UK DEBT MANAGEMENT OFFICE

Response to DMO Consultation Paper on the Secondary Market for Gilts

June 2000

Introduction

1 On 24 January 2000 the DMO issued a consultation paper on whether, in the light of the possible introduction of new trading technologies, the DMO should change the nature of its relationship with the gilt-edged market makers (GEMMs).

2 The DMO received thirty-six written responses along with a number of oral comments. These came from a variety of sources including fund managers, GEMMs, gilt-edged inter-dealer brokers (IDBs), other brokers, various exchanges, the London Clearing House, the Financial Services Authority, the Bank of England, the Office of Fair Trading, and other interested individuals (a full list of respondents appears in the Annex). Some respondents made broad general comments while others focused on the particular questions posed in the original consultation paper. The quality of the comments received was very high and the DMO appreciates the time and effort that went into their preparation.

3 This paper outlines below the approach the DMO proposes to take following its review of the responses. This is followed by a brief summary of the responses. The paper then identifies a number of details of the proposal that remain unresolved and that need to be taken forward in further consultation. The paper concludes with an indication of the steps that need to be completed before the proposal can be implemented.

Please direct any comments on the questions raised in this paper to Allison Holland, UK Debt Management Office, Cheapside House, 138 Cheapside, London EC2V 6BB, 020 7862 6534 or email them to allison.holland@dmo.gov.uk.

THE PROPOSAL

4 In light of the responses received, the DMO proposes that an inter-GEMM market in benchmark stocks should be established, similar to that outlined as Option 3 in the original consultation paper. In broad terms, this will require the GEMMs to make firm prices to each other in a range of benchmark stocks. This market would only be available to the GEMMs. However, the DMO hopes that the existence of this central market will facilitate and encourage the development of a range of other products in the wider market.

5 The DMO believes that, although this option imposes an extra burden on the GEMMs, a central committed market would provide a benefit to the entire market, including the GEMMs, at a time of limited issuance. It ensures that the GEMMs have access to a minimum depth of liquidity in certain stocks and that prices in that market are fully efficient, allowing the GEMMs to carry on their wider market-making activities in confidence. This will be of particular value in an environment where a number of (potentially exclusive) trading venues exist. The DMO hopes that this model will make it more likely that entry barriers facing prospective GEMMs remain at an acceptable level, maintaining a high degree of competition in the provision of market-making services. This should ensure that any benefits resulting from the new system are reflected in the service that GEMMs provide to investors.

THE RESPONSES

Option 1: Continuation of the existing system

6 A number of respondents indicated that the current structure would remain appropriate in a new trading environment characterised by automated trading systems. One respondent suggested that in a period of low liquidity and low issuance it was the best structure. Others believed that there was a definite need for a change. Some respondents believed that the current structure was out of date, while a number of other respondents believed that a change was necessary to prevent harmful fragmentation of the market. There was a general level of acceptance, however, that electronic trading was inevitable in some form, which would bring greater efficiency in trade execution.

7 Continuing with the current set of benefits and obligations for GEMMs is attractive in that it does not impose any additional burdens on the GEMMs. However, the DMO shares the concern of other respondents that it could add to the harmful effect of any market fragmentation. A fragmented market where a number of alternative trading venues compete for liquidity could make it very difficult for the GEMMs to meet their market-making obligations. They may be excluded from particular trading venues; this would limit their ability and opportunity to lay-off positions acquired during the course of their market-making activities. They may also face a reduced information set, hampering their ability to price gilts efficiently and reducing their ability to manage their risk effectively.

8 In addition, these new trading venues may in practice set certain entry requirements that would constitute an additional barrier to entry for a prospective GEMM. This could result in lower competition in the provision of market-making services to the market, another undesirable outcome.

Option 2: Centralised quotation system

9 There was little enthusiasm for this model from any category of respondent. Some of the investors who responded indicated that automated dealing systems would be beneficial for small trades in benchmark stocks. However, they also noted that they were always likely to prefer to negotiate large trades bilaterally.

