

UK DEBT MANAGEMENT OFFICE

DMO Policy Regarding 'Special' Gilt Repo Operations

Introduction

The DMO's Debt Management 1999-2000 Remit from the HM Treasury states that: 'For the purposes of market management, the Debt Management Office may create and repo out stock' (paragraph 16). As a result, the DMO has been negotiating special repo agreements with the Gilt-edged Market Makers (GEMMs). This follows on from the announcement by the Bank of England in February 1998 when it provided details of a special repo facility for GEMMs in 9% Treasury Stock 2008. In the event, this facility was not activated. The DMO has not yet engaged in a special repo operation.

This note is intended to clarify the DMO's existing approach to intervening in the repo market in specific stocks. Whilst this approach remains discretionary, the DMO hopes that it will give participants in the gilts and repo markets more information about the circumstances and details of any such repo operation. To that extent it is intended to reduce uncertainty over the DMO's possible actions when trading gilts outright, on basis or in repo.

The document then outlines the details of a possible non-discretionary repo facility on which the DMO would welcome comment by market participants. (If such an automatic facility were introduced, it would not be available until the 2000-2001 financial year and only after several months' notice had been given.) Comments are welcome from market participants on the proposed additional option and should be provided by **8th October 1999** to **Martin Duffell** at the **UK Debt Management Office, Cheapside House, 138 Cheapside, London, EC2V 6BB; telephone 0171 862 6517; fax 0171 862 6509; e-mail: martin.duffell@dmo.gov.uk.**

UK Debt Management Office

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The DMO's Existing Approach to Special Repo Operations

1. As already noted, whilst the DMO has the authority to conduct repo operations in specific gilts, it has not yet done so. The DMO's overall approach is to allow the repo market in specific stocks to clear through relative price movements. If particular stocks come to command a premium in the repo market, this should encourage holders of those stocks to repo them out. Such premia should reward gilt investors for developing the capacity to participate in the repo market. The ability to repo specific stocks to the market is designed to dissuade manipulation of the market in specific stocks by reducing the prospect of excessive returns and to address instances of market disruption or dislocation when a particular stock is temporarily in extremely short supply.

2. As such, the current ability to repo special stocks is entirely discretionary. However, various market participants have requested that the DMO clarify the circumstances in which it would operate and the methods that would be used. There have also been some suggestions that the uncertainty about the criteria that the DMO would use in deciding whether to engage in a special repo operation was leading to a reluctance, for example, to undertake basis trades in gilts due to uncertainty over specific stock availability and pricing.

3. ***Circumstances in which a special repo operation would be considered:*** The DMO will take a number of factors into consideration when deciding whether to create stock for repurchase. But it will only wish to do so at times where there is evidence of *severe market dislocation or disruption*. The DMO will judge such circumstances by considering a range of indicators, including evidence of delivery fails in the repo market, extreme tightness of particular stocks in the repo market, a breakdown in the market-making mechanism and/or a reluctance to deal in the futures or basis markets. Such circumstances will need to have been *persistent* and not be tied to any particular event or difficulties encountered by individual market participants in repoing in specific stocks. For example, such operations may not just be linked solely with problems connected with the delivery process into the gilt



futures contract. Stocks other than those deliverable into the futures contract could also be considered. (The DMO also retains the option to tap stock outright if deemed necessary.)

4. **Terms of a DMO special repo operation:** Whilst the terms of any special repo operation may need to be varied in the light of the market circumstances at the time, the DMO's working assumption would be that any special repo operation:

- would be available only to GEMMs, and only to those who had signed the appropriate repo agreements with the DMO;
- would normally involve the overnight repo of stock at 0% interest charged to the DMO. (This rate would be subject to review if the level of repo rates were substantially different from their current level in order to maintain approximately the same level of premium);
- would entail the DMO requiring to be given general collateral at the Bank of England's prevailing repo rate against the stock being lent to offset the cashflow implications of the repo;
- would entail the DMO announcing the amount and terms at which such a repo operation had been conducted and the amount of stock created (if appropriate) but not the counterparties with which it had dealt. Whilst the identity of the counterparties using the facility would remain anonymous to the general market, the DMO would reserve the right to share the information with other official regulatory bodies in appropriate circumstances;
- could be rolled over, but this judgement would be made on a case-by-case basis.

