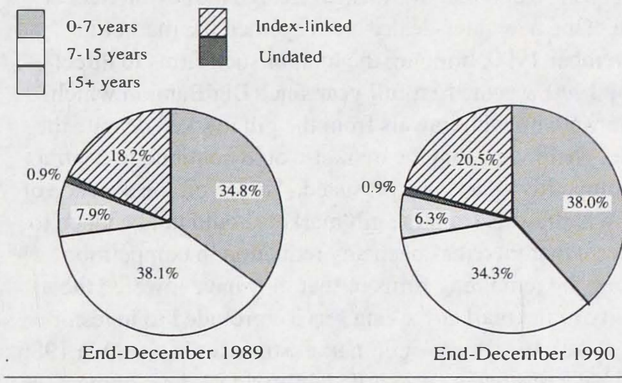
# The gilt-edged market: developments in 1990

*This note updates some of the material presented in two previous articles[1] which reviewed the development of the gilt-edged market since Big Bang. Developments during 1990 confirmed that the market structure introduced in October 1986 has bedded down, and the gilt-edged market makers (GEMMs) as a whole recorded a full-year profit for the first time since Big Bang. The main operational development over the period was the series of gilt-edged conversions which began in November 1989.*

There were no new issues of gilt-edged stock during 1990 and, taking account of redemptions totalling £8.6 billion in the course of the year, the total nominal value of stock outstanding (including accrued uplift on index-linked stock) fell from £128 billion at end-1989 to £122 billion at end-1990. Official operations in the gilt market in 1990 were largely directed towards market management. Chart 1 shows the maturity breakdown of all gilts in market hands as at the end of 1989 and 1990. The absence of new issues during 1990 has meant that the market's holdings of long-dated conventional gilts have continued to decline in both absolute and relative terms, accounting for 6.3% of total holdings by the end of the year, compared with 7.9% at the end of 1989.

The number of actively traded gilt-edged stocks outstanding has fallen by 16 from 100 to 84, both through redemptions and as a result of conversion offers. In his Mansion House speech in October 1989, the Chancellor announced an experimental offer to give investors in smaller, less liquid gilt-edged stocks the opportunity to convert into larger, more liquid issues. The following day the Bank gave details of the first gilt-edged conversion—from 9¾% Conversion Stock 2006 into 9% Treasury Loan 2008—and since then there have been eight further conversion offers, details of which are shown in Table A.

**Chart 1**
**Market holdings of gilt-edged stock: market value**




The conversion programme was launched when the gilt market was shrinking, with official purchases of gilts adding to the contractionary effect of redemptions of existing stock. The scale of official buying-in of gilts has declined since November 1989, but with the redemption of £8.6 billion of stock during 1990 and the absence of new issues, the market has continued to contract. Against this background, the aim of the conversion programme is to enhance the liquidity of the gilt market by consolidating pairs of similar stocks into larger issues which, by virtue of their increased size, are more liquid.

**Table A**
**Conversions of gilt-edged stock**
Amounts of stock are quoted in £ millions nominal

| Date of conversion | Surrender stock | Amounts outstanding before conversion | Amounts outstanding after conversion | Percentage of stock converted | Conversion stock | Amounts outstanding before conversion | Amounts outstanding after conversion | Rate of conversion (a) |
|---|---|---|---|---|---|---|---|---|
| 15.11.1989 | 9 3/4% Conversion 2006 | 702 | 15 | 98 | 9% Treasury 2008 | 1,800 | 2,521 | £105.00 |
| 22. 1.1990 | 12% Exchequer 1999-2002 | 1,265 | 105 | 92 | 12% Exchequer 1998 | 2,500 | 3,659 | £99.90 |
| 10. 2.1990 | 9 3/4% Conversion 2001 | 802 | 35 | 96 | 10% Treasury 2001 | 1,050 | 1,806 | £98.55 |
| 11. 4.1990 | 10% Conversion 2002 | 591 | 21 | 96 | 9 3/4% Treasury 2002 | 1,450 | 2,030 | £101.80 |
| 19. 5.1990 | 9% Exchequer 2002 | 1,190 | 89 | 93 | 9 3/4% Treasury 2002 | 2,030 | 3,071 | £94.55 |
| 28. 7.1990 | 8 1/2% Treasury 2000 | 1,200 | 109 | 91 | 9% Conversion 2000 | 1,554 | 2,609 | £96.70 |
| 20. 9.1990 | 10 1/2% Exchequer 2005 | 1,050 | 23 | 98 | 9 1/2% Conversion 2005 | 1,881 | 2,992 | £108.25 |
| 18.11.1990 | 10% Treasury 2004 | 725 | 22 | 97 | 10% Treasury 2003 | 1,000 | 1,703 | £100.05 |
| 25. 1.1991 | 13 3/4% Treasury 2000-2003 | 1,360 | 52 | 96 | 13% Treasury 2000 | 1,817 | 3,171 | £103.55 |

