. In addition the Bank expects institutions thus connected to take particular care in ensuring that confidential information does not pass between themselves. The Bank intends that this same bar between brokers and related principals will apply in the Sterling deposit market; and will wish to consider with market practitioners its application to all wholesale money market instruments.

Procedural Rules for the Market

London Terms

24 All deals with counterparties in the UK are to be conducted on the basis of this Code. But the provisions may extend beyond UK shores, for example where a UK broker is arranging deals between two overseas counterparties for settlement abroad. Any deals with overseas counterparties which are made on a different basis in any respect must be identified as such at the outset of the deal, and the terms notified so there can be no possibility of confusion.

25 A principal is bound to deal at the quoted rate (price) with an acceptable name in a marketable amount once he has informed a broker of his requirements at that rate. He remains so bound for a reasonable period unless the broker is informed otherwise or a time limit was placed upon the principal's interest (eg "firm for one minute only"). At the same time brokers have a duty to make it clear whether the prices quoted are firm, or merely for guidance, and to give an indication of the amount involved: they are also expected to confirm with principals at reasonable intervals that their interest is still firm. A broker who quotes a firm rate without qualification is committed to deal at that rate, in a marketable amount. A broker, if quoting only on the basis of one or two names shall qualify his quotation, eg one small offeror—only two names paying.

26 The acceptable definition of a marketable amount varies from market to market but will generally be familiar to those practitioners involved. Where principals are proposing to deal in unfamiliar markets, it is recommended that they ask brokers what amounts are sufficient to validate normal market quotations. If a smaller amount is involved, this should be specified by the principal when initially requesting the price.

Passing of Details

27 The passing and recording of details forms a vital adjunct to the concluding of deals, and the possibility of errors and misunderstanding is increased by both delay and the resulting passing of details in batches. Brokers shall therefore pass details, and principals be prepared to receive them, as soon as practicable after deals have been concluded. However brokers should not normally pass payment instructions in the foreign exchange and currency deposit markets where a transaction has been arranged between UK banks: in these instances the counterparty banks have a responsibility to give and receive instructions with minimum delay. Confusion is likely to be minimised by the use of standard settlement instructions.

Confirmations

28 Confirmations are the final check on the details of the deal a broker has arranged and must be sent out without delay. All confirmations should include the name of the other counterparty and all other details of the deal, including commission charged by the broker to the principal. The majority of differences payable by brokers arise from misunderstood or wrongly reported payment instructions or from errors in the quotation of interest rates: it is vital therefore that principals should check confirmations carefully and immediately upon receipt so that discrepancies can be quickly revealed and differences minimised. Principals should also make enquiries of brokers about particular confirmations which have not been received within a reasonable time of a deal being concluded or about any changes in contract terms (eg calls, rate changes, rate fixes etc.). Checking of all confirmations must not be done by dealers in the dealing room.

29 A corollary of this obligation on principals to check carefully such confirmations is that a reasonable time limit should be placed on the liability of brokers for differences. In the case of a broker's error, foreign exchange market practice has been that a broker remains liable for the resulting differences for two full business days following the principal's receipt of the broker's confirmation (except where the error could not reasonably be detected by the principal). If the principal has made the initial error, he of course remains liable throughout. It is suggested that this practice is universally adopted in these markets. Where the parties in dispute cannot agree, the Bank will stand ready to arbitrate.

30 It used to be common practice for principals in the foreign exchange and currency deposit markets to request a telex confirmation for use as a deal check in addition to the formal written confirmation. However, the introduction of the automated confirmation system means that this should in due course no longer become necessary and may indeed lead to confusion over which of the two confirmations is to be treated as final should the two differ in any way.

Differences payable in other circumstances

31 Differences do not always result from errors in payment or repayment instructions. Differences also occasionally arise because a broker has in good faith indicated a firm rate but has subsequently discovered that he could not substantiate that quotation even though he has a moral responsibility to do so. Such differences are paid in the foreign exchange market via the Honorary Treasurer of the FECDBA, and documentation supplied on the details of and circumstances surrounding the deal: no such mechanism exists in the sterling markets, but the Bank will wish to consult practitioners as to whether a formal system for settling sterling differences is needed. In the foreign exchange market the Bank is aware that differences are not always settled through the official mechanism and that market participants may have recourse to so-called 'points banks'. Such action is not recommended, and the Bank will be taking steps to monitor the extent of its use.

