Gilt repo—and beyond

Ian Plenderleith, Executive Director for monetary operations praises[1] *the start of the gilt repo market in January 1996 and its subsequent steady and sustained pace of development. He also reviews the programme of reforms in the gilt market and describes the Bank's current thinking about possible structural changes in the sterling money markets.*

I want to begin today by celebrating a palpable success.

Nearly six months from launch, the gilt repo market is cruising confidently along the glide path on track for the global market. Its development so far has been marked by:

- steady, sustained growth;
- built on a sound market structure;
- attracting a steadily widening range of participants;
- generating rising turnover; and
- already delivering evidence of the benefits we looked for—enhanced liquidity and improved efficiency in the gilt market and in other sterling markets.

In sum, the market is now approaching critical mass as a major international repo market. That is a remarkable achievement after less than six months.

Gilt repo: progress so far

The introduction of gilt repo trading undoubtedly represents the biggest change in the structure of the gilt market since Big Bang, whose tenth anniversary we reach this October. Like Big Bang, the start of gilt repo trading was preceded by an extended period of careful planning and preparation. Also like Big Bang, the change had to happen on a single day. But unlike Big Bang, the new market has thus far exhibited a pattern of growth that has been *substantial* in size and *sustained* in its pace of expansion, but above all *steady* and *orderly*. It is wholly to the good that there has been no sudden explosion of activity, because that kind of headlong rush would inevitably force dealers into trading misjudgments and overstretch both management control and back-office support, at precisely the time when all concerned were most exposed as they worked their way up the learning curve. And the impression that would give, of a market that was trying to run before it could walk, would actually serve to discourage the client base from using the market and hence delay its long-run development.

It is an enormous gain, therefore, that we have avoided these potential pitfalls and have instead achieved a pace of development that is steady and sustained. This is evident if we look at various aspects of the market's growth so far. We have seen, first a steady expansion in the *range of participants*. Naturally, the key professional market participants were there at the outset—the gilt-edged market-makers, the discount houses, the major banks and securities firms and the wholesale brokers. Joining this core group, we have seen additional participants enter the market at a pace determined essentially by their perception of what gilt repo can add to their business and by the practical requirement for them to vet and sign up the necessary legal agreements with their chosen counterparties and to have the necessary front-office and back-office (or delegated triparty) arrangements in place.

At quite an early stage, we saw the entry of some of the major building societies, for whose treasury management activities the gilt repo market has obvious relevance. Alongside them, we have seen central banks progressively begin to sign up, attracted particularly by the opportunity to place funds on a secured basis and by the facility repo offers for managing their liquidity.

Beyond them, we have begun to see some of the domestic UK institutional investment firms enter the market. Many of these are, of course, extremely important to the gilt market as lenders of stock, and it is good news for the market that stock lending has continued to flourish alongside repo, with indeed some new lenders entering the market as others extend their activity into repo. Fund managers more generally can be expected to take longer to enter the repo market, because of their need first to observe proper procedures for segregation of client funds. But some hedge funds have already begun to participate in the market, and we expect international participation more generally to grow considerably further as gilt repo takes its place alongside the other major international government bond repo markets. Beyond that, the involvement of corporate treasury managers is in prospect and there should be interest from all who would see value in placing money against the security of an asset—government bonds—which carries no credit risk. In that sense, as the modern form of secured money, repo has potential attraction to a huge range of participants; but it will remain important that new participants first take care that they have the necessary vires to operate in repo.

(1) In a speech given to the Annual Open Gilt Repo Market Conference in London, on 12 June.

