

INDEX-LINKED GILTS

A PROPOSAL FOR THE CONDUCT OF INDEX-LINKED GILT AUCTIONS AND THE INTRODUCTION OF A SPECIALIST INDEX-LINKED GILT-EDGED MARKET MAKER LIST

A. SUMMARY OF PROPOSALS

1. The UK Debt Management Office (DMO) will hold the first index-linked gilt (IG) auction in October 1998 and intends to introduce a separate gilt-edged market maker (GEMM) list for IG specialists shortly.

IG Auctions

2. IG auctions will be for a single stock and conducted on a common price basis within a £½ -1 billion (cash) size range. GEMMs and end investors will be consulted at quarterly meetings on their advice for the precise stock(s) for the auction(s) in the following quarter. At the end of each calendar quarter, the DMO will then publish the stock details (or their maturity ranges) for the auction(s) in the following quarter.

3. The DMO plans to commence IG auctions on a quarterly basis from 28th October, 1998. The frequency and size range of auctions in future years will be reviewed in the light of experience. A non-competitive bidding facility of up to 10% in total of the nominal amount of stock being auctioned will be available to IG GEMMs. The non-competitive allotment will be allocated on the basis of stock allotted to competitive bids at the three previous IG auctions. A successful bidder will be allotted a maximum of 40% of an IG auction (net of any bids for clients and short positions). The DMO will not tap or sell IGs in the three weeks either side of an IG auction but may switch IGs other than in the maturity area of the auction stock. IG taps will only be used for market management purposes from October 1998.

IG GEMMs

4. Privileges of IG GEMM status:

- Have sole access to competitive bidding at IG auctions;
- Have access to the 10% of the IG stock being auctioned which is reserved for IG GEMM non-competitive bids;
- Have sole access to the IG stocks that may be sold or switched through the DMO's secondary market dealing desk. (Stocks available for outright sale or switches will be publicised on the DMO's 'Shop Window' screens.);
- Have access to any separate IG screens that the IDBs may establish to service only IG GEMMs;
- Advise the DMO over the IG stock(s) to schedule for auction in the quarterly consultation meetings.

5. Obligations of IG GEMM status:

- Participate actively at IG auctions, achieving allotments, over a period, roughly commensurate with secondary market share (and with a minimum of 3% of stock available at IG auctions averaged over 3 auctions);
- Quote two-way prices in all IG stocks at all times to all customers;
- Seek to maintain an average IG market share of at least 3% on a 6-month rolling average basis;
- Be a member of the London Stock Exchange;
- Provide the DMO with market intelligence and other data.

6. The DMO has discussed these proposals with the London Stock Exchange, which is considering any possible implications for its rulebook.

Timetable

7. The DMO intends to publish the separate IG GEMM list and establish the new market-making arrangements in the week commencing 7th September 1998. In order to be considered for inclusion on the initial IG GEMM list, applications for IG GEMM status should be made to the DMO by 24th July 1998. Application forms for IG GEMM status are available immediately from the DMO contacts below.

8. Requests for application forms for IG GEMM status, or questions about this document, should be addressed to:

Ms Jo Whelan (tel: 020 7862 6531) or Mr Martin Duffell (tel: 020 7862 6517):

**UK Debt Management Office,
Cheapside House,
138 Cheapside
LONDON EC2V 6BB.**

Fax. 020 7862 6509

B. INDEX-LINKED GILT MARKET REFORMS

9. The UK Treasury, in conjunction with the Debt Management Office and the Bank of England, conducted a consultation exercise in January 1998 on the possibility of the UK Government moving to issuing index-linked gilts mainly through auctions, as opposed to currently through 'tap' issues. In addition, the views of market participants were also sought on the possibilities of introducing a separate list of index-linked gilt-edged market makers and redesigning the structure of the IGs to conform more closely to recent international innovations.

10. Twenty-eight written responses were received from GEMMs, fund managers, representative bodies and academics. In addition, meetings were held with GEMMs and fund managers with a particular interest in the market. Annex A summarises the responses to the consultation document.

11. Although not unanimous, the responses indicated that there is now general market support for sales of index-linked gilts via auctions, following the US experience with auctioning Treasury Inflation Indexed Securities (TIIS). Taking account of the outcome of the consultation exercise, the Government has therefore decided to introduce an auction programme for index-linked gilts, starting in October 1998.