(a) The nominal amount received of the stock being converted into per £100 nominal of the stock from which the conversion is being made.

(1) 'The gilt-edged market since Big Bang', in the February 1989 *Bulletin*, pages 49–58 and 'The gilt-edged market: developments in market-making in 1989', in the February 1990 *Bulletin*, pages 68–70.

The nine conversion offers to date have been structured so as to be essentially neutral in terms of price, coupon and maturity, thereby giving holders of the less liquid stock the opportunity to substitute like for like and enhance liquidity, but not force upon them investment decisions involving significant changes in the duration or average coupon of their portfolios. The nine conversions which have been offered so far have been well received by the gilt market, and all have been very successful in terms of acceptances (the average take-up has been 95%). The Bank has for some time had arrangements whereby it will bid a price to GEMMs for stocks where the amount in issue is too small to expect a two-way market to exist. These arrangements have been of particular assistance in the case of investors who are inadvertently left holding a small amount of a stock which has been the subject of a conversion.

The number of GEMMs remained constant at nineteen during 1990 and that of Stock Exchange money brokers at nine. One new inter-dealer broker joined the market in November 1990, bringing the total of such firms to three. Thus 1990 was the first full year since Big Bang in which there were no withdrawals from the gilt market, despite the widely held view that the market would continue to contract as competitive pressures persisted. However, the absence of any withdrawals from the gilt market should not be taken to indicate that there has been any reduction in competition among the remaining firms or that they have lowered the quality of the market-making service provided to investors. It is rather that the new gilt market structure initiated in 1986 may have reached a period of stability in its development, as evidenced by the fact that, as a group, the GEMMs, having more or less achieved breakeven in 1989, have recorded annual post-tax profits for the first time since Big Bang.

Details of the financial performance of the GEMMs as a whole are shown in Table B.

**Table B**
**Capitalisation of gilt-edged market makers**
£ millions

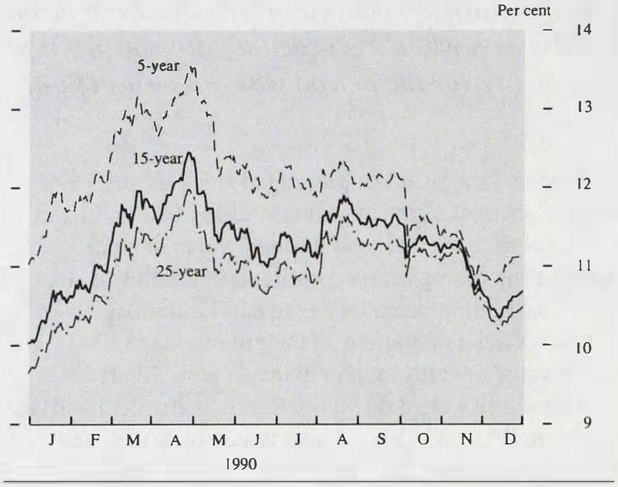
| | October 1986 to end-1988 | 1989 | 1990 |
|---|---|---|---|
| GEMMs' capital at beginning of period (a) | 595 | 420 | 395 |
| Changes as companies joined or withdrew | - 70 | -55 | — |
| Net injections or withdrawals of capital | 85 | 42 | -40 |
| Operating profits (+)/losses (-) (b) | -190 | -12 | +40 |
| GEMMs' capital at end of period | 420 | 395 | 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 and tax.

