The gilt-edged market: developments in 1995

This article reviews the gilt-edged market in 1995, continuing the annual series begun in 1989. Numerous changes to the gilt market were announced as part of the most extensive programme of reform since Big Bang in 1986. World bond markets rallied, particularly towards the end of the year, when yields in some countries approached their 1993 lows. This fall reflected a gradual reduction in expectations of world economic growth and inflation. Gilt yields fell over the course of the year, and turnover increased slightly. More than £27 billion worth of stock was issued, and the number of gilt issues with over £5 billion outstanding reached 18. One new gilt-edged market-maker started business during the year and three withdrew, leaving a total of 20.

Structural reforms in 1995

During 1995 a series of reforms were introduced or announced as part of the continuing development of the gilt market. These are designed to maintain and enhance the attractiveness of the gilt market to investors, and thereby help reduce government funding costs.

Issuance techniques

- An auction calendar, and a size range of £2–3 billion per auction, were included in the Chancellor's remit to the Bank in March for funding in 1995/96. This consolidated the move in recent years towards a schedule of auctions. The remit also indicated before the start of the financial year the proportions of stock, by maturity and type, that the authorities were aiming to issue, and provided for quarterly announcements by the Bank of the maturity range of the stock to be auctioned in the following quarter.

- The joint Treasury/Bank Report of the Debt Management Review(1) (DMR) was published on 19 July. This confirmed auctions as the primary means of issuance of conventional stock and announced plans for greater transparency in tap issuance.

- The DMR announced that the government would amend the framework for funding with effect from 1996/97. This had two major components. First, it removed the current prohibition on funding with debt of less than three years' maturity. This prohibition contrasts with the practice in most other industrialised countries. The government will thus be able in future to issue debt of any maturity, within a set maturity structure to be determined each year. Secondly, it refocused debt issuance away from the Public Sector Borrowing Requirement onto the Central Government Borrowing Requirement, reflecting the fact that money raised through debt issuance is used entirely to finance *central* government operations.

- On 3 August, the Bank introduced its changes to procedures for tap sales. Tap issues are now announced at 10.15 am for bids at 10.45 am, and details of the amount sold at the initial and any subsequent mini-tenders are published.

- Towards the end of September, the Bank convened the first of the planned formal meetings with gilt-edged market-makers and end-investors. These are held quarterly to seek views on the maturities of the gilts to be issued at auction in the following quarter. Both the agenda for the meetings and the minutes were published. The process was repeated in December.

Repo

- On 21 February 1995, the Chancellor confirmed that the tax changes needed to facilitate an open gilt repo market would be introduced.(2) A repo is a sale of stock with a simultaneous agreement to repurchase it at a future date. Repo enables market participants to borrow cash against gilt collateral and so finance long positions in gilts. Reverse repo enables participants to borrow stock and to cover short positions.

- On 29 March, the Bank published 'Plans for the Open Gilt Repo Market', setting out plans for the structure and operation of the market and announcing that it would begin on 2 January 1996. At the same time, drafts of a Gilt Repo Legal Agreement and a Code of Best Practice were issued by two working parties of market practitioners convened by the Bank.

- The Bank announced, on 12 July, that from January 1996, the ex-dividend period for all gilts would be reduced from 37 calendar days to seven working days (except 3½% War Loan, for which the period was reduced to ten working days).

- On 27 July, a consultative paper on the settlement of gilt repo transactions was issued by a third working party.

(1) The executive summary of the report is reproduced in the box, 'Debt Management Review' on page 226 of the August 1995 *Quarterly Bulletin*.
(2) See the box on 'The open gilt repo market' on page 131 of the May 1995 *Quarterly Bulletin*.

- The Bank issued a package of final papers on 8 November, including legal documentation for use in the gilt repo market, the Code of Best Practice and a paper setting out points of detail on settlement matters.(1)

- The London Stock Exchange published rule changes to facilitate gilt repo on 8 December.

- The Gilt-Edged Stock Lending Agreement was amended so that its provisions would dovetail with those of the new Gilt Repo Legal Agreement, and released on 22 December.

- As a consequence of the introduction of an open gilt repo market, a number of gilt-edged market intermediaries announced changes to their corporate structure toward the end of 1995. Specifically, most Stock Exchange money brokers announced that they would be merging their gilt business with a discount house or bank, mostly from within the same financial group, to offer an integrated repo and stock lending service.

- The gilt repo market started on 2 January 1996, since when there has been no restriction on the ability to repo, borrow or lend gilt-edged stock. Initial indications are that the market started smoothly and that activity is steadily building up.

Strips

- On 25 May, the Bank issued a consultative paper on the creation of an official stripping facility for gilts.

- It was announced on 10 July that the Government had decided in principle to introduce the tax changes that would make a stripping facility possible.

- On 19 September, the Bank announced that the new stock to be auctioned later in September (7½% Treasury Stock 2006) together with the three existing benchmark stocks (8% Treasury Stock 2000, 8½% Treasury Stock 2005 and 8% Treasury Stock 2015) would become strippable on the introduction of an official stripping facility. The aggregate amount of strippable stock outstanding at end-1995 was £29.2 billion. All these stocks have dividend dates of 7 June and 7 December.

- The Finance Bill, published on 4 January 1996, contained provisions for regulations to set out the terms on which unstripped gilts can be exchanged for their stripped components.