12. This document describes the detailed procedures proposed for the operation of the index-linked auctions. The proposal should be seen in the context of the plans for issuance of index-linked gilts in 1998-99 which were set out in detail in the 1998-99 Debt Management Report published by the Treasury on 19 March 1998. The Debt Management Report also reported the key decisions which the government had made in response to the consultation on index-linked gilt auctions. In particular it announced the Government's plans to introduce quarterly index-linked gilt auctions, with the first one scheduled for 28 October 1998 and the second on 27 January 1999. It also stated that the size range of auctions would be £½ -1bn (cash) and that they would be held on a common price basis. In addition, the authorities pre-committed to a minimum of £2.5 billion (cash) of index-linked gilts issuance per year over the foreseeable future in order to maintain liquidity in the market following the introduction of auctions. Once IG auctions commence, the authorities reserve the right to tap IGs, but only for market management reasons.

13. The Debt Management Report also announced that the Government currently has no plans either to redesign or to concentrate index-linked gilts issuance on benchmark issues. The remit which the government has set for the DMO in 1998-99, set out in the Debt Management Report, commits the DMO, over the medium term, to aim to issue index-linked gilts in such a way as to maintain liquidity in most maturity areas across the curve.

14. In addition, it stated that in introducing index-linked auctions, the authorities were also aware of concerns about the need to assist GEMMs in maintaining liquidity during the change from tap issuance to auctions. Only about half of the sixteen GEMMs are currently active in the IGs market. Consequently, the Government proposed to introduce a separate index-linked GEMM list, prior to the start of auctions.

15. The following sections review the rationale for the introduction of IG auctions and a separate IG market maker list, set out the proposed arrangements for the structure of IG auctions and the details associated with the operation of the separate list. The draft wording of the Operational Market Notice as it applies to IG auctions and GEMMs is given at Annex B. Given that a round of market consultation has already been conducted, the DMO regards these as firm proposals. However, the DMO would be prepared to consider amendments to any of the details if strong contrary views are expressed by a significant number of IG market participants.

C. BACKGROUND REASONING

The Rationale for IG Auctions

16. The introduction of an IG auction programme will improve the predictability and transparency of the method of sale of these instruments. This should, over the longer-term, benefit investors, GEMMs and the Government by increasing and better focusing demand. This development is in line with the earlier reforms to the UK authorities' debt management programme, following the Debt Management Review in 1995, which adopted predictability and transparency as the guiding principles of debt management, in order to minimise the Government's debt issuance costs, over the longer-term.

17. In addition, IG auctions will enable investors and GEMMs to plan their strategies further ahead given the degree of certainty of timing of extra supply. In particular, this may encourage more international interest in IGs. Reduced reliance on the tap process should ensure that the authorities have greater assurance of meeting their sales target for IGs.

18. The authorities recognise, however, that the IG market is less liquid than that for conventionals. This reflects the absence of a natural hedging instrument (such as a futures contract) and the buy-and-hold strategies employed by many investors.

19. The format of IG auctions will, at least initially, be one of common price in order to encourage the GEMMs to build up short positions prior to the auction with some comfort that these can be filled at an auction price common to the rest of the market. This should help to ease risks caused by a lack of a hedging instrument. In addition, IG auctions will contain an option on a non-competitive allocation of stock that GEMMs can acquire by purchasing stock on a competitive basis at the previous three IG auctions (see below). This non-competitive facility should further help GEMMs to pre-sell the auction stock, prevent any one GEMM and its clients cornering the fresh supply of an issue and provide an incentive for GEMMs to participate regularly in the auction process.

The Rationale for a Separate IG Market-making List

20. The market for IGs differs somewhat from conventionals. They are less widely traded because of their specialist appeal and end-investors tend to hold them to maturity; effective hedging mechanisms are largely absent; and specialist expertise and systems are needed to trade them. In practice, therefore, a few GEMMs tend to do most of the turnover in IG stocks so that there is already a *de facto* specialist GEMM list.

21. To support the planned introduction of IG auctions, the DMO needs to ensure that GEMMs who specialise in IGs not only accept the obligation to bid at IG auctions but also contribute to providing liquidity in the secondary market.

22. In addition, the distinct label of "IG GEMM" should enable firms to market themselves more easily to clients as IG specialists. This may help create a virtuous circle, allowing greater development of client business by ensuring high quality coverage from specialists, thereby increasing the end-investor demand for the product. Similarly, this should help to build up liquidity in the secondary market.

23. Without a specialist list, there might be a problem with fair-weather market-making behaviour. GEMMs might enter the IG market when it appeared profitable to do so (for instance, when real yields were falling) and withdraw in difficult market conditions when clients wish to liquidate positions. Also, without a list that conferred bidding privileges, some GEMMs might seek to purchase a high proportion of stock at IG auctions without making a commitment to provide liquidity in the secondary market. This could make the task of those firms seeking to support secondary market liquidity more difficult since they could face greater risks in building up positions prior to an auction.