10 The DMO is of the opinion that there is little need to increase obligations in this area. There are many single-dealer systems already active in the market and there are indications that some multiple-dealer systems (which would offer all the benefits of this option) may enter the market voluntarily. These systems offer firm prices, for trades up to a certain size, from one or several market-makers to investors. The DMO welcomes the introduction of these systems. In addition, the DMO plans to begin publishing, over the course of the day, indicative mid-prices in the gilt benchmarks in the very near future. These intra-day prices would be available to the wider market as a reference point. This will add to the transparency of the market and increase investors’ information set.

Option 3: Inter-GEMM market with quote obligations

11 There was widespread support from the GEMMs for this option, although there were differences of opinion in precisely how it should be delivered. Some respondents believed that mandatory quoting should be limited to the benchmark stocks. Some thought it would be particularly good for sub-10 year stocks. The majority of respondents who considered this option believed that such a model would improve liquidity in the market. One respondent, however, was concerned that it could lead to a reduction in the number of GEMMs, with a consequent reduction in liquidity, because it may not be in line with every GEMM's business model or the technology required may not be available to all GEMMs.

12 One respondent suggested that this structure could increase the volatility of prices because all the submitted quotes would be driven off the price of the (illiquid) long gilt futures contract on LIFFE. Therefore the prices quoted would change with every change of the futures price.

13 Some respondents suggested that the mandatory quote obligations should be flexible intra-day. For instance quotes would only need to be provided for 5 hours out of an 8 hour day and that the GEMMs would have flexibility about when to meet that obligation. Others suggested that prices should go 'subject'[1] around various news events but in general should hold in all circumstances. Others suggested that the DMO should define a 'fast' market[2].

14 Respondents were also split on whether obligations could be met by posting quotes on any IDB screen or whether it should be on only one designated broker's screen. Those who favoured an open, non-specific approach expected that technology would provide a means of pooling the information, creating a consolidated 'virtual' market. Others suggested that endorsing one system provider would be "convenient". This single franchise would be allocated for a fixed period of time (of up to five years) as a licence; it was suggested that the DMO should act as facilitator in determining who should get the franchise.

15 The choice of whether the market should be delivered over one platform or over multiple platforms remains open. However, selecting one system effectively creates

[1] That is all prices are withdrawn from the screens temporarily.

[2] That is a market where conditions are temporarily so erratic and volatile that providing liquidity imposes an unacceptable level of risk on a GEMM.

a monopoly, could delay the implementation of the proposal and is likely to cut across the wider business objectives of some firms. The DMO would therefore prefer, if practicable, to adopt the latter approach to this issue. Additionally, adopting this approach means that brokers will have a continuing incentive to develop and maintain an attractive service, encouraging further technological innovation.

16 Respondents generally considered that it would be necessary for a potential system provider only to be authorised by the FSA; it would not be necessary for this service to be provided by a recognised investment exchange. This, of course, does not preclude an existing exchange from offering the service.

17 The DMO considers that a committed market between the GEMMs will improve their access to liquidity and aid them in fulfilling their wider market-making obligations. The DMO believes, in line with the majority view, that such a market will be beneficial to liquidity in the market. The DMO also hopes that this model will not create any overriding business or technological issue for any GEMM. In this context, since almost all of the GEMMs who are active in the wholesale market participate in similar markets for other bonds, the DMO judges it to be broadly consistent with their wider business model and hopes that many of the technological issues would already have been addressed.

18 It is difficult to be sure about the impact on market volatility; this model may simply make the underlying volatility of the market more transparent. GEMMs' prices are already driven by the futures price but at the moment these prices are not observed. There is no reason to think that the market would become more volatile than the futures market. Additionally, the DMO is not aware of any undesirable impact on market volatility in markets where a similar model has been adopted.

