

*United Kingdom*  
**Debt  
Management  
Office**

Cheapside House  
138 Cheapside  
London EC2V 6BB

# **UNITED KINGDOM DEBT MANAGEMENT OFFICE**

## **The Debt Management Office's Relationship with the Gilt-Edged Market Makers and Inter-Dealer Brokers: A Description**

**October 1999**



# THE UK DEBT MANAGEMENT OFFICE'S RELATIONSHIP WITH THE GILT-EDGED MARKET MAKERS AND INTER-DEALER BROKERS

<b>INTRODUCTION</b> .....	<b>3</b>
<b>I GILT-EDGED MARKET MARKERS</b> .....	<b>3</b>
GEMM COMMITMENTS .....	3
(a) <i>Market-making</i> .....	4
(b) <i>Participation in primary issuance</i> .....	4
(c) <i>Provision of data to the DMO</i> .....	4
THE FACILITIES AVAILABLE TO GEMMS .....	5
ACCESS TO INTER-DEALER BROKERS OFFERING GEMM-ONLY FACILITIES .....	6
SPECIAL MARKET OPERATIONS .....	6
GEMMA REFERENCES PRICES .....	7
<b>II INTER-DEALER BROKERS</b> .....	<b>7</b>
<b>III INTERACTION WITH THE SETTLEMENT SYSTEM</b> .....	<b>7</b>

## INTRODUCTION

This paper describes briefly the Debt Management Office's relationship with the gilt-edged market makers (GEMMs) and the recognised gilt-edged inter-dealer brokers (IDBs). It reflects the transfer of responsibility for the gilts market from the Bank of England to the DMO,<sup>1</sup> and the establishment of a specialist list of index-linked market makers. It replaces the description of the Bank of England's relationship with the GEMMs published in June 1997.<sup>2</sup> Further details about the DMO's dealing and auction procedures are set out in the DMO's Operational Notice, "*Official Operations in Gilt Edged Market*" issued in September 1999.

If you have any queries on this paper, please contact Allison Holland, UK Debt Management Office, Cheapside House, 138 Cheapside, London EC2V 6BB; Tel +44 (0)207 862 6534, or email [allison.holland@dmo.gov.uk](mailto:allison.holland@dmo.gov.uk).

## I GILT-EDGED MARKET MARKERS

1 The liquidity of the gilt-edged market continues to be underpinned by the presence of competing market makers, the GEMMs, which undertake to make on demand and in any trading conditions, continuous and effective two-way prices in gilts at which they stand committed to deal.

2 GEMMs may specialise in one or both of the following sectors: first, in conventional gilts, conventional strips and floating rate gilts; and, second, in index-linked stocks. GEMMs committed to the latter sector are known as index-linked GEMMs (IG GEMMs). In addition to being authorised by the FSA, either directly or under the terms of the EEA passport, GEMMs must satisfy certain obligations, described below, and be members of a recognised investment exchange (RIE), such as the London Stock Exchange (LSE), registered as a market maker in gilts.

3 In addition, firms who are recognised by the DMO as gilt-edged market makers will also have demonstrated that they have a viable business strategy and adequate capital, management and operational resources to perform this function.

### GEMM commitments

4 Firms accepted by the DMO as GEMMs agree to meet a number of obligations on a continuous basis. The aim of these obligations is to ensure that GEMMs contribute to the liquidity of the secondary market and provide appropriate support to the primary issuance of government debt. The obligations are as follows:

---

<sup>1</sup> Announced by the Chancellor of the Exchequer on 6 May 1997 and effective from 1 April 1998.

<sup>2</sup> "*The Gilt-Edged Market: the Bank of England's Relationship with the Gilt-Edged Market Makers and Inter-Dealer Brokers*", June 1997 – also referred to as "the Blue Book".