24. However, establishing a specialist IG GEMM list does run the risk that it sets up a significant entry barrier to GEMMs or others wishing to trade IGs actively. The aim of the authorities in establishing such a list is not to entrench and protect the business of the IG GEMMs on the list from competition or to restrict the options open to investors. Hence, the requirements set out below for entry to the list have been designed to ensure that a firm on the list should realistically be able to make a market and place IGs actively and competently, but have not been set so high as to discourage serious entry into the market.

25. The number of IG GEMMs could fall below a minimum, which the DMO felt was necessary to ensure competition at auctions. In such a scenario, the DMO would reconsider the arrangements for a separate list and would examine alternative market structures. The DMO does not intend to publish a minimum number of IG GEMMs below which it deems that the market and auctions would not remain competitive. This is because the dynamics of the market are not necessarily related to the precise number of firms on the list.

The Proposed Structure of IG Auctions

26. The main features of the IG auction structure have already been established in the light of the earlier consultation responses. Hence, IG auctions will be for a single stock on dates published in the annual remit to the DMO; they will initially be for between £½ -1 billion (cash); and will be held on a common price basis. As with conventional auctions, the market makers and end investors will be consulted at quarterly meetings on their advice for the precise stock(s) for the auction(s) in the following quarter. At the end of each calendar quarter, the DMO will then publish the stock details (or their maturity ranges) for the auction(s) in the following quarter.

27. The DMO plans to commence IG auctions on a quarterly basis from 28th October 1998. The frequency and size range of auctions in future years will be reviewed in the light of experience and will also depend upon the total amount of IG issuance that the Treasury sanctions in the annual borrowing programme. This will be for a minimum of £2.5 billion (cash) for the foreseeable future.

28. As set out in the draft Operational Notice (Annex B), the timing and bidding arrangements for an IG auction will be similar to that of a conventional gilt auction although only IG GEMMs will be allowed to make competitive bids by telephone and direct to the DMO (other GEMMs and customers will be allowed to bid competitively through an IG GEMM). The substantive differences to the conventional auction process are that:

- **Setting the price bidders pay:** The auction will be conducted on a common price basis. Hence, successful competitive bids will be allotted at the same

clearing price. The DMO will not set a minimum price at which it will accept bids. It reserves the right not to allot stock to competitive bids, even if the auction would otherwise be uncovered, if this would reduce the clearing price to a level that was substantially below the market price at close of bidding. However, this right would only be exercised in extreme circumstances in which an unacceptably large loss of revenue would otherwise be suffered by the public.

- **Allocation of a non-competitive bidding facility:** The DMO reserves the right to set aside a proportion of an issue for non-competitive bidding. A non-competitive bidding facility of up to 10% of the nominal amount of the index-linked stock being auctioned will be available to IG GEMMs. Even though these bids will be filled at the same clearing price as the competitive bids, exercising this bidding facility will enable IG GEMMs to be certain of an allotment of stock. This will help to ensure a spread of supply amongst the IG GEMMs and give some comfort that they will be able to fill some of their short positions if they pre-sell the auction. The non-competitive allotment will be allocated on the basis of the share of stock allotted to competitive bids at the three previous IG auctions. This will give IG GEMMs an incentive to participate competitively in order to acquire an option to exercise a non-competitive bid facility in future auctions.

In steady state, the 10% non-competitive facility will be allocated to IG GEMMs *pro rata* in relation to their share of the competitive allotment averaged over the previous three IG auctions. Following the commencement of when-issued trading on the Tuesday eight days before an IG auction, the DMO will inform each IG GEMM of its share of the non-competitive facility. In the first IG auction, the non-competitive facility will be allocated equally amongst the IG GEMMs. In the second and third auctions, the non-competitive facility will be allotted *pro rata* in relation to the relative shares of the competitive allotment of the previous one and two auctions respectively. (Subsequent entrants to the IG GEMM list would accumulate a share in the non-competitive facility in relation to their competitive allotments at IG auctions following their entrance.)

- **Limit on a successful bidders' share:** The DMO allots auction stock to individual bidders at its absolute discretion. In particular, it may decline to allot stock to an individual bidder if to do so would be likely to lead to market distortion. At an IG auction, no single GEMM (including its parent) should expect to be allotted more than 40% of the stock on offer, including its non-competitive allocation of the issue on offer on its own account, net of client bids and net short positions in the when-issued and parent stock. Hence, if an IG GEMM bids for more than 40% of the auction issue it will be required to submit immediately a report to the DMO detailing the clients for whom it is bidding and its net short position in the when-issued and the parent stock. If the GEMM is still going to receive more than 40% of the issue on its own account, it will be scaled back to 40% and the stock allotted to other competitive bidders. If a client bids successfully for more than 40% of an auction, its allotment would also be scaled back.

