The future structure of the gilt-edged market: official operations

This note explains how the Bank is conducting its secondary market operations in gilt-edged in the initial stages of the new market structure.

1 In the Bank's blue paper 'The Future Structure of the Gilt-Edged Market' (April 1985) the Bank indicated that it would in due course wish to examine the possibility that a part of the funding programme might be put on a more regular footing, with greater reliance on the primary gilt-edged market. To this end we intend, later this year, once the initial change in market structure has taken place, to explore with market participants the detailed form of a possible experimental series of auctions covering a part of the Government's funding through conventional stocks. In the meantime we have no present plans significantly to alter our methods of operation in the primary market.

2 The immediate need therefore is to define more precisely how, after 27 October, the Bank will conduct its official secondary market operations, and this is the principal objective of this paper. Section I describes the Bank's general approach to the management of the gilt-edged market and Section II sets out our current operational techniques in the primary market, which we propose to continue to use unchanged in the initial stages of the new market structure. The remaining two sections cover our operations in the secondary market, where the change in market structure makes some adaptations necessary: Section III sets out our proposals for official operations in tap stocks (and tranchettes); and Section IV sets out our proposed approach to dealing in other stocks.

3 The arrangements described in this paper have been developed on the basis of helpful discussions with the Gilt-Edged Market Makers' Association and individual market makers. The arrangements will be subject to continuing review and modification in the light of experience.

Section I—The Bank's general approach to gilt-edged market management

4 A fundamental long-term objective of the Bank's approach to gilt-edged market management is to encourage the development of a broad and liquid market for government stocks. Over time this should help us to meet the Government's funding policy aims at least cost. The aim of funding policy since last year has been a full fund of the PSBR over the financial year as a whole, taking public sector debt sales to the non-bank private sector and external and foreign currency finance of the public sector together. In 1985/86 we broadly achieved this aim: the relevant calculations are shown in Annex I.

5 Whatever the particular techniques employed, this long-term objective imposes a certain discipline on the issuing authorities as the sole source of new stock. If the market is to function effectively and develop successfully the issuing authorities need to adopt a broadly consistent pattern of behaviour. In the case of an auction system on US lines this discipline takes the form of a constraint over the timing of new stock issues of particular types. Final investors or market intermediaries would not have the confidence to enter an auction without reasonable assurance that further stock of the same type would not be brought to the market for some period ahead. The constraint on *timing* can involve short-term disturbance to the market if the auction happens to occur when surrounding market circumstances are unreceptive. In the case of a system such as our own, involving a more continuous official presence in the secondary market, the corresponding constraint relates to the *prices* at which the Bank deals. Final investors and market intermediaries would be unable to operate with any confidence unless they have reasonable assurance that we will not arbitrarily change the prices at which we deal from day to day: we must work with the price trends set by the market itself. This constraint can mean that we fall behind in our funding objective (though we have not in practice done so to any significant degree for many years) and this too can cause short-run disturbance.

6 Of course these general constraints cannot be translated into *absolute*, hard and fast rules providing investors with total certainty about official behaviour. To meet their funding objectives under an auction system, for example, the authorities must have some reasonable flexibility to vary the types and amount of stock offered from one auction to the next. Similarly, under our own present arrangements the Bank must retain discretion—within the general framework of consistent behaviour—to adjust its prices more or less quickly to bring them into line with those prevailing in the market, to take account, for example, of the position in relation to the funding programme or the flow of new information into the market.

Section II—Official operations in the primary market

7 The general approach described above sets the framework for our operations in the primary market. In the initial stages of the new market structure we expect to continue with the same techniques in the primary market as at present.

8 The essence of our approach in the primary market is that we aim to bring sufficient stock, taking one month with another, to achieve the funding objective described in paragraph 4 above, and in doing so respond flexibly to demand as we see it emerging in different areas of the market. To this end we make use of a range of instruments—full-coupon conventional stocks of various maturities, convertibles, low-coupon conventionals and index-linked stocks—and we generally aim to have a variety of different types and maturities of stock on our book so that we can respond to demand where it emerges. In deciding the type of stock and the maturities of new issues we have regard not only to the pattern of demand for stock, but also to cost considerations and the profile of future maturities, with the general aim, other things being equal, of trying to maintain a reasonably smooth maturity pattern and ensuring that the average life of the debt does not become unduly short.