Tax reforms

- The introduction of open gilt repo trading (see above) has been made possible by a major reform of the withholding tax system for gilts: most wholesale investors can now receive dividends gross of withholding tax. Those eligible under the new regime can elect to hold their gilts in what is known as a STAR account in the Central Gilts Office (CGO) and thereby receive gross gilt coupon payments. UK corporate investors pay tax on this income on a quarterly basis.

- Since January 1996, all manufactured gilt dividends(2) have been payable gross in all circumstances, enabling investors to repo across coupon dates without incurring a liability to withholding tax. Also, pension funds have ceased to be taxed on their fees for stock lending (to ensure a level playing field in the tax treatment of gilt stock lending and repo).

- On 24 May, the Inland Revenue announced that what had become known as the ‘three dividend rule’ would no longer apply. As a result, overseas investors in gilts no longer need to have the intention of holding stock over at least two, or preferably three, successive dividend dates to receive their dividend payments on FOTRA stock gross of tax.

- The cumulative effect of these changes is that for overseas corporate investors, the distinction between FOTRA stocks, which are free of withholding tax on application, and non-FOTRA stocks disappears for practical purposes.

- The Inland Revenue announced on 25 May 1995 that it was consulting on fundamental tax reform for gilts and bonds. Following this consultation, the Chancellor announced on 10 July that, from April 1996, gilts and bonds would be taxed on a total return basis for most investors, with no distinction made between capital gains and income, and with relief given against capital losses.(3) This reduced the premium attaching to low coupon stocks, and reduced the variance of stocks around the yield curve. Apart from some simplifications, the present taxation arrangements will continue to apply to individuals and trusts.

- A further important tax reform is that when an official stripping facility is introduced, coupon interest will be paid gross of tax on the strippable gilts.

- Further details of the new tax regime were announced in the November 1995 Budget, and the provisions were set out in the Finance Bill.

Central Gilts Office

- Improvements to the CGO during 1995 included measures to deal with gilt repo:

(1) See the note on the gilt repo market on pages 325–30 of the November 1995 *Quarterly Bulletin* which outlines the key features of these documents. Copies of the package are available from Ms Michelle Morris, Gilt-Edged & Money Markets Division, Bank of England, Threadneedle Street, London, EC2R 8AH.
(2) A manufactured dividend is a cash payment made to a counterparty in place of the *real* dividend payment that the counterparty would have received from the government if it had still been registered as holding the stock on the ex-dividend date.
(3) See the box on ‘Changes to the taxation of gilts and the development of an official strips market’ on page 228 of the August 1995 *Quarterly Bulletin.*

- Operational capacity has been substantially increased, with upgraded hardware, to cater for a possible increase in volumes consequent upon repo.

- The CGO operational timetable has been extended at both ends of the day, to allow members more time for inputting and to facilitate the use of gilt repo as a money market instrument.

- The CGO service is being kept under review as the repo market develops.

● On 24 November, the Bank announced that three international centralised securities depository institutions would be members of the CGO and offer settlement and custody services from 4 March 1996: Bank of New York, Cedel Bank and Euroclear.

● The Bank also announced on 24 November that CGO would be upgraded by the early part of 1997, using CREST software. In parallel, the Bank announced that it would be reviewing with all market participants and other interested parties the strategic requirements for payment and settlement systems for financial markets in the United Kingdom as a whole and that, with this in mind, the Bank would keep open the option of merging the two settlement systems.

Index-linked gilts

● On 14 and 15 September 1995, the Bank of England hosted a conference on the development of the index-linked market. It brought together end-investors, market-makers, academics and government issuers from a number of countries to discuss the role of index-linked debt in the framework for government debt issuance, the market structure for index-linked debt, and techniques for extracting information on real interest rates and inflation expectations from index-linked debt. The Bank and Treasury papers prepared for the conference are available(1) and are being formally published together with a summary of the conference proceedings.

● The Bank announced on 14 December that, following the September conference, it was consulting the market in detail on the merits and practicalities of establishing a separate list of index-linked market-makers, and of holding a pilot series of auctions of index-linked gilts in the next financial year.

● After reviewing various other ideas discussed at the conference, the Bank announced that the authorities had no plans to introduce Limited Price Index (LPI) gilts or earnings-linked gilts for the time being.(2) This reflected, amongst other things, the uncertain scale of demand for such products and the potential adverse impact on the liquidity of index-linked gilts. These issues will be kept under review.

The various developments to the gilt market described above fall into three main categories: measures to increase transparency and predictability of issuance methods; steps, such as repo, to promote the liquidity and efficiency of the secondary market; and enhancements to gilt-edged stock as an investment instrument, through the availability of a strips facility, for example. Many of these developments are being facilitated by important changes to the tax system and enhancements to gilt settlement services. The overall objective is to help reduce the government's long-term financing costs.

Gilt yields in 1995

Over the course of 1995, bond yields declined in the major economies, reflecting a steady reduction in expectations of growth and inflation in many countries (see Chart 1). The yield on the ten-year benchmark gilt started the year at 8.67% and trended gradually downwards, reaching an intra-year low of 7.36% on 6 December and ending the year at 7.41%.

