The Development of Alternative Trading Systems in the U.K. Gilts Market: Lessons and Implications*

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Introduction

The use of electronic trading mechanisms has become increasingly widespread in equities markets. They have also become a significant feature of some government bond markets, in particular the U.S. Treasury market, but as yet are not a significant feature of the market for U.K. government bonds, the gilts market.[1]

This paper considers the policy issues that arise from the possible introduction of such systems into the gilts market and outlines the U.K. Debt Management Office's (DMO) policy response to these developments.

1 Gilts Market: Background

1.1 General background

The gilts market is a mature market; the first marketable British government security was issued in the eighteenth century. The current market structure of the gilts market was introduced in 1986, following the "Big Bang"; it has changed little since then.

1. The most recent survey by the Bond Market Association identified 74 systems offering electronic trading services in fixed-income markets.

* The complete version of this paper can be found at www.dmo.gov.uk.

Gilts trade relatively infrequently compared with, for example, the FTSE-100 stocks. There are, on average, over 26 times more trades a day in equities in London than gilts, but the average size of a gilts trade is over 80 times that of an equity transaction. This indicates that trading behaviour in the two markets is significantly different and that structures that work in one market may not work in the other.

1.2 Role of issuer

In April 1998, the DMO took responsibility for the issuance of U.K. government debt. Its key objective is to support the government's aim of minimizing its financing costs, taking account of risk. In addition, it has a strategic objective to maintain orderly and efficient markets and to promote a liquid market for gilts. A liquid gilts market should minimize the government's cost of raising funds by reducing some of the risks investors face, consequently reducing any risk premium that exists on gilts.

The general principles that guide the DMO in its approach to the creation of new trading venues are as follows.

(i) Liquidity and efficiency of the gilts market: The DMO would be concerned if the market became excessively fragmented or if liquidity was damaged significantly.

(ii) Orderly market environment: The DMO wants gilts to be traded in an orderly and regulated environment, ensuring at least some minimum degree of investor protection.

(iii) Entry/exit of gilt-edged market-makers (GEMMs): The DMO's ability to confer or to revoke the primary dealer status of any institution should not be constrained by any external influences.

(iv) Interests of retail investors: The manner in which these new trading venues would affect retail investors' ability to secure best execution and meet their need for transparency are issues that also need to be addressed.

1.3 The role of primary dealers

In common with many other government bond markets, the U.K. gilts market is characterized by the presence of primary dealers, the GEMMs. Due to the trading characteristics of the secondary gilts market, where the majority of investors may not be actively trading every day, there is unlikely to be an even flow of demand and supply of gilts. Therefore, the DMO considers that a system of committed liquidity providers, which bridge the gap between demand and supply, reducing execution risk, is beneficial to the secondary market.

In return for providing this market-making service in the secondary market, the GEMMs have special privileges with respect to auctions. The DMO also carries out a range of other secondary market operations exclusively through the GEMMs.[2]

The issuer also benefits in the primary market from the presence of primary dealers with some obligations to participate in primary issuance. This mitigates governments' event risk arising from adopting a transparent approach to primary issuance.[3] Primary dealers can also provide the issuer with a variety of useful market intelligence and act as an efficient distribution mechanism, facilitating the transfer of stock from the issuer to the end investors.

Overall, the DMO believes that a list of designated primary dealers is advantageous to both the primary and secondary markets. Therefore, it is likely that certain privileges in the primary market will continue (for the foreseeable future) to be linked to the provision of certain services in the secondary market.

There are currently 16 recognized GEMMs in the gilts market.

1.4 Role of gilt-edged interdealer brokers

Another feature of the gilts market is the gilt-edged interdealer broker (IDB) who intermediates exclusively between the GEMMs. Almost all trades between two GEMMs are intermediated by an IDB. These transactions make up approximately 40 per cent of total turnover in the gilts market.[4]

The purpose of the IDBs is to allow the GEMMs to unwind any unwanted positions acquired in the course of their market-making activities, within the closed environment of GEMMs. The IDBs act as principal to all trades, preserving post-trade anonymity. Trade information is kept within the GEMM community and is not disseminated to the wider market.

