

The gilt-edged market: developments in market-making in 1989

This note updates some of the material presented in an article⁽¹⁾ a year ago reviewing the development of the gilt-edged market since Big Bang. It reports in particular on the capitalisation and financial performance of the gilt-edged market makers (GEMMs) in 1989 and on the degree of concentration of their market shares. It suggests that there was a significant improvement in the financial performance of the GEMMs in 1989.

The number of GEMMs contracted from twenty-two to nineteen during 1989, with three firms withdrawing in the late summer.⁽²⁾ There has thus been a net reduction of eight in the number of GEMMs in the period of just over three years since Big Bang, when twenty-seven firms began operating as GEMMs. In part reflecting the reduced number of GEMMs, the number of inter-dealer brokers declined from four to two during 1989 and the number of Stock Exchange money brokers from ten to nine.

The withdrawals from market-making during 1989 do not appear to have impaired the overall quality of service provided for clients nor the liquidity and competitiveness of the market. That there should be continuing withdrawals was not unexpected, but the contraction in numbers has been less than many commentators projected. An important reason why so many firms have continued as market makers may be that during 1989 the financial performance of the GEMMs showed significant improvement, achieving close to break-even in their overall profit/loss experience after sizable losses in the first two years after Big Bang.

Financial performance

Details of the financial performance of the GEMMs as a whole are given in Table A. The figures up to the end of 1988 were published in the earlier *Bulletin* article. During 1989, the GEMMs incurred operating losses of £12 million, a part of which reflects the position of firms which withdrew during the year. This represents a

significant reduction on the losses, as already published, of £190 million incurred in 1986-88. Besides these operating losses, the capitalisation of the GEMMs as a whole, which had stood at £420 million at the end of 1988, was reduced in 1989 by £55 million of capital withdrawn by the three firms who ceased to be GEMMs, but was increased by £42 million of additional capital injected by GEMMs. The net effect of these movements left the capitalisation of the GEMMs as a whole at the end of 1989 little changed over the year at £395 million.

It does not seem likely that this marked improvement in the GEMMs' financial performance can be attributed to any easing in the generally difficult operating environment they have faced. The size of the gilt-edged market continued to decline as the authorities purchased stock: the total of gilt-edged stock outstanding fell by 9% from £142 billion at end-1988 to £129 billion at end-1989. The gilt market moved during the year within a relatively narrow range, providing little scope for position-taking strategies; such price adjustments as occurred were triggered generally by sudden and unanticipated developments such as the sharp fall in world equity markets in mid-October 1989.

Table A
Capitalisation of gilt-edged market makers
£ millions

| | October 1986 to end-1988 | End-1988 to end-1989 |
|---|-----------------------------|-------------------------|
| GEMMs' capital at beginning of period (a) | 595 | 420 |
| Changes as companies joined or withdrew | -70 | -55 |
| Net injections or withdrawals of capital | 85 | 42 |
| Operating losses (b) | -190 | -12 |
| GEMMs' capital at end of period | 420 | 395 |

Source: Bank of England

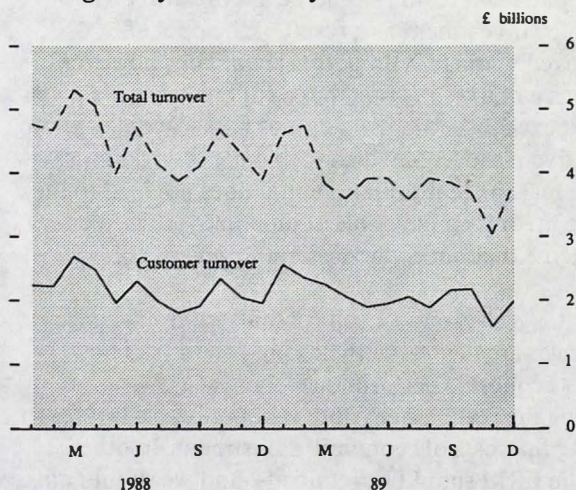
(a) Capital base, as set out in the Bank of England's 'Blue Paper' ('The future structure of the gilt-edged market') published by the Bank in April 1985 and reproduced in the June 1985 *Bulletin*, pages 250-87.

(b) Net profits/losses after overheads.

(1) 'The gilt-edged market since Big Bang', in the February 1989 *Bulletin*, pages 49-58.