Chart 1
Ten-year government bond yields

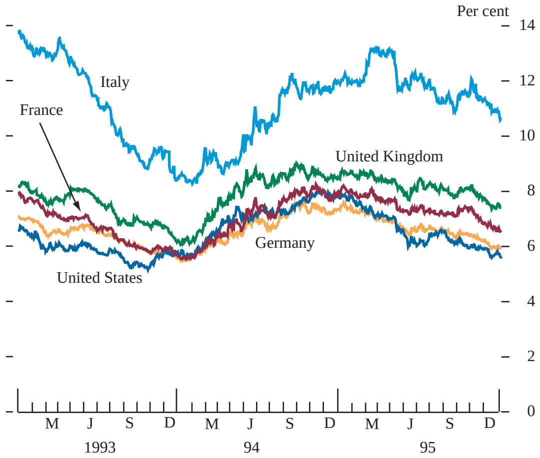


Chart 2, showing the differentials of ten-year gilt yields over US, French and German government bonds, illustrates the intra-period and inter-market volatility that can occur even where a consistent trend across markets is evident over the medium term. The spread of UK yields over the United States widened at the end of June (to a 1995 peak of 230 basis points), reflecting political uncertainties in the United Kingdom and expectations of interest rate reductions in the United States. Gilt prices firmed over the summer as domestic political factors became less important, but faltered in October after the slightly uncovered (ie not all stock was sold) September gilt auction (see below). A well-covered gilt auction in October, coupled with market worries over the US budget process, contributed in the autumn to a narrowing of spreads over US government bonds. Gilt spreads over German and French government bonds exhibited less volatility.

(1) From Ms Michelle Cook, Monetary Analysis, Bank of England, Threadneedle Street, London EC2R 8AH.
(2) LPI bonds would be indexed to the lower of, say, 5% and the Retail Price Index. Earnings-linked bonds would be indexed to a measure of earnings growth.

Chart 2
Ten-year yield differentials of the United Kingdom over the United States, France and Germany

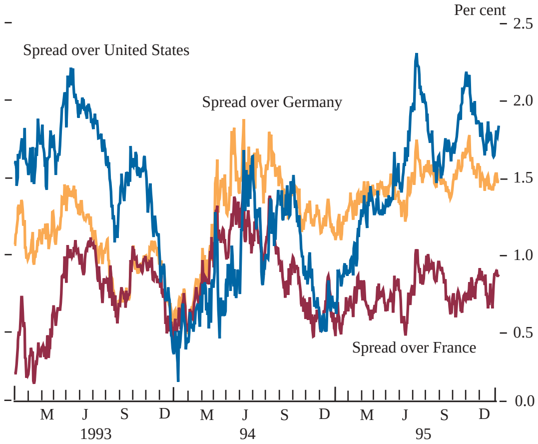
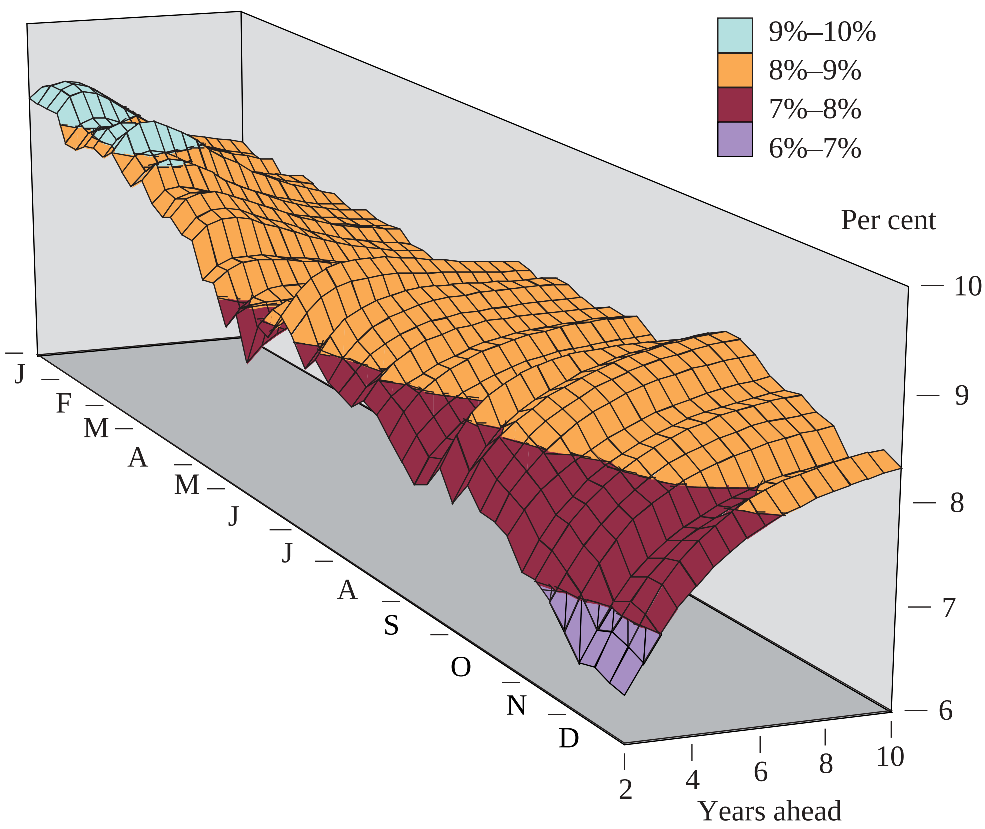


Chart 3
Par yields on British government stocks

Over the year as a whole, gilt yields declined from their autumn 1994 levels, and an upward-sloping curve developed. Chart 3 illustrates how bond market rallies in both 1993 and 1995 were associated with upward-sloping yield curves. (Although the chart uses par yield curves, broadly the same picture is obtained using zero coupon curves.) Chart 4 shows the associated changes in implied forward interest rates. The forward curve ceased to be inverted in late spring, as implied forward rates two to six years ahead fell below implied forward rates further out; the curve became increasingly positive-sloping later in the year.

