
The gilt-edged market: the Bank of England's relationship with the gilt-edged market makers and inter-dealer brokers

The Bank of England announced in December 1996 that it would no longer require the gilt-edged market makers (GEMMs), its counterparties in the gilt market, to be separately capitalised firms. This change, which took effect from 3 March 1997, allows firms to merge their specialist gilt-edged market-making subsidiary into their main operating entity if they so wish. The Bank's counterparties must, however, continue to satisfy a range of obligations. These obligations and the facilities available to market makers are set out in the following paper. The paper also covers the role in the gilt market of the inter-dealer brokers, who provide a service to the GEMMs and continue to be subject to supervision by the Bank.

This paper sets out the Bank of England's relationship with the gilt-edged market makers (GEMMs) with which it transacts business and describes the arrangements that apply to the inter-dealer brokers (IDBs) operating in gilts. It replaces the description of the arrangements set out in the Bank's paper of April 1985 ('The future structure of the gilt-edged market') and subsequent market notices, and reflects the ending of the requirement for separate capitalisation and the associated arrangements for prudential supervision of GEMMs by the Bank. The arrangements are subject to review and modification in the light of experience.

I Gilt-edged market makers

The liquidity of the gilt-edged market continues to be underpinned by the presence of competing market makers which undertake to make, on demand and in any trading conditions, continuous and effective two-way prices in gilts at which they stand committed to deal.

The Bank will consider applications from firms that wish to offer a gilt-edged market-making service and enter into a counterparty relationship with the Bank in gilts. Applicants must be able to satisfy the obligations set out below and must be members of the Securities and Futures Authority (SFA). To ensure that the core of the gilt-edged market is subject to Stock Exchange trading rules, applicants must also be subject to the rules of the London Stock Exchange for their gilt business. Details of the application process are provided in Section IV of this paper.

Acceptance by the Bank as a GEMM does not qualify an institution to participate in the Bank's money-market operations. Those who wish to be considered as money-market counterparties and who believe they meet the requirements are invited to contact the Head of the Gilt-Edged and Money Markets Division of the Bank.⁽¹⁾

Obligations

Firms are accepted by the Bank as GEMMs if they agree to meet a number of obligations on a continuous basis. The

aim of these obligations is to ensure that GEMMs contribute to the liquidity of the secondary market and provide appropriate support to the primary issuance of government debt. The obligations are as follows:

(a) Market making

The basic obligation of GEMMs is to make, on demand and in any trading conditions, continuous and effective two-way prices in gilts at which they stand committed to deal, in appropriate size as discussed in advance with the Bank, thereby providing continuous liquidity for the investing public.

The Bank will monitor closely each GEMM's performance against its undertaking, taking account of the role it plays in the market, based on data provided by the GEMM and continuing discussions with management; failure to live up to that undertaking would ultimately result in the ending of the relationship with the Bank and the termination of the associated facilities. The essential purpose of this obligation, which is mirrored in the rules of the London Stock Exchange, is to ensure that GEMMs provide, in all trading conditions, a market-making service to users of the market generally, rather than providing a dealing service that is largely confined to a narrow group. In assessing whether a GEMM is providing a service to the market in general, the Bank may also take into account the degree of distinction between the firm's market-making activity and the activity of other non-market-making proprietary trading areas in the same group and the relative scale of activity in these areas.

The market-making obligation described above applies specifically to gilt-edged stocks. The Bank encourages those accepted as GEMMs to make markets in as wide a range of listed sterling debt securities as possible. GEMMs are expected to make markets in *all* gilts, including conventionals, index-linked and floating-rate gilts. Although it is recognised that the depth of liquidity is currently less in index-linked than conventional issues, GEMMs should stand

(1) Gilt-Edged and Money Markets Division, Bank of England, Threadneedle Street, London, EC2R 8AH. Further details of the arrangements for money-market operations are given in the Bank's paper 'Reform of the Bank of England's operations in the sterling money markets', issued in February 1997 and in Operational Notices which may also be obtained from this address, or by telephone on 0171-601 3604.

ready to make prices and, over time, to demonstrate an appropriate level of participation in index-linked market activity. Once the gilt stripping facility is introduced, GEMMs will be expected to make a market in strips as part of their general market-making obligations. In assessing the fulfilment of the market-making criterion, the Bank will take special account of the position of those GEMMs that serve smaller investors and their brokers.

