

DMO PROPOSALS ON THE STRUCTURE OF THE SECONDARY MARKET FOR GILTS

PROGRESS REPORT 1: August 2000

Introduction

On 23 June 2000, the DMO published its response to its consultation paper on the structure of the secondary market for gilts, the 'response paper'; the original consultation paper was published on 24 January 2000. In the response paper, the DMO outlined in broad terms its suggestion that an inter-GEMM market with quote obligations be established. That paper identified a number of issues where further consultation would be required before full details of the proposed inter-GEMM market could be finalised. The DMO followed up the publication of the response paper with a short round of consultation with the Gilt-Edged Market Makers (GEMMs) on some of those issues. This paper outlines a number of suggestions on the outstanding issues, taking account of this further round of consultation.

The DMO is continuing to have discussions with the GEMMs, the gilt-edged inter-dealer brokers (IDBs) and other interested parties about the remaining unresolved issues, including the issue of platform provision. Against this background, the details of the proposed market outlined in this paper should be regarded as work in progress. This paper will be followed in due course by others as further details are clarified.

The quote obligations: some specifics

On 30 June, the DMO issued a questionnaire to all the GEMMs; a copy is included as annex A to this paper. All the GEMMs active in the wholesale segment of the market submitted responses. The suggestions outlined below broadly reflect the balance of views expressed in those responses.

Number of bonds covered: In the response paper, the DMO indicated that it believed that the new obligation should extend to between five and ten bonds. Almost all the GEMMs thought that bonds in the two, five, ten and 30-year maturity bracket would be desirable. The majority of GEMMs also favoured the inclusion of a

bond in the 15-year maturity bracket because this is an important point on the swaps curve. Some GEMMs indicated that a three-year stock would also be useful, while others mentioned a desire for a seven-year bond, another key point on the swaps curve. In light of these responses, the DMO would suggest that a minimum of 5 bonds be selected of approximately 2, 5, 10, 15 and 30-years maturity. The selection of specific bonds will be an ongoing task as bonds mature and new bonds are issued and from time to time may throw up some difficult choices. For example, some GEMMs thought that the cheapest-to-deliver bond in the futures basket, the CTD, should be included. Currently the CTD is the 10-year benchmark but this might not be the case in the future when the DMO issues a new 10-year bond. The issue then will be which of the 10-year benchmark and the CTD to select or whether both should be included. It is intended that this decision should be determined by the preferences of the GEMMs.

Quotation period: The DMO consulted the market on whether the quote obligation should hold on a continuous or a flexible basis. The GEMMs were split on this issue. However, several GEMMs mentioned the need for traders to be absent from the desk from time to time. Others noted the occasional, short-lived difficulties that can arise with systems, which might affect their ability to automatically generate or transmit prices. A flexible approach would allow GEMMs to cover these eventualities while still meeting their obligations. On balance, the DMO feels that a flexible approach would be best, particularly in the early days of the system. In line with other markets that adopt this approach, and many of the responses received, the DMO would suggest that the quotes should be supplied for five hours out of a designated eight-hour period. Another benefit of a flexible approach is that it negates the need for pre-defined events to be identified when the screens should go 'subject'. However, the DMO would hope that a broad range of prices will be available in the market at any one time.

Maximum size of the spread: A number of issues arose when considering what the maximum size of the bid-offer spread should be. These include trader coverage and the general resource cost involved with continuous monitoring of a screen. Another issue that arose was the concern that narrow spreads could lead to GEMMs trading unwittingly in response to small changes in prices resulting from a change in a

parameter that feeds into their automatic price generator. If the spread is wide enough then GEMMs may not feel compelled to change their quoted price in response to small changes in other factors, such as the futures price. This would also potentially reduce some of the pressure on the capacity of any platform provider. Given that there will be many GEMMs providing over-lapping prices at any one time, the 'touch' will almost always be narrower than the maximum spread set. Moreover, GEMMs who actively want to execute a particular trade will probably post an order within that touch. The DMO suggests, therefore, that the spread should be relatively wide, at least initially, at about 3 basis points. This could be narrowed in the light of experience and further consultation with the GEMMs. The precise price equivalent would be identified when the specific bonds were selected.

Size of the quote obligation: All GEMMs indicated that they would be comfortable quoting up to £5mn in short-dated bonds. Respondents were roughly split on whether a size of £5mn or £3mn should apply in medium-dated bonds but they had diverse views on the size that should apply in long-dated bonds (although the majority favoured £1mn). The DMO believes that a wider spread should provide adequate compensation for the risk represented by a larger quote size. It would prefer a larger quote size, providing meaningful depth to the market, at the expense of a wider spread. Given that the suggested 3 basis points spread is quite wide, the DMO suggests that a size of £5mn, £5mn and £2mn should apply to short, medium and long-dated bonds respectively.

Review process: The DMO intends that all the issues identified above will be reviewed on a regular basis. This review process should be controlled by the GEMMs, although the DMO would be available to act as facilitator and provide the necessary secretariat functions. The majority of respondents suggested that a quarterly review should be sufficient. How this review process will be structured will be determined in due course in the light of consideration by the GEMMs.