This change was reflected in an increase in the spread between long and medium par yields, from a low of -38 basis points on 20 June 1994 to being positive in May 1995, and peaking at 32 basis points on 27 October, shortly after the fourth auction in the year of the benchmark

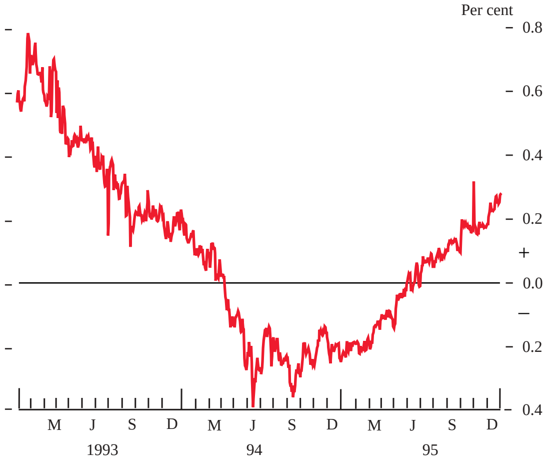
Chart 4
Implied forward interest rates in 1995



This 3D surface illustrates how the implied forward rate curve has evolved week-by-week since the beginning of the year. The shading emphasises the level of forward rates at any given point on the surface. The implied forward rates are annualised six-month interest rates derived from the zero-coupon yield curve.

20-year stock (see Chart 5). This ended a period of inversion at the long end of the yield curve.

Chart 5
Spread between 20-year and 10-year par yields



There are several possible explanations for the changing shape of the yield curve. First and most obviously, the change may have reflected a shift in market expectations of future inflation and interest rates. It is also possible that the greater scale of issuance of 20-year stock during calendar 1995 compared with 1994 contributed to the development of an upward-sloping yield curve. A further possibility is that other factors contributed to the change, such as the reduction in volatility, making the convexity properties of longer maturity bonds less valuable.[1]

Chart 6 shows implied bond market volatility in some of the major markets. It was on average much lower in all markets in 1995. In addition, the apparent correlation between implied volatility in the UK and German government bond markets was much greater in 1995 than in the previous two years, and the levels were more comparable.

Chart 6
Implied bond market volatility

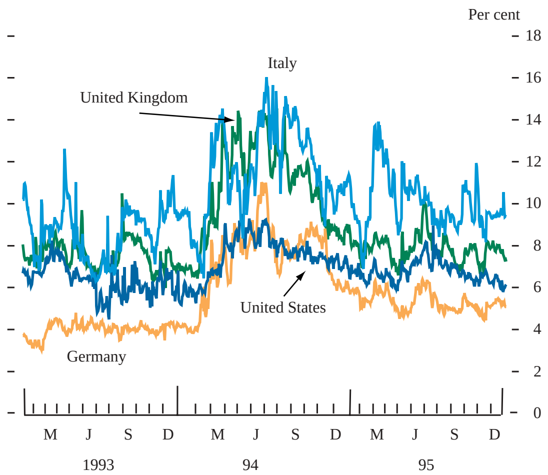
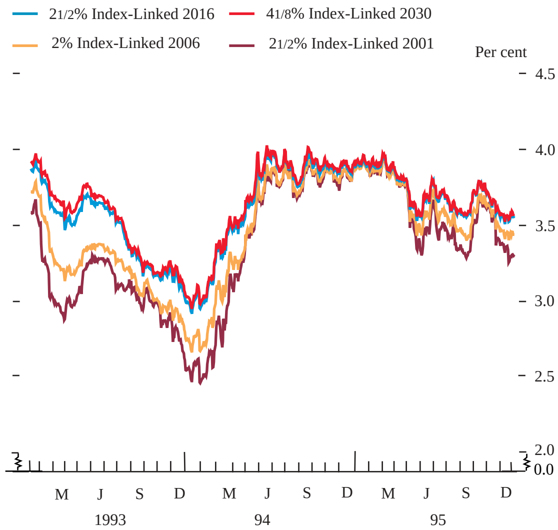


Chart 7 suggests that the real yield curve became positive in 1995. Yields on different maturities of index-linked stocks tended to diverge in 1995 compared with 1994.

Chart 7
Real yields on British government stocks



Gilt-edged funding requirement

In the funding remit to the Bank for 1995/96,[2] the PSBR was forecast at £21.5 billion, with a gilt funding requirement of £23.1 billion, including £4.1 billion to re-finance maturing gilts. The Treasury's Summer Economic Forecast increased the forecasts to £23.6 billion and £25.8 billion respectively. In the November 1995 Budget, the PSBR was again revised upwards, to £29.0 billion, and the gilt funding target was increased to £31.1 billion, including a larger underfund from the previous year.[3] On the following morning the Bank announced that, as a result of the changes, the remit had been revised and that a further gilt auction would be held in February 1996, bringing the total number of auctions in the financial year to nine.

Stocks issued

There were gross sales to the market of £27.4 billion of stock in calendar 1995, of which £7.1 billion was made in the first calendar quarter of 1995, and the remaining £20.3 billion in the current 1995/96 financial year.