From the *statistical data* we have collected, we can see a similar picture of a progressive expansion of activity. We collect data quarterly, and have figures so far to the end of February: the end-May figures are coming in during this month and we will publish them when they are complete. Already by the end of February, we believe there were up to 100 firms participating in the market and, from data reported by over 60 of the main participants, we estimate that by the end of February the market had already reached at least £36 billion outstanding, with daily turnover in the first two months of the market's life averaging at least £12 billion a day. This, of course, is in addition to the substantial volume of stock lending still being undertaken; it has indeed always been the intention behind the reform that market participants should have genuine freedom of choice between repo and stock lending, utilising whichever best meets their needs. The activity in repo, not surprisingly in the early months, is concentrated in the shorter maturities, with 65% at maturities up to one week, though with some 20%–25% reported at maturities above one month. The monthly M4 data give us an indication of repo activity by banks and building societies since then. They show that banks' and building societies' repos had reached £23 billion, and their reverse repos £29 billion, by end-April, suggesting continuing sustained growth in the market as a whole.

On these figures, gilt repo had already, by the end of February, grown to around three times the size of stock lending and around twice the size of the eligible commercial bill market.

Alongside this sustained growth in the scale of activity, it is encouraging that repo has also begun to develop the *pricing characteristics* we would expect to see in a fully fledged trading market. General collateral rates have moved closely in line with the overall constellation of money-market rates, with overnight GC repo rates usually very close to interbank rates, but term GC rates trading ten basis points or more below interbank rates: this is the relationship one would expect, given the secured nature of money placed on gilt repo. All of this is evidence of active matched-book trading, which provides a firm foundation for the new market's liquidity. The result has been to reduce the cost of financing gilt positions, from at least Libor to a margin below Libid; and in parallel, basic stock lending fees have been more than halved, from 25 basis points to ten basis points or less. This reduced cost of financing, and the ability for any participant to take short positions through repo, has helped new players to enter the market, which in turn improves the liquidity of the gilt market and thus achieves one of the principal benefits we looked for in gilt repo. It has also enhanced the quality of the sterling money markets and deepened the swap market.

As importantly, the repo market has, as expected, generated differential rates for stocks on *special* delivery, ie the market is clearing by price. Holders of particular stocks wanted on repo have been able to repo them out against money costing typically up to 100 basis points below GC rates. Differential repo pricing in this form is a normal characteristic of a mature repo market and it is therefore a sign of healthy development that specials are a growing feature of gilt repo activity. That specials rates have generally been more moderate than in other repo markets may reflect the highly developed network of gilt stock lending arrangements which gilt repo has inherited and which has facilitated efficient supply of stocks in special demand. The range of stocks trading special may be expected to broaden as the market grows.

The Bank welcomes such activity and will in no way seek to impede specials trading, though, as we have indicated, we stand ready to take action if we encounter tactics designed to distort or disrupt the market, because such activity can reduce market efficiency, deter end-investors and raise funding costs. In fact, extreme special rates have only appeared once, in relation to 15% Exchequer 1997, and that situation was quickly resolved.

Equally encouraging have been the dogs that did not bark, by which I mean the notable absence of any significant problems with the market infrastructure—legal, regulatory and operational. A great deal of work was undertaken last year to develop a standard legal agreement for gilt repo, and a Code of Best Practice, as well as tax changes designed to facilitate repo trading, and enhancements to the CGO settlement system. This preparation, in which market practitioners were closely involved, has been taken to heart by the market: undocumented trades are few and far between (and we hope they will become even fewer), and the Code has been adopted as an essential guide to best market practice by virtually all players. The CGO, too, has worked effectively in handling the introduction of repo trading; drawing on experience to date, we will shortly be putting round proposals for some minor adjustments to the CGO daily timetable for settlement. The gilt repo market has benefited enormously from a safe and efficient infrastructure, and all of you who contributed to the hard work last year deserve a great deal of credit for a job well done.

But, as I urged last year, continued vigilance is essential to ensure that repo activity is prudently conducted and properly controlled. If there is one aspect of gilt repo trading that gives me pause, it may not surprise you to learn that it is the question of margin. One reason why repo can be such a safe instrument while also being so flexible is through remargining during the life of a repo. Many repo transactions are, as I have mentioned, very short term, and participants may or may not be happy to undertake overnight transactions without margin; that is a matter for them. But market sentiment can change very rapidly, and the counterparty risk and price risk of repos, particularly term repos, should not be ignored. The Code is explicit on the importance of marking to market and then remargining to cover any material exposure, and it is vital to the well-being of the market as a whole that all market participants adhere to this; we do hear reports of some that do not: they are the ones who would suffer if anything went wrong.

