

Gilt-edged settlement: Phase 2 of the CGO Service

This note describes the changes which were introduced to the Central Gilts Office Service⁽¹⁾ on 27 October 1986. These changes ensured that the Service was ready to provide an integral part of the infrastructure of the gilt-edged market following Big Bang. They principally involved extending the Service from one that was concerned solely with the movement of stock to one that also provided a mechanism for making assured payments for all transfers of stock between members of the Service.

Phase 1 of the CGO Service, which was introduced in January 1986, provided members with computerised stock accounts which allowed them to receive and deliver stock without waiting for the underlying transfer of ownership to be recorded on the main register maintained by the Bank of England. Members (who were the then jobbers, ie market makers, the Stock Exchange money brokers, the discount houses and the various bank nominee companies that hold stock on behalf of institutions authorised to act as stock lenders) were able to deliver stock to one another in book entry form through terminals located in their offices; deliveries between members of the Service and non-members were effected by means of stock transfer forms; and all deliveries, whether by book entry or by stock transfer forms, were notified to the Registrar for recording on the main register. In all cases, payment had to be effected outside the Service, directly between the parties concerned.

Operation of Phase 2 of the CGO Service commenced on 27 October and entailed two separate but related changes: an expansion of membership to include the new market makers and the inter-dealer brokers; and the introduction of assured payment arrangements, together with a range of new facilities. As at 27 October the number of members was:

Market makers	27
Stock Exchange money brokers	9
Inter-dealer brokers	6
Discount houses	7
Banks (and other nominee companies)	18
International Commodities Clearing House Limited	1
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Assured payment arrangements

Even as the Phase 1 Service was being developed, urgent consideration was being given to the content of Phase 2. In the prospective new structure of the gilt-edged market it was judged essential to have a payments system that would provide assurance of payment; and this view was reinforced by a number of market participants who responded to the Bank's draft proposals of November 1984 on the future structure of the market. Furthermore,

it was clear that the introduction of such a payment system would benefit not only the settlement of bargains between CGO members but also movements of stock lent within the system, since lenders would be immediately secured by the associated payment.

Payment arrangements used by other settlement systems were examined, including those provided by the Federal Reserve Bank of New York (and the clearing agents operating within the FRB System), Euroclear, CEDEL, ICCH (for LIFFE's gilt contract) and the Institutional Net Settlement arrangements proposed for TALISMAN. All of these systems embodied varying degrees of guaranteed payment arrangements, but none seemed to provide an appropriate pattern for the gilt-edged market in London. Therefore, in spring 1985, the Bank put forward proposals to the settlement banks that operate London's same-day payment systems, ie CHAPS and the Town Clearing, for an assured payments system in the gilt-edged market that provided for an irrevocable payment instruction to be generated simultaneously with the movement of stock between CGO accounts.

The CGO's assured payment system requires each member to maintain an account at one of the settlement banks and is based on three principles, namely:

- (i) When the CGO system transfers stock on settlement day from the CGO account of the seller to the buyer, the buyer's settlement bank incurs an irrevocable commitment to pay to the seller's settlement bank on the same day.
- (ii) The settlement bank's exposure arising from its irrevocable commitment to make payment should be fully covered by a charge given in its favour by the buyer over stock held on the buyer's CGO account and over monies receivable by the settlement bank on behalf of the buyer for any stock subsequently transferred out of its CGO account.
- (iii) The CGO system ensures that stock only moves off a CGO account against an irrevocable payment commitment as in (i) above.

(1) The history of the CGO project and the inauguration of Phase 1 on 2 January 1986 were described in the March 1986 *Bulletin*, pages 56-7.

Following discussion of these principles the settlement banks agreed in May 1985 to participate in these arrangements subject to their being satisfied both on the practical details and on the receipt of watertight security from members of the CGO Service.

The practical arrangements were developed in close consultation with the settlement banks and members of the Service. Particular attention was given to the procedure for withdrawing stock from the CGO Service either for delivery to a non-member or by way of physical collateral certificate (eg to allow the member to secure cash loans from a non-member): it was essential that any procedure should be consistent with the basic principle that stock should not move except against an assured payment. After consideration of a number of alternatives a procedure was finally agreed whereby the CGO only allow the release from the CGO system of an item of stock with a value of £100,000 or more against the receipt of a banker's draft. In the discussions it was also recognised that the value of each stock movement between members should equate closely to the associated assured payment and therefore a comparison is made to ensure that this is so; a similar check is made in respect of stock which is withdrawn from the Service.

