UK DEBT MANAGEMENT OFFICE

REVERSE AUCTIONS: PROPOSALS FOR CONSULTATION

APRIL 2000

Introduction

1. The DMO's Remit from HM Treasury for the financial year 2000-01 states that the DMO would consider buying back debt with a cash value of £3.5 billion of which 'at least £2.5 billion will be through reverse auctions of non-strippable conventional gilts with over £1 billion (nominal) in issue and maturities in calendar years 2003 to 2008'. The buy-backs will permit further issues of benchmark stocks, especially in longer maturities and the DMO has already announced the intention to auction a new current coupon June 2032 issue in May 2000. This paper sets out how the DMO proposes to carry out such reverse auctions and the issues on which comment is sought from gilt market participants and investors. The DMO welcomes comments on the proposals and will publish a document setting out the definitive procedure before any reverse auctions are held.

2. Comments on the proposals should be sent by **19 May 2000** to: *Paul Mills, UK Debt Management Office, Cheapside House, 138 Cheapside, London EC2V 6BB; Telephone 020 7862 6521; Fax 020 7862 6509; E-mail paul.mills@dmo.gov.uk*. The DMO will aim to produce a response to any comments received by mid-June so that the timing of reverse auctions in the following calendar quarter can be discussed at the DMO's usual consultation meetings with GEMMs and representatives of end-investors on 19 and 20 June.

Debt Management Objectives in the Buy-back Programme

3. The DMO's 2000-01 Gilt Remit from the Treasury sets out why the buy-back programme has been initiated. Through purchases of less liquid stocks, the DMO and Treasury hope to be able to maintain the supply of benchmark issues at a time of fiscal cash surpluses. This should make a contribution to market liquidity at a time of strong demand for long-dated and index-linked gilts.

4. The range of stocks to be considered as candidates in a reverse auction was announced in the remit. The stated criteria narrow the choice of stocks down to 8% Treasury 2003, 10% Treasury 2003, 6¾% Treasury 2004, 9½% Conversion 2005, 7¾% Treasury 2006, 8½% Treasury 2007 and 9% Treasury 2008. These stocks constitute around £37.2 billion (nominal) outside central government portfolios with a clean price market value of around £41-42 billion.

5. This range of stocks was chosen to provide a sufficiently wide range of candidates to sustain a number of reverse auctions. Even shorter maturity stocks were not considered as buy-back candidates because such purchases would reduce gross gilt supply in the next two years (when the Exchequer is still projected to be in cash surplus). Stocks in the gilt futures basket were not considered, to avoid disruption to the long gilt futures contract valuation. Stocks of greater maturity than the futures basket were excluded because this is where greatest demand for conventional gilts is concentrated. Strippable stocks in the relevant maturity bracket were not considered for reverse auction as these tend to be the larger, more liquid issues and it has been a long standing debt management policy to increase the proportion of the market that is strippable.

6. Other stocks may be considered for purchase by the DMO but these operations would be ad hoc purchases in smaller size in the secondary market (see section below on other purchases).

7. In its conduct of reverse auctions, the DMO will also be mindful of the need to ensure:

- *Transparency in gilt market operations*. The UK authorities' general approach is to give gilt market participants as much notice as operationally practicable of large scale gilt operations. Unless advised otherwise, the DMO's presumption is that reverse auctions should be scheduled on the same timetable as switch auctions with the date (and probably the stocks) announced in the quarterly gilts auction calendar and the maximum amount to be purchased and stocks confirmed with approximately eight days' notice.

- *Value-for-money*. The DMO will try to achieve the requisite amount of gilt purchases in the most cost-effective manner for the Exchequer. This will be a guiding principle in the design of the reverse auction process and in the acceptance of offers in the auctions (ie. the DMO will generally accept the lowest relative price offers of stocks as assessed by its own yield curve model). The DMO will not, however, take views on the absolute level of yields of the stocks offered to it across the different maturities.

Reverse Auction Format and Process

8. ***Format***: The DMO proposes that reverse auctions will largely follow the pattern and timetable that apply to switch gilt auctions. The process will be on a competitive, offer-price basis. The DMO will rank the offers by price and accept stock from the lowest relative prices offered (as measured against the DMO's yield curve model) until the desired amount is purchased. The DMO would reserve the right to reject any offers of stock if they were judged to be at an excessive premium.

9. A multiple stock auction format is proposed (see below) whereby all offers of stock would be channelled through the gilt-edged market-makers (GEMMs) and there would not be a non-competitive offer facility for either GEMMs or retail investors.

