

UNITED KINGDOM

DEBT MANAGEMENT OFFICE

**Index-linked Gilt Switch Auctions:
Consultation Document**

12 March 2001



UK DEBT MANAGEMENT OFFICE

INDEX-LINKED GILT SWITCH AUCTIONS: PROPOSALS FOR CONSULTATION

MARCH 2001

Introduction

1. The DMO's Remit from HM Treasury for the financial year 2001-02¹ states that subject to the conclusions of a consultation exercise with the market on the introduction of index-linked gilt switch auctions, the DMO may launch such auctions in 2001-02. In July 1999 the DMO issued a consultation document on switch auctions, and published a response in September 1999². The first conventional gilt switch auction was held on 21 October 1999, and a further four have been held to date, all involving conventional stocks. This document sets out how the DMO proposes to extend the conduct of switch auctions to index-linked gilts, and the issues on which comment is sought from gilt market participants and investors. The DMO welcomes comments on the proposals and will publish an addendum to its operational market notice setting out the definitive procedure before any such operations are held.
2. Comments on the proposals should be sent by **6 April 2001** to: Gurminder Bhachu, UK Debt Management Office, Cheapside House, 138 Cheapside, London EC2V 6BB; telephone 020 7862 6512; fax 020 7862 6509; e-mail gurminder.bhachu@dmo.gov.uk. The DMO will aim to publish a response to any comments received by early May so that the details of any index-linked gilt switch auctions in July to September 2001 can be discussed in June at the DMO's regular quarterly consultation meetings with Gilt-edged Market Makers (GEMMs) and representatives of end-investors.

¹ "Debt and Reserves Management Report 2001-02", Her Majesty's Treasury (March 2001), available on the DMO web site at www.dmo.gov.uk/remit/dmr2001_02.pdf

² "Response to DMO Consultation Document on Switch Auctions and 'Cash-Plus' Conversion Offers", available on the DMO web site at: www.dmo.gov.uk/gilts/public/consdoc/conresp.pdf



Index-linked gilt switch auctions

Rationale

3. The primary aim of introducing index-linked gilt (IG) switch auctions in 2001-02 would be to facilitate switching longer by index-tracking funds as a particular stock is about to fall out of a significant index, so contributing to market stability.
4. Unlike with conventional gilts, the DMO does not currently concentrate index-linked issuance into benchmarks, but issues relatively evenly across the longer maturities. Hence the aim of IG switch auctions under current policy would not be to build up the size of individual stocks more quickly than can be achieved through outright auctions alone, but would primarily serve a market management purpose. As such, the DMO envisages holding IG switch auctions relatively infrequently.
5. However, the DMO's Remit from HM Treasury for the financial year 2001-02 looks forward to a consultation exercise on the possible re-design of index-linked gilts. As part of that consultation exercise, the DMO expects to seek views on whether (and if so, the extent to which) the existing stock of index-linked gilts should over time be converted or switched into issues based on the new design. This potentially opens up a wider role for IG switch auctions, on which further views will be sought in the forthcoming consultation.

Proposed amendments relating to index-linked gilts

6. Unless otherwise stated below, the DMO intends that the features of conventional switch auctions will also apply to index-linked stocks³. However, comments are sought on the following issues where there are likely to be differences due to the different nature of the instruments involved.

³ See Annex 1 for a summary of the framework for the conduct of conventional switch auctions.



Candidate stocks and size

7. Following a switch auction, the DMO would ensure that a sufficient amount of the source stock would remain for a viable market to be expected to exist. Given that index-linked stocks typically trade at prices which are a multiple of £100 (due to the accrued inflation since the first issue of each bond), a given nominal value of index-linked stock represents a much higher market value than the market value of a comparable conventional stock trading close to par. **The DMO proposes not to hold an IG switch auction for a stock that would reduce the amount in issue to below £1.5 billion (nominal). In addition, the size range of such an offer is envisaged as £250 million to £750 million (nominal) of the source stock.** Hence, stocks of less than £1.75 billion (nominal) in issue would not be made subject to a switch auction.
8. Given the primary rationale for introducing IG switch auctions as stated in paragraph 3, **the DMO proposes to apply the following different maturity brackets for index-linked stocks: short (0-7 years) and medium/long (over 4½ years).** This should ensure that switch auctions should not result in excessive forced re-balancing by index-tracking investors.

