

UK DEBT MANAGEMENT OFFICE

Response to DMO Consultation Document on Reverse Auctions

JUNE 2000 (modified July 2003)

Introduction

The DMO received 20 responses to its consultation document on reverse auctions (dated 26 April 2000). Fifteen gilt-edged market-makers (GEMMs), four gilt investing institutions and one investor representative group responded. The DMO is grateful for the constructive comments received from gilt market participants.

2. Respondents were generally supportive of the concept of reverse auctions as a means of providing more scope for the issuance of new, and particularly longer-dated, benchmark gilts in the current market environment. The overall approach outlined in the consultation document - that the auctions should be held on a multiple stock, competitive offer-price basis, channelled exclusively through the GEMMs with no non-competitive facility - was also broadly endorsed.

3. However, some divergence of opinion appeared regarding one or two of the particular questions on which the DMO sought feedback – in particular, the number of stocks to be included in each auction. The DMO has taken account of comments received in shaping its final approach, outlined below.

4. Some concern was expressed about the potential size of the buy-back programme given the size of the 3G mobile telephone spectrum auction proceeds and the disruption this could cause in the gilts market. To address this issue, the Treasury announced on 12 June 2000 a change to the gilt sales programme in the light of the likely spectrum auction proceeds in 2000-01. Although the originally



planned size of the buy-back programme is unchanged at £3.5 billion (cash), this may be raised to £5 billion at the time of the Pre-Budget Report in the light of experience with the initial buy-back operations and the updated official forecast of the 2000-01 central government net cash requirement forecast. As outlined in the original consultation document, the DMO envisages the commencement of reverse auctions in 2000Q3.

Discussion of Specific Questions

5. **Question: How many stocks should be nominated for inclusion in any one multiple stock auction? (ie. should the same seven stocks be available for sale to the DMO at every auction, or just a subset of the named stocks)?**

The DMO concluded in the consultation document that a multiple stock reverse auction was the preferable format to consider. No one dissented from that proposal, but there was considerable discussion about the merits of including all seven eligible stocks¹ in each auction or whether a subset was preferable. A number of GEMMs and two investors proposed that all seven stocks should be included in each reverse auction. This would remove the uncertainty over which stocks were to be included in a particular auction, facilitate inventory control for the GEMMs and switching for investors and give greater protection for the Exchequer from dominant holders of one or two of the stocks.

6. However, a large majority of GEMMs and the remaining investors preferred auctions to be held comprising a subset of the possible gilts – with three of four stocks chosen on a rolling basis most often recommended. The reasons given against including all the stocks in a reverse auction were that it would be administratively more complex for both the bidders and the DMO (given the importance attached to the timely publication of the result); that a purchase of stocks with widely dispersed maturities could result in disruptive yield curve movements;

¹ 8% Treasury 2003, 10% Treasury 2003, 6¾% Treasury 2004, 9½% Conversion 2005, 7¾% Treasury 2006, 8½% Treasury 2007 and 9% Treasury 2008.



and that a subset of stocks would better focus attention on the auction, giving investors an opportunity to deal in larger volumes of each stock.

7. The DMO has therefore decided to adopt a 3-4 stock format for reverse auctions alternating between the four 2003-05 stocks (8% Treasury 2003, 10% Treasury 2003, 6¾% Treasury 2004 and 9½% Conversion 2005), and the three 2006-08 stocks (7¾% Treasury 2006, 8½% Treasury 2007 and 9% Treasury 2008).

8. Question: If a subset of stocks is chosen, should these be announced in the quarterly auction calendar or the week preceding the auction? Three respondents suggested announcing the subset of stocks in the preceding week to the auction. They believed that this would reduce the concession built into the offers of stock that the holders would demand, so protecting value-for-money for the Exchequer. However, the majority of respondents believed that the reverse auction candidates should be identified in the regular quarterly auction announcement to give investors greater certainty over the process.

