The gilt-edged market: developments in 1992

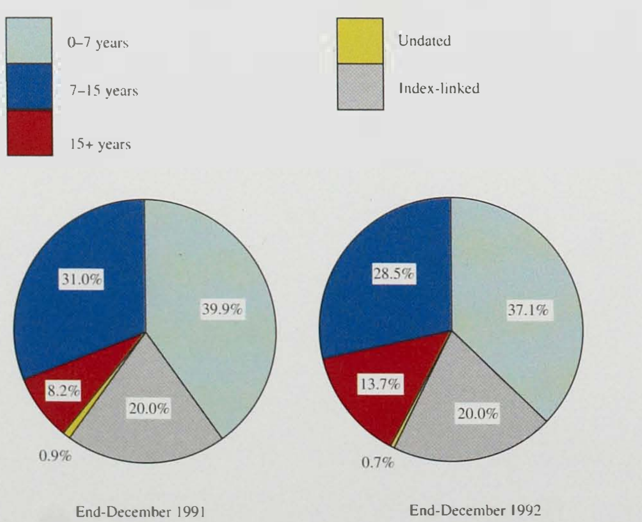
This note continues the series of annual[1] articles which have reviewed developments in the gilt market since Big Bang. The gilt-edged market makers (GEMMs) as a group recorded their third successive year of increased profits, with 1992 their most profitable year to date. On this occasion, the note also includes a summary of the results of a survey of a cross-section of domestic and overseas investors in the gilt market undertaken last year by the Bank. The general impression from the survey was favourable: current arrangements in the gilt market are working well, although there were some suggestions for change. The resources devoted by the GEMMs to the needs of retail investors in gilts have been increased following a surge in business from that source in November.

Gilt funding in 1992

The total nominal value of gilt-edged stock outstanding rose from £122.4 billion at end-1991 to £144.1 billion at end-1992, exceeding the previous peak of £141 billion which was reached in March 1988. The net increase of £21.7 billion comprised gross issues amounting to £31.2 billion less redemptions of £9.5 billion. Of the new issues, £5.1 billion were made in the 1991/92 financial year (ie in the first quarter of 1992) and the remaining £26.1 billion were made in the current financial year.

Chart 1 shows the maturity breakdown of all gilts in market hands at the end of 1991 and 1992. The most notable feature was the increase in the market's holdings of long-dated conventional gilts—from 8.2% to 13.7% of total holdings—offset by falls in holdings of shorts and mediums in roughly equal proportions. The most important influence behind this shift in balance was the fact that, of the £27.8 billion (nominal) of conventional stock issued in 1992,

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



around £12 billion had a residual maturity in excess of 15 years; although relative changes in gilt prices also had an effect. In addition, a further £9 billion issued was of medium-dated stock with a maturity of between 7 and 15 years. The decision to concentrate new issues in longer-dated maturities was influenced by good demand for such stocks from domestic institutional investors, which were the major buyers of gilts in the course of 1992 as they sought both to increase their holdings of gilts and to lengthen their portfolios. Issues of shorter-dated conventional stocks and of index-linked stock were also made throughout the year, although there was a notable increase in demand for such stocks in the uncertain market conditions which prevailed following the decision to suspend sterling's membership of the ERM in September.

There were seven issues of completely new stocks during 1992 (four conventional and three index-linked), whereas all other issues since the return to funding in January 1991 had been additions to existing stocks. The motivation for these new issues was threefold. First, 20-year and 25-year benchmark conventional stocks were issued early in the year—and subsequently re-opened to increase their size—to extend the maturity range of conventional stocks; an index-linked stock maturing in 2030 was also issued with the same intention. Second, new current-coupon 5-year and 10-year benchmark stocks for 1993 were created in October and December respectively, to provide sufficient current-coupon benchmark stocks following the sharp fall in short yields in the fourth quarter. Third, new index-linked stocks were created maturing in 1998 and 2004 to ensure that obvious gaps in the maturity range of stocks were closed. In recognition of the need to attract as broad a constituency of investors as possible, all new stocks issued in 1992 had FOTRA status, enabling interest to be paid free of tax to overseas holders.

In addition to the issues of completely new stocks, the authorities continued their policy of re-opening existing issues to build up large, liquid benchmark stocks in a range

(1) In the February 1989 *Bulletin*, pages 149–58; in the February 1990 *Bulletin*, pages 68–70; in the February 1991 *Bulletin*, pages 49–52; and in the February 1992 *Bulletin*, pages 56–59.

of maturities. In the course of the year, re-openings led to the creation of three stocks with more than £5 billion outstanding, and there are currently a further five with outstandings of more than £4 billion.