19 Mandatory quoting to other GEMMs will be restricted to a set of benchmark stocks. This should limit the additional risk to which the GEMMs are exposed and also reduce the impact on overall market volatility since the prices of other stocks will continue to be determined as they are now. The precise details of how this system will work will be determined in consultation with the GEMMs and potential systems providers. In particular the precise number of stocks to be covered, the size that the quote must be firm in and the maximum spread have yet to be determined. This will allow the GEMMs to participate in the decisions determining the level of

additional risk they will be required to undertake. The issues that remain to be resolved are outlined further below.

20 It is not intended that this market will substitute for the existing IDB structure; it is merely an extension of that model. The DMO would expect a continuing role for IDBs offering a traditional broking service in the full range of non-benchmark gilts, possibly alongside the committed inter-GEMM market in the designated benchmarks.

21 The FSA and the OFT have indicated that they are content with this approach.

Option 4: Full electronic dealership market

22 There was only muted enthusiasm for this option. One respondent expressed the opinion that widening participation could be beneficial in a "mature electronic market". Others thought that professional dealer participation in a benchmark system was feasible, while others thought that some kind of Tier 2 market would be inevitable or that this would represent the second (evolutionary) stage of implementation of the inter-GEMM model. Some respondents thought that the system could be widened to price-takers but others believed that this would devalue the GEMMs' franchise and would lead to the withdrawal of some GEMMs from the market. There was generally strong resistance to the idea of allowing other non-GEMM participants to post quotes. Several respondents noted that if that were to be the case then the GEMMs' obligation to provide liquidity to that participant should be relaxed, as it currently is to users of a registered wholesale dealer broker. This is to avoid exposing the GEMMs to competition from fair-weather market makers, who, unlike the GEMMs, would not be obliged to provide liquidity in difficult market conditions.

23 The question of a central counterparty arose here. Some respondents believed that a central counterparty would be absolutely necessary in a system with wide participation, although others thought that entry criteria could be set so as not to require the use of a central counterparty.

24 The DMO believes that this model may evolve naturally from the inter-GEMM model. However, it sees little need to mandate its development and believes the market should evolve as it wishes.

PERIODIC CALL AUCTIONS

25 There was very little demand for periodic call auctions as an addition to any of the options outlined in the original consultation paper. Respondents pointed out that these auctions could give rise to potential manipulation of prices and that they do not provide a service to investors who require immediacy of execution. There were, however, some exceptions to this point of view. Some respondents thought they might add value in the off-the-run stocks or that they would be useful for odd-lots[3].

26 On balance, the DMO believes that periodic call auctions are unlikely to offer any additional liquidity to investors and could be open to price manipulation. Therefore the DMO has no plans to introduce them.

CENTRAL COUNTERPARTY

27 Of those respondents who expressed an opinion, most favoured the introduction of a central counterparty. Others thought that there was no immediate need for one. One respondent thought that it would only become a major issue if there were a move to a general order book environment; another that it would be necessary if option 4 were implemented. The DMO agrees that a central counterparty would probably be necessary if option 2 or option 4 were to be adopted; however, given the proposed route, a central counterparty is not crucial.

28 The DMO would, in principle, welcome the introduction of a central counterparty as such an organisation can generally add to the stability of a market, reducing some of the settlement risk faced by market participants. However, as gilts settle in an assured payment system[4] and the settlement cycle is short (T+1), the DMO believes that a central counterparty would add little to settlement risk reduction. Therefore, the DMO considers that, whilst a central counterparty may bring some cost savings through netting of transactions and possible cross-margining of positions with other products, the introduction of one is a matter for the market participants to decide.

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[3] That is where the trade size is less than £1mn nominal.

[4] Gilts will settle in a true delivery versus payment (DVP) environment by the end of 2001.

OPTIONS FOR THE RETAIL MARKET

29 Overall there was little support for establishing a separate market for retail investors. GEMMs active in this area have already established their own single-dealer trading systems where they deliver firm prices to their clients. The DMO does not believe that there is any necessity to oblige them to support an additional and alternative service.