(b) Participation in primary issuance

Although there are no formal underwriting arrangements for gilts, the Bank expects all GEMMs, as part of their commitment to the market, to participate actively in gilt issuance via auctions and taps and, in particular, to bid on a competitive basis at auctions.⁽¹⁾

The Bank allots auction stock to individual bidders at its absolute discretion. In particular it may decline to allot stock to an individual bidder if it appears that to do so would be likely to lead to market distortion. As a guideline, successful bidders should not expect to acquire for their own account at auction more than 25% of the amount on offer. In applying this guideline to a GEMM, the Bank will take account of sales to clients and to other GEMMs, whether made directly or via the inter-dealer brokers. ‘Own account’ will be taken to include the position of the group as a whole, not just the market-making business, with the exception of any Chinese-walled entities. The Bank will discuss the coverage of this guideline on a case-by-case basis with the GEMMs.⁽²⁾

(c) Provision of data to the Bank and acceptance of the Bank’s monitoring arrangements

The Bank expects GEMMs to provide it with relevant information on gilt-market developments regularly, both via contact with the Bank’s dealing room and through periodic meetings with the management of each firm.

GEMMs are also expected to provide statistical data to the Bank. The Bank’s interests in collecting these data are two-fold: first, to monitor general market conditions; and second, to monitor the compliance of GEMMs with their obligations. The Bank provides detailed reporting specifications to GEMMs as part of the application process and updates them as necessary. In brief, they cover: a GEMM’s daily gilt positions and futures and options business; ‘when issued’ trading and auction positions, including large customer business; weekly turnover statistics; and a bi-annual summary of profit and loss and capital.

As the market-making activity may be part of a wider business, the Bank will discuss with each of its counterparties the extent of the business which should be reported under these arrangements.

The Bank expects GEMMs to have appropriate systems to be able to provide the specified data on a continuing basis. Such systems, and the reports they generate, should be subject to review on a periodic basis by a GEMM’s internal audit function.

GEMMs that are active in gilt repo are also required to contribute to the Bank’s quarterly statistical survey of the gilt repo market.

The Bank will liaise with the SFA, the London Stock Exchange and other authorities responsible for the regulation of the GEMMs. Information held or received by the Bank under the arrangements described in this paper may be used or disclosed by the Bank for the purposes of any of its functions and may be disclosed to any supervisory authority to enable or assist that authority to discharge its functions.

The facilities available to GEMMs

To assist those market participants that are willing to take on the market-making obligations, and that demonstrate the capacity to do so, the Bank will offer the following facilities. These facilities are not available to other participants in the gilt market.

(a) Dealing relationship with the Bank

As part of its operations in the primary and secondary markets, the Bank is prepared:

- to receive *telephone bids in auctions* from GEMMs, on their own behalf or for clients, direct to the Bank’s dealing room;
- to receive bids from GEMMs for any gilt sales offered by *tap*;
- to receive bids from GEMMs at any time between 9.00 am and 5.00 pm for any stock that the Bank may have in its portfolio and that has been made available for resale via the ‘*Shop Window*’. It is entirely at the Bank’s discretion whether or not to accept bids;
- to bid a price of its own choosing for *stock with three months or less to maturity* offered to it by GEMMs;
- to bid a price of its own choosing for *index-linked stock* offered to it by GEMMs;
- at its discretion to undertake *switches of stock* proposed to it by GEMMs. The Bank will normally undertake switches only between stocks of the same type (eg conventional, index-linked, floating-rate) and maturity area; and
- to bid a price of its own choosing for stock where the amount in issue is too small for a two-way market to

(1) The GEMMs can also each make a single non-competitive bid at auctions up to limits specified by the Bank.

(2) See the Bank’s Operational Notice ‘Official Operations in the Gilt-Edged Market’ issued in June 1996.

be expected to exist (eg the *rumps of certain stocks* that have previously been subject to conversion offers).

Further details of these facilities are set out in the Bank's Operational Notice, 'Official Operations in the Gilt-Edged Market', issued in June 1996.

(b) Access to inter-dealer brokers

A number of competing inter-dealer brokers (IDBs) provide dealing facilities in gilts between the GEMMs. The essential purpose of these arrangements is to enable the GEMMs to unwind stock positions that arise from their market-making activities with investors or their agents. Access to the gilt IDBs is available only to the GEMMs. Under London Stock Exchange rules, GEMMs may make information received from the IDBs available only to those staff directly engaged in meeting the market-making obligations of the GEMM. This includes the gilt sales force.

The Bank monitors the working of the IDB arrangements on an ongoing basis.

(c) Stripping and reconstitution facilities

Following the introduction of the gilt stripping facility (planned for autumn 1997), any member of the Central Gilts Office (CGO) will be able to hold strips in the CGO. The facility to strip and reconstitute gilts will, however, be available only to GEMMs. GEMMs will be expected to make a market in strips as part of their general market-making obligations.

GEMMA reference prices

As part of an initiative by GEMMA (the Gilt-Edged Market Makers Association), the GEMMs submit their closing prices in gilts to the Bank each day. The Bank collates the information and publishes an average price for each stock on the wire services. These prices (the reference prices) are used in the CGO system for valuation purposes and by the market as a whole. On behalf of GEMMA, the Bank reviews periodically the accuracy and timeliness of each GEMM's contribution to these prices.