Commissions

32 In all transactions in these markets, brokers shall quote dealing prices excluding commission charges and separately identify brokerage. Rates of brokerage (including any negotiable discount) should be agreed in advance and only by directors or senior managers on each side and in no event by dealers themselves.

Changes in Payment Instructions

33 Principals should ensure that alterations to original payment instructions, including the paying agent where this has been specifically requested, should be immediately notified to the counterparty in a deal. This notification should be supported by written or telex confirmation of the new instructions and, in the case of overseas deals, should be sent in addition to the broker.

Repos

34 The Bank has established appropriate arrangements for the borrowing and lending of gilt-edged stocks by the gilt-edged market makers through the medium of the Stock Exchange money brokers.

35 Where sale and repurchase (or transfer and retransfer) arrangements are entered into by a listed institution, the Bank will wish to ensure that in every case there is *physical delivery* of the securities concerned. In addition there must be marking to market of the underlying instruments at the close of business each day. Those engaging in repos should insist in each and every deal that the other counterparty confirms that it is acting as a principal and not as an agent in the transaction.

Secured deposits

36 The Bank considers that where deposits are taken on a secured basis in these markets (eg in the discount

market) there should be physical delivery of the collateral provided. In particular, the Bank does not recommend the use of "held to order" facilities.

Inducements to Conduct Business

Gifts and Favours

37 No broker, including management, employees and persons acting in concert with such parties, shall offer or give inducements to dealing room personnel of a principal. No gifts or favours whatsoever shall be given unless the broker is satisfied that the person responsible for controlling the relevant operations in the principal concerned has been informed of the nature of the gift or favour, and has accepted that it is appropriate. Similarly employees of principals, or persons acting in concert therewith, shall not solicit inducements from brokers, nor shall they receive unsolicited gifts or favours from brokers without informing the person responsible for their operations of their nature and getting agreement from this person that they may be accepted. Action to the contrary is liable to prosecution.

Bets

38 The making or arranging of bets between brokers and principals is expressly forbidden.

Entertaining

39 Management in both principals and brokers are responsible for ensuring that entertainment offered in the course of business does not exceed reasonable limits. Whilst it would be inappropriate to lay down precise guidelines, it is essential for management in all listed institutions to formulate suitable policies to guard against abuse and to accept clear responsibility for their observance by their own staff.

Dealing Policy

After-hours dealing

40 24-hour trading has become accepted in some markets, most notably in foreign exchange. Dealing after-hours in other centres must therefore form an integral part of the operations of many international banks, both in London and elsewhere. Such dealing involves additional hazards. For example, when dealing continues during the evening, either in London or elsewhere, from premises other than the banks' dealing rooms, one of the counterparties involved might subsequently forget, or deny, having done a deal. Brokers too might be involved and thus run the risk of a claim for a difference from a bank whose counterparty denies having dealt. Managements should therefore issue clear guidelines to their staff, both as to the nature and extent of such dealing permitted; and make arrangements to ensure that all such deals are both properly authorised and confirmed by telex direct to the counterparty's dealing room.

Deals at Historical Rates

41 On occasion banks have been under pressure from commercial customers to roll over maturing forward contracts on the basis of previous, rather than current, rates. Banks in London have also sometimes experienced pressure from head offices overseas to roll on forwards at non-current rates. This practice is not recommended and should only be done with the express permission of senior management. The BBA has recommended that, when extending the maturity of any forward contract, the current market spot rate should be used to liquidate the maturing contract and as the base from which to calculate the new forward rate. This recommendation is strongly endorsed. Failure to use the current spot rate may result in a bank effectively collaborating in the concealment of a profit or loss or contributing to the perpetration of a fraud.

Dealing in fictitious rates

42 This is expressly forbidden.

Dealing for personal account

43 Management should consider carefully whether their employees should be allowed to trade for own account in any of the instruments covered in this Code. Where this is allowed, it is the responsibility of management to ensure that adequate safeguards are established to prevent abuse. These safeguards should reflect the need to prevent insider trading in any form and to ensure that no action is taken by employees which might affect the interests of the customers of a broker, or the counterparts of a principal.