9 The main approaches we use for issuing stock are:

(i) Offers for sale by tender—new stocks (or large new tranches of existing stocks) issued by tender. Tenders for conventional stock normally have a minimum price, which is set in line with market prices at the time the new stock is announced. Tenders for index-linked stock normally have no minimum price, but in practice, as with tenders for conventional stocks, we would not normally allot at a price below where the market was at the time the stock was announced. Both types of tender are allotted on a common price basis: all successful bidders pay a common striking price, which is the lowest price at which tenders are accepted, but higher bidders have priority in the allotment of stock. Both types of tender are effectively underwritten by the Bank of England, ie stock not taken up in the tender is subscribed by the Bank and is then available for us to sell 'on tap' in the secondary market (see Section III below). Tender offers usually involve a relatively sizable amount of stock (perhaps £750–1,000 million in the case of a full-coupon conventional issue); to spread the impact on cash flow, the stock is often offered for subscription on a partly-paid basis. To give investors time to tender, we necessarily have to allow a few days between the announcement of the stock (most frequently on Fridays) and first dealings in it in the secondary market (typically the following Thursday); but in some situations, where it was helpful to have the stock immediately available to respond to expected market demand, we have on occasions issued a new stock (or tranche of an existing stock) directly to the Bank so that we have it available to sell in the secondary market straightaway.

(ii) '*Tranchettes*' of existing stocks. This approach enables us to replenish our portfolio by bringing small additional supplies of several different stocks, which are placed directly into our book and are then available for sale to the market. In this way we can respond flexibly to variations in the pattern of demand during the ordinary course of trading with minimal disturbance to market conditions.

10 The choice between these two approaches depends on a range of considerations, including the state of the market, the state of our portfolio and how far advanced the funding programme is in relation to our funding objective. Consistently with our general approach described in Section I, we do not normally expect to sell the whole of any new issue straightaway. The main purpose of new issues is rather to replenish our portfolio of stocks, so as to enable us to maintain the funding programme. We aim to do this with the least possible disturbance to market conditions: any downwards effect on prices is generally limited by the knowledge that we do not sell stock on a falling market; and there can be occasions when new supplies of stock after a market adjustment can help the market to consolidate at a new trading level.

11 The table in Annex II attached analyses the new issues in 1985/86 according to type of stock and method of issue.

Section III—Official operations in the secondary market: tap stocks and tranchettes

12 Exactly the same general considerations govern our approach to secondary market operations. The guiding principle is that we do not sell stock into a falling market but only when it is stable or rising, typically selling successive blocks of stock at progressively higher prices—the steepness of the progression depending upon our assessment of the underlying strength of market demand on the one hand and upon where we stand in relation to the funding programme on the other. When the market falls we refrain from further sales, and we may on occasion, particularly if we judge the fall to be erratic or disorderly, and again depending upon our position in relation to the funding programme, provide some measure of market support by buying stock which is offered to us outright, normally at prices somewhat below the prevailing market price. We do not resume selling until either the market recovers to its initial level or the downward price adjustment appears to have been completed and the market shows evidence of having stabilised. Then we will often re-enter the market in the first instance by selling small amounts of stock which we may hold in our portfolio, other than taps or tranchettes, in order to test the market strength, though we may re-enter by selling tranchettes or tap stocks if we are bid for a sizable amount and judge that this reflects significant investor demand. In this latter case we tend to be somewhat more flexible in adjusting prices of tranchettes than of tap stocks.

13 Our operations in the secondary market in the new market structure will continue on this basis, but within this framework we need to develop modified operating techniques to adapt to the larger number of market makers and to dealing over the telephone. The rest of this

section discusses the approach we propose to adopt to selling sizable blocks of stock, ie taps or tranchettes, where it would be public knowledge that the block of stock in question was available for sale; Section IV below discusses our proposed approach to selling other holdings of stock.

14 Arrangements in this area need to satisfy two objectives—

(i) A market maker prepared to take the initiative, and the risk, of bidding for a tap stock or tranchette, in whatever size, in isolation from the rest of the market, should be able to benefit from that initiative if the market subsequently moves in his favour.

(ii) At the same time, the arrangements must provide for the orderly handling of a situation in which a number of market makers are bidding more or less simultaneously for a tap stock or tranchette, possibly in an aggregate amount which exceeds the available supply.

15 Our proposal for reconciling these objectives is as follows.

16 The Bank will whenever possible respond to bids for tap stocks and tranchettes while the bidder is 'on the line'. But decisions on some bids—eg those which raise wider questions of funding tactics—will need to involve the Government Broker and/or the Head of the Gilt-Edged Division. In such cases the response to the bidder's call will be returned quickly, normally within a minute or two, and the bidder will have an opportunity to confirm or withdraw his bid. Assuming that he confirms his bid and that there has been no further bid for the stock, the bid will simply be treated on its merits, within the framework of the general approach described in Section I and paragraph 12 above.