Reform of the gilt and sterling money markets

All of this is a considerable success story and I have no doubt that we shall see gilt repo take its place in the core group of major international repo markets. But having described progress so far, I want to outline where we go from here in building on this very successful start. I want first to talk about further reforms in the gilt market, and then describe where we have got to in our thinking about possible structural changes in the sterling money markets.

In relation, first, to the *gilt market*, it is helpful to see the series of changes that have been implemented in the last few years, or are in train for the immediate future, as forming five parallel planks which, taken together, constitute a coherent platform for a modern trading market in gilts.

The *first plank* is the *debt management framework*, which was extensively reviewed in the joint Treasury/Bank of England Report of the *Debt Management Review* published last year. This set out clearly the objectives the authorities pursue in the debt management field, and it provided for the authorities to issue at the beginning of each financial year a clear statement of their debt management plans for the year ahead, in the form of a public remit from the Treasury to the Bank of England as its debt manager. That process provides a clear framework within which debt management policy can be developed each year in the light of needs in the year ahead, and within which the Bank of England can then carry forward the necessary market operations to finance the central government's borrowing requirement. Importantly, the remit is published, so that the market is fully informed of the authorities' plans, and that commitment to transparency has undoubtedly yielded benefits, both to the authorities in more effective debt management, and to market participants in enabling the market to function more effectively.

This work is, however, not yet complete. Policy decisions in the debt management area need to be rooted in a clear understanding on the part of the authorities of the structure of debt they would like to have—for example what proportion at fixed rate or floating rate or in index-linked form, and what maturity structure. Essentially the need is to identify an optimal debt portfolio, both as a long-run target for debt management policy and as a benchmark for the debt manager's performance. These are difficult issues, which no country has yet successfully resolved. We have work in hand in this area and hope to offer it for public discussion in due course.

The *second plank*, of reform in the gilt market, is the *selling programme*—the means by which we sell gilts. Here we have introduced changes with two aims in mind—to make the selling programme more *structured*, and more *transparent*. In terms of a more structured approach, we have clarified that we sell gilts essentially through three avenues—a regular monthly programme of auctions is by far the predominant method of sale, in line with a calendar published at the beginning of each year; occasional tap sales in specified circumstances; and a third leg which we are just in the process of putting in place, the so-called 'shop window', through which we will post details of very small amounts of official holdings of which we are ready to dispose if there are buyers. To make these three avenues as transparent as possible, we publish on our screens full details of our operations as they are undertaken. And we will very shortly be publishing a full 'Operational Notice' which will bring together in one handy reference document complete details of how our operations are conducted in this new, more structured and transparent approach.

Here too, however, we have work still in progress, in particular in relation to index-linked gilts. In a fruitful conference last September, we organised a discussion with market participants, academic experts and overseas debt managers of ways in which the index-linked market might be developed further. Part of the discussion addressed the particular role of auctions in selling index-linked debt. Views were mixed, but the sense on balance was that the index-linked market was probably not yet sufficiently developed to sustain a regular programme of auctions. Hence, we took the view that we should continue for the time being with our current approach of selling indexed gilts by tap sales timed to respond to perceived demand. But as the index-linked market grows, we will want to keep in sight the possibility of introducing auctions. And the very welcome recent decision by the US Treasury to issue US government bonds in a form that protects against inflation seems likely to deliver a substantial boost to worldwide interest in index-linked debt: this could bring forward the time when we can reconsider auctions here.

It is in the *third plank* of gilt market reform that repo makes its contribution, through improving the *liquidity* and *efficiency of the secondary market*. I have outlined above the gains already evident from repo, but I should add to the score card the important contribution of tax reform, where big changes, particularly in relation to withholding tax, aim substantially to remove tax anomalies, and hence improve the efficiency of the market and enhance its attractiveness to international participants.