Record-keeping

44 The Bank will require detailed records to be maintained as a condition of being a listed institution, as follows.

Principals

45 All listed institutions acting as *principals* will be required to maintain a list of the *names* of those counterparties with whom they have dealt at or above the specified size limits in the relevant instruments during the previous 18 months (or such shorter period as may be chosen by the listed institution for its own purposes to define a wholesale counterparty). This list need not include other listed institutions but it must include all non-listed institutions and individuals who, by such transactions, have become wholesale counterparties of that listed institution. Any further transactions in the relevant instruments by these institutions or individuals with that listed institution, irrespective of size, will no longer be afforded the protection of the Financial Services Act. The Bank may ask to see this list at any time, although it will not require it to be submitted to it on a regular basis.

46 All listed principals are required to explain orally to a counterparty with whom they are to engage in a relevant transaction when, as far as that listed institution is concerned, they will *become* a wholesale counterparty, and subsequently to confirm this in writing. The listed institution must also fully explain the implications that this carries for future transactions between that listed institution and the particular counterparty. Individual counterparties nevertheless have the right to negotiate whatever arrangements with the principal which they consider to their best advantage. Copies of all such correspondence must be kept and be made available to the Bank on request. In the case of deals done through brokers, the counterparty will become a wholesale counterparty of the broker alone, and not of the listed principal. In such a case, it should be the *broker* who takes responsibility for explaining the implications of the transaction to the particular counterparty.

47 All listed institutions will be required to maintain comprehensive records of all transactions undertaken which fall within the Bank's regulatory ambit. These records must include full details of date, time (except where shown to be impracticable), instrument, rate, amount and counterparty, together with arranging broker if relevant. Such records must permit audit trails to be carried out for at least two years after execution. There will be no general requirement to report all such transactions to the Bank, although the Bank reserves the right to undertake random spot checks to ensure that adequate records are being maintained.

48 However the Bank will take a particular interest in all transactions *below* the specified minimum limits undertaken by a listed institution with a wholesale counterparty; and will require *all* such deals to be reported to it at three monthly intervals, within 14 days of the end of each calendar quarter. Such reports will include full details of the transactions as referred to above.

49 The Bank may wish to be supplied with full reports of all transactions between listed non-bank principals and related counterparties.

50 A complete record of written complaints and responses to them will be required. They must be kept for six years at head office or at the office where the complaint has arisen. Firms must investigate complaints completely, compensate customers where appropriate and tell them they can take the matter to the Bank.

Brokers

51 Listed brokers will be expected to maintain a list of the names of the counterparties to any transactions within the defined area which they have arranged. This

need not include listed institutions but should include *all* non-listed institutions or persons which are counterparties to a transaction at or above the size limits specified.

52 In such transactions it is the broker's responsibility to ensure that the Code of Conduct is satisfied in all relevant respects. It is also its responsibility to explain this to the affected counterparties, and to point out that any such transactions are not afforded the protection of the Financial Services Act.

53 Comprehensive records of all transactions arranged by a listed broker must be kept for at least two years after execution, and be made available to the Bank at any time, although the Bank will not require them to be submitted at regular intervals.

54 The use of recording equipment to tape telephone calls is growing in both brokers' offices and principals' dealing rooms. The Bank wishes actively to encourage this practice. It will discuss with brokers whether their use could become a *compulsory* requirement and for how long such tapes could reasonably be stored. When installing such equipment, both brokers and principals should take steps to inform other market participants that conversations will thereafter be recorded.

Marketing techniques

55 The Bank will not make any rules on cold calling or advertising, since they would be inappropriate for these professional markets. [Some reference to SIB rules may be made]

Disputes

56 A mechanism for hearing complaints by anyone against a listed institution and for arbitrating amongst unresolved disputes concerning the application of the Code, or of current market practice, will be established. Hitherto, this role has been performed by the Joint Standing Committees in the sterling and foreign exchange and currency deposit markets. Under the new framework it will be appropriate for the Bank to exercise this function, drawing on the advice and expertise of members of the Joint Standing Committees or other market practitioners as appropriate.

Market terminology and definitions

57 The use of generally accepted concise terminology should reduce misunderstandings and frustration, and to this end Schedules I to IV set out, without purporting to be exhaustive, accepted market terminology and definitions and aspects of trading which are explicit to these particular traditional markets. (Schedule V will set out market terminology and definitions in the foreign currency asset markets, but is not at present available.) Their coverage is as follows:

Schedule I	Market terminology and definitions for the sterling deposit markets, including calculation of interest and brokerage.
Schedule II	Calculation of interest payable in a leap year
Schedule III	Calculation of proceeds on Sterling CDs
Schedule IV	Market terminology and definitions in the foreign exchange and currency deposit markets, including calculation of brokerage

Schedule I

Market terminology and definitions used in sterling deposit markets

1 Put on

When a principal "puts a broker on" the broker is given an order to arrange a deal on the principal's behalf. The broker may be put on either "firm" or "under reference", with or without a specified amount, or time limit.