The remit provided for the Bank to aim to make approximately 15% of sales in 1995/96 in index-linked stocks, with the remainder in conventional stocks in

(1) Convexity shows the curvature of the price-yield relationship and is, broadly, the rate at which the price sensitivity of a bond with respect to yield changes with yield, ie the second derivative of price with respect to yield. During 1995, gilt market volatility (as measured, for example, by the implied volatility of gilt options) was lower than in the previous year; implied volatility is calculated from at-the-money options prices and measures the expected degree of price movements in the underlying security for the remaining life of an option, and so is an indicator of uncertainty about future bond prices. Implied volatility averaged 7.9% in 1995, down from 10.7% in 1994. When volatility is low there is, in principle, less of a premium attached to bonds with high convexity, (the prices of which in principle rise by proportionately more in a rally than they fall when the market is falling). Twenty-year current coupon gilts have relatively high convexity, so the diminishing attractiveness of this property may have contributed to the fact that 20-year gilt prices did not rally as strongly as 10-year gilts towards the end of the year.
(2) Published by HM Treasury on 30 March 1995 and reproduced on pages 134–35 of the May 1995 *Quarterly Bulletin*.
(3) At the end of the 1994/95 financial year, the amount of underfunding was £1.4 billion, although it was not possible to finalise this figure until November 1995.

approximately equal proportions of one third each of short, medium and long maturities (3–7 years, 7–15 years and over 15 years respectively).

The Bank continued to build up, in a range of maturities, large, liquid issues which the market uses as benchmark stocks. Seven of the nine auctions during 1995 added to existing stocks. Two new stocks were created in 1995: a 20-year benchmark was created at the beginning of the year and auctioned on three subsequent occasions; and in auctions in the latter part of the year a 10-year benchmark for 1996 was created and built up. All conventional stocks issued by auction and by tap in 1995 paid coupon interest free of tax to overseas holders on application.

Method of stock issuance

Auctions formed the primary means of funding in 1995, continuing the trend of recent years. Nine auctions were held in calendar 1995; three in the first quarter and the remaining six in the current financial year. As noted above, three auctions are being held in the final quarter of 1995/96.

Table A gives auction details for 1995. The auction amounts ranged from £2 billion to £3 billion, as provided for in the remit. A total of £22.0 billion of stock was issued at auction, accounting for 93% of conventional issuance in 1995, and raising £21.3 billion. The average level of cover was 1.65 times, marginally below the average for the previous calendar year. The January auction of the 20-year benchmark was well-received, with no tail (see note to Table A), as was the February auction of the ten-year benchmark. The March auction added a further £2 billion to the 20-year benchmark stock in somewhat difficult market conditions.

Table A
Auction results

Stock title	Status	Amount of issue £ billions	Date of auction 1995	Average yield per cent	Times covered	Tail (a)
8% 2015	New	2.0	25 Jan.	8.58	1.79	—
8½% 2005	Fungible	2.0	22 Feb.	8.72	2.08	—
8% 2015	Fungible	2.0	29 Mar.	8.40	1.24	2
8% 2000'A'	Fungible after 5 days	2.0	26 Apr.	8.30	2.17	—
8½% 2005	Fungible	2.5	29 June	8.42	2.00	—
8% 2015	Fungible	2.5	26 July	8.33	1.42	1
7½% 2006	New	3.0	27 Sept.	8.02	0.99	7
8% 2015'A'	Fungible after 6 days	3.0	25 Oct.	8.33	1.997	—
7½% 2006	Fungible	3.0	6 Dec.	7.45	1.12	11

(a) The difference in basis points between the average yield and the highest yield at which bids were allotted.

The first auction of the new financial year in April was an 'A' tranche of the five-year benchmark stock, merging with the parent stock in the ex-dividend period five days after issue: a fungible issue may have been unattractive to investors not wishing to receive a large amount of accrued interest. The auction scheduled for June was put back one day to give the market time to digest the Summer Economic Forecast published by the Treasury on 28 June. The auction of the long benchmark at the end of July was well bid following the end of a period of political uncertainty early in the month with the Prime Minister's re-election as leader of the Conservative Party.

The September auction of £3 billion of a new ten-year benchmark for 1996 was the first gilt auction to be uncovered (albeit only very marginally so), and the tail of seven basis points was the longest then recorded. Notwithstanding the market turbulence in which the auction took place, it was disappointing that 'when issued' trading in the run-up to the auction, which is normally seen as an effective mechanism for price discovery, failed to find a level at which the auction would clear.

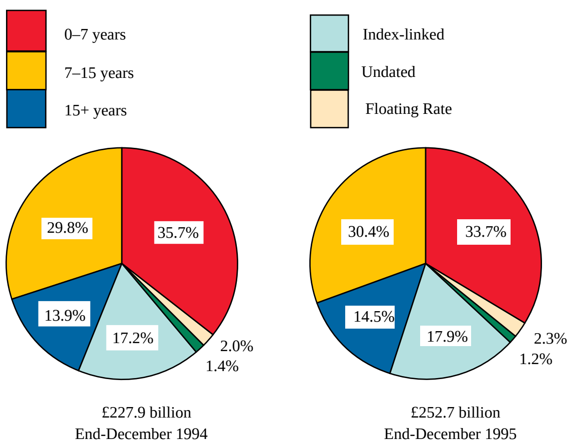
The October auction of the long benchmark, issued as an 'A' tranche for the same reasons as the April auction stock, was all but twice covered with no tail. The early December auction was held after the Budget but ahead of the thin trading that tends to precede the Christmas break. Despite an auction of German bunds being held on the same day as the gilt auction, the auction was fully covered. The record tail of 11 basis points, however, indicated a wide dispersion of bids, and again led to questions about the effectiveness of price discovery in the 'when issued' period.

