Consultation on Index-linked Gilts Auctions

Introduction

The 1997-98 Debt Management Report stated that the UK authorities see positive merit in moving to an index-linked gilts auction programme as soon as is feasible, subject to first reviewing the impact of the initial US experience in auctioning inflation-indexed securities, and conducting a further round of consultation with the market. In the consultation document "the future of UK debt and cash management" issued in July 1997, the current Government confirmed that it intended to proceed with this consultation, with a view to introducing auctions for index-linked gilts.

2. This consultation document presents a brief review of the outcome of the US experience so far, and then sets out a series of questions where we would welcome comments by market participants who would be involved in index-linked auctions.

The programme for this consultation exercise, and index-linked auctions

3. Copies of this consultation document are being sent to each of the 17 GEMMs, and to the associations of end-investors and individual firms. Further copies are available on request. We will arrange meetings with any market participants who wish to hold discussions on this consultation. But written comments in response to the questions below would be most welcome, and should be sent to the following address, by 30 January 1998:

Miss N Trebble,
HM Treasury,
Debt and Reserves Management Team,
2nd floor, Treasury Chambers,
1, Parliament Street,
London SW1P 3AG.

Any telephone enquiries should be made in the first instance to Nicola Trebble on 0171 270 4655.

4. The timing of the subsequent start of auctions, assuming that these are feasible, is subject to various uncertainties. The time needed to prepare the arrangements for auctions will depend on the details of those arrangements, which will need to be decided in the light of this consultation. Market participants may also need time to make preparations, and are invited to comment on that in questions 5 and 6 below. The transfer of debt management operations from the Bank of England to the Treasury may also affect the timing of the introduction of auctions.

The US experience of auctioning inflation indexed securities

5. The US have now held 4 auctions, in which they have issued $31bn of new 5-year and 10-year inflation-indexed securities to the public. This is the start of a long-term programme to establish this new instrument in the US Government debt portfolio. By the end of 1998, the US authorities plan to have established a regular calendar for issuing new 5,10 and 30-year inflation-indexed securities.

6. We understand that the US Treasury is satisfied both with the performance of the new instruments, and with the auctions. The US authorities consider that they have established a programme which will, over the years, reduce their debt interest costs. Costs are reduced for the issuer because they save the inflation risk premium priced into conventional yields. And the US authorities consider that they can bear the risk of inflation more efficiently than can any single investor, no matter how large. They believe that they have succeeded in establishing a new viable indexed instrument that offers investors an opportunity to diversify their portfolios.

7. Our interpretation is that the US auctions have gone well overall, although they have had mixed results. The first attracted more than double the demand of a typical auction, with cover of over 5:1, but part of this initial success may have been because of a "novelty effect". All the auctions have achieved good cover. The July auction of the first 5-year inflation-indexed security saw more cautious demand, although the cover ratio was still higher than the average for the 5 year fixed rate auctions. At that time, the market was affected by budget negotiations in Congress, which included proposals to redefine the CPI to lower its growth rate. And the auction took place against a background of lower inflation expectations. Just before the auction, it was announced that the reference CPI, which would apply to the new 5-year security, showed a decline. The subsequent second auction of these notes in October saw a better auction performance, against renewed concerns about inflation. That auction attracted stronger demand, at higher prices.

8. The US authorities have looked at trading and market depth. Analysis of this is difficult because the market is still developing. Trading volumes are low, and this could raise concerns of associated liquidity risks. But the low level of transactions may reflect the immature state of the market, as well as the fact that investors buy these securities to hold them for long-term investment and not for trading purposes. Most of the trading has been focused in the when-issued period. The US authorities have reported that there have been no problems distributing stocks: relatively large amounts of the stocks have been distributed to a wide spectrum of investors on initial issue, through the auction process, and that (contrary to some press reports) dealers have been able to sell their residual holdings reasonably quickly after auctions. Spreads and trading activity in inflation-indexed securities have been similar to those quoted in off-the-run conventional Treasury bonds.

9. The US authorities have also reported that the US market has developed, with the Treasury's commitment to their index-linked issuance programme, to create new uses for these securities. New mutual funds have been established that invest primarily in indexed securities; some portfolio managers have begun to diversify their funds; private issuers have issued their own indexed products; and a swap market has also developed. More than $2 billion of additional inflation-indexed securities have been issued by a variety of non-Treasury borrowers. In July 1997, the Chicago Board of Trade introduced a new futures contract, which listed futures and option contracts on 5 and 10-year inflation indexed securities. However the volume of trading in these contracts has been limited.

10. France has now also announced plans to issue index-linked government bonds. The French authorities announced on 3 December that they would seek Parliamentary approval to sell index-linked bonds as soon as possible, with the intention of selling the first such bond before May 1998.

