General Discussion*

Commenting on Charles Gaa's last point, Allison Holland asked what happens when, or if, during times of crisis, backup systems such as telephone markets are no longer available. As she had mentioned during the discussion of the delivery of the inter-GEMM mandatory quotes, the market-makers were very keen on retaining a role for the voice brokers. Holland expected the existing IDBs to not only offer an electronic trading system but to also retain their voice-brokering desks, and this might make them more robust to times of market stress and market crises. She said that there is some brief evidence that after 11 September, EuroMTS and BrokerTec in Europe experienced a withdrawal of liquidity even though they continued to operate. They did not meet their purpose of allowing interdealers to manage their inventory risk as effectively as they had prior to 11 September.

Holland then returned to the idea of transparency. She thought that with the direction taken, one would see an increase in transparency in the market, in that some of the dealers who are supplying their prices to the central pool of liquidity will be very comfortable about supplying similar prices to a wider market. This raises questions about who benefits financially from data provision. One of the issues that market-makers in the United Kingdom feel very strongly about is that they own the prices, and if anybody is going to profit from selling these prices to Reuters or Bloomberg or whom-ever, that benefit should accrue to the market-makers.

* Prepared by Christine Bies.

Holland also touched briefly on the idea of direct access that came out of the Audet, Gravelle, and Yang paper. The authors were considering it in terms of allowing the large institutional investors direct access to the IDB segment of the market. Holland mentioned a consultation in 1998, on the role of the IDBs and perhaps extending membership of the IDBs. One of the things that came out very strongly in that consultation was that whether it be large institutional investors or just other wholesale market participants, the market-makers would perceive those players as fair-weather market-makers, and it's perhaps one way to think about modelling this. Basically, the dealers would require some relaxation of their market-making obligations to these new IDB participants. Therefore, from a large institutional investor's point of view, do they get more liquidity by being part of the IDB system (at the expense of losing their committed liquidity provision at other times), or does it make more sense for them to allow the exclusive club to continue but receive the benefit of committed liquidity provisions in the secondary market?

Lawrence Schembri noted that ten specialists in indexed gilts were mentioned in the presentation. He asked if there was any difference in the characteristics of the markets for indexed gilts as opposed to the other ones.

Holland responded that—in common with the situation in Canada—the index-linked market, characterized by the buy-and-hold investors, is even more illiquid than the conventional market. She said that there is very little free-floating stock around, and the activity is concentrated around the auctions, "so there's a peak of activity across all index-linked stocks when we're auctioning an IG, but then it's just deadly quiet, and therefore there's quite a lot of risk for the market-makers." If they're left with an inventory position following an auction, it's very difficult for them to unwind it, and they have to warehouse that position until the next event in the market. It is fair to say that there is quite a heterogeneous approach to inventory-risk management across our market-makers. In the United Kingdom, there are American dealers, European dealers, and U.K. dealers, and their approach is not exactly the same. Some of them definitely have much tighter controls on the exposures they can take and the length of time they can run those exposures. Therefore, they have varying needs for an effective secondary market.

Asani Sarkar spoke of the parallel with the U.S. case. He said that a somewhat similar issue came up in the U.S. government bond market. The response was to form GovPx, a central reporting agency that would report all the quotes—but there was no requirement to have mandatory quotes. Comparing the U.K. situation with that, the British authorities have gone

one step further by having a mandatory quoting procedure. Sarkar was curious to know the thinking behind that.

Holland responded that they did look at the U.S. model, and that one of the advantages the U.S. Treasury bond market has over the European markets is that it is much deeper and much more liquid. She added that it is interesting that there are no market-making obligations on the dealers in the U.S. market. It's a voluntary provision of liquidity, whereas in European markets, there is a mandatory market-making obligation. The U.K. authorities thought that they were closer to the European markets than to the U.S. bond market. EuroMTS, which has been very successful, first in Italy and now in the other European sovereign bond markets, is based on a notion of committed liquidity provision in the interdealer market.

John Murray felt that the perspective suggested by the discussion tended to be very national, rather than international. He said one could imagine an international pool of liquidity: all sorts of governments simultaneously issuing debt, wanting to minimize their financing costs, perhaps not even having the best claim to that lowest financing cost in the broader sweep of things. He asked whether there could be some danger in approaching this in a segmented, national perspective, as opposed to adopting something a little more global. Could there be something missed as each government and each regulator sits down and says "what suits my market?" What brought the issue home to him is the sense in Europe of national markets being forced to consider the broader picture and hoping that something bigger and better emerges. When one talks about numbers of dealers, who should be included—just the ones in one's national market, or those who potentially compete in less direct ways? Murray wondered whether the scope of the discussion is just a little too provincial.

Holland considered this an interesting point. She said that the British would like to encourage more international participation in their market. Their key investor base is domestic, and the market is dominated by the presence of the domestic pension fund and insurance companies. She mentioned the perception of the gilts market, of being a very odd local market with some very odd trading characteristics. She added, however, that she did not believe this to be the case any longer, since the conventions are now quite standard. Holland thought that if anything could be done to encourage the market-makers to be more active in promoting the market to their international clients, then that has to be beneficial, and it is only when heterogeneous investors enter the market that it becomes a much more naturally liquid market. Then one could begin to relax some of the forced liquidity provision mentioned here. She hoped that after a couple of years, the market-making obligations in the interdealer market could be eliminated and that, for instance, the market-makers' concerns about the entry of international dealers into the market could be perceived as more of an opportunity than as a threat (as they currently are perceived because of this very fair-weather market-making).

Walter Engert brought up the paper's statement that the DMO does not have any specific target for the number of GEMMs, but that the author would be concerned if it fell into single digits. He asked what their response would be.

Holland replied that this is obviously something they hadn't thought about very clearly yet, but with a small number of market-makers, they may have a bit too much power in determining what the issuer does. She suggested that if this occurred, direct participation by the institutional investors at the auctions would be considered, moving a little bit away from using the market-makers as the exclusive distribution mechanism. She concluded by saying that it was difficult to predict what other changes might be introduced.