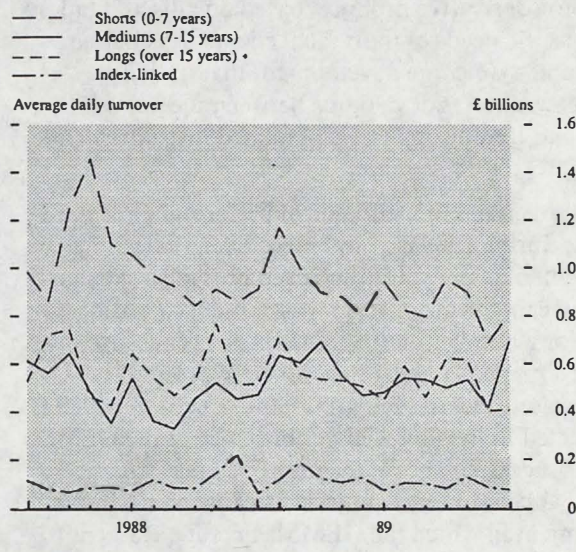
(2) The withdrawal of one firm on 4 January 1989 is included in 1988 for the purpose of the material in this note and in the earlier *Bulletin* article.

Chart 1
Average daily turnover: by value



Equally, turnover provided no discernible boost to the GEMMs' business. Total turnover by value (Chart 1) declined somewhat to around £4 billion a day during most of 1989, though this still represents more than a trebling of turnover as compared with the pre-Big Bang level of around £1¼ billion a day. Turnover by value with customers was reasonably steady at around £2 billion a day in 1989. The breakdown of customer turnover by maturity band (Chart 2) shows no notable changes during 1989. The slight easing in overall turnover is no more

Chart 2
Customer turnover by maturity band



than might be expected given the contraction in the total stock of gilt-edged holdings: as a ratio of stock in market hands, customer turnover was in fact slightly higher in 1989 than in 1988, notably in the medium and long maturity bands (Chart 3). Customer turnover by number of bargains (Chart 4) continued the moderate decline which has been evident since before Big Bang, running at around 2,000 bargains a day in 1989. The average size of customer deal increased somewhat in 1989 to just over £1 million.

Chart 3
Ratio of average daily customer turnover to market holdings

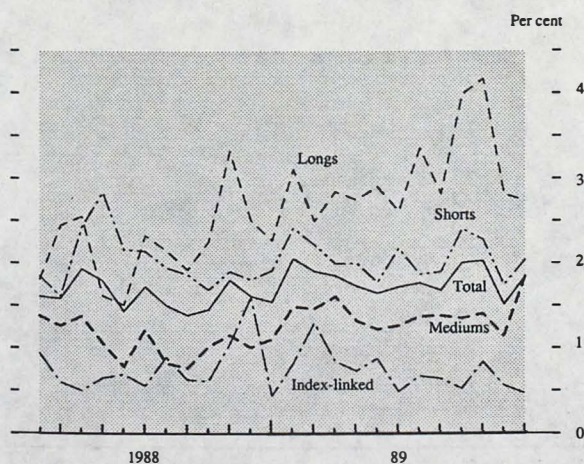
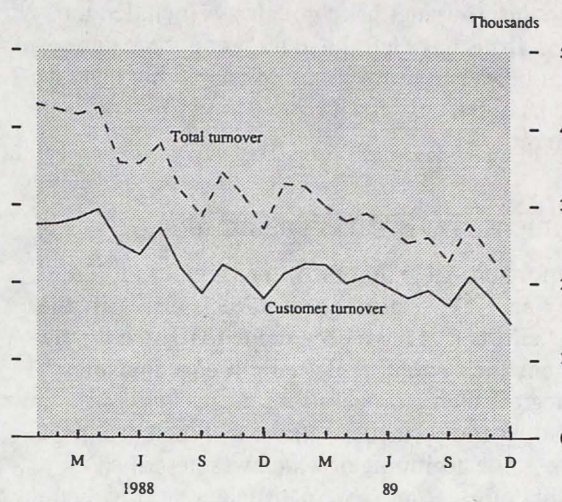


Chart 4
Average daily turnover: bargains

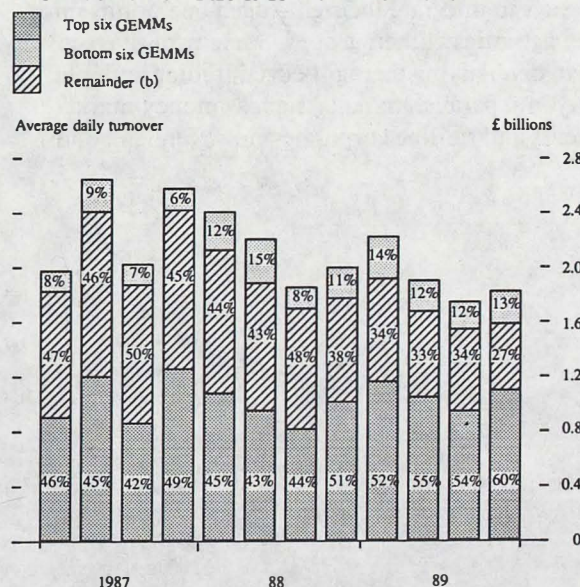


Concentration of market shares

Nor does the improvement in financial performance appear to reflect any lessening in competitive pressure among GEMMs. Feedback from investors continues to suggest that the quality of service provided by the GEMMs remains high and that continuing efforts are being made by GEMMs to win new business and expand their client base.