In 1992, the authorities continued successfully to pursue a mixed range of issuing techniques, combining auctions of single large blocks of stock with direct placings of smaller amounts of stock with the Bank for sale 'on tap' to the GEMMs in the secondary market; stock was sold in both fully paid and partly paid form. There were five auctions over the course of the year for a combined amount of £12 billion (nominal), just under 40% of the total stock issued. The auctions were for amounts of between £1.8 billion and £2.75 billion which was rather larger than in 1991: this may in turn account for the fact that the degree of cover—which ranged from two to one and a quarter times—was rather less than in the previous year. However, at no auction was the tail (the difference between the average yield and the highest accepted yield) more than two basis points, testifying to the concentration of bidding.

A large part of the remaining £19 billion (nominal) of stock was sold on tap to the GEMMs, enabling the Bank to respond quickly and flexibly to demand for stock, both conventional and index-linked, across a range of maturities. The advantages of this issuing technique in certain circumstances, for both the authorities and the market, were amply illustrated during the strong rally which followed the general election, when in two separate operations at 2.30 am and again at 8.15 am on 10 April a total of £1.6 billion of new stock was issued and immediately sold; in addition, throughout the night much more than this amount was sold from the Bank's own holdings. Thus the authorities were able to secure funding in large quantity while at the same time ensuring that the market's demand for stock was satisfied in an orderly fashion. The same techniques were used to similar advantage in the rally in the gilt market following sterling's suspension from the ERM in September.

Investor survey

The approach to funding described in the preceding paragraphs received broad support in a survey of a cross-section of investors in the gilt market which the Bank conducted in the first quarter of 1992. The survey covered both the quality of service which the investors were receiving from the GEMMs and also the conduct of funding operations. It was intended as a follow-up to a similar survey on market-making alone which was carried out in 1988 to ascertain the effectiveness of the new arrangements put in place at the time of Big Bang. In view of the changes which had taken place in the gilt market in the intervening period, it was very useful to receive investors' perceptions of the current state of the market and the Bank's role within it. Responses were received from around 70 investing institutions, including a number of overseas participants.

Much of the survey dealt with recent experience with auctions, and there was broad consensus in favour of the £2.0 billion–£3.0 billion range chosen for the size of auctions in the 1992/93 financial year. Similarly, the choice of stocks to be auctioned, particularly the concentration on current-coupon benchmark stocks with FOTRA status and the use of part-payment facilities, met with general approval. There were, however, some respondents who felt that the FOTRA concession was insufficient and that steps should be taken to abolish withholding tax completely; it was nevertheless appreciated that this raises issues going beyond the gilt market.

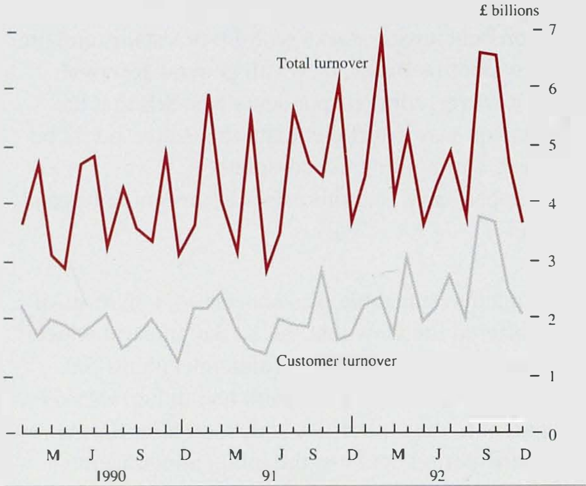
As far as the auction timetable was concerned, a number of respondents offered the view that the 10 day interval which existed between the first and second announcements for much of 1991 was too long. This point had in fact already become apparent to the authorities and, soon after the survey was sent out, the period between the initial announcement and the release of the full details of the auction stock was shortened to one week. The when-issued trading period between the second announcement and the morning of the auction itself was felt to be very valuable, a conclusion which has been supported by clear evidence of active investor participation in this market ahead of auctions. Although most investors appear to prefer to secure a fixed amount of stock at a known price in the when-issued market rather than submitting bids at auctions, there was a small number who would have welcomed the opportunity to bid direct at auctions. Such a facility is in fact already in place, since investors can submit written applications to the Central Gilts Office in London and to the Bank's Registrar's Department in Gloucester right up to the 10.00 am deadline for applications; of course, investors can also arrange for GEMMs to bid on their behalf through the telephone bidding arrangements available to the GEMMs.