10. The DMO aims to announce the date of reverse auctions in its end quarter announcement that sets out auction details in the succeeding quarter. On the

Tuesday in the week prior to any reverse auction the DMO would announce the maximum cash value of the total stock it was prepared to buy back. Depending on feedback from this consultation, the particular stocks available to be offered at the auction could be announced either in the quarterly calendar or in the auction notice in the week preceding the auction.

11. ***Process:*** On the day of any reverse auction:

- GEMMs may make an unlimited number of telephone offers in the stocks involved until 10:20 am and a maximum of 4 further offers per stock between 10:20 and 10:30 am.
- The DMO would aim to publish the results by 11.10 am although the complexity of a multiple stock auction may mean that publication of the result is delayed beyond the normal timetable. The result would include for each stock the nominal amount purchased; the lowest, average and highest prices accepted; and the percentage of offers accepted at the highest price.
- Settlement would normally occur on the following business day, with any cancellation of stock purchased via the auction normally being carried out on that day.

12. The DMO proposes that there would not be any allocation limits on the proportion of the offers it accepts from any one GEMM. Hence, the DMO could buy all the stock purchased from one GEMM if its offers were the lowest. The DMO would retain the discretion not to accept any of the offers made through the auction.

13. Subsequent editions of the DMO's operational gilt market notice will incorporate details on how reverse auctions will be conducted.

Questions for consideration

14. Some of the details of the conduct of reverse auctions are as yet undecided, and the DMO would welcome the views of market participants on the following questions, given the stated objectives of the buy-back programme.

15. ***How many stocks to include in a multiple stock reverse auction?:*** One possible format would be to hold a reverse auction for a single stock. This approach has the virtue of bidding simplicity for market-makers and processing for the DMO. However, in order to motivate holders of the stock to make offers at reasonable prices, the DMO would need to commit to any one reverse auction for a particular stock being the only one in the foreseeable future for that stock.

16. In view of the difficulty of making such a commitment, the DMO believes that a multiple stock reverse auction structure is the only feasible format to consider. A multiple stock auction allows a wider range of gilt holders to participate in any one auction, so protecting value-for-money considerations for the Exchequer. This follows the precedent that the Bank of England established when conducting reverse gilt auctions in 1989 and is the approach currently followed by the US Treasury in its buy-back programme. Given that seven stocks have been identified as candidates for purchase through reverse auctions, the alternatives are:

- For the DMO repeatedly to hold reverse auctions that involved being willing to entertain offers for the same seven stocks already indicated on each occasion; or
- For the DMO to choose a subset of three or four of the seven stocks that could be offered at a particular auction. A different subset of the seven would be selected at future auctions, with all stocks being selected at least once over three auctions.

17. The former choice of offering to buy some of the same seven stocks at each auction would give greater certainty to the process and permit GEMMs more flexibility over inventory control. However, it potentially risks placing the Exchequer in a vulnerable position on value-for-money grounds if investors know that they would be able to offer the same stocks repeatedly to the DMO – although there would be no commitment that a quantity of any one of the stocks would have to be bought at any one auction.

Question: Given the requirement for the DMO to secure value-for-money for the Exchequer, 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)? If a subset, should these be announced in the quarterly auction calendar or the week preceding the auction?

18. ***Size and frequency of reverse auctions?:*** Given the remit projection of between £2.5 billion and £3.5 billion of buy-backs in cash terms, there is a trade-off between auction size and frequency. One option would be to hold 4-6 auctions of between £0.5 and 1 billion (cash) in the period 2000Q3 to 2001Q1. Conversely, smaller buy-back auctions (of £0.25 - £0.5 billion cash) could be held more regularly on 6-10 occasions over the same period. Fewer but larger auctions have the advantage of concentrating market attention on a few events which should help with generating investor interest in selling, but at the risk of richening the buy-back candidates excessively to the detriment of the Exchequer. Conversely, smaller more frequent auctions reduce inventory risk for the GEMMs. At present, the DMO favours the option of holding larger but fewer reverse auctions but is keen to hear the views of market participants.

Question: Should reverse auctions be larger and less frequent or smaller and more frequent?

19. ***Non-competitive retail offering facility:*** At present, the DMO offers and advertises a non-competitive bidding facility for bids of up to £500,000 at outright conventional auctions but no such facility exists at switch auctions. The Bank of England made available a non-competitive offering facility during the reverse auctions of 1989. The question arises as to whether a non-competitive facility in small size should be offered in the forthcoming reverse auctions, even though retail investors could still offer their stock in the auction through brokers. (Making such a facility available is technically feasible, although it would add somewhat to administrative costs, particularly if all holders of a stock were to be informed individually beforehand.)