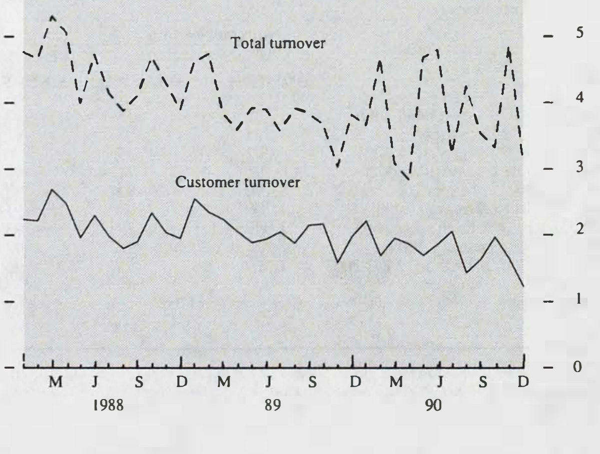
During 1990 the GEMMs recorded post-tax profits of £40 million, equivalent to an overall return on capital dedicated to the gilt market of just above 10%. This contrasts markedly with the losses incurred in the two earlier periods which together amounted to just over £200 million, or roughly one third of the market's total capitalisation at the time of Big Bang. Notwithstanding the £40 million post-tax profit, the capitalisation of the GEMMs as a whole remained unchanged at £395 million, £40 million of capital having been withdrawn, largely in the first half of the year. This modest withdrawal of capital during a year in which no firms left the market is consistent with the view that the gilt market structure may have reached maturity. It may also reflect the current need for large financial groups to allocate capital as efficiently as possible across the whole range of their operations, a trend which is evident in other markets.

**Chart 2**
**Yields on gilts during 1990**



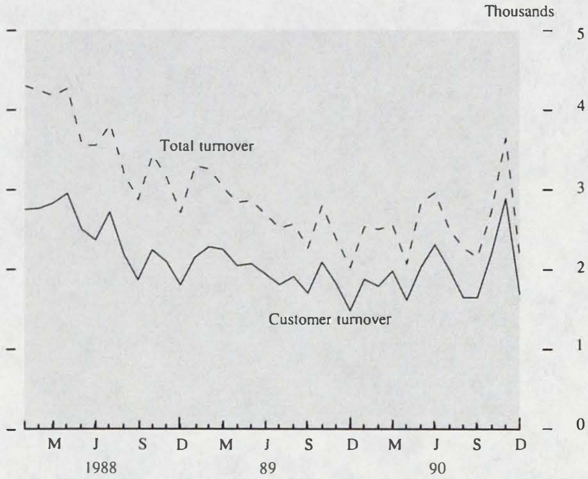

The significant improvement in the GEMMs' financial performance has been achieved against a background of continuing intense competition, a relatively difficult operating environment and a slight decline in retail turnover. Gilt yields fluctuated substantially during 1990, as can be seen from Chart 2, and the market continued to be difficult to read and trade. The market weakened in the early part of the year, with gilt yields peaking at the end of April 1990 at levels last seen in the early 1980s. Thereafter, the Iraqi invasion of Kuwait on 2 August caused yields to rise again, albeit not back to April's levels, while the announcement on 5 October that sterling was joining the exchange rate mechanism and the simultaneous reduction in the general level of interest rates brought about a sharp fall in yields.

**Chart 3**
**Average daily turnover: by value**



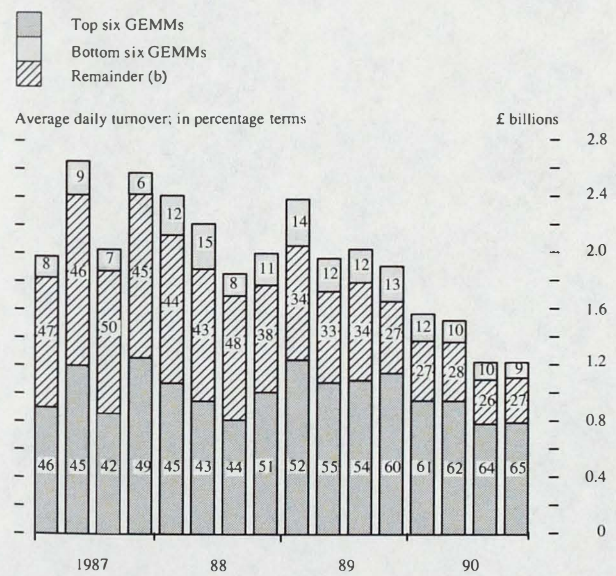
Taking the market as a whole, total turnover by value (Chart 3) was broadly unchanged from 1989 at an average of just under £4 billion a day, but the monthly pattern showed greater variation than in previous years, ranging from a daily average of £2.8 billion in April to one of £4.9 billion in November. Turnover by value with customers declined slightly from around £2 billion a day in 1989 to £1.8 billion a day, while the average size of customer deals fell from just over £1 million to just under, which is comparable with the average size of customer deal seen in 1988. Daily customer turnover by number of bargains (Chart 4) remained constant at an average of around 2,000 a day in 1990.