2 Firm (principal)

- (i) When a principal puts a broker on "firm" and no specific amount is mentioned, the principal is bound to deal in a marketable amount at the quoted price provided that the names are acceptable.
- (ii) When a broker quotes without qualification he is bound to deal firm in a marketable amount at the time he makes the quote, provided that the names are acceptable.

3 Under reference

When a principal puts a broker "under reference", or puts him "under reference" having previously put him on firm, the broker must refer to the principal before he passes his name. If a broker quotes a price "under reference" he must have the opportunity to check with one of his principals before being expected to deal in a marketable amount.

4 Take off

When a principal "takes a broker off" either a single order or several orders, he must, if he has put the broker on firm, check whether the broker is already committed to deal on his behalf.

5 Putting a price

When a broker approaches a principal to "put a price on" a transaction, then that price is for immediate acceptance or acceptance within an agreed period in respect of the particular transaction only - it is not

tantamount to "putting the broker on firm" for other transactions in or near to the particular period.

6 Put through

This is where a principal is prepared to take funds and on-lend them to a borrower, to whom the original giver is, for whatever reason, not prepared to lend.

7 Bids and offers

To avoid confusion arising between CDs and deposits, "bid" and "offer" should be restricted to bids and offers for money: paper should be referred to as "buy" and "sell" or "issue".

8 Clean

A "clean" or "straight" deposit is one where there is no CD involved: eg, "I pay for clean (or straight) threes" or "I lend clean (or straight) sixes".

9 Straight

The words "straight dates" mean "even dates", ie, a CD or deposit maturing on the same date of the month (eg, 16 January - 16 July). Long sixes or short sixes are maturities either side of this date.

10 Roll overs

A "roll over" loan is a loan for a fixed period during which there are regular specified intervals at which the interest rate is re-established.

A "roll over" or "reissuable" CD is one on which the term but not always the rate of interest are fixed but a new CD is issued at specific intervals.

11 Calculation of interest and brokerage

- (i) Interest on CDs and deposits or loans is calculated on a daily basis on a 365 day year.

Interest on a deposit or loan is paid at maturity, or annually and at maturity, unless special arrangements are made at the time the deal is concluded.

On *secured* loans the discount houses and Stock Exchange money brokers do not pay interest at intervals of less than 28 days. The current general practice is to calculate at the close of business on the penultimate working day interest outstanding on secured loans to the last working day of each calendar month and to pay the interest thereon on the last working day of the month.

- (ii) Brokerage: all brokerage is calculated on a daily basis on a 365 day year and brokerage statements are submitted monthly.

Schedule II

Calculation of interest in a leap year

The practice of most local authorities concerning the calculation of interest in a leap year depends upon

whether interest falls to be calculated on a daily or an annual basis. The position may differ as between temporary and longer-term loans.

1 Temporary loans

Because temporary loans may be repaid in less than one year (but may, of course, be continued for more than a year) interest on temporary money is almost invariably calculated on a daily basis. Thus any period which includes the 29 February automatically incorporates that day in the calculation; in calculating the approximate amount of interest, the number of days in the period since the last payment of interest is expressed as a fraction of a normal 365 day year, not the 366 days of a leap year, which ensures that full value is given for the "extra" day.

Examples:

- (i) Assuming last previous interest payment 1st February (up to and including 31 January) and date of repayment 1 April (in a leap year). Duration of loan for final interest calculation — 29 days (February) + 31 days (March) — 60 days.

Calculation of interest would be

$$P \times \frac{r}{100} \times \frac{60}{365} =$$

- (ii) Assuming no intermediate interest payments. Loan placed 1 March and called for repayment 1 March the following year (leap year). Total period up to and including 29 February — 366 days. Calculation of interest would be

$$P \times \frac{r}{100} \times \frac{366}{365} =$$

This is in line with banking practice regarding interest on deposits which is calculated on a "daily" basis and no conflict therefore arises.