The *fourth plank* is the less glamorous, but critically important, field of *market infrastructure*. The membership from March of this year of CGO by the main international depository and settlement systems helps to improve international access to the gilt market. But we have major work in hand on CGO itself: CGO is well on track for a substantial upgrade which, *inter alia*, will provide an improved service for settling repo and the facilities necessary for gilt stripping. This upgrade is being conducted utilising CREST software, and in parallel with CREST, so that the option of merger of these two systems can be kept open. Merger will be for consideration in the future, but the first priority remains to get both of these systems into operation, with the start date for the CGO upgrade still set for the early months of the next year.

Looking further ahead, there are other aspects of the market's infrastructure where we want to pursue improvements—for example, in the relationship between the CGO, which provides same-day book-entry electronic transfer, and registration, which takes place some days later; and in relation to the ex-dividend period, which has already been substantially shortened but should ideally be removed altogether. And the successful inauguration in April of real-time gross settlement (RTGS) for wholesale payments offers the prospect in due course of full delivery-versus-payment (DVP) for gilt settlement.

The *fifth plank* of gilt market reform is to continue to improve the *gilt-edged instruments* themselves. Here, too, we have major work in hand, in the development of strips for gilts. With the tax reforms now in place, and once the CGO upgrade is operative, it should be possible to start strips in the early months of next year. Strips will greatly enhance the flexibility of gilts as an investment and will be a further significant enhancement to the market's liquidity and efficiency.

In parallel, we will continue to consider the scope for new instruments and innovation in instrument design, where our touchstone is always to look at investor demand and seek to respond if the scale of demand is sufficient. This has led us to develop a wider range of debt instruments than any other major government borrower and we continue to see merit in maintaining a diverse portfolio of borrowing instruments, though built on a bedrock of liquid benchmark issues which provide the basic building blocks for trading activity.

These five planks form the basic structure of the reform programme in the gilt market and, as I have indicated, there is more work there still to do—notably in the analysis of the government's optimal debt portfolio, in developing strips for gilts and in expanding the index-linked sector, and in the CGO upgrade. Repo is an important step in carrying forward this platform of reform. But repo also opens up opportunities for changes in the structure of the *sterling money markets*, and here, too, we have work in hand.

We have said that the development of gilt repo trading activity could make it sensible to contemplate changes in our money-market operations, and that we would consult at the appropriate time. That remains our intention, but in recent months there have been several important developments helping to carry this process forward.

First, with the track record we now have of the performance of the repo market to date, we can be much more confident that it would prove capable of providing an effective avenue for our official money-market operations if we wish to make use of it, ie that operations by us, designed to influence repo rates, would be transmitted to the structure of interest rates across the economy as a whole. We may not quite be there yet, but repo activity is approaching critical mass and we can now have much greater confidence that it will develop into a fully mature market. We quite recognise, of course, in this connection, that a decision by the Bank to operate in repo would itself be likely to be a major stimulus to the market's continued growth.

But we have also had important information in other areas in recent months. With the inauguration of RTGS in April, we are now engaging in the provision of liquidity within-day against collateral to the banks participating in that system. Looking further ahead, we now have a clearer idea of how money-market operations are likely to be conducted by the European central banks participating in EMU if and when monetary union takes place.

These apparently unrelated developments matter, because they are pieces in the jigsaw that we need to put together coherently in planning any change in our money-market operations. It is not just a matter of whether or not we extend our operations into repo. In addressing that question, we need to consider the full range of the instruments in which, and the counterparties with which, we deal in a variety of current and possibly prospective operations—our within-day operations for RTGS, which I have mentioned, our twice-monthly gilt repo facility open to the monetary sector as a whole, our dealing relationship in gilts with the GEMMs, and the nature of possible future operations by the participants in EMU, as well as our current daily operations in bills in the money market. We need to consider these various dealing and counterparty relationships as a coherent whole, rather than focusing on just one of them in isolation. The past several months have given us a much better read of developments in a number of these areas—notably in relation to repo. We now have several important pieces of the jigsaw that we lacked before, and we hope that we will soon be able to bring our thinking to you for wider discussion.