The 40% share for an IG auction is higher than the 25% share limit used in a conventional gilt auction. This reflects the likelihood of a smaller number of potential bidders and the smaller absolute size of IG auctions leading to the likelihood that a higher proportion of the auction may be bid for by a small number of bidders.

- **Tapping moratorium:** There will be a moratorium on the DMO tapping, selling or buying-in IGs during the three weeks either side of an IG auction. In addition, during this period, the DMO will not switch the IG auction stock (or the announced maturity area of the auction).
- **Interaction of auctions and taps:** Once the quarterly IG auction commences in October 1998, the DMO will only resort to tapping IGs for market management reasons rather than as a major financing source. The last conventional tap (for market management reasons) occurred in November 1996 and similar taps have not been required recently. However, the authorities recognise that there may be a greater market management need for IG taps than is currently the case for conventionals. This is due to the lower liquidity of the market, the difficulty of hedging for the GEMMs and the possibility that it will take some time before the pattern of IG demand switches towards the time of auctions. Hence, the remit to the DMO makes provision for up to £0.5 billion (cash) of tapping in 1998-99H2.

The DMO reserves the right to repo IGs for market management reasons; this could either be of stocks already held in official portfolios or by creating and subsequently cancelling stock simply for repo. Any such operations would be published and be available to all IG GEMMs.

The Proposed Operation of the Separate IG GEMM List

29. **Number:** As stated above, the DMO does not intend to publish a minimum number of IG GEMMs below which it deems that the market and auctions would not remain competitive. If an insufficient number of GEMMs decided to join a separate list, the DMO would review whether to proceed with IG auctions.

30. **Recognition Criteria:** Given the existence of a de facto specialist GEMM list, initial applicants to the IG GEMM list are likely to be able to demonstrate a track record in IG trading and distribution. As with the recognition of conventional GEMMs, for a firm to be considered for entry on the IG GEMM list, applicants will need to:

- demonstrate a viable business strategy for developing their business in IG trading and distribution. As detailed below, the DMO would expect an IG GEMM to be able to demonstrate that it could maintain an average secondary market share of around 3% or more (unless specialising only in servicing retail brokers and clients);
- demonstrate in-house expertise and systems (staff, IT, risk management) in IG stocks and trading;
- be a member of the London Stock Exchange and be, or be prepared to be, a GEMM operating under LSE rules.

31. **Minimum market share:** The DMO would expect an IG GEMM to maintain a minimum average secondary market share of around 3% in IGs, measured on a six-month rolling average basis. (The average weekly turnover in IGs transacted by GEMMs during early 1998 was £1.25 billion nominal.) An exception to this requirement would be made for a firm that committed to service only retail brokers and clients in IGs. The DMO will inform each IG GEMM of their weekly secondary market share, and the 6 month rolling average.

32. This market share requirement is intended to ensure IG GEMM status only applies to firms interested in participating in IG auctions and in contributing to secondary market liquidity. The 3% requirement is designed to be indicative rather than 'hard' in that an IG GEMM would not be removed from the list as soon as its 6-month rolling average share fell below 3%. Otherwise, IG GEMMs might resort to 'churning' stock in order to raise their market share artificially and turnover data would become a less accurate measure of market activity. However, if a firm's share was persistently below 3%, the DMO would require the firm to outline their business strategy for raising market share. If no improvement was discernible, the DMO would require the firm to leave the IG GEMM list in due course. Any such exit would be published to the market.

33. **Probationary period:** It is unreasonable to expect a firm new to the IG market to enter the IG GEMM list with a market share of 3% straight away. Hence, if a new firm wishes to join the IG GEMM list, it would be expected to demonstrate a business plan capable of delivering at least 3% of market share within six months. The firm would, however, be required to take on the other obligations and privileges of IG GEMM status.