The remaining £6.1 billion of gross sales of stock was sold to the gilt-edged market-makers (GEMMs) for onward sale to the market. Ten tap packages were brought during the year; four were of index-linked stock only, four were of a combination of index-linked and conventional stock, and two packages were taps of the floating-rate gilt together with index-linked stock. Before the release of the Inland Revenue consultative paper on tax reform in late May, the authorities refrained from issuing index-linked stock into a strong market rally because of the possibility that the forthcoming tax announcement could create uncertainty in the market.

Stock outstanding

The total nominal value of gilt-edged stock outstanding (including the inflation uplift on index-linked stocks) rose from £227.9 billion at end-1994 to £252.7 billion at end-1995 (and from £211.8 billion to £233.2 billion excluding the inflation uplift). Chart 8 shows the

Chart 8
Maturity breakdown of stock outstanding



breakdown of stock outstanding (at nominal prices including inflation uplift) for all gilts at end-1994 and end-1995.

The proportion of short:medium:long conventionals changed from 45:38:17 at the end of 1994 to 43:39:18 at the end of 1995, reflecting the greater issuance of mediums and longs than shorts during the calendar year. Over the same period, the modified duration of conventionals outstanding (excluding small stocks) rose slightly to 5.51 years (see Table B).

Table B
Modified duration(a) of conventional gilts

	End-1994	End-1995
Shorts (0–7 yrs)	3.09	2.78
Mediums (7–15 yrs)	6.50	6.60
Longs (>15 yrs)	9.10	9.43
Total conventionals	5.42	5.51

(a) The 'duration' of a bond is the weighted average of the time to each of its cash flows, where the weights are the present values of each of the payments as a proportion of the total present value of all the cash flows. 'Modified duration' is an adaptation of this to give the price sensitivity of a bond to changes in its yield.

Details of the last annual survey of gilt holdings, showing sectoral holdings of gilts, were published in the Bank's 'Gilts and the Gilt Market: Review 1994–95'. The next survey of holdings, as at end-1995, is currently under way.

Table C shows the 18 stocks of which there was £5 billion nominal or more outstanding at the end of 1995. This compares with 14 such stocks at the end of 1994, and with only three such stocks three years ago, reflecting the policy of developing benchmark issues. Further, there are now four stocks with over £8 billion outstanding, up from two at the end of 1994; the 1995 long benchmark exceeds £9 billion. The combined nominal value of the 18 largest stocks at end-1995 totalled £122.4 billion, constituting 60% of total conventional stock outstanding.

Table C
Large-issue stocks at end-1995

Stock	Original issue date	Nominal amount outstanding (£ millions)
8% 2015	26 January 1995	9,500
8 1/2% 2005	29 September 1994	8,900
8% 2003	3 December 1992	8,600
7 1/4% 1998	23 October 1992	8,150
7% 2001	29 July 1993	7,750
8 3/4% 2017	30 April 1992	7,550
8 1/2% 2007	16 July 1986	7,397
6% 1999	28 October 1993	6,600
9 3/4% 2002	15 August 1985	6,527
6 3/4% 2004	30 September 1993	6,500
8% 2013	1 April 1993	6,100
7 1/2% 2006	28 September 1995	6,000
Floating Rate 1999	31 March 1994	5,700
9% 2008	11 February 1987	5,621
8 3/4% 1997	9 October 1969	5,550
9% 2012	7 February 1992	5,360
9% 2000	3 March 1980 (a)	5,358
9% 2011	12 July 1987 (a)	5,273

(a) Date of creation, on conversion from other stocks.

Turnover in the gilt market

Chart 9 shows turnover in gilts on the London Stock Exchange by value, while Chart 10 shows the number of bargains. Both charts show total turnover and customer turnover, the difference between the two being trades among market principals. As can be seen, turnover levels are driven by customer activity, with core market activity remaining broadly constant over time. It is possible that this relationship may be affected by the start of the gilt repo market in January 1996. Although gilt repo trades will not themselves be reportable to the Exchange, the interaction of the gilt repo and cash gilt markets may lead over time to behavioural changes in the cash gilt market.

Chart 9
Average daily turnover: value

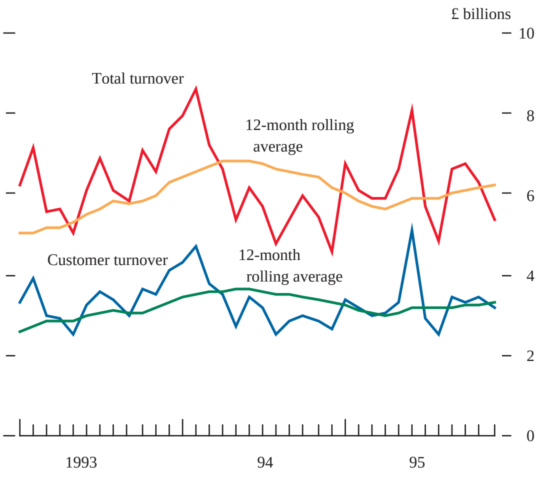
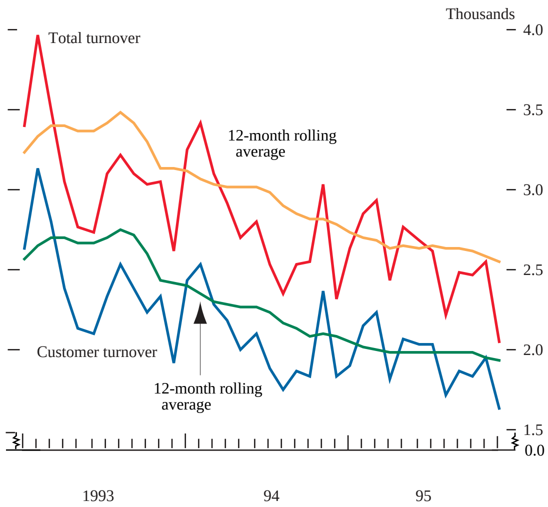