30 However, given that the DMO would not expect all GEMMs specialising in servicing the retail investor to be in a position to meet the mandatory quote obligations in the inter-GEMM market, the DMO intends that GEMMs can apply to be classified as specialist retail GEMMs (RGEMMs). This would allow them to access the inter-GEMM market on a price-taking basis. However, the DMO would as a consequence re-examine the terms under which they participate in conventional gilt auctions.

31 There is generally a good trading relationship between the potential RGEMMs and the other GEMMs. Both categories appear happy to trade odd-lots with each other at the other's instigation. It was generally accepted that it would not be necessary to formalise this relationship.

32 There were mixed views on what constituted a retail trade with the suggested size of a retail trade varying from £50,000 to £1mn nominal. Others believed that the client base should determine what was and was not a retail trade. The DMO intends to discuss this issue with the prospective RGEMMs.

THE PROPOSED INTER-GEMM MARKET IN MORE DETAIL

33 In broad terms, the GEMMs will be required to provide firm quotes on an anonymous and continuous basis in a designated set of benchmarks to other GEMMs on an approved screen or screens over a particular time period. These quotes must be firm up to a certain size and the spread between bids and offers must be within a specified maximum. Compliance with these obligations will be monitored by the DMO. Trades will be executed on a fully anonymous basis and trading information will remain within the group of GEMMs.

34 However, the DMO intends that the precise details of how the proposal would be implemented will be agreed between the DMO and the GEMMs (and IDBs) through a

process of further discussion. The DMO will also open discussions on implementation issues with potential systems providers.

35 Issues to be resolved through further discussion include:

- **In what size should these quotes be firm?** A variety of sizes were suggested. The DMO believes that the obligation should not be too onerous nor lead to an unacceptably large risk-taking position for the GEMMs. Therefore, the DMO expects that a size of around £3mn nominal in shorts and mediums (although £5mn may be feasible in shorts), and £1mn at the long-end would be appropriate.

- **What should be the maximum spread allowed?** This could be specified in yield terms; for example, a one basis point in yield would be equivalent to about 3p in ultra-shorts, 7p in a 5yr bond, 8p in a 10yr bond, 15p in a 15yr bond and 20p in ultra-longs. Or it could be specified in terms of price; say, 3p in 0-5 year bonds; 8p in 6-10 year bonds; 10p in 11-15 year bonds and 20p in 15+ year bonds. Again, the DMO believes that the size of the spread should be wide enough to adequately compensate the GEMMs for the risks that they are undertaking. The expectation would be that the spread would widen with maturity.

- **Are there any situations where the obligations would be relaxed?** The DMO believes the obligations should be meaningful and that the existence of a committed market is most useful in times of market stress. Therefore, it would expect that the obligations would only be relaxed just in advance of major economic data releases (to be identified) and, for the particular stock(s) involved in outright, reverse and switch auctions, during bidding and between the close and the announcement of the results.

- **How many benchmarks should be covered?** The DMO believes that around 5-10 stocks should be sufficient to populate the curve and to allow the GEMMs to price and hedge other stocks with confidence. Maturity areas would also need to be determined but desirable maturities would probably include 1, 3, 5, 7, 10, 15 and 30 years.

- **What determines an eligible benchmark?** Possible criteria would be that the most recently issued stock in a particular maturity area would be included, provided it had more than £5bn nominal outstanding and was strippable.

- **Is there a need for a central counterparty?** The DMO intends that trades will be executed on an anonymous basis both pre- and post-trade. This will require either the broker to deal on a matched principal basis, as is the case with the existing gilt-edged IDBs, or for trades to be executed through a central counterparty. Given that the IDBs already act on a matched principal basis, the DMO does not believe that the introduction of a central counterparty in gilts is necessary to implement the system.

- **Where do GEMMs need to post their prices?** GEMMs would have to post their prices on an endorsed system open to all other GEMMs. However, this could be one of many endorsed systems or simply one named service. Where a multitude of screens are used, this could give rise to an information management problem for the GEMMs and the DMO.