Some respondents advocated that the authorities should move from the current discretionary auction timetable to a pre-announced auction calendar, similar to those which operate in France and the United States. The wish on the part of investors for predictability is understandable but, while accepting that funding policy should be consistent and coherent, the Bank's view remains that there are also advantages to both the authorities and the market as a whole in retaining an element of flexibility in the execution of the funding programme, particularly with regard to tap sales as a supplement to the auction programme. As noted above, this flexibility was put to good use in the course of 1992.

Turnover in the gilt market

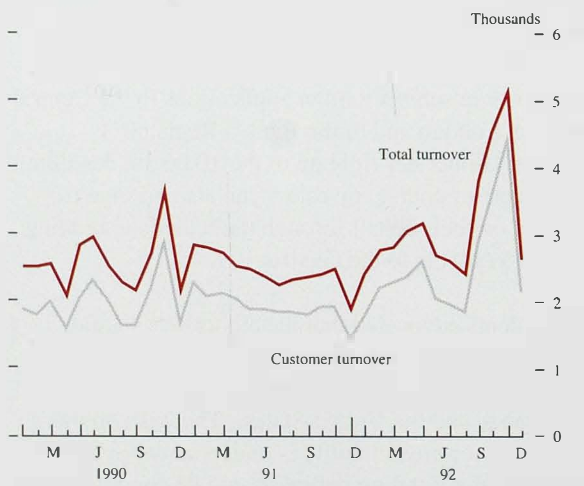
Chart 2 shows that total turnover by value in gilts increased from an average of around £4.4 billion per day in 1991 to £4.9 billion in 1992. Within this total, there was also an increase in turnover by value with customers, from under £2 billion per day in 1991 to around £2.5 billion per day in 1992. There were peaks in customer turnover in April following the general election (an average of £3 billion per day) and again in September and October (averages of £3.7 billion and £3.6 billion per day) as a result of the surge in demand after sterling's suspension from the ERM. The

Chart 2
Average daily turnover: by value



average size of customer deal remained largely unchanged at just over £1 million and consequently there was a sharp rise in the daily average of customer turnover by number of bargains (Chart 3) from around 2,000 in 1991 to 2,500 in 1992.

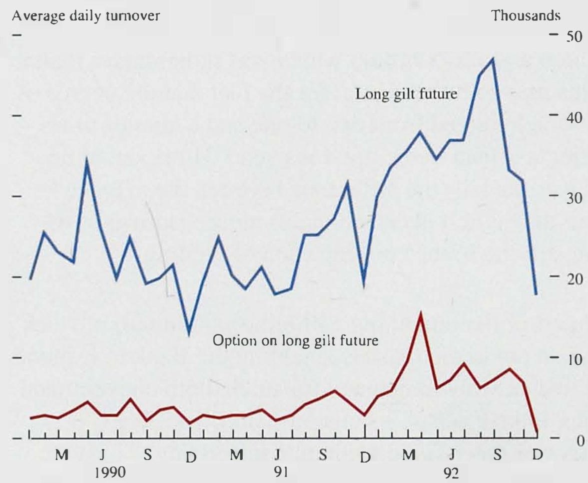
Chart 3
Average daily turnover: bargains



The daily average for customer bargains was noticeably higher in October (3,500) and November (4,400), no doubt augmented by the increase in retail investor interest in the gilt market during that period. The increase in demand from retail investors followed the announcement of the early repayment of 9% Treasury Loan 1992–1996 and advice in several personal finance columns as to the attractions of gilts over other savings products in the face of expectations of an imminent cut in interest rates. The sudden surge in interest in the early part of November led to a trebling of the normal number of daily small gilt bargains and inevitably there were some settlement delays around this time. However, the GEMMs, together with the Bank and the Stock Exchange, took steps temporarily to increase the market's capacity to deal with retail gilt transactions, thereby avoiding any substantial backlog. Although the volume of retail business has now returned to more normal levels and the permanent capacity of the market to deal with small gilt bargains has been increased, the authorities and the GEMMs are monitoring demand and are undertaking a thorough review of all aspects of this sector of the market.