II Inter-dealer brokers

As explained above, the arrangements under which a number of competing IDBs provide dealing facilities to the GEMMs have an important role in contributing liquidity to the gilt market.

IDBs are expected to provide a service to the GEMMs as a whole, and not to be confined to a narrow group. The Bank seeks to satisfy itself on a continuing basis that each IDB is fulfilling that requirement.

The Bank is prepared to consider an application from a firm provided that it can demonstrate that:

- it has the capacity—in terms of capital and of management and operational resources—to perform this function; and
- a broadly based demand for its services exists among the GEMMs.

Where an IDB has ownership links with a GEMM or broker dealer, competitive pressures may make it more difficult for it to demonstrate the necessary broadly based demand for its services among the GEMMs. The Bank would not, however, rule out such links.

The form of the Bank's prudential supervision of the IDBs and the information the Bank needs for that purpose are described in more detail in the Annex to this paper. A definitive description is also available in the Bank's Blue Folder—'Supervisory arrangements for core participants in the gilt-edged and money markets'.⁽¹⁾

III Settlement

The CGO provides a computerised book-entry transfer system for the secure and efficient settlement of transactions in gilts. An upgraded system is to be introduced during 1997 which will facilitate the settlement of gilt repo and strips and incorporate a number of new features including more flexible membership and account management arrangements.

Membership of the CGO is open to all gilt market participants. To ensure that full use is made of the protection offered by the CGO assured payments system, the Bank requires all GEMMs and IDBs to be members of the service.

Under current CGO arrangements GEMMs and IDBs must be direct members of the system. Once the CGO upgrade is introduced, different membership structures will become available including, in particular, the possibility of sponsored membership. The Bank expects that, in many cases, GEMMs will wish to remain direct members of the system, so as to retain full control over the timing of the settlement of their trades. There is no objection to a GEMM sponsoring the membership of other group companies. The Bank is also content for a GEMM itself to become a sponsored member subject to assurances that the ability of the GEMM to settle its business will not be compromised. In particular, the Bank expects that a GEMM:

- will have agreed with its potential sponsor that the GEMM will have priority access to the sponsor's facilities whenever necessary;
- is otherwise satisfied that any timetable constraints involved in the use of the sponsored membership route will not inhibit the GEMM from fulfilling its role as a provider of liquidity to the gilt market; and

(1) Available from the Capital and Wholesale Markets Division, Bank of England, Threadneedle Street, London, EC2R 8AH, or by telephone on 0171-601 4682.

- has adequate contingency arrangements for access to the CGO in the event of a systems failure by the sponsoring member.

A GEMM will probably find it easier to meet these requirements if the sponsoring member is itself a group company, but that is not a requirement.

IV Application process

An important objective of the Bank's arrangements is to promote competition among GEMMs and among IDBs. To that end, the Bank encourages participation in the gilt-edged market by all those who are able to demonstrate adequate capacity to perform the functions described in Sections I or II.

The Bank is prepared to accept applications from prospective GEMMs or IDBs at any time. Those interested in applying should approach the Gilt-Edged and Money Markets Division of the Bank for preliminary discussions and will be asked to provide certain standard information as the basis for further discussion. In considering an application, the Bank will, where appropriate, liaise with the SFA, the London Stock Exchange and other relevant authorities.

Applications from firms wishing to become gilt IDBs will need to be supported by evidence of a broadly based demand for their services in the form of letters from GEMMs indicating a willingness in principle to use their service.

Annex

Prudential supervision of inter-dealer brokers

This annex explains the role of the IDBs in the gilt market, and describes the framework of prudential supervision that the Bank applies to these firms.

Inter-dealer brokers

The IDBs have an important role in contributing liquidity to the gilt market by allowing GEMMs to unwind, between themselves and on an anonymous basis, stock positions that arise from their market-making activities with investors or their agents. IDBs are expected to provide a service to the GEMMs as a whole, and not to be confined to a narrow group. The Bank seeks to satisfy itself on a continuing basis that each IDB is fulfilling that requirement.

The activities of IDBs, in addition to inter-dealer broking in gilt-edged securities, may include inter-dealer broking in: certain sterling fixed interest, floating-rate interest and index-linked securities, together with a range of Ecu-denominated securities; sterling money-market instruments; exchange-traded futures and options contracts relating to these instruments, together with repo and stock borrowing and lending transactions in the same instruments; warrants on gilt-edged stock; negotiated options on gilts and non-gilt sterling debt securities; and sterling-denominated forward rate agreements and interest rate swaps.

The confidential indications of GEMMs' positions acquired by IDBs in the course of their business means that IDBs are not permitted to take positions in securities or instruments in which they act as IDBs. Moreover, management and staffing of the inter-dealer broking entity must be separated from that of other position-taking entities within a group.