9. Given the decision to alternate reverse auctions between the two subsets of eligible stocks and the need to announce the dates of auctions in the quarterly calendar, **the DMO has therefore decided to publish the subset of stocks to be purchased in the forthcoming quarter in the regular quarterly auction announcement.**

10. Question: Should reverse auctions be larger and less frequent or smaller and more frequent? A small number of respondents suggested that reverse auctions should be smaller and more frequent to facilitate GEMM inventory control, preserve value-for-money and mitigate the threat of stock-specific squeezes. However, a strong consensus supported the view that auctions should be larger in size and less frequent in order to focus attention on the reverse auction programme and to enable investors to deal in sufficient size. As suggested in the consultation paper, sizes of £½ -1 billion were most often mentioned.



11. The DMO shares the view of the majority of respondents that such an approach is more likely to concentrate investors' and analysts' attention by giving funds the opportunity to deal in size. **The DMO has therefore decided to plan on the basis of holding larger but fewer reverse auctions over the remainder of the financial year (ie. 4-6 auctions over the remaining three calendar quarters of the current financial year²). The minimum possible size of a reverse auction will be £500 million (cash) with the maximum possible size being £1 billion (cash). The precise maximum size of any particular reverse auction will be announced in the week preceding the reverse auction. The DMO will reserve the right not to purchase stock up to this value if it does not deem sufficient of the offers made represent value-for-money for the Exchequer.**

12. **Question: Is a non-competitive retail offering facility warranted?** There was near unanimity on this issue, with all but two respondents sharing the DMO's initial view that such a facility was not necessary. In a standard multiple stock reverse auction, making a non-competitive offering facility available would be logistically complex. Moreover, given that competitive offers for some stocks might not be received or accepted, a non-competitive price could be indeterminate. Retail investors can, of course, participate competitively in a reverse auction through brokers and GEMMs.

13. Consequently, **the DMO has decided not to introduce a non-competitive retail offering facility.** However, the DMO is mindful of the possible impact on liquidity of a particular stock should it be reduced to "rump" status as a result of a reverse auction. In the somewhat unlikely scenario of a rump being created by this process, the DMO would write to holders of the stock offering to buy it back at a price equivalent to the average price set at the previous reverse auction. There would be no charge for this transaction.

² The range of 4-6 reverse auctions is intended to achieve the current target of £2.5-3.5 billion (cash) of purchases. If this target is raised to £5 billion at the time of the Pre-Budget Report, a larger number of reverse auctions may be required.



Other Issues

14. **Expansion of the scope of the DMO's secondary market purchases.** As a means of supplementing buy-backs through reverse auctions, in the initial consultation document the DMO proposed an expansion of the stock for which its dealers are prepared to bid for on demand from GEMMs, to include the four non-rump double-dated gilts³ and shorter-dated (2001-06 maturity) index-linked gilts. The proposal that the DMO bid for the non-rump double-dated gilts was generally welcomed. Concern was expressed by some index-linked GEMMs however, that liquidity in shorter dated index-linked gilts might be adversely affected by DMO purchases in the secondary market.

15. The DMO confirms its plans to respond to offers for an expanded range of gilts, as proposed in the consultation document, from 3rd July 2000. In relation to shorter-dated index-linked gilts, the DMO emphasises that it does not intend to bid actively for such stock but, as now, would only respond to offers from GEMMs. Once purchased, the DMO would not be obliged to publicise such stock for sale on its wire service pages (the 'Shop Window'). However, the DMO would be willing to entertain bids for such stocks if liquidity conditions in the index-linked market necessitated such sales.

16. **Specific stocks included in the reverse auction process:** Some respondents expressed concern about the inclusion of 6¾% Treasury 2004 in the list of stocks that could be offered for sale in the reverse auction process. This stock is currently actively traded at prices that are expensive to the estimated gilt yield curve. There were fears that a major purchase of this stock via reverse auctions could reduce liquidity in this issue.

17. The DMO will continue to be prepared to purchase 6¾% Treasury 2004 via reverse auction. However, if the relatively high price of the stock in the secondary market persists and is reflected in offers submitted in a reverse auction, it is unlikely

³ 8% Treasury 2002-06, 3½% Funding 1999-2004, 5½% Treasury 2008-12 and 7¾% Treasury 2012-15.



that the DMO would acquire a significant amount of the stock given that auction allocation of purchases to offers will be judged on a relative value basis.