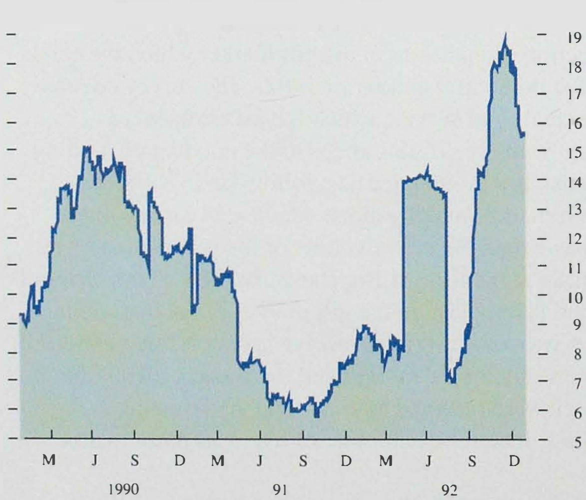
Turnover in 1992 in the LIFFE gilt derivatives (Chart 4)—the long gilt future contract and the option on the long gilt future contract—increased over the previous year, with

Chart 4
LIFFE gilt contracts: number of contracts



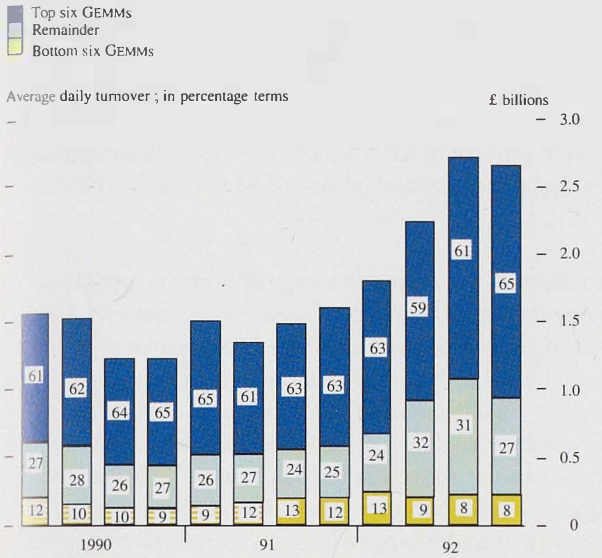
volume of the long gilt contract reaching record levels. The average daily turnover reached its highest level in August (44,700 contracts) and September (46,500 contracts) as tensions increased ahead of the French referendum on ratification of the Maastricht Treaty on 20 September. Chart 5 shows the annualised yield volatility of 10% Treasury Stock 2001, a stock of roughly 10 years to maturity.(1) The chart shows the low level in volatility reached in mid-1991, a peak in the second quarter of 1992 caused by the sharp fall in yields immediately following the general election, and the sustained period of volatility both

Chart 5
Yield volatility of 10% Treasury 2001



(1) The series has been calculated from daily percentage changes in yields and using a backward-looking three-month window.

Chart 6
Distribution of GEMMs' retail turnover(a)



(a) Excluding identified dividend business.

before and immediately after sterling's withdrawal from the ERM.

Chart 6 provides a breakdown of the distribution of retail market share among GEMMs handling wholesale business (measured as share of turnover with clients and agency brokers and excluding IDBs, other GEMMs and the Bank). The most noticeable change in 1992 compared with 1991 is that the middle-ranking firms substantially increased their market share, accounting for an average combined share of around 29% against 25% last year. The share of these firms was above 30% in the second and third quarters which may well be linked to the fact that these periods coincided with peaks in investor activity. Against this, both the top six firms and the bottom six firms lost market share, although the share of the latter group was naturally distorted by the entry of two new firms to the market and the withdrawal of another. This in turn largely explains the large difference in the share of the bottom six firms between the first quarter (13%) and the remainder of the year. The overall analysis again supports the view that there continues to be strong competition among the GEMMs to provide the most effective service to customers.

GEMMs' financial performance

The number of GEMMs increased from eighteen to nineteen in the course of 1992 as two new firms joined the market in April and May and one firm withdrew in September. The number of Stock Exchange money brokers and inter-dealer brokers remained constant at eight and three respectively. The GEMMs as a group were able to post an increase in their overall profit for the third year in succession. Their annual post-tax profit of £65 million, an increase of £16 million over 1991, was by some way their best performance since Big Bang. In addition, this post-tax profit reflects significantly higher tax payments by GEMMs than in previous years. As in 1991, a small number of individual GEMMs continued to incur losses, but only on a modest scale. More generally, some of the GEMMs which undertake a wider range of functions beyond market-making in gilts continued to benefit from profits from other sources. Details of the financial performance of the GEMMs as a group are shown in the table below.