Questionnaire

The American experience

Q1. Have you or your firm participated directly or indirectly in the US Treasury inflation-indexed security auctions?

Q2. Do you have specific comments on the format of the US auction - uniform price, size, etc?

Q3. Have the US auctions made you more or less willing to participate in UK index-linked auctions? Please explain your reasons.

Pre-announcement/transparency

11. Following the conclusions of the Debt Management Review (published in July 1995), the UK authorities remain firmly committed to transparency in debt management policy and operations. This involves consulting on issues which affect the debt markets, and then clearly explaining policy and plans, including an annual calendar of auction dates for conventional gilts. This provides clarity of policy and transparency of supply, so that investors and market makers can plan their involvement. The UK authorities are committed to this transparency in debt management policy and operations because it delivers lower debt management costs, over the long term.

12. For index-linked auctions, we would propose to follow the pre-announcement format that we currently use for auctions of conventional gilts. Under this format, we would announce an annual calendar of auction dates at the beginning of the financial year, and the target for total issuance. The specific stock or maturity range of stock to be auctioned would then be announced quarterly, with consultation on this included in the normal quarterly consultation round, and the exact amount to be auctioned (and the specific stock if not already decided) would be announced in the week before each auction, at the beginning of the when issued market.

Q4. Have you any views on the proposed pre-announcement format and timings? Would you prefer the authorities to retain more, or less flexibility, and, if so, for what reason?

Amount and frequency/timing

13. In considering the following questions, it may be useful to assume an illustrative figure for index-linked gilt issuance in 1998-99. Suppose that the proportions in which gilts were issued in 1997-98 were carried through to 1998-99. Then, given a CGBR forecast of £5.5 b [1] and gilt redemptions of £16.7 b in 1998-99, we might issue £4 b of index-linked gilts next year. Given this illustrative figure:

Q5. How much notice would you require in order to participate in index-linked auctions?

Q6. What preparations, if any, would you need to make before participating?

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[1] as forecast in Table 2.2 of "The Economy and the Public Finances: Supplementary Material", published with the Pre-Budget Forecast.

Q7. How should the £4 billion of index-linked gilts be sold? All through pre-announced auctions? What reasons if any might there be to retain taps?

Q8. What should be the minimum and maximum amount offered in each auction?

Q9. How often should auctions take place?

Q10. Are there times in each month, or each quarter, which would be better or worse for auctions?

Q11. Would you see any interaction between UK and US index-linked auctions?

Q12. How close should the timing of UK auctions be in relation to US index-linked auctions?

Taps and buying in before and after auctions.

14. For auctions of conventional stocks, the UK authorities currently operate a purdah period surrounding the auction, during which there are no official sales of stocks in the maturity area of the auction stock.

15. In order to help support the liquidity of the index-linked market, the Bank of England is prepared to make a bid for index-linked stock. The Bank expects to be approached by a GEMM to buy in index-linked stock only where the transaction cannot be readily executed in the market and so the Bank's bid will typically be at a discount to market levels, so that the Bank does not substitute itself for market mechanisms.

16. For auctions of index-linked stocks, it would clearly be sensible for the authorities to proscribe taps or official sales or buying-in of index-linked stocks in the maturity area of the stock to be auctioned, during, say, the two weeks <u>before</u> an auction. But the position concerning further sales or buying-in of stock <u>after</u> the auction needs to be considered carefully, if there is a need to support the liquidity of the index-linked market.

17. Our strong presumption is that we cannot see any net advantage to the government as issuer in offering any concessions in the form of further issues, after the auction, at or near the auction price. Nor can we see that there could be any net advantage to the government as issuer in buying-in, after the auction, at or near the auction price.

Q13. Do you have any comments on the proposed approach, bearing in mind that any support for the liquidity of the index-linked market after the auction must provide a demonstrable net benefit for the Government as issuer?

Should there be a separate list of index-linked market makers (IG GEMMs)?

18. The Bank of England conducted a consultation exercise in December 1995 on the merits and practicalities of establishing a separate list of index-linked market makers (and of holding pilot auctions). The Bank's conclusions from that consultation were that, <u>if</u> an IG GEMM list were to have been established:

- the list would have consisted of the eight GEMMs then active in index-linked gilts, plus the two retail specialists that were then active. Other applications would have been invited and considered on the basis of a business plan;

- the benefits would have been sole access to taps and auctions, and to the official dealing desk, and to the IDB screens for index-linked gilts;

- the obligations would have been to quote continuous two way prices to all market participants (including other GEMMs), and an expectation that they would maintain a secondary market share of at least 3%, to be applied flexibly and assessed on a qualitative basis.