20. The DMO's current view is that a non-competitive facility would not be made available. In a standard multiple stock reverse auction, making a non-competitive offering facility available would be logistically complex given that competitive offers for some of the stocks may not be received or accepted, making the non-competitive price indeterminate. However, if a stock or stocks became rump issues as a result of a buy-back[1], the DMO would write to all remaining holders and offer to buy stock at a relative price equivalent to the average price at the previous reverse auction. This service would be offered free of charge. This arrangement would enable holders to sell their stock to the Government without incurring transactions costs if Government purchases reduce significantly the liquidity of the stock. However, given the size of the buy-back programme in 2000-01 and the stocks involved, this is a relatively remote possibility.

Question: Given the presumption of the DMO that it will conduct multiple stock reverse auctions and offer a free selling facility if a stock becomes a 'rump' issue through the process, is a non-competitive retail offering facility warranted?

Other secondary market purchases

21. As part of standard debt management operations as set out in its Operational Notice, the DMO transacts in gilts in the secondary market in relatively small size. Purchases can be of marketable stocks for National Investment Loans Office (NILO) funds under management, 'rump' stocks where the DMO is committed to making a bid on demand to GEMMs and stocks, particularly index-linked, where the DMO is asked to make a bid by a GEMM – although these stocks are advertised on the DMO's wire service pages and subsequently sold back into the market. During 1999-2000, the DMO made around £0.5 billion (cash) of net purchases of gilts

[1] Given the stocks chosen as candidates for buy-back and the size of the projected programme, the only stock that could possibly be reduced to below the current size cut-off for rump status (£0.4 billion nominal) is 10% Treasury Stock 2003 and only if the purchases of stocks were concentrated on that issue.

through these channels. Central government holdings (DMO and NILO) of each gilt-edged security are published with a three-month lag in the DMO's quarterly review.

22. As a complement to purchases of gilts through reverse auctions, the DMO is proposing to expand the stock for which it is prepared to offer a bid on demand to GEMMs. In particular:

- ***Double-dated stocks***: There are currently four double-dated non-rump stocks in the market[2] (excluding double-dated stocks likely to be redeemed in 2000-01). These total around £4.4 billion (nominal) in issue and £4.0 billion (nominal) in non-central government portfolios. The DMO proposes that from Monday 3 July 2000, it would respond to requests for bids to its dealers for these stocks but would not normally place the stock it acquires through this channel back into the market. If it had accumulated holdings in these stocks, the DMO would be prepared to respond to bids but would not necessarily seek to sell its whole position. The aim of this approach would be to allow the market to sell these stocks to the DMO, and for the DMO gradually to accumulate a net position in these issues without declaring them as 'rump' stocks or reducing their liquidity substantially.

- ***Index-linked stocks:*** The DMO's financing remit specifies that it will only auction index-linked stocks of 2009 maturity and longer. While a tap issue of a shorter maturity index-linked stock is possible and permitted under the remit for market management reasons, there has been insufficient demand to justify a tap issue of these stocks since the introduction of index-linked auctions in November 1998. As now with other index-linked stocks, the DMO is proposing to respond to requests for bids for the index-linked stocks 2½% IL 2001, 2½% IL 2003, 4⅜% IL 2004 and 2% IL 2006 but would not necessarily publicise all of the acquired stock on its wire service pages for resale. However, it would be prepared, as now, to respond to bids from index-linked GEMMs. Again, in this manner, the DMO would aim to acquire a net holding of these stocks if they were offered while still

[2] 8% Treasury 2002-06, 3½% Funding 1999-2004, 5½% Treasury 2008-12 and 7¾% Treasury 2012-15.

being willing to sell smaller amounts to maintain market liquidity. The market value of these four stocks is currently around £17.5 billion.

23. Given the potentially significant impact that such secondary market transactions could have on meeting the Government's financing needs, the DMO intends to update the amount and maturity composition of any Central Government net purchases whenever it publishes the financing arithmetic. This would normally occur whenever the financing remit was updated (eg. at the time of the Pre-Budget Report and the Budget) or the arithmetic was published (eg. as the annex to the agendas of the quarterly consultation meetings with GEMMs and gilt investors). In addition, the DMO would continue to publish stock-specific central government holdings in its quarterly review (with a three-month lag) and would propose to publish its holdings of the double-dated and index-linked stocks that it had acquired through the process detailed above on a weekly basis. Any stock acquired through secondary market dealing would not normally be cancelled at the time by the DMO although it would reserve the right to cancel such stock on one or two times during the year. Market participants and index providers would be given notice of any such cancellation.

UK Debt Management Office **26th April 2000**