IDBs should be insulated as far as possible from any adverse development in other parts of any group to which they may belong. The Bank requires that IDBs be separately established in a member country of the European Economic Area as companies or partnerships with dedicated capital. The Bank also seeks assurances from substantial shareholders that they accept ultimate responsibility for the liabilities of the firm. An IDB may not, without the agreement of the Bank, have as a partly or wholly-owned subsidiary any other entity operating in financial markets.

IDBs wishing to use closed-circuit screens as a means of communicating with the GEMMs may install their own equipment or they may use the Stock Exchange's Integrated Data Network (IDN) or a commercial service. In any of these cases, they will be required to allow the Stock Exchange authorities to have, for monitoring purposes, access to the prices and amounts they are quoting.

Supervisory arrangements for the IDBs

The Bank requires the IDBs to be members of both the London Stock Exchange and the SFA. This ensures that the IDBs are subject to appropriate rules for the regulation of trading practices and for proper professional standards. The Bank is responsible, with the SFA, for the prudential supervision of the IDBs. The Bank's supervision is complemented by a close familiarity with the business of each IDB, developed by quarterly bilateral discussions. Compliance with the Bank's rules means that those SFA rules relating to financial supervision are largely disappplied from the IDBs. However, the remainder of the SFA rules continue to apply in full, and in particular those relating to the conduct of business. The Bank liaises on regulatory matters with the SFA, the London Stock Exchange, and other authorities, and may in this context exchange information with them to assist them in the execution of their respective regulatory responsibilities.

IDBs are required to accept full responsibility for both sides of each transaction undertaken. They must operate on a matched principal basis at all times and immediately cover positions arising from error or non-delivery. In the case of a delayed delivery of stock purchased by an IDB, the IDB may in turn delay delivery of the stock, but will remain ultimately responsible for it.

As investment firms, the IDBs are required at all times to meet minimum capital requirements, as set out in the EU Capital Adequacy Directive (93/6/EEC). The Bank has established prudential requirements that are superequivalent to CAD. These are set out in the Blue Folder—'Supervisory arrangements for core participants in the gilt-edged and money markets'. The Bank's provisions include an additional capital test for the IDBs, whereby the total value of uncompleted transactions (counting both sides of transactions separately) is restricted to a maximum of 800 times their capital base. This test will, under normal circumstances, deliver a higher level of capital than the minimum CAD requirements. The multiplier test reflects the Bank's view that the main risks that the IDBs run will tend to be proportional to the total amount of their uncompleted transactions. The two main sources of risk are:

- the risk of being held responsible for losses arising from adverse price movements following a misunderstanding with a GEMM. In the event of such a misunderstanding, the IDB must, immediately on discovery, buy or sell the stock as appropriate to eliminate any accidental exposure that has arisen; and

- the risk that, on an adverse price movement, a counterparty fails to complete a transaction to which it had previously agreed. Again, the IDB must, immediately on discovery, buy or sell stock as appropriate to eliminate any exposure that may arise.

However, the Bank recognises that there may be occasional sharp peaks in the market demand for the IDBs' services and it is prepared—exceptionally and under conditions set out in the Blue Folder—to accommodate requests for an IDB to undertake business above the 800 multiplier, subject to the capital remaining at all times above the CAD minimum requirements.

Systems and controls and reporting

The Bank seeks to satisfy itself that IDBs have adequate methods of identifying and controlling the risks they face. In particular, firms are expected to monitor continuously their uncompleted transactions, and to ensure that CAD minimum requirements can be calculated and monitored as necessary.

The Bank requires IDBs to make regular supervisory reports to it, as detailed below. The Bank also requires immediate reporting of any differences arising from misunderstandings with GEMMs as described above, where the loss to the IDB exceeded 10% of its capital, and of any delay in completion of a previously agreed transaction by a counterparty that had not been notified to and agreed in advance by the IDB. In addition to these reporting requirements, the Bank reserves the right to call for supplementary information at any time.

As detailed in the 'Arrangements for supervisory reporting'

for IDBs, firms will be required to make the following electronic reports to the Bank:

(a) Daily reports

- Details of any failed transactions, positions, losses arising from broker error, and unconfirmed trades.
- Auction-related turnover reported during 'when issued' periods.
- CAD capital requirements on request.

(b) Weekly reports

- Details of unsettled transactions, turnover by maturity and transaction type, capital base and usage, and large exposures.

(c) Monthly reports

- Capital base details and profit and loss.

(d) Quarterly reports

- CAD capital requirements and details of any large exposures.

In addition to these electronic reports, the IDBs are expected to submit a full paper-based quarterly balance sheet and profit and loss account, and, annually, copies of: audited financial statements; a reconciliation of these statements to the Bank's quarterly returns; the auditor's report; and the internal control letter to the SFA.