2 Longer term loans

The following procedure for the calculation of interest on loans which cannot be repaid in less than one year (except under a TSB or building society stress clause) was agreed between the British Bankers' Association and the Chartered Institute of Public Finance & Accountancy on 12 December 1978.

A

The total amount of interest to be paid on a longer-term loan at fixed interest should be calculated on the basis of the number of complete calendar years running from the first day of the loan, with each day of any remaining period bearing interest as for 1/365 of a year.

Normal local authority practice for the calculation of interest in leap years is to disregard 29 February if it falls within one of the complete calendar years. Only when it falls within the remaining period is it counted as an additional day with the divisor remaining at 365.

Example: $3\frac{1}{2}$ year loan, maturing on 30 June of a leap year.

First 3 years' interest: $P \times \frac{r}{100} \times 3 =$

Final 6 months' interest: $P \times \frac{r}{100} \times \frac{182}{365} =$

Certain banks, however, require additional payment of interest for 29 February in all cases, and it was therefore agreed that:

- 1 both the original offer or bid and the agent's confirmation must state specifically if such payment is to be made.
- 2 The documentation must incorporate the appropriate phraseology.

Interest on longer term loans should be paid half yearly, on the half-yearly anniversary of the loan or on other prescribed dates and at maturity.

B

Interest on variable rate loans, or roll-overs, which are taken for a fixed number of years with the rate of interest adjusted on specific dates, should be calculated in the same manner as for temporary loans.

Schedule III

Calculation of proceeds on sterling CDs

All calculations are on the basis of a 365 day year.

- (a) The formula for calculating sale proceeds for maturities of up to one year is as follows:

Proceeds =

$$\text{Principal} \times \frac{(\text{issue rate} \times \text{tenor in days}) + 36,500}{(\text{quoted yield} \times \text{days to run}) + 36,500}$$

eg If a new £100,000 three-month sterling certificate of deposit is bought on 28 January to yield $10\frac{1}{4}\%$ (ie on 28 April, the holder would receive £102,589.04) and sold on 27 April at a yield of $10\frac{1}{4}\%$ the calculation of the amount receivable on the sale is as follows:

Example:

Calculation of proceeds

$$\begin{aligned} &£100,000 \times \frac{(10\frac{1}{4} \times 90) + 36,500}{(10\frac{1}{4} \times 1) + 36,500} \\ &= £102,560.24 \end{aligned}$$

The proof of this is that £102,560.24 plus interest at $10\frac{1}{4}\%$ for one day is £102,589.04.

- (b) For fixed rate sterling CDs with more than one year to maturity, the sale proceeds are calculated by the repeated discounting of the proceeds at maturity plus successive annual payments.

Example:

A £250,000 sterling CD issued on 21 June 1982 at 11½% to mature on 21 June 1984 is sold on 18 January 1983 to yield 10½%.

Amount at maturity	250,000.00
Interest 21.6.83 to 21.6.84 (366 days)	<u>28,202.05</u>
	£278,202.05

$$\text{Discount for the year 1983/4} \\ £278,202.05 - 1 + \frac{366 \times 10\frac{1}{2}}{36,500} = £250,705.96$$

Interest 21.6.82 to 21.6.83	<u>28,125.00</u>
	£278,830.96

$$\text{Discount for the period} \\ 18.1.83 \text{ to } 21.6.83 \text{ (154 days)} \\ £278,830.96 - 1 + \frac{154 \times 10\frac{1}{2}}{36,500} = £266,531.27$$

Sale proceeds = £266,531.27

- (c) For a sterling CD issued at a variable rate, eg at a certain margin over a specified indicator rate (which should be LIBOR), the sale proceeds are calculated according to the relevant data for that particular sterling CD, viz. the stated margin over LIBOR being applied to the quoted yield for the period outstanding between date of sale and the next interest date.
- (d) Discounted sterling CDs are bought and sold on a discount per annum basis.

$$\text{Discount} = \text{Principal} \times \frac{\text{Rate}}{100} \times \frac{\text{Days}}{365}$$

eg Discount at 12½% on £1,000,000 for 182 days

$$£1,000,000 \times \frac{12.5}{100} \times \frac{182}{365} = £62,328.77$$

Therefore proceeds =
£937,671.23

The true cost or yield is always higher than the discount rate:

$$\text{Yield} = \frac{\text{Discount rate}}{\frac{(\text{Discount rate} \times \text{Days})}{36,500}}$$

eg

$$1 - \frac{(12.5 \times 182)}{36,500} = 13.3309\%$$

Schedule IV

Market definitions and terminology in the foreign exchange and currency deposit markets, including conventions on brokerage

1 Brokerage

A General (foreign exchange and currency deposits)

- Brokerage arrangements are now freely negotiable.
- These arrangements should be agreed in advance of any particular transaction by directors and senior management.