**(a) Market-making**

By agreement with the DMO, GEMMs make on demand, and in any trading conditions, continuous and effective two-way prices in all gilts in those sectors in which they stand committed to deal. The purpose of this obligation is to ensure that GEMMs provide a market-making service to users of the market generally, supplying continuous liquidity to the investing public in all trading conditions, rather than providing a dealing service which is largely confined to a narrow group of investors. However, GEMMs are not required to make markets to other GEMMs. This obligation is also relaxed for 'rump' stocks.<sup>3</sup>

GEMMs may agree with the DMO to make a market in conventional gilts, strips and floating-rate gilts and/or to do so in index-linked gilts. GEMMs should stand ready to make prices and, over time, to demonstrate an appropriate level of participation in secondary market activity. Although there is no explicit target for this level of participation in the conventional sector, the DMO expects the GEMMs to maintain an economically significant share of this market. In the index-linked sector, IG GEMMs are required to maintain a market share of at least 3% on a six-month rolling average basis. IG GEMMs are actively encouraged to stand ready to make a market to any non-IG GEMM.

**(b) Participation in primary issuance**

There are no formal underwriting arrangements for gilts, but the DMO expects all GEMMs, as part of their commitment to the market, to participate actively in gilt issuance via auctions (and taps where appropriate) and, in particular, to bid on a competitive basis in auctions. IG GEMMs are expected to achieve allotments, averaged over three auctions, broadly in line with the IG GEMM's average secondary market share. For fuller details of the operation of auctions please refer to the DMO's Operational Notice, 'Official Operations in the Gilt-Edged Market', issued in September 1999.

**(c) Provision of data to the DMO**

GEMMs agree to provide the DMO with market intelligence and other relevant information on gilt market developments regularly, both via contact with the DMO's dealing desk and through periodic meetings of management with the DMO.

At the close of business each day, the GEMMs also provide to the DMO closing prices for all the stocks in which they stand committed to make a market. These prices are used to calculate the official GEMMA closing price for each stock (see below, under GEMMA reference prices). The DMO

---

<sup>3</sup> 'Rump' stocks are those stocks where the amount in issue is too small for a liquid two-way market to be expected to exist. The DMO will provide, on request, to any GEMM a bid in a 'rump' stock.

reviews periodically the accuracy and timeliness of each GEMM's contribution to these prices.

The GEMMs also provide statistical data on turnover and positions to the DMO. This is to enable the DMO, first, to monitor general market conditions, and second, to monitor the performance of the GEMMs.

5 The DMO will monitor each GEMM's performance against its undertaking, taking account of the role it plays in the market, based on data provided by the GEMM, feedback from the market, auction participation data and continuing discussions with management. Consistent failure of a GEMM to meet its undertaking ultimately results in the ending of the relationship with the DMO and the termination of the associated facilities.

### **The facilities available to GEMMs**

6 In order to assist the GEMMs in fulfilling their market-making obligations, the DMO makes the following facilities available to the GEMMs:

- the DMO accepts competitive telephone bids in conventional and switch auctions only from GEMMs, and in index-linked auctions only from IG GEMMs, on their own behalf and for their clients;
- the DMO makes available a proportion of the amount of stock on offer at conventional and index-linked auctions for non-competitive bids by GEMMs (or IG GEMMs). In conventional auctions each GEMM may make non-competitive bids for up to 0.5% of the amount of stock on offer. In IG auctions, the DMO sets aside 10% of the amount of stock on offer. Each IG GEMM is allocated a proportion of this, dependent on its competitive allotments in the previous three auctions. The DMO notifies each IG GEMM of its maximum non-competitive allowance in advance of the auction.
- the DMO accepts telephone bids exclusively from GEMMs for any gilt sales offered by tap or switch tap;
- at its discretion, the DMO accepts bids from GEMMs at any time between 9.00 and 5.00 pm for any stock that has been made available for resale via the 'Shop Window';
- the DMO bids a price of its own choosing for stock with six months or less to maturity offered to it by any GEMM committed to the relevant sector of the market;<sup>4</sup>
- the DMO stands ready to bid a price of its own choosing for index-linked stock offered to it by index-linked GEMMs;
- at its discretion, the DMO will undertake switches of stock proposed to it by GEMMs committed to that sector of the market. The DMO will normally undertake

---

<sup>4</sup> This facility will only begin when the DMO takes on responsibility for Exchequer cash management.

switches only between stocks of the same type (eg conventional, index-linked, floating-rate) and maturity area;

- the DMO bids a price of its own choosing for stock where the amount in issue is too small for a liquid two-way market to be expected to exist (eg the rumps of certain stocks that have previously been subject to conversion offers);
- only GEMMs (DMO, and Bank of England) can strip and reconstitute gilts (see below);
- the DMO holds a quarterly consultation to allow the GEMMs (or IG GEMMs) to advise on the stock(s) to schedule for auction in the following quarter; and
- the DMO undertakes to provide GEMMs with aggregated market share statistics on a regular basis.