**Chart 4**
**Average daily turnover: bargains**




As noted above there does not appear to have been any reduction in the competitive pressures on GEMMs in 1990, and there continues to be strong competition to provide the best possible service to clients. This view of the competitive position is supported by an analysis of the distribution of

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




(a) Excluding identified dividend business from 1989.

(b) The decrease in the share accounted for by this group in part reflects the reduced number of GEMMs.

market share among GEMMs handling wholesale business (measured as share of outside turnover with clients and agency brokers). Chart 5 shows that, although the degree of concentration in the gilt market was slightly increased in 1990, the business is still well spread. In 1990, the combined share of the top six GEMMs was a little above 60% of the market, as compared with around 55% in 1989. The combined share of the bottom six firms appears to have found a natural level at around 10% (none with less than 1% individually) and that of the remainder at around 27%. This pattern of distribution of market share throughout 1990 is consistent with the view that the gilt market may have entered into a more settled structure.

The preceding analysis makes it clear that the major improvement in the GEMMs' profitability in 1990 cannot be directly linked to operating conditions in the gilt market, which remained challenging. The initiatives taken by the GEMMs in previous years to introduce tighter management and operational controls and to integrate their gilt-edged business more closely into their groups' overall activities in fixed-interest securities no doubt contributed to their success in 1990. It is noteworthy that the GEMMs have been able to establish a firm financial basis for their activities notwithstanding the shrinkage of the gilt market as a result of the absence of new issues—a development that was not foreseen when the GEMMs prepared themselves for business at the time of Big Bang.

The environment in which all types of financial institutions currently operate is becoming increasingly difficult, leading management to look very carefully at all aspects of their organisations' business, but especially at cost structures. The gilt market is no exception to this general rule, with overheads continuing to be scrutinised very closely. The GEMMs are undoubtedly leaner now than at any time since Big Bang, but this is no more than is to be expected of a market which has had to adapt to new, and often still changing, circumstances. Against such a background the GEMMs have also recognised that risks as well as costs need to be rigorously monitored, with continuing efforts being made to improve risk management systems and put in place more comprehensive controls. The GEMMs continue to use derivative products—in particular the LIFFE long-gilt future and short sterling contracts—to assist them in controlling risks by hedging their positions in the cash market.

The process of integrating gilt-edged business with activity in other fixed-interest bonds within the same group has continued. There is clearly scope for considerable co-operation between different currency fixed-interest teams within the same group, particularly as far as cross-selling is concerned, and this process may be facilitated when fixed-interest activities are located in the same dealing room, as is increasingly the case.

The diversification of GEMMs' business highlighted in previous years has continued, and the scope will be further enhanced by the recent decision by the Bank to allow GEMMs to undertake business in ECU-denominated instruments. This decision was taken in response to requests from a number of GEMMs and, although not all firms are expected immediately to begin trading in such instruments (sometimes because they are already traded elsewhere in the group), others will view this as a useful addition to the range of services they can offer, particularly in the light of the significant expansion taking place in the ECU bond market.

The increase in GEMMs' profitability in 1990 appears very largely to result from measures taken in 1989, and in some cases earlier, to strengthen the way in which their gilt-edged business is controlled and to define their plans more clearly within the context of the overall group to which they belong. The conversion programme operated by the authorities may also have helped by enhancing the liquidity of the gilt market. It remains to be seen how the market will evolve in the future, but in the meantime the GEMMs appear more optimistic about the outlook. The grounds for optimism lie in the GEMMs' generally profitable performance in 1990; the scope for continuing integration of their business within their group; and the ability to diversify their activity further, including into ECU instruments.