Q14. Should there be a separate list of IG GEMMs? How would this help index-linked gilt auctions?

Q15. Should there be any privileges for being an index-linked GEMM? What benefits would such privileges provide to the issuer?

Q16. If there were a separate list of IG GEMMs, should their obligations include a requirement:
a) along the lines suggested above?
b) to bid actively and competitively at auctions?

<u>Participation</u>

Q17. Would you expect to participate in index-linked auctions? To what extent?

Q18. If not, why not? What would your concerns be?

Q19. (For market makers only:) to what extent would you expect your customers/clients to be involved in an auction?

Q20. What kind of position would you be prepared to go into an auction with, or come out of an auction with?

<u>When issued market</u>

Q21. Should the WI market operate any differently to that for conventional stocks?

<u>Format of auctions</u>

Q22. Which would you prefer: uniform or competitive bid price auctions?[2] Why?

Q23. How would your behaviour change in a uniform or competitive bid price auctions? Would the extent that you would be prepared to participate differ, with the format? Why?

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[2] In uniform price auctions (also known as common price auctions), all accepted bids are allocated at the lowest accepted price. In competitive bid price auctions, successful bidders are allocated stocks at the prices which they bid. In both formats of auctions, bids at higher prices are allotted in full, and bids at the lowest accepted price are pro-rated if necessary.

Q24. In a uniform price auction, how could the issuer protect itself from a situation in which a small number of large players might all happen to bid low?

Q25. Options that we might consider for structuring the auction include cutting off accepted bids:
i) by volume, eg at the level which 90 per cent of bids are above;
ii) at a minimum (unannounced) price (or yield) level;
iii) by volume, but only if there is considerable spread in the lowest bids that would otherwise be accepted.
What's your view of each of these options?

Q26. For conventional auctions, there is currently a guideline which states that successful bidders should only expect to acquire up to 25% of the amount on offer for their own account. Should a similar guideline be adopted for index-linked auctions? What figure would be appropriate?

Q27. Assuming that there was a clear specified method of conversion between prices and yields, which would you prefer to bid in terms of - prices or yields? Why?

Q28. If bid-price auctions were adopted, should the amount of non-competitive bids be subject to the same limits as for conventional gilts? (i.e. 0.5% of the nominal amount on offer for GEMMs, or £500,000 (nominal) for non-GEMMs.) If you would prefer a different limit, how would this help the auction process?

Stocks

Q29. Should we adopt index-linked gilt benchmarks, and just issue those, eg at 5,10, 20 and 30 years? Or should we continue to issue across the yield curve?

Q30. Obviously, if we were to issue an index-linked gilt benchmark, there would be a trade off between its size, and how long its on the run. We would welcome comments on this issue.

Re-design

19. If we were to consider re-designing our index-linked gilts, the model that we might consider adopting could be the US/Canadian model, which includes the following features:

- a 3 month lag, i.e. uprating of principal in line with the reference price index of 3 months earlier;
- semi-annual coupons (as now);
- strippability;
- aligned coupon dates, to facilitate strip fungibility;
- benchmark issuance;
- actual/actual daycount convention;
- secondary market trading in decimals;
- secondary market trading on a real basis.

20. However our presumption is that the tax treatment on our redesigned index-linked gilts would remain as now, with eligible corporations granted an indexation allowance, and individuals not subject to capital gains tax on sales of unstripped index-linked gilts. This would differ from

the tax treatment in the US, where the capital uplift is included in taxable income in the year it occurs.

Q31. If we were to consider re-designing our index-linked gilts, what value would you see (separately for us as issuer, and for the market) in our moving to the above design?

Q32. Are there particular features of the above model which would be most useful?

Q33. If index-linked gilts were to be made strippable, it would be highly desirable for the coupons strips from different bonds to be fungible. Should strip fungibility in fact be a prerequisite for allowing stripping to take place?

Q34. In order to achieve exact coupon strip fungibility, the nominal coupons on the bonds in question would have to be equal - equivalently, the bonds would need to have aligned coupon dates, the same RPI value, and the same real coupon. Do you agree or do you have an alternative proposal for how to achieve exact fungibility?

Q35. The design of the US index-linked stock includes a guarantee that the final repayment of principal on redemption of the security will not be less than the original principal value of the security, i.e. that the nominal value of the principal will be hedged against negative inflation. Would this be a useful feature, or an unhelpful complication? What value would you put on such a feature?

Q36. Would you have any concerns that redesign would reduce the attractiveness of existing index-linked gilts?

Q37. Are there any other changes that we should make? What value would they have?

Any other comments

We would welcome any other comments that you would wish to make about index-linked gilts, and auctions.

HM Treasury