Platform provision

The issue of whether the market should be delivered over one designated platform, provided by one broker, or whether a GEMM could meet its obligation by providing a

price on one of a number designated platforms is complex. In the response paper, the DMO indicated a preference for the latter approach, if practicable. Some GEMMs have indicated that using a single platform could be simpler and save on resource costs. For example, they would only have to build an interface with one system rather than, potentially, building an interface with many systems. Other GEMMs noted that using multiple platforms meant that there would be an alternative trading-venue available in the event of a system failure. This approach would also maintain competition in the provision of these trading systems, so that the GEMMs would not be locked into some technology that may become redundant in the future.

In order to progress this issue, the DMO suggested that GEMMA establish a working group, with a DMO representative, to conduct a fact-finding exercise. The DMO suggests that the purpose of the exercise should be to identify the technical requirements of the GEMMs, and the DMO, and to identify those existing electronic trading platforms, available from interested parties, that appear to meet those requirements.

The GEMMs have subsequently selected the members of this working group; the list of members appears in Annex B. This group will issue an open invitation to interested parties to make representations to it on the issue of platform provision in due course. It is expected that this invitation will be posted on the DMO's website. The DMO hopes that this group will be in a position to present their findings to the DMO and to the GEMMs collectively towards early in October. The DMO hopes that this information would then allow a preferred approach of the GEMMs to be identified. Work could then begin to draw up precise technical specifications and project plans.

The DMO would expect to prepare further progress reports as further details are clarified and would expect the next report to be issued shortly after the working group presents their report.

Please direct any comments on this report 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 A: QUESTIONNAIRE ON ASPECTS OF INTER-GEMM MARKET

Q1. Of the following list of stocks, which would you like to see on this platform?

8TY00		9TY08	
7TY01		5TTY09	
7TY02		6QTY10	
6HTY03		9CV11	
5TY04		8TY15	
8HTY05		8TY21	
7HTY06		6TY28	
7QTY07		4QTY32	
Other (please specify)			

Q2. How many stocks should be included?

5		10	
7		Other (please specify)	

Q3. Going forward, what should the criteria be for a stock to be included on the platform?

Size outstanding (please specify a minimum)	
Most recently issued	
Maturity (please specify)	
Other	

Q4. How often should the stock list be reviewed?

Monthly		Semi-annual	
Quarterly		Annual	
Other (please specify)			

Q5. Once reviewed, how much notice will GEMMs require before changing the stock list?

Day		Month	
One week		Quarter	
Fortnight		Other (please specify)	

Q6. Should the quote obligations be binding for the whole of a specified time period (e.g. 9.00 to 15.00) or should they be flexible (e.g. 5 hours out of 8 hours)?

Continuous time period		Flexible	
Preferred time period (please specify)		How many hours (please specify)	

Q7. What events should the screens go 'subject' for?

All ONS UK economic releases		Official economic releases for other countries (please specify)	
UK MPC result			
UK MPC minutes			
Results of ECB meeting			
Auctions involving a designated stock			
Other UK data (please specify)			
Other (please specify)			

Q8. How long should they go subject? (Please specify)

Data releases	Before	After
Auctions (from close of bidding to)	After result	Other

Q9. What size should the obligation hold in?

						Other
Shorts	£5mn		£3mn		£1mn	
Mediums	£5mn		£3mn		£1mn	
Longs	£5mn		£3mn		£1mn	

Q10. What spread should apply?

Basis points Pence

						Other
Shorts	1bp/3p	<input type="text"/>	2bp/6p	<input type="text"/>	3bp/12p	<input type="text"/>
Mediums	1bp/8p	<input type="text"/>	2bp/15p	<input type="text"/>	3bp/30p	<input type="text"/>
Longs	1bp/20p	<input type="text"/>	2bp/40p	<input type="text"/>	3bp/60p	<input type="text"/>

Q11. Following trade execution, what length of time delay do you require to refresh your prices?

None	<input type="text"/>
1 min	<input type="text"/>
3 min	<input type="text"/>
5 min	<input type="text"/>
Other (please specify)	<input type="text"/>

Q12. If a GEMM's system were to fail, what should happen?

Their ability to trade stopped?	<input type="text"/>
Obligations on all GEMMs relaxed?	<input type="text"/>
Other (please specify)	<input type="text"/>

Q13. If a platform provider is one of several and fails, should obligations on GEMMs be relaxed (on all systems) until that system is restored?

Yes No

Any additional comments.

ANNEX B: MEMBERS OF THE E-TRADING WORKING GROUP

Euan Harkness, Chairman of GEMMA

Kim Rosenkilde, Global Head of Government Bond Trading, ABN Amro

Martin Koester, Head of ECN projects, Barclays Capital

Martin Cross, Head of Gilt Trading, CSFB

Chris Dovell, Head of GEMM, Greenwich Nat West

Stuart Cheek, Fixed income sales, UBS Warburg

Allison Holland, UK Debt Management Office