34. **Privileges of IG GEMM status:** IG GEMMs would

- Have sole access to competitive bidding at IG auctions. Given that IG auctions are to be held on a common price basis, only IG GEMMs will have the ability to bid competitively to the DMO. Otherwise clients or other traders (including GEMMs who are not IG GEMMs) would be able to circumvent the IG GEMMs at auctions with the reassurance of paying only the clearing price. As with conventional auctions, this bidding will be via telephone for the present. The DMO will consider moving to electronic auction bidding in due course.
- Have access to the 10% of IG auction stock reserved for IG GEMM non-competitive bids (see above).
- Have sole access to the IG stocks that may be sold or switched through the DMO's secondary market dealing desk. At present and unlike in conventional, the IG stocks that are sold or switched through the DMO's desk do not appear on the 'Shop Window'. With the establishment of an IG GEMM list, the DMO intends to publicise its IG operations through the Shop Window screens and these will be accessible to the whole market. However, only IG GEMMs would have access to switches and outright sales with the DMO. If the DMO were to repo IGs for market management reasons, this facility would only be available to the IG GEMMs.
- Have sole access to any separate IG screens that the IDBs may establish to cater only for IG GEMMs.
- Advise the DMO over the IG stock(s) to schedule for auction in the quarterly consultation meetings. The DMO anticipates that this advice would be given separately to that on the conventional auction schedule.

35. **Obligations of IG GEMM status:** IG GEMMs would be expected to;

- Participate actively at IG auctions. The DMO would expect each IG GEMM to bid competitively at each IG auction. Allotment to an IG GEMM at any one auction will depend on the firms' client business and appetite for auction risk at

the time. However, the DMO would expect IG auction allotment to be roughly commensurate with an IG GEMM's secondary market share when averaged over 3 auctions. Hence, as a minimum, the DMO will expect each IG GEMM to be allotted a minimum of 3% of stock available at IG auctions averaged over 3 auctions, unless an IG GEMM has recently joined the list or is specialising solely in retail business. (The 3% minimum share would include non-competitive allotments).

- Quote two-way prices in all IG stocks at all times to all customers. IG GEMMs would be expected to quote two-way prices on IGs in all market circumstances. The DMO will consider surveying investors to ensure that IG GEMMs are observing this obligation.
- Seek to maintain an average IG market share of at least 3% on a 6-month rolling average basis. As discussed above, this requirement would not be applied immediately to IG GEMMs new to the list or one specialising in the retail market. The DMO would take into account the IG GEMMs' reported transactions data and any other relevant information when making this assessment.
- Be a member of the London Stock Exchange.
- Provide the DMO with relevant information. As with conventional GEMM status, IG GEMMs would be expected to report their positions and turnover in IGs to the DMO and supply market intelligence.

36. The DMO will monitor IG GEMM observance of these obligations through analysis of auction participation, IG turnover data and market liaison. It will meet periodically with each IG GEMM to review performance.

Timetable

37. The DMO intends to publish the separate IG GEMM list and establish the new market-making arrangements in the week commencing 7th September 1998. The obligation to make markets in IGs by GEMMs not on the list would then be removed. The IG GEMMs will be consulted on the appropriate stock for the first IG auction at the GEMM consultation meeting on 21st September. The first IG auction is scheduled for 28th October.

38. In order to be considered for inclusion on the initial IG GEMM list, applications for IG GEMM status should be made to the DMO by 24th July 1998. Application forms for IG GEMM status are available immediately from the DMO contacts below. The DMO are happy to discuss the application process or the proposals set out in this document with any market participant.

Requests for application forms for IG GEMM status, or questions about this document, should be addressed to:

**Ms Jo Whelan (tel: 020 7862 6531) or Mr Martin Duffell (tel: 020 7862 6517):
Fax. 020 7862 6509**

**UK Debt Management Office,
Cheapside House,
138 Cheapside
LONDON EC2V 6BB.**

Annex A: Responses to Consultation on Index-linked Gilts Auctions

1. The UK Treasury, in conjunction with the Debt Management Office (DMO) and the Bank of England, conducted a consultation exercise in January 1998 on the possibility of the UK Government moving to issuing index-linked gilts mainly through auctions, as opposed to the current method of issuance through 'tap' issues. In addition, the views of market participants were also sought on the possibilities of introducing a separate list of index-linked gilt-edged market makers and redesigning the structure of the IGs to conform more closely to recent international innovations.

2. Twenty-eight written responses were received from GEMMs, fund managers, representative bodies and academics. In addition, meetings were held with GEMMs and fund managers with a particular interest in the market. This annex summarises the responses to the consultation document.

Market reaction to the prospect of Index-linked Gilts (IG) auctions

3. Responses to the prospect of IG auctions were generally favourable. Of the GEMMs who were active in the IG market, most expressed support, some strongly. In their view, auctions would offer a significant improvement in transparency and predictability compared with the current system of issuance of IGs through taps, and auctions would be more efficient for the issuer, and the market. A small number expressed reservations or opposition, reflecting their concerns about the transfer of risk to GEMMs, and their preferences for the current system of issuance. Several GEMMs expressed concern about the current illiquidity of the IG market, and any steps that would further reduce liquidity. There were also concerns about whether the timing of demand would shift to auctions, and whether the volume of issuance would be sufficient to support a move to auctions. Several GEMMs said that their views had been influenced in favour of auctions by the US experience of auctioning Treasury Inflation Indexed Securities. This had shown that auctions could be done, without damaging the IG market.