- The DMO would not expect the supply of prices to multiple systems to cause too many problems, so long as systems accept standard data feeds. GEMMs are likely to automate this procedure. But monitoring several screens to track all available prices in a stock could be more problematic.

- The scale of this problem may not, however, be much greater than the one the GEMMs currently face with three IDBs to monitor. The number of interested service providers may be limited by the absence of a central counterparty. Preserving post-trade anonymity in the current environment will require any designated broker to act on a matched principal basis. Some potential service providers may not be comfortable dealing on this basis. Additionally, a closed system with mandatory provision of liquidity may not be consistent with some brokers' business strategies. Where systems use a standard open application programme interface (API), middleware solutions can be developed to pool information centrally, reducing the scale of the problem, both for the GEMMs and the DMO.

- The DMO will need to consult with prospective service providers on how to collect (and collate) the information it will require in order to monitor compliance of the GEMMs' obligations.

NEXT STEPS

36 The DMO would like to receive comments on the questions highlighted above. The DMO intends to discuss these details further with the GEMMs, through the Gilt-Edged Market Makers Association (GEMMA), and potential service providers, before determining the definitive set of obligations for GEMMs and the criteria for the designated broker(s). It would expect these meetings to take place in July. The DMO would be particularly grateful for any comments received in advance of these meetings.

37 Once the final details have been decided upon, the DMO will make them public.

38 Once these details are known, interested systems providers can begin designing the specifications of the system. As the DMO prefers; were it to adopt an open approach to the question of system delivery, interested brokers could then open discussions with the DMO to acquire the necessary endorsement of their system. If, however, in response to comments received on this paper, the DMO were to decide to allocate the franchise to just one broker, then these providers would have to prepare to tender for the service. This would then be followed by a series of meetings to determine the preferred service provider. The successful applicant could then begin working on developing the necessary system.

39 The DMO will also need to begin discussions with prospective RGEMMs about the benefits and obligations that will apply to that classification.

40 The DMO will also need to consult the London Stock Exchange about the necessary rule changes to recognise the different status of RGEMMs and to formalise the new obligation for a GEMM to make firm prices on a continuous basis to other GEMMs in a range of designated benchmark stocks. There may also be some changes necessary to the rules on inter-dealer brokers, although these may already be broad enough to cover the provision of the proposed inter-GEMM market. Any resultant rule changes will require consultation before they can be implemented.

41 The DMO would hope that the structure could be implemented early in 2001; the implementation date will be publicised in due course.

Please direct any comments to Allison Holland, UK Debt Management Office, Cheapside House, 138 Cheapside, London EC2V 6BB, 020 7862 6534 or email them to allison.holland@dmo.gov.uk.

ANNEX: LIST OF RESPONDENTS

GEMMs

ABN Amro Bank NV

Barclays Capital

CS First Boston Gilts Limited

Deutsche Bank AG (London Branch)

Goldman Sachs International Limited

Greenwich Nat West Gilts Ltd.

HSBC Bank plc

JP Morgan Securities Ltd.

Lehman Brothers International (Europe)

Merril Lynch International

Morgan Stanley & Co. International

Salomon Brothers UK Limited

Societe Generale (London Branch)

Intercapital Gilt Trading

Winterflood Gilts Limited

Brokers

Cantor Fitzgerald International

Garban – Intercapital WCLK

King & Shaxson Bond Brokers

BrokerTec Europe Ltd.

Instinet UK Limited

Investors

Association of British Insurers

Henderson Investors Limited

Lombard Odier Investment Management

Kauders Portfolio Management

Schroders Investment Management Limited

Norwich Union Investment Management Limited

Other

Bank of England

Financial Services Authority

Office of Fair Trading

London International Financial Futures & Options Exchange

London Clearing House

London Stock Exchange

Pat Phillips

Financial Markets Group, London School of Economics

Consumers' Association

International Securities Market Association