When the DMO judged that the need for the operation was over, any stock created for this purpose would be cancelled or retained on official portfolios and the market notified.

A Possible Non-Discretionary Special Repo Facility

5. The following paragraphs outline an alternative, non-discretionary approach to operations in the specific repo market, upon which the DMO is seeking feedback and comment from market participants. Such a facility is



being considered due to the practical difficulty of precisely defining the circumstances in which the DMO would in practice offer a specific repo facility. If the gilts market is to be given any greater certainty over the timing, terms and conditions of such a facility, it needs to be automatic on pre-set terms.

6. These automatic arrangements would largely supersede the approach outlined above if adopted, although they would only be invoked after the market had been given several months' notice of the start of the facility and would not commence until the 2000-2001 financial year. However, the DMO would still reserve the right to create and repo out stock in other extreme conditions of market dislocation and/or systemic risk, notwithstanding the above.

7. To reduce the uncertainty about the circumstances and terms of any operation by the DMO, it is ready to consider a proposal to stand ready to offer overnight any stock in the repo market, at a fixed penal rate, at any time. The availability of this facility would not be linked with the indicators of market breakdown set out above; it would instead be automatically available on request to any GEMM who had signed the appropriate agreement with the DMO. Non-GEMMs would be able to have access to such an operation through a GEMM, and the DMO would expect GEMMs to be able to present proof, if asked, that they were 'putting through' any trades done for a non-GEMM. If required, such repos could be rolled over overnight on request and any stock created by such a process would be cancelled once the stock was no longer demanded in repo. Such a facility would need to be unlimited in amount. However, if large amounts of stock were regularly being requested or rolled forward, the DMO would want to review whether it was meeting its intended purposes as a penal facility of last resort.

8. Such a facility would allow market participants to price in, with more certainty, any intervention by the DMO, leading to a more liquid market for particular stocks.



9. **Features of such a facility:**

- **Pricing:** The DMO's aim would be to ensure that an automatic facility did not substitute for normal market processes whilst providing certainty over how penal the facility would be. This could either be at fixed overnight rate (probably 0%) or a fixed margin below overnight general collateral (GC) repo rates (probably 500bps).
- **Size:** In order to reduce the costs of listing fees and other administrative costs, the availability of the facility would need to be subject to a minimum size of, probably, £10 million nominal per stock per counterparty.
- **Timing:** The counterparty involved would need to inform the DMO of their request for stock creation and repo by 4.30pm of the business day immediately preceding the day of the transaction.
- **Publication:** In addition to listing any stock created for repo purposes, the DMO would envisage publishing any such amounts on its wire service pages early in the trading day. Whilst the identity of the counterparty(ies) using the facility would remain anonymous to the general market, the DMO would reserve the right to share the information with other official regulatory bodies in appropriate circumstances.
- **Cash-handling:** As with the discretionary facility, the cash leg of such any such automatic special repo facility would be unwound via a back-to-back general collateral repo with the same counterparty on the day. The future operations of the DMO in its Exchequer cash management role would thus be entirely independent of the operation of the above-mentioned standing repo facility.

10. **Questions for market participants:**

- Do gilt and repo market participants believe that the introduction of an automatic special repo facility, at a known premium, is necessary or warranted?



- Should such a facility be available only to the to GEMMs who had signed the appropriate agreement with the DMO? Should the facility be extended to other interested repo counterparties who had signed the relevant documentation?
- Given the need for an automatic facility to be sufficiently penal to avoid substituting for normal market conditions, how penal should the rate be? Should it be expressed as a fixed overnight rate (eg. 0%) well below GC overnight rates; a fixed number of basis points below either GC or the Bank of England repo rate (eg. GC – 500bps); or possibly a fixed percentage (eg.10%) of GC or Bank of England base rates (thus, with current base rates at 5.25%, the DMO's special repo rate could be fixed at 0.525% overnight)?