4. Of the end-investors, almost all the respondents who were most active in the index-linked market expressed strong support for auctions. Views of the other respondents were more mixed, with some preferring auctions and some preferring the tap system or wanting taps phased out slowly.

Pre-announcements and transparency of issuance plans

5. All the responses supported the suggestion made in the consultation document, that the Treasury should follow the pre-announcement format that is currently used for auctions of conventional gilts. This would include announcing a target for total issuance and an annual calendar of auction dates at the beginning of the financial year, and announcing the specific stock or maturity range of the stock for each auction quarterly, following the normal quarterly consultation round.

Format of auctions

6. Feedback from the consultation was that the majority of the GEMMs who were active in IGs would prefer a common price format for IG auctions; some of them expressed a strong preference for this format. Several stated that their participation would be weaker if these auctions were run on a competitive bid price format. A small minority expressed a strong preference for the competitive bid price format for these auctions. The majority of responses from end-investors were also in favour of the uniform price format.

7. Comments in favour of the uniform price format were that it was easier, safer and would work best for participants. Comments strongly suggested greater participation and higher bid prices under the uniform price format. Further points put forward for this format were that it would be closest to the current IG tap system; it would follow the US experience; it would be better for liquidity; and it would provide confidence that bidders would get stock. GEMMs were more concerned of being short of IGs after an auction than being long.

8. Comments in favour of the competitive bid price format were that this would provide higher rewards for those participants who had more market intelligence, and that this format could be more efficient, and produce less volatile results.

Size and frequency of auctions

9. Assuming that the government might issue £4 billion of IGs, responses focussed on two main options: holding 4 auctions a year of between £½ and £1 billion (eg with 75% auctions, 25% taps), or holding 8 auctions a year of £½ billion or less (with less need for taps). A few responses suggested auctions of up to £2 billion. Most of those who suggested larger auctions either wanted concentrated issuance into a few gilts, or for more than one stock to be sold at each auction. Some respondents were concerned that smaller auctions would work against the efficiency of the auction process, and discourage participation. Concerns were also expressed that it would be slightly difficult to schedule 8 IG auctions, along with conventional auctions.

10. In discussions, several GEMMs suggested that the DMO should auction 2 or 3 stocks at a time, as this was occasionally done with taps before. But other GEMMs expressed strong views against this, because demand for one IG would be stronger than for the other(s), and this could cause difficulties for the GEMMs and the issuer.

Taps and buying in before and after auctions

11. Respondents endorsed the suggestion in the consultation paper that there should be a purdah period around auctions, when there would be no buying-in or taps.

Other aspects of the format of auctions

12. The consultation paper also asked how the issuer could protect itself, in a common price auction, from a situation where bid prices tailed off and the whole stock would otherwise be sold at a disproportionately low price, which would carry an unacceptable cost to the taxpayer. Feedback on this issue from the consultation exercise was that any intervention would work against auction efficiency, and that the Treasury should only reserve the right not to allot stock in a similar way as the Bank had done for conventional auctions. (The current operational notice which covers auctions of conventional stocks states that the Bank reserves the right not to allot all of the stock on offer, although it would consider this only in exceptional circumstances, eg where the auction was covered only at an unacceptably deep discount to the prevailing market level.)

13. Finally, several GEMMs suggested that the Treasury might want to consider introducing incentives to bid. The main suggestions were for a non-competitive element, possibly scaled according to levels of market activity or bidding, or the option that the French authorities offer, whereby primary dealers have an option to take up a non-competitive additional allocation of stock for up to 24 hrs after the auction, with the option for each dealer scaled to reflect the size of their bidding over recent auctions.

Retaining limited taps

14. The consultation paper asked what reasons there might be for retaining taps. Responses revealed a wide and well spread range of views, varying between extremes of “no taps”, and “half and half, taps and auctions”. But the majority saw a need to retain the flexibility for some taps in the first year, to deal with the possible need for market management.

15. Arguments put forward for stopping taps were that the timing of demand might not shift to auctions unless we forced it by withdrawing taps. And that retaining taps would detract from auctions, and work against the efficiency and objectives of the auction process.