17 If, on the other hand, before a response has been given to the initial bidder, the Bank's dealers are being approached by other market makers wishing to bid for the stock, ie if other lights are flashing on the dealers' telephone screens, the Bank will inform the initial bidder (who may then revise his bid), and all other market makers who subsequently call in to bid, that it is delaying its response until all calls have been answered, ie until the screen is clear. The Bank will then co-ordinate all the bids for the stock before responding to any bidder.

18 At that stage, the Bank might be faced with a range of bid prices and would need to decide the lowest price at which it would sell as well as the amount it was prepared to sell at that price, which might be less than the amount applied for. The Bank would propose to allot stock at a common price, with bidders at above that price normally allotted in full and bidders at the lowest accepted price scaled down in proportion to the amounts bid for if necessary. To keep this procedure as simple as possible, bidders for the stock in question (other than the initial bidder) would not be permitted to adjust their initial bid. They would, however, be able to submit a multiple bid, ie for separate amounts at different prices (eg £10 million at $95\frac{1}{2}$ and a further £5 million at $95\frac{3}{8}$).

19 For the same reason the Bank would not be able to negotiate the terms for switches out of other stocks into the tap or tranchette at the time when it was co-ordinating a large number of bids. It would, however, if asked to do so, be prepared to indicate to a market maker whether it was in principle prepared to take stock in such switches and in roughly what amount [eg 2 (tap) for 1 (of other stock) money for money]. In that case a successful bidder for the tap or tranchette would have to specify the stock he wished to deliver immediately on being notified of our response to his bid. The Bank will regard a market maker's bid for a tap stock or tranchette as binding in these circumstances even if it were not subsequently possible to agree upon the price of the other stock offered. The price bid by the Bank will normally be somewhere between the bid and middle prices of the stock at the time of the tender but the Bank reserves the right to bid a lower price if the prices of outside stocks have risen unusually against the tap/tranchette.

20 The Bank will announce publicly when a stock is available as a tap or tranchette, in which case the above procedures would apply. When the Bank has decided that it is no longer a seller of a tap at a particular price, the Bank will announce that decision publicly, but will not be committed to continue dealing at the earlier price if it has made no such announcement. This apart, the Bank would intend to make no further announcement until a tap or tranchette was exhausted (or sufficiently nearly so as to be no longer operable under these procedures).

21 The Bank will make these announcements, together with announcements of new issues, through public contributor pages on Reuters, Telerate and Topic. It will also publish on these pages its buying price for stocks within three months of maturity (see paragraph 28 below).

22 Essentially, these procedures amount to applying the tender arrangements familiar in the context of offers for sale by tender (paragraph 9 (i) above), on an ad hoc basis among the market makers who have bid, on those occasions when there is a sudden widespread scramble for stock. Often when this situation arises, it is at the market opening, and to help ensure that the procedures are orderly and do not unnecessarily interrupt normal market trading, the Bank will be prepared to receive bids for tap stocks or tranchettes between 8.40 am and 8.50 am, with a view to responding before 9.00 am. Any bid received at this time will be regarded as firm as to both size and price. We would expect the need for this kind of ad hoc tender to arise less frequently during the actual course of the working day, though the Bank would be open to bids until 5.00 pm.

Section IV—Official operations in the secondary market: other stocks

23 The Bank's day-to-day operations in stocks other than taps or tranchettes are normally on a relatively

modest scale, and they are still governed by the general approach to gilt-edged market management outlined in Section I above.

24 In the case of stocks available *for sale* to the market (eg stock acquired through a switch or outright purchase) our holdings are usually limited to a relatively few issues at any time; they rarely amount to more than £50 million in any particular stock.

25 Where we happen to acquire a larger holding of, say, as much as £100 million, which we are prepared to sell, we will announce the fact and respond to bids in the same way as for taps and tranchettes in Section III above. But it would evidently not be sensible to offer smaller holdings for competitive bidding by up to 27 market makers

26 We will therefore aim to sell such smaller holdings in response to bids from individual market makers in the course of market trading. We recognise that market makers will not know whether or not we have a holding of the particular stock in question. Since the holdings are likely to be small, we will not publish them; but if a market maker bids us for a stock which we do not hold, we may be able to invite him to bid for a holding of a comparable issue. In the initial stages of the new market structure the Bank does not plan to deal through the IDB system and would not do so without further consultation with GEMMA.

27 Similar arrangements will apply to such *outright purchases* of stock as the Bank may wish to undertake on its own initiative.