Capitalisation of gilt-edged market makers

£ millions

	Oct. 1986 to end-1988	1989	1990	1991	1992
GEMMs' capital at beginning of period (a)	595	420	395	395	432
Net injections or withdrawals of capital	+15	-13	-40	-12	+24
Operating profits (+)/losses (-) (b)	-190	-12	+40	+49	+65
GEMMs' capital at end of period	420	395	395	432	521

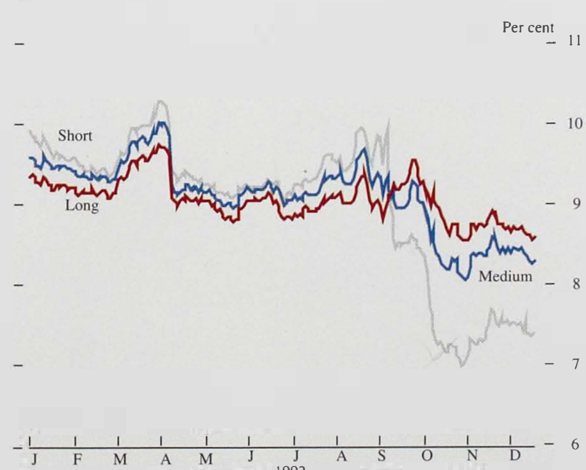
Source: Bank of England.

(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.

The overall post-tax return on the GEMMs' starting capital in 1992 was 15.0%, up from 12.4% in 1991. The combination of post-tax profits of £65 million and a net injection of capital of £24 million meant that the capitalisation of the GEMMs as a group increased from £432 million at the beginning of the year to £521 million by the end.

In seeking to identify the reasons for the GEMMs' strong performance in 1992, it is evident that the market as a whole enjoyed two particularly profitable periods. The first was in April and was clearly linked to the surge in investor interest which took place immediately after the general election, while the second covered September and October, coinciding with the strong rally in the market following the events of 16 September. Official supply of stock to the market was also at its highest during these periods. The extent of these sharp upward movements in the market is well illustrated by Chart 7, which shows changes in gilt

Chart 7
Yields on representative conventional gilt-edged stocks(a)



(a) Representative stocks: short–10½% Exchequer 1997; medium–9¾% Treasury 2002; long–9% Treasury 2008.

yields in 1992. In addition, some GEMMs were clearly able to take good advantage of the more volatile conditions which prevailed during the year, correctly anticipating market movements and positioning themselves accordingly. On the other hand, it is equally clear that conditions for the GEMMs during periods when the gilt market was marking time, such as over the summer months in the approach to the French referendum on Maastricht, were more difficult, in the absence of strong investor interest.

The quality of the market-making service provided by the GEMMs was also addressed in the survey of investors referred to above. The process of consolidation of investors' relationships with a smaller group of GEMMs has continued since the 1988 survey, when it appeared that investors had tended to concentrate their business on between six and ten GEMMs. Comparable figures from this survey, which predated the entry of the two newest GEMMs, suggest that this consolidation process has continued, so that as a general rule investors tend to deal regularly with between four and eight firms. There are of course exceptions, with certain investors dealing with a larger or smaller group of GEMMs. The responses to the survey are also consistent with the analysis of the distribution of GEMMs' retail turnover in Chart 6: five of the top six firms were mentioned by over half the respondents, while the top six as a group accounted for around 60% of the total number of references by investors. Every GEMM was, however, mentioned by a number of investors.

In general, the responses to the survey pointed to an encouraging degree of satisfaction among the investor community with the gilt market-making service provided by the GEMMs in terms of the range of gilts for which the firms were prepared to quote prices, the spreads, and the size of deal for which the GEMMs were able to make competitive prices. The overall speed of response from GEMMs to requests for prices, both in normal and adverse market conditions, was (with only a few exceptions) considered satisfactory. A number of investors found it helpful to be able to transact other sterling bond business with GEMMs in addition to gilts, or other types of business with companies within the larger financial groups of which the GEMMs are part.

Some concerns were, however, expressed by respondents, including in a small number of cases dissatisfaction with the number of firms providing a service in certain areas of the market. It is clear that individual firms have developed expertise in distinct areas of the yield curve, or in types of stock, which enable them to quote on finer terms. A particular example of this is the index-linked market where, perhaps inevitably because of its size and specialist nature, the majority of trades tend to be shown to a relatively small number of GEMMs.

The results of the survey helped confirm the view which has been emerging over the past four years that the gilt market is evolving in line with the needs of investors, both domestic and international. This is particularly encouraging given that both investors and GEMMs have had to come to terms with the transition from the buying-in of gilts in the late 1980s to new issuance on a substantial scale in the early 1990s, a potentially difficult process which has, however, taken place with minimum disruption. The Bank would wish to encourage investors to continue to offer their views on the gilt market so that they can be reflected in its further development.