16. Arguments put forward for continuing with taps were that these might be necessary in the first few years of auctions to support the secondary market, at least initially, if it was too illiquid in between auctions. Demand would take time to shift, as behaviour of investors and GEMMs adjusted and taps might be necessary to provide support in the transitional period.

Separate IG GEMM list

17. There was a clear consensus amongst respondents on this issue: all the GEMMs who were currently active in the IG market, and all the end-investors who responded wanted a separate IG GEMM list in the context of IG auctions. A few GEMMs who were not currently active in the IG market expressed views against a separate IG GEMM list.

18. Arguments given in support of the separate IG GEMM list were: to improve the transparency of the market (eg so overseas investors knew with whom to deal); to encourage GEMM involvement; and to improve commitment and liquidity in the IG market. Several respondents saw a separate IG GEMM list as a necessary requirement to support the introduction of IG auctions, in order to ensure that those GEMMs who were active and who provided liquidity in the secondary IG market were able to get stock at auction. Many respondents also made the point that any obligation to maintain a minimum market share would need to be policed and enforced.

Benchmark stocks

19. Responses covered two aspects of benchmark stocks. First, several respondents stated very clearly that there was no such thing as "benchmark status" for IGs, i.e. particular IGs (such as 10 yr, 30yr) were not used as benchmarks for measuring the performance of portfolios in particular maturity areas. A 10 yr IG was no more significant than an 8 year, or 12 year, and the market would not pay a premium for "benchmark" IGs, just because they were a particular maturity, eg 10 year or 30 year. This meant that, if the Treasury were able to concentrate issuance on a few bonds, these could stay "on the run" for several years.

20. But, given that at the time of the exercise there were 12 IGs in issue, spread across the yield curve (or 11 as far as the IG market was concerned; the 4 5/8 IG 1998 was by then so close to maturity it was effectively a conventional stock), views were mixed as to whether it would be useful to concentrate issuance in 4 bonds, say, to build up liquidity in those. Some respondents saw that additional liquidity as very useful, but others were concerned that this might make the other IGs more illiquid or they simply wanted issuance to continue across the curve. The majority view of responses was that the auction arrangements should allow issuance to cover the curve.

Redesign

21. Respondents were interested in the questions on redesign, and gave some useful detailed views, but the consensus response was that, whilst there were advantages in index-linked gilt redesign, these did not justify the transitional costs and difficulties that the market would incur in assimilating the redesign.

22. Responses indicated that moving to the US design would have several advantages, specifically a shorter index lag, strippability, and moving onto an international standard, and would be useful in the longer-term. However investors (domestic and international) did not find that the current IG design raised any barriers to investment. If the Treasury were to consider introducing redesigned IGs, then conversions would be preferable to launching the new design alongside the old, because they would carry less risk of fragmented market

liquidity. But conversions could still carry such risks because some investors might plan to hold their existing IGs to redemption, to offset specific liabilities, and they would not want to exchange them.

Annex B: Proposed Supplement to the Operational Market Notice concerning the Conduct of Index-linked auctions

Any reference to GEMMs in this section should be read as applying to the specialist index-linked market makers on the list approved by the DMO.

Auction Procedure

1. Auctions will be used in conjunction with taps to issue index-linked stock.
2. Prior notice of auction details:
The DMO Remit for each financial year will indicate:
 - the number of auctions planned for the financial year ahead
 - the dates planned for each auction
 - a range for the size of the auctions (in cash terms).
3. The issuance programme, and in particular the number and timing of auctions, may be varied during the year but the Government is committed to a minimum annual issuance of £2.5 billion in cash terms for the foreseeable future. Any revisions will be announced.
4. At the end of each calendar quarter (typically at 3.30pm on the last working day) plans for the auctions to be held in the following quarter will be announced. These will indicate either the stock (indicating a new stock where relevant) or, where further market feedback would be valuable, a maturity range.
5. At 3.30pm, eight calendar days before each auction (i.e. the Tuesday of the week before an auction held on a Wednesday), the DMO will publish the auction details: stock, amount offered, and any other details needed, including prospectuses and application forms for the issue. When-issued trading in the stock may then commence. Issues of existing stocks will be fungible with the parent issue.
6. Competitive bids may only be made to the DMO by GEMMs. The auctions will be conducted on a common price basis. Competitive bids must be for one amount and at one price expressed as a multiple of 1/32nd of £1 (until the introduction of decimalisation when the multiple will be 0.01 of £1); and for at least £1,000,000 nominal and multiples thereof. All successful bidders will receive stock at the same price: where a GEMM's bids are above this price it will be allotted in the full amount bid; allotments for bids at the striking price may be scaled. The DMO will not publish a minimum price.
7. There will also be a facility for non-competitive bids, which will be allotted in full at the striking price of the successful competitive bids. A total of 10% of the nominal amount on offer will be made available to the GEMMs and each of the GEMM's access to this facility will be related pro rata to their successful competitive bidding at the previous 3 auctions. (Following the commencement of when-issued trading, the DMO will communicate to each GEMM its non-competitive bidding allocation). Other bidders can make a non-competitive bid by post of up to £250,000 (nominal), subject to a minimum application of £1,000 (nominal) and a limit of one bid per applicant.