Analysis of the distribution of market shares among GEMMs handling wholesale business (Chart 5) suggests that continued intense competition has not led to any substantial concentration of turnover. Although there has been a modest increase in the market share of the largest GEMMs, with the combined share of the top six rising from just under 50% of the market in 1987-88 to around 55% in 1989, it is notable that the combined market share

Chart 5
Distribution of GEMMs' retail turnover^(a)



(a) Excluding identified dividend business in 1989.
 (b) The decrease in the share accounted for by this group in part reflects the reduced number of GEMMs.

of the bottom six has been maintained in the range of 10%–15% (none with less than 1% individually). Moreover, the groupings have not always included the same firms: firms have left the market and there has been movement between the groupings. None of this suggests that there has been any lessening in competitive pressure in the market.

Development of GEMMs' business

It seems more probable that the improvement in GEMMs' financial performance in 1989 is primarily the product of efforts that have been made to tighten up the management and operation of their gilt-edged business and to integrate their gilt operations more closely into the overall trading and securities activities of their groups. This process, the beginning of which was described in some detail in the earlier *Bulletin* article, was already in progress in 1987 and 1988 and has continued in 1989.

In terms of the management and operation of their gilt-edged activities, the emphasis among the GEMMs has been on seeking ways to improve their gilt-edged market-making service for clients without increased resort to unwanted position-taking on the part of the GEMMs themselves. Hence close attention has been directed to ensuring that prices made to clients reflect the market situation and that position-taking is kept within limits. Management controls on costs have also been progressively tightened and budgeting has improved. In all these respects, the GEMMs' activities as market makers have been subject to closer and more effective management and it is encouraging that, in parallel with the continued quality of service provided to clients, the benefit can be seen in improved financial performance.

At the same time, GEMMs have directed greater attention to focusing their gilt-edged expertise onto areas of business that offer scope for profitable activity and to seeking ways to integrate their gilt-edged operations into the wider activities of their groups. Some firms have given priority to diversifying their gilt-edged trading and sales capability into parallel markets, such as money-market instruments and sterling corporate and sovereign bonds.

Diversification into money-market instruments has been facilitated by the arrangements set in place by the Bank in October 1988⁽¹⁾ by which it is ready to consider accepting GEMMs as dealing counterparties both in gilts and in money-market instruments. In the case of bonds, the sizable increase in new issue activity by a variety of sovereign and corporate borrowers, already evident in 1988, has been maintained in 1989. The volume of gross issues of non-gilt fixed-interest sterling bonds totalled over £9 billion in 1989. Other GEMMs have devoted resources to developing arbitrage activity, both within the gilt-edged market and between gilts and related instruments. Yet others have directed efforts to developing derivative products based on gilts and tailored to the specific needs of individual clients. It is both a natural and a welcome development that in this way closer integration is developing between the gilt-edged market and trading in a range of related instruments.

The improvement in the financial performance of the GEMMs during 1989 is undoubted. Even that improvement is not yet sufficient to provide a satisfactory return on capital committed to the gilt-edged business, though for a number of the GEMMs their expertise in gilt-edged market-making may generate profitable business elsewhere in their group, the benefit of which is not reflected in the financial performance of the GEMM itself. As suggested above, the improved performance does not appear to reflect any significant change in the environment in which the GEMMs operate. Rather, it appears to be the result of continuing improvement both in the quality of management and control of their business and in the coherence of the various business strategies they are pursuing. In part this is no doubt the result of natural progress up the 'learning curve' since the fundamental change in market structure at the time of Big Bang. But it also suggests that the structure itself may have bedded down and be approaching a stable state. It would not be unexpected if there were further changes from time to time in the population of GEMMs, but experience in 1989 provides encouraging evidence that a viable market structure may be emerging in a form which meets the underlying objectives of the changes initiated at the time of Big Bang.

(1) 'Bank of England operations in the sterling money market', reproduced in the February 1989 *Bulletin*, pages 92–103.