18. Some respondents suggested that strippable stocks could also be included in the range of those to be included in reverse auctions. Given the projected size of the buy-back programme envisaged for the 2000-01 financial year, the DMO does not believe that strippable stocks need to be included in this range. However, if the fiscal position in future years entails the continuation of the reverse auction programme, the Treasury and DMO would consult on the desirability of including strippable stocks in the programme in the remit-setting process.

19. ***The reverse auction process and timetable:*** The initial consultation document set out a proposed format for the reverse auction process and timetable. No respondents raised any substantive problems with the proposed process and timetable and so this remains as set out in the initial consultation document. Offers from GEMMs will be made in whole £ millions (nominal) of the stock(s) and in clean price terms to two decimal places.

The full timetable is given in Annex A. Annex B sets out how the DMO proposes to announce the result of a reverse auction on its wire service pages.

UK Debt Management Office

14th June 2000



ANNEX A: REVERSE GILT AUCTION TIMETABLE AND PROCESS

End quarter auction announcement: to include date(s) of reverse auctions in forthcoming quarter and stocks to be purchased.

On the Tuesday of the week prior to the reverse auction (3.30 pm): announcement of the *maximum* cash value of the total stock the DMO is prepared to purchase. The cancellation date of the stocks bought in will also be announced.

On the reverse auction day:

- **Before 10.20 am:** GEMMs allowed to make an unlimited number offers - on a clean price basis - for the stocks concerned.
- **Between 10.20 am and 10.30 am:** GEMMs allowed up to 4 further telephone offers per stock.
- **By 11.10 am:** The DMO will aim to publish the result of the reverse auction.

The result will include for each stock:

- the lowest, average and highest price accepted (and their yield equivalents);
- the percentage of offers accepted at the highest price;
- the nominal amounts offered, purchased and remaining;
- the total cash value of the stocks offered and purchased.

On the first working day after the auction: settlement and cancellation of the stock bought back.

Format

Bidding format: Offers of the pre-specified stocks will be made to the DMO by GEMMs in units of whole £ millions (nominal). Offers will be made on a clean price basis to two decimal places.

Auction format: Reverse auctions will be held on a multiple stock, competitive offer-price basis. Successful sellers will be paid the price at which they offered stock. There will be no non-competitive offering facility.

Allocation process: The DMO will convert the prices offered to yield equivalents, subtract from these values the theoretical yields for each stock as calculated by its yield curve model and allot acceptances to the highest relative yields/lowest relative prices offered. Allotment continues until the maximum stated cash amount of stock is purchased. There will be no limits on allocation of purchases to particular stocks



or GEMMs – hence, the whole reverse auction could be allocated to one stock offered by one GEMM if this was the cheapest relative offer made.

The DMO will reserve the right to reject any offer of stock that it judges to be at an excessive premium.



ANNEX B: PUBLISHED FORMAT OF A REVERSE AUCTION RESULT

<i>Gilt</i>	<i>Prices and Yields Accepted</i>						<i>Percentage of stock offered accepted at the highest price</i>
	<i>Lowest</i>		<i>Average</i>		<i>Highest</i>		
	<i>£</i>	<i>%</i>	<i>£</i>	<i>%</i>	<i>£</i>	<i>%</i>	
<i>Stock A</i>							
<i>Stock B</i>							
<i>Stock C</i>							
<i>Stock D</i>							

<i>Gilt (£m nominal)</i>	<i>Amount Outstanding</i>	<i>Amount Offered</i>	<i>Amount Purchased</i>	<i>Amount Remaining</i>
<i>Stock A</i>				
<i>Stock B</i>				
<i>Stock C</i>				
<i>Stock D</i>				

Maximum size of reverse auction: £ million (cash)

Amount of stock offered: £ million (cash)

Cover (offers relative to maximum size):

Amount of stock purchased: £ million (cash)