IG switch auction format

9. Unlike conventional gilts, outright auctions of index-linked gilts are conducted on a uniform price basis. Adopting a uniform price format can reduce the problem of the “winner’s curse” that holds under a competitive price format. Given the relative differences in liquidity in the two sectors of the market and the availability (or otherwise) of hedging instruments, the DMO felt that reducing this risk was appropriate for outright auctions of index-linked gilts. This should give some comfort to Index-linked GEMMs (IG GEMMs) who had built short positions ahead of the auction and would help maximise participation.

10. However, given the different nature of the risks involved in a switch auction, the DMO would welcome comments on the appropriate auction format (uniform or bid-price). The procedure would be very similar under both formats, including the DMO publishing an indicative clean price of the existing source stock at 10am on the morning of the auction, and bidders then bidding a clean price for the new destination stock, with the relevant nominal quantity of the source stock that they were willing to switch at that price. The DMO would rank the bids according to the prices bid for the destination stock and allot the switch to the highest bidders. The only difference between the two formats would be that, under a uniform price format, all successful allocations would be settled using the same dirty price ratio (derived using the striking price⁴ of the destination stock), whereas under a bid-price format all successful allocations would be settled using the dirty price ratio implied by the price that bidders bid for the destination stock.

11. The DMO proposes that bidding would be limited to IG GEMMs only. A non-competitive bidding facility would not be available.

IG switch taps

12. A natural extension of the switch auction procedure is the option to hold switch taps involving index-linked gilt stocks⁵. As with outright issues of stock by tap, this could be a valuable market management tool when a small-scale switch might ease market illiquidity in a particular stock or area of the curve. It would be deployed only in extreme market conditions at a time when the Exchequer did not need the cash receipts from an outright tap of the destination stock but did not warrant the lead time involved in consulting on, and holding, an IG switch auction. The choice of IG switch tap stocks would be constrained by the same considerations as for IG switch auctions. However, an IG switch tap would be announced at short notice and would be limited to a maximum of £250 million

⁴ The striking price is the highest price of the destination stock at which the switch auction becomes fully allocated.

⁵ The DMO already has the capability to hold switch taps involving conventional stocks – see Annex 2 for a summary of the conventional switch tap framework.



(nominal) of the source stock.

Questions for market participants

13. The DMO would welcome views on any of the issues raised in this paper, and specifically:

- Is a £250 - 750 million (nominal) possible range the most appropriate for IG switch auctions?
- Are the proposed maturity brackets appropriate for IG switch auctions or should the authorities retain a set of three maturity brackets (as with conventional switch auctions)?
- Should the auction allocation procedure be on a uniform price basis or a bid-price basis? (ie. should all bidders transact the switch at the highest accepted effective dirty price ratio, or should the switch be transacted at the effective ratio at which the successful bidders bid?)

14. Prior to conducting any IG switch auctions or IG switch taps, the DMO will issue an addendum to both its operational market notice and the September 1999 switch auction response paper to outline how such operations would be conducted.

UK Debt Management Office

12 March 2001



Annex 1: Summary of the framework for the conduct of conventional switch auctions

Candidate stocks

- The DMO would not hold a switch auction for a stock that could reduce the amount in issue to below £4.5 billion (nominal).
- Other considerations being equal, priority will be given to switching non-strippable gilts when appropriate. However, strippable stocks *could* be amongst the first switch auction source stocks.
- Switch auctions would not be used as a means to issue entirely new stocks to the market. The DMO will not hold a switch auction into a stock that has been auctioned outright less than 21 days earlier. A stock will not be converted out of within eighteen months of its last auction date.
- The DMO would envisage only holding switch auctions where both the respective stocks were within the same maturity bracket (0-7 years; 5-15 years; 14 years and over).
- The DMO commits not to hold a switch auction out of a stock that is cheapest-to-deliver (CTD), or has a realistic prospect of becoming CTD, in a gilt futures contract for which there is open interest outstanding. However, this moratorium will not apply if there is no open interest in any of the listed contracts of the gilt future. The DMO will be free to consider switch auctions into stocks that are CTD for a listed futures contract.