Attention was also given to the risks associated with the introduction of stock into the system. As a result it was decided that high-sum transfers (with a value of £5 million or more) being delivered by non-members to CGO members should be specially examined by the Registrar's Department preferably before, but otherwise immediately after, processing in the CGO to ensure that they appeared to be in a fit state for registration.

The arrangements for the settlement of payments involve the CGO system netting the debit and credit payment instructions to produce one daily balance for each member; each member's net balance is notified to his settlement bank, which then posts his bank account accordingly. The total postings for the individual settlement banks are settled through their accounts at the Bank of England.

Additional Phase 2 facilities

A number of other changes were made to the system for Phase 2, including additional security features, arrangements for pledging stock and facilities to allow partly-paid stock to be held within the system.

Three new security features were incorporated in Phase 2:

- positive acceptance—an instruction to transfer stock entered by the giver at his terminal is not effected until the taker has accepted the transaction at his terminal;
- members are provided with a facility that allows them to ascribe different levels of authority to their terminal operators;

- the security of the communications network has been enhanced.

Gilt-edged securities may be pledged on an overnight basis in book entry form: during Phase 1, pledging was carried out against overnight collateral certificates issued by the CGO. Under the new arrangements a member may instruct the system from his terminal to assemble a package of stocks from his portfolio to a specified value and to offer that package to another member. On acceptance of the offer by the second party, the movement of stocks takes place against the creation of an assured payment instruction. This book entry collateral facility, which is known as delivery-by-value, also provides for each package of stocks to be returned to the pledgor in the morning of the following working day against a further assured payment.

Phase 2 also enables members to maintain accounts in partly-paid newly issued stocks. CGO members may now deposit allotment letters into their CGO accounts and deliver these stocks to other members against assured payment.

The broad detail of most of the above facilities was agreed early in 1985, enabling much of the system design to be undertaken during the summer and autumn. With good progress being made, the CGO were able to respond to requests from a number of prospective members for a facility that would allow the input of stock movement instructions from their CGO terminals via a diskette produced from their own computer systems, thereby eliminating duplication of input and reducing the risk of error. Other facilities were also considered for inclusion in Phase 2, but the need to ensure that the system would be ready by 27 October meant that a number had to be left over to a later date. In this respect Phase 2, like Phase 1, represents a further building block in the development of the CGO Service.

Contractual arrangements

At the same time as the practical arrangements were being devised, work was also being undertaken on both the legal aspects of the assured payments system and the nature of the settlement banks' security. Since the assured payment liability of a member's settlement bank arises at the time of the transfer of stock to that member from another CGO member, it seemed appropriate that the security should take the form of a floating charge given by each member to its settlement bank over stock held on its CGO account and receipts arising from transfers out of that account.

The detailed negotiations in this area centred on the terms of the floating charge and on the contractual framework that needed to be established to underpin the assured payments system. The contractual framework involved the establishment of bilateral agreements in common form between the Bank and each member and two sets of agreements between the Bank and the settlement

banks—the rights and duties of the banks to one another are set down in a single, global, agreement while the banks' direct relationships with the CGO are governed in separate bilateral agreements. Further agreements were negotiated bilaterally between each member and its settlement bank on a basis consistent with the assured payments system and incorporating the detailed arrangements between the parties relating to the provision of a floating charge. Stock lending agreements were also established between the money brokers, the market makers and stock lenders.

Operation of the CGO Service

Daily average numbers of transactions processed by the CGO during 1986 are set out in the table. The increase in member-to-member movements since Big Bang largely

Average numbers of transactions per day in 1986

	Jan.-Oct.	Nov-Dec.
Stock transfer forms:		
credits to CGO accounts	1,400	1,250
debits on CGO accounts	1,400	1,350
Member-to-member movements	1,100	2,850
Total	3,900	5,450
Delivery-by-value movements	..	400

reflects the additional transactions now being made through the inter-dealer-broker network.

The crucial need to deliver Phase 2 on schedule meant that no significant resource was devoted to the subsequent development of the CGO Service. Attention is now, however, being focussed on this with a view to widening membership of the Service and introducing additional facilities (Phase 3).⁽¹⁾

(1) Further information about the CGO Service and its future development may be obtained from The Manager, Central Gilts Office, Bank of England, 1 & 2 Bank Buildings, Princes Street, London, EC2R 8EU.