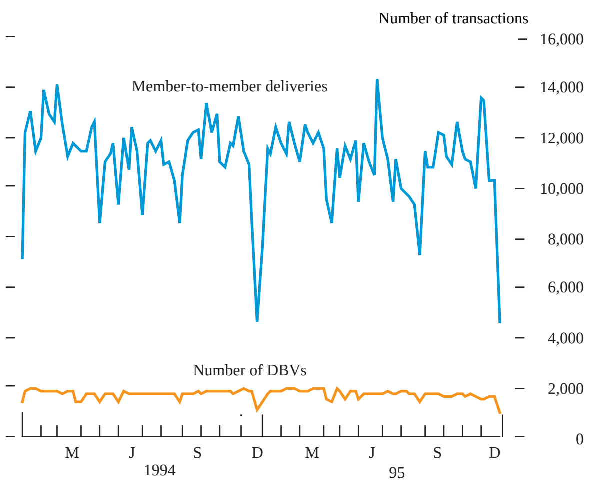
Chart 10
Average daily turnover: bargains



The two charts show that turnover by value rose slightly in 1995, after having declined during the difficult market conditions of 1994, while the number of bargains struck continued to trend marginally downwards as average bargain sizes increased. Over 1995 as a whole, average daily turnover was £6.2 billion, little changed from £6.1 billion in 1994. The average number of daily transactions declined from 2,800 in 1994 to 2,600, while the average size of customer deal rose from £1.5 million to £1.7 million. The increase in the average bargain size corresponds to market perceptions of a trend toward larger lot trades. Most of the increase in turnover by value occurred during June 1995 and was tax-related. It was accounted for by 'bed-and-breakfasting' of gilts, where a gilt is sold and repurchased by the same investor, normally on the same day. These trades were undertaken on a large scale by many institutional investors in June to ensure that they would minimise any tax liability arising on their gilt holdings, regardless of the outcome of the Inland Revenue's consultations on proposals for tax reforms (see above).

Data on work volumes in the Central Gilts Office, the settlement system for gilts run by the Bank, are shown in Chart 11. This shows that deliveries of specific stock from one CGO member to another (member-to-member deliveries)(1) were on a very slight downward trend during the year. This is consistent with Stock Exchange turnover data, as the CGO data show the number of transactions rather than their value. Delivery-by-value trades (DBVs) are the transfer of unspecified gilts of a specified value; a mechanism frequently used to provide general collateral against loans of specific gilts, or to finance long positions in gilts. The number of DBVs declined marginally during 1995. It is possible that the volume of transactions in CGO will increase during 1996, following the introduction of gilt repo trading.

Chart 11
CGO weekly volumes



After a surge during the 1994 bear market, stock lending stabilised in 1995 close to the new levels. The average level of stock lending fell slightly from £12.7 billion in 1994 to £12.0 billion in 1995. The low for the year was £10.4 billion in early September. Since the beginning of the open gilt repo market in January, stock lending no longer has to be channelled through Stock Exchange money brokers, and the Bank will therefore no longer be able to obtain comprehensive data on stock lending. The Bank has asked the major market participants to provide data on the scale of their gilt stock lending and repo activity, with a view to publishing aggregated data in due course.

Although turnover in gilt derivatives on LIFFE, the London International Financial Futures and Options Exchange, declined during 1995, as shown in Chart 12, this reflected more the extraordinary surge in volumes in February 1994, when the market fell sharply, than any decline in underlying interest in derivatives contracts. During 1995, turnover in futures averaged 54,000 contracts a day, down from 76,000 a day in 1994, but still 16% above the average for 1993. Turnover in options showed a more subdued pattern, with average daily turnover down 26% on 1994, and down 15% on 1993, at 7,000 contracts. It is possible that the removal of restrictions in January 1996 on shorting the market will have implications for the pattern of trading in gilt derivatives and for the interaction of derivatives with the cash market.

Chart 12
LIFFE gilt derivatives: number of contracts

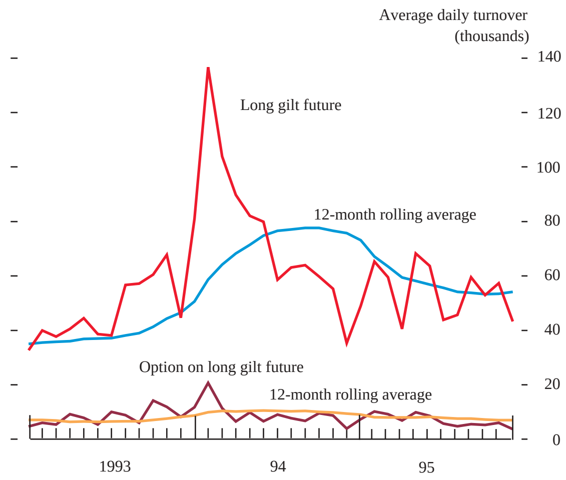
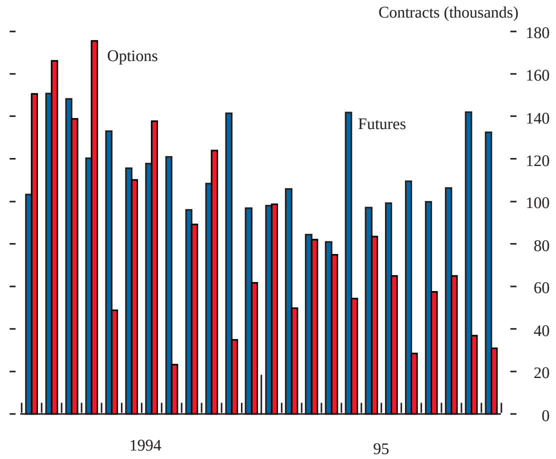