8. The terms and conditions of the issue as set out in the prospectus for the stock in question will apply to telephone applications for stock and to any stock which may be allotted as a result of such applications. Telephone applications will constitute (a) requests that stock allotted be credited directly to the GEMM's CGO account; (b) irrevocable undertakings to accept such stock by member-to-member delivery through CGO by the deadline for such deliveries on the day following the auction; and (c) agreement that the consideration to be input in respect of such delivery will be the aggregate amount payable by the GEMM on the allotment of such stock in accordance with the terms of the prospectus.

Bidding procedure

9. The bidding procedure is as follows:

- Each auction will close at 10.30am.

- **GEMMs** may bid by telephone, on their own behalf or for clients, direct to the DMO's dealing room; GEMM's non-competitive bids may also be made by telephone. Telephone applications will be irrevocable. The DMO's record of a bid will prevail in the event of any dispute or misunderstanding.
 - On the morning of the auction, they may make an unlimited number of *competitive* bids up to 10.20am and a further 8 competitive bids per stock between 10.20am and 10.30am. Competitive bids made by telephone must be in multiples of £1 million (nominal).
 - Each GEMM may submit their one non-competitive bid by telephone at any time up to 10.30am. If a GEMM does not request their full non-competitive amount, the remainder of their entitlement will be added to the stock available for competitive bidders.

- **Other applicants** may only bid non-competitively by completing an application form which must be received in one of the following ways:
 - to arrive at the Bank's Registrar's Department in Gloucester not later than 10.30am on the day of the auction; or
 - to be lodged by hand at the DMO at Cheapside House not later than 10.30am on the day of the auction.

Determination of the results

10. As already noted, index-linked auctions will be conducted on a common price basis with no minimum price. There are no formal or informal underwriting arrangements, but the DMO expects all the GEMMs to participate actively in the auction process and to bid on a competitive basis at auctions, as part of their commitment to the market.

11. The DMO reserves the right not to allot all of the stock on offer, although it would consider this only in exceptional circumstances, eg. where the auction was covered only at a level unacceptably below the prevailing market level. If stock is unallotted at an auction, the unallotted part of the amount on offer would be held in official portfolios. It would not subsequently be made available to the market at a price below the allotment price for a period of at least two months after the relevant auction, and in any event not before market conditions had stabilised.

12. The DMO will allot stock to individual bidders at its absolute discretion. In particular it may decline to allot stock to an individual bidder if it appears that to do so would be likely to lead to market distortion. As a guideline, successful bidders (or their clients) should not expect to acquire at the auction for their own account more than 40% of the amount on offer; in the case of GEMMs, the DMO will take account of sales to clients and via the gilt Inter Dealer Brokers, but non-competitive bids will be included.

13. Allocations at the clearing price are rounded down to the nearest half percentage point and all such allocations are in multiples of £1,000 nominal of stock (so that there is no rounding if the clearing price is at an odd number of 1/32nds per £100 nominal of stock). In addition, a very small amount of the stock is retained to cover roundings etc.

Publication of the results

14. The DMO aims, whenever possible, to publish the result of each auction within 40 minutes of the deadline for bids, ie. by 11.10am. It will publish summary statistics including the common allotment price, the pro rata allotment at this price; the real yield equivalent to that price (and the inflation assumption made in calculating the real yield); the total value of accepted non-competitive bids, the allotment split between GEMMs and non-GEMMs; and the ratio of bids received to the amount on offer (the cover), including bids rejected in whole or in part on account of price.

15. If an auction were uncovered, the DMO would make an announcement to that effect and state the amount of unallotted stock held on official portfolios. The DMO would also remind the market of the procedures described above for keeping unallotted stock off the market for a period.

Secondary market activity by the DMO

16. DMO will neither tap nor sell index-linked stock in the 3 weeks either side of an auction and will not conduct any switches involving the stock to be auctioned. The facility where the DMO is prepared to bid for index-linked stock offered by the GEMMs will also be withdrawn for that period.

17. The DMO reserves the right to repo index-linked stocks for market management reasons. Any such operations would be published and available to all GEMMs on the IG list.