(i) In the (probably rare) case where we wished to provide substantial market support, say, of £100 million or more we would make a public announcement (on screens) inviting market makers to submit offers of stock. Such an announcement would normally be made at 4.30 pm for offers to be submitted at 4.40 pm. Acceptance would be at the Bank's discretion, but we would normally expect to take the cheapest offers. Scaling down in proportion to the amounts offered would be undertaken if necessary. The Bank would respond to such offers as soon as possible, and in any event by 5.00 pm. No further announcement would be made unless the scale of support provided was materially different from that suggested in the 4.30 pm announcement.

(ii) Where we wished to buy only smaller amounts we would do so in direct dealings with individual market makers.

28 At the same time, as indicated in paragraph 13 (iii)–(v) of the blue paper, in response to a market maker's initiative, the Bank will also be prepared—

(a) to bid a price of its own choosing for stock with three months or less to maturity offered to it by market makers;

(b) to bid a price of its own choosing for index-linked stock offered to it by market makers; and

(c) at its discretion to purchase outright, at prices of its own choosing, other stock that may be offered to it by market makers. The Bank expects to exercise this discretion more liberally for stocks with between three and twelve months to maturity than for other stocks.

These operations would only be carried out through direct dealings with individual market makers. In the case of (a) the Bank expects to publish its buying price continuously. In the case of (b) and (c) the Bank will expect to be approached by a market maker only where the transaction could not readily be carried out in the market and will expect normally to bid somewhat below the price prevailing in the market, with the extent of the discount on the market price depending upon the amount of stock offered and upon where we stood in relation to the funding programme

29 The Bank will be prepared to consider proposals for switches from individual market makers. We will normally be prepared to undertake a switch at prevailing market prices, in order to assist market liquidity, if we are in a position to do so (which often of course we will not be), though the Bank will normally expect to be a net seller of stock when undertaking switches. Where a switch involves official funds not under the Bank's direct control it may take some time to arrange, and the terms will depend on the needs of the funds involved. For the particular arrangements applying to switches into taps or tranchettes see paragraph 19.

30 Finally, the Bank's dealers will have discretion to undertake very small-scale 'sampling' transactions directly with the market makers.

Annex I
The funding arithmetic

The objective of the Government's funding policy is a full fund of the Public Sector Borrowing Requirement over the financial year as a whole through sales of public sector debt to the non-bank private sector and through external and foreign currency finance of the public sector.

In 1985/86 this objective was achieved and the PSBR was exactly funded over the financial year (measured as the twelve banking months from April 1985). This entailed gross official gilt-edged sales of £11.9 billion, an average of £1 billion a month. The figuring is as shown in the tables below.

The PSBR and funding: 1985/86

£ billions

Public sector borrowing requirement (less net sales of local authority and public corporation debt to the non-bank private sector)		7.5
Funding		
Net sales of gilt-edged		
To non-bank private sector	3.1	
To overseas sector	2.1	
Net sales of national savings instruments to non-bank private sector	2.2	
Net sales of certificates of tax deposit to non-bank private sector	0.2	
Other external and foreign currency finance of the public sector	-0.1	
Total funding		7.5
Under/overfunding of the PSBR		—

Analysis of gilt-edged sales: 1985/86

£ billions

Gross official sales	11.9	
Redemptions and official purchases of stock near maturity	6.5	
Net official sales	5.4	
of which to:		
Non-bank private sector		*3.1*
Overseas sector		*2.1*
Monetary sector		*0.2*

Among the various elements in the arithmetic, forthcoming gilt-edged maturities are of course public knowledge, but none of the other elements are known in advance with certainty, either to the authorities or to market participants. However, private and, in the case of the PSBR, official forecasts of these items are available.

In the light of this arithmetic, which is subject to continuous revision through the year in the light of new information as it emerges, the authorities set an objective for gross official gilt sales at the beginning of each month (but there is no aim of a full fund each month, because of the unevenness of net sales owing to redemption profiles and the fluctuations of the monthly PSBR). The objective is not overriding, however: we are prepared to undershoot if market demand for stock is weaker than usual or overshoot if it is stronger than usual, though we would expect to make good the undershoot or overshoot in subsequent months.

Annex II
Analysis of gilt-edged issues in 1985/86

£ billions (nominal)

1 By type of stock		
Full coupon conventionals:		
Up to 5 years	1.1	
5–10 years	1.9	
10–15 years	0.95	
Over 15 years	7.25	
Total		11.2
Convertible		0.85
Low coupon conventionals		1.45
Index-linked		0.85
Total		**14.35**
2 By method of issue		
Taps: issued by tender	5.2	
issued direct to Bank	3.7	
		8.9
Tranchettes (12 packages of small amounts of 35 stocks)		5.45
Total		**14.35**