Chart 13
Open interest on LIFFE in futures and options



GEMMs' financial performance

Building on the gains that resulted from a strengthening gilt market in the final quarter of 1994, the GEMMs returned to profit in 1995 having made operating losses in 1994. Their

(1) A member-to-member delivery is a delivery of a specified nominal amount of a specified stock from one CGO member to another through the CGO system.

financial performance was particularly strong in the first half of 1995. As in previous years, performance varied markedly between individual GEMMs. A profit was reported by nearly half the GEMMs that were active throughout 1995. The GEMMs in aggregate returned a profit in every quarter apart from October to December, with the strongest results being in the second quarter. The profit figures of the GEMMs in Table D do not fully reflect group income from gilt business; for example, related business, such as hedging positions and arbitrage trading, is often booked elsewhere in the group.

Table D
Capitalisation of gilt-edged market-makers

£ millions

	Oct. 86–End 1990	1991	1992	1993	1994 (a)	1995 (b)
GEMMs' capital at beginning of period (c)	595	395	432	511	734	812
Net injections or withdrawals of capital	-38	-12	15	164	138	-13
Operating profits (+)/ losses (-) (d)	-162	49	64	59	-60	13
GEMMs' capital at end of period	395	432	511	734	812	812

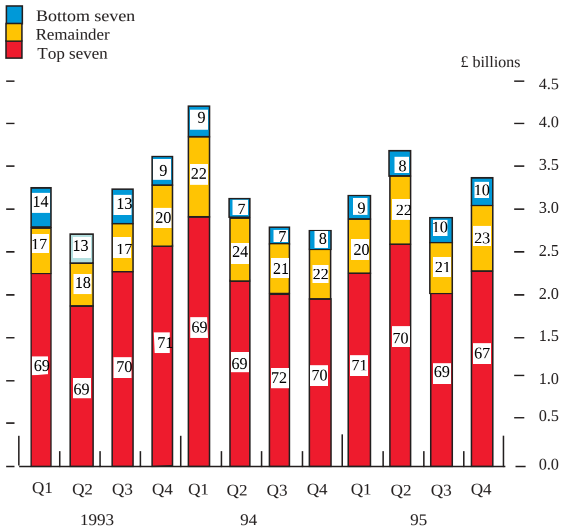
(a) Data for 1994 have been revised.
(b) Data for 1995 are provisional.
(c) Capital base, as set out in the Bank of England's 'Blue Paper' ('The future structure of the gilt-edged market') published by the Bank in 1985 and reproduced in the June 1985 *Bulletin*, pages 250–87.
(d) Net profits/losses after overheads and tax.

During 1995, there was one new GEMM and three departures, leaving a total of 20 GEMMs at the end of the year. Retained profits of £13 million, reflecting the stronger financial performance in 1995, offset net capital withdrawals of £13 million; the amount of capital dedicated to the gilt market was unchanged from the previous year at £812 million at the end of 1995.

Approximately £30 billion of business in index-linked gilts was transacted by the GEMMs in 1995. Although this business was little changed between 1994 and 1995, the number of players with more than 5% of index-linked business increased from five to eight, helping to open up the market. The combined share of the top five GEMMs in index-linked business fell from 91% in 1994 to 76% in 1995. Spreads contracted, and market liquidity in index-linked was generally regarded as being somewhat improved.

Chart 14 shows GEMMs' retail trade with clients and agency brokers.[1] The total share of the top seven firms was unchanged at approximately 70%. Although the firms comprising the top seven remained unaltered, their rankings changed: only two of the top seven firms held the same position in 1995 as in 1994.

Chart 14
Distribution of GEMMs' retail turnover[a]



(a) Figures shown in the columns are the percentage shares of each group of GEMMs.

Summary

During the last year trading conditions for gilts were less turbulent than in either 1993 or 1994. The underlying structure of the market functioned well, and the GEMMs continued to fulfil their role in providing liquidity. A series of important reforms to the market were implemented or were announced for future implementation. Open gilt repo trading commenced smoothly on 2 January 1996. Further changes to the structure of the gilt market due to be implemented in 1996/97 include major tax reforms in April 1996, the introduction of an upgraded CGO service, and a gilt stripping facility. Other possible reforms, including those to the index-linked market, remain under review as part of the on-going development programme for the gilt market, designed to help reduce the government's long-term financing costs.

(1) This measure of 'retail' does not include trade with inter-dealer brokers, direct trades with other GEMMs nor trades with the Bank. In order to offer a better comparison between companies engaged in very similar business activities, the data exclude the two small-deal specialists, which conduct a large number of relatively low-value trades.