7 The DMO also reserves the right to undertake transactions, such as special repo, for market management purposes. Any such transactions are only carried out with or through the GEMMs, the DMO's gilt market dealing counterparties.

8 Further details of these facilities are set out in the DMO's Operational Notice, 'Official Operations in the Gilt-Edged Market', issued in September 1999.

### **Access to inter-dealer brokers offering GEMM-only facilities**

9 In addition to the facilities outlined above, the GEMMs have the additional benefit of exclusive access to the services of a number of competing gilt-edged inter-dealer brokers (IDBs). These IDBs specialise in providing dealing facilities in gilts between the GEMMs. The purpose of these arrangements is to enable the GEMMs to unwind unwanted stock positions that arise from their market-making activities with investors or their agents. A gilt-edged IDB must be endorsed by the DMO and registered with an RIE in that capacity (see below).

### **Special market operations**

10 From time to time, the DMO may enter into special repo arrangements with the GEMMs for market management purposes. This may arise, for example, where a stock becomes difficult to trade or the DMO considers a false market has been created due to market manipulation. In these cases, GEMMs may be required to offer evidence of delivery fails. In order to participate in these special market management operations, GEMMs are required to become gilt repo counterparties of the DMO.

### **Stripping and reconstitution facilities for conventional gilts**

11 Any member of the gilts settlement system<sup>5</sup> is able to hold strips in the system. The facility to strip and reconstitute gilts is, however, available only to GEMMs, the

---

<sup>5</sup> Gilts are settled through the Central Gilts Office (CGO). The Bank of England operated this, but in May 1999, this responsibility passed to CrestCo.

DMO and the Bank of England. The DMO arranges with the provider of the settlement system for this facility to be made available to new GEMMs.

### **GEMMA references prices**

12 As mentioned above, each day, each GEMM submits to the DMO closing prices in all gilts in which it makes a market. The DMO collates the information and publishes an average price for each stock on the wire services. These prices are provided by the DMO on behalf of GEMMA, the Gilt-Edged Market Makers' Association, and are known as the GEMMA reference prices. The prices are provided as a public service and are used in the CGO system for collateral valuation purposes and by many other market participants for marking-to-market.

## **II INTER-DEALER BROKERS**

13 The arrangements under which a number of competing gilt IDBs provide dealing facilities to the GEMMs have an important role in contributing liquidity to the gilt market. These arrangements allow the IDBs to provide screens on an exclusive basis to the GEMMs, where GEMMs can advertise to the GEMM community their desire to trade. They also enable the GEMMs to deal with one another on an anonymous basis, by allowing the IDB to act as a riskless principal in the trade. The DMO monitors the working of the gilt IDB arrangements on an ongoing basis. In particular, the DMO is concerned to ensure that a gilt IDB service is available to all GEMMs and that the market maker trading structure is effectively supported by the IDB arrangements.

14 Firms endorsed as gilt IDBs specialising in providing a GEMM-only facility will have demonstrated a viable business strategy, and adequate capital, management and operational resources to perform this function and be a member of an RIE, registered with it in that capacity. They will also have provided evidence of a broadly based demand amongst the GEMMs for the provision of its service. Additionally, DMO-endorsed IDBs undertake to report details of their weekly turnover data to the DMO.

## **III INTERACTION WITH THE SETTLEMENT SYSTEM**

15 The Central Gilts Office (CGO) currently facilitates settlement of gilt transactions. The Bank of England provided this service in the past but CrestCo took over responsibility for CGO in May 1999; in mid-2000, CGO will be merged with CREST.

16 CGO is an assured payments system for gilts. Membership of the service allows for the secure and efficient settlement of gilt trades by electronic means. The DMO settles all its gilt transactions through CGO. Additionally, the facility to strip and reconstitute gilts is only available through CGO. Therefore, the DMO requires all GEMMs to be members of the service. Membership of CGO is, however, open to all gilt market participants.