Size of switch auctions

- The maximum size range of a switch auction will be £½ -2 billion (nominal) of the source stock. However, a number of switch auctions out of one stock may be held over a period if necessary. A maximum allocation limit at switch auctions may be considered on a case-by-case basis depending on the circumstances of the switch auction in question.

Timetable for the conduct of a switch auction

- The possibility and range for the potential size of switch auctions would be specified in the Treasury's annual remit to the DMO published in the Debt and Reserves Management Report. Also, if applicable, the Remit would state how switch auctions were to be integrated into the overall portfolio strategy of the Government, if relevant.
- Unlike conversion offers, however, the DMO proposes that it would preannounce the auction and settlement date(s) of switch auction(s) in the quarterly auction calendar, including the stocks involved. This would follow the usual consultation with market participants at the relevant quarterly meetings. As with standard auctions, switch auctions would normally be scheduled for Wednesday mornings.



- On the Tuesday of the week prior to the switch auction, a press notice would be issued confirming the details of the switch auction, settlement details, maximum size and whether any limit on maximum allocation will apply. However, given the uncertainty over the amount of the destination stock to be created as a result of the switch auction, this stock would not be created and listed until settlement (as with a standard conversion offer). Consequently, a formal ‘when-issued’ market in the new stock would not exist.
- On the switch auction day:

At 10am, the DMO would publish on its wire service screens an indicative clean price for the source stock involved in the switch auction.

Between 10.00 and 10.20am, Gilt-edged Market-Makers (GEMMs) would be allowed an unlimited number of telephone bids to switch a nominal quantity of the source stock into the destination stock at the clean price of the destination stock (given the indicated 10am clean price of the source stock).

Between 10.20 and 10.30am, GEMMs would be allowed up to 10 telephone bids to switch a nominal quantity of the source stock into the destination stock at the clean price of the destination stock (given the indicated 10am clean price of the source stock).

By 11.10am, the DMO would aim to publish the results of the switch auction. These would include the highest, lowest and average clean prices of the destination stock which were successful, and their dirty price ratio equivalents; the percentage allotted of the bids at the lowest accepted price; the nominal amount of the source stock that would be switched; and the nominal amount of the destination stock that will be created as a result.

- Settlement of the switch auction would normally occur the following business day unless specified otherwise.



Annex 2: Summary of the framework for the conduct of conventional switch taps

The choice of switch tap stocks is constrained by the same considerations as for switch auctions. However, a switch tap would be announced at short notice and would be limited to a maximum of £0.5 billion (nominal) of the source stock. The tap result and allocation would be calculated on a uniform price basis. The DMO would not publish a minimum price for the destination stock but would reserve the right not to allot bids if they were at too great a discount to prevailing market terms. Given the greater complications of bidding at a switch tap, the DMO would give more notice than for an outright tap of stock.

Timetable

- Day preceding the tap:

3.30pm: DMO announces intention to switch tap including the source gilt against which the switch will occur; the destination stock; and the maximum nominal amount of the source gilt allowable for switching. DMO has the discretion to impose a per GEMM allocation limit.

- Day of the switch tap:

10.15am: DMO announces clean price of the source stock at which it will settle the switch.

10.45am: Opening of bidding by GEMMs. Bids comprise nominal quantities offered of the source stock (in units of £1 million), and the clean prices bid for the destination stock (to 2 decimal places). GEMMs would be limited to a maximum of six bids.

10.50am: Close of bidding.

As soon as practicable after 10.50am: Publication of tap results. The DMO would publish on the screens the nominal amount of the source gilt offered and the nominal amount successfully switched, the nominal quantity of the destination gilt created, the new amounts outstanding following the switch tap, and the striking (clean) price of the destination gilt. Settlement and creation of the new stock would be on the following business day. Source stock that was successfully switched would be cancelled at the same time as the new stock was created.

If the switch tap attracted insufficient demand to clear (at acceptable prices), the remainder would not be created.