B Currency deposits

- Calculation of brokerage on all currency deposits shall be worked out on a 360 day year.
- Brokers' confirmations and statements relating to currency deposits should express brokerage in the currency of the deal.
- In a simultaneous forward-forward deposit (eg one month against six months), the brokerage to be charged shall be on the actual intervening period (in the above example, five months).

2 Other market definitions

Currency deposits

A Length of the year

For the purpose of calculating interest, one year is in general deemed to comprise 360 days; but practice is not uniform in all currencies or centres.

B Spreads and quotations

Quotations will normally be made in fractions. Quotations and transactions should not be expressed in fractions of less than ½ per cent. (Quotations in decimals are normally used in short-dated foreign exchange dealings.)

C Call and notice money

For US dollars (and sterling), notice in respect of call money must be given before noon in London. For other currencies, it should be given before such time as may be necessary to conform with local clearing practice in the country of the currency dealt in.

3 Market terminology

The markets in foreign exchange and currency deposits operate at considerable speed and the many possibilities of misunderstanding can be minimised by the use of generally-accepted, concise terminology. This section of the Paper sets out commonly-used expressions and endeavours to clarify their accepted meaning. Adherence to them will do much to reduce misunderstanding and frustration; their use is therefore strongly recommended. Special care should

always be taken to specify the particular currency referred to and to adopt what is now standard spot market terminology, both in currencies and in sterling, so that all discussions are couched in terms of:

- (i) round amounts of sterling-bid and offered, when dealing in US dollars/sterling;
- (ii) round amounts of US dollars bid and offered, when dealing in other currencies.

In cases which will be obvious the terms listed below may be used in relation to lending and borrowing as well as to selling and buying.

Offered at ..

Comes at Seller of sterling - as in (i) above

I give at ... US dollars - as in (ii) above

I sell at ...

I offer at ..

I bid at

I pay at Buyer of sterling - as in (i) above

I take at ... US dollars - as in (ii) above

I buy at ...

Spot Cash settlement two working days from today.

Forward All deals over two working days from today for periods of one month onward fixed at the time of dealing. Where the maturity falls on a non-trading day, it takes place on the following working day. Where the deal is arranged on a day for which spot delivery occurs on the last working day of the month, it matures on the last working day of the appropriate month in the future.

End/end Forward swaps or currency deposits arranged for implementation before or at spot delivery on the last working day of the month should be described as "end/end" if it is intended that they should mature on the last working day of the appropriate future month.

Shorts; Short Dates All deals for a broken number of days up to the one month date.

Forward/forward A forward sale against a forward purchase or forward purchase against a forward sale.

Swap A spot sale against a forward purchase or spot purchase against a forward sale.

When talking about "forwards", dealers refer only to the forward date, eg a dealer buys spot and sells three months forward, he will say to his counterparty, "I offer three's" or "I sell three's". (The reverse is true in the \$:£ market.)

Par Price is the same on both sides of the swap.

At a premium A currency which is more expensive to purchase forward than for spot delivery.

Long Excess of purchases over sales.

(over-bought)

Short Excess of sales over purchases.

(over-sold)

Open position Difference between total spot and forward purchases and sales in a currency on which an exchange risk is run.

Square Purchases and sales are equal.

Firm A dealer making an offer or bid on a "firm" basis commits the bank but he would be advised to add some qualification (eg "firm for one minute" or "firm for one million only").

Under reference A deal cannot be finalised without reference to the bank which placed the order, whose name should not be mentioned until reference has been made to that bank.

Choice A broker or bank is a buyer or seller at one price.

Details Information a dealer requires after the completion of a transaction, ie name, rate and dates.

Mine The dealer takes the "spot" or "forward", whichever has been quoted from his counterparty. NB This is a very dangerous term and must be qualified by the amount involved.

Yours Reversal of above. (The dealer giving the spot or forward.) NB This is a very dangerous term and must be qualified by the amount involved.