There are currently three endorsed IDBs in the gilts market.

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2. See "Official Operations in the Gilt-Edged Market: Operational Notice by the U.K. Debt Management Office," November 2001, for full details of these operations.
3. GEMMs are expected to participate actively in auctions and are expected to bid in line with their share of secondary-market trading. In the case of index-linked auctions, there is a target of 3 per cent minimum allotment set for index-linked GEMMs.
4. Based on data reported by the GEMMs for financial year 2000–01.

2 Gilts Market: Electronic Trading

2.1 The changing environment

A number of the GEMMs participate in existing fixed-income electronic trading systems, including interdealer platforms and multiple dealer-to-client systems.

Of themselves, these developments are to be welcomed where they improve the operational efficiency of the market and improve customers' access to liquidity. However, where they risk impairing liquidity at the core of the market, a policy response is warranted.

2.2 Policy response

In January 2000, the DMO published a consultation document that sought views on whether and how it should respond to the possible entry of electronic trading systems into the gilts market.[5] The consultation paper considered a number of different options, consisting of: no change in policy; the introduction of a centralized quotation system; the introduction of a centralized inter-GEMM market with quote obligations; and the introduction of a full electronic dealership market.

Responses were received from a wide range of market participants. The DMO considered these comments and identified its preferred approach in a response document issued in June 2000.

The DMO shared the concern of some respondents that no change in policy could add to the harmful effect of any possible market fragmentation. Therefore, the DMO decided to introduce an inter-GEMM market with mandatory quote obligations. These new obligations will require GEMMs to provide firm quotes to other GEMMs in a small number of benchmark bonds. The provision of mandatory quotes on a near-continuous basis will necessitate the adoption of some electronic trading technology.

This approach is similar to the mandatory liquidity provision common in most European government bond markets. The DMO believes that a central committed market will provide a benefit to the entire market, ensuring that GEMMs have access to a minimum depth of liquidity in certain stocks and that prices in that market are fully efficient, allowing the GEMMs to carry on their wider market-making activities in confidence. This will be of particular value in an environment where a number of (potentially exclusive) trading venues exist. The DMO hopes that this model will make it more

5. See "The Secondary Market for Gilts: A Consultation Paper," January 2000.

likely that entry barriers facing prospective GEMMs remain at an acceptable level, maintaining a high degree of competition in the provision of market-making services. This should ensure that any benefits resulting from the new system are reflected in the service that GEMMs provide to investors.

A working group of elected representatives of the GEMMs and a representative of the DMO considered the question of how these quotes would be provided to the market. This group has concluded that the best way is to allow each GEMM to supply their prices to any recognized IDB. Adopting this approach preserves competition in the provision of IDB services. This means that brokers will have a continuing incentive to develop and maintain an attractive service, encouraging further technological innovation.

The DMO plans to bring these mandatory quote obligations into effect early in financial year 2002–03. As noted above, given competition in the market-making sector, any resulting increase in liquidity in the inter-GEMM sector should pass through into the wider market.

Conclusion

Introducing new market structures to an existing market raises issues that differ from those that would be raised if it were a new market. Natural inertia and a fear of change can lead to significant switching costs; these need to be borne in mind when considering the appropriate policy response to the introduction of electronic trading.

As issuer, a primary dealer network provides an effective way in which to mitigate execution risk. The DMO continues to see an important role for the GEMMs; therefore, it needs to ensure that the GEMMs' cost and risk trade-off is maintained at a level that ensures the continued participation of a core number of dealers.

The DMO's initiative in the inter-GEMM market builds on the existing IDB structure but will hopefully create the necessary environment to encourage the natural development of more transparent and operationally efficient mechanisms such as multiple dealer-to-client trading systems. However, the DMO does not intend to mandate such developments.

While some GEMMs remain skeptical about whether the DMO initiative will improve liquidity in the IDB market, others, given their experience of European fixed-income markets, are more positive. It will provide a mechanism for a GEMM to unwind an unwanted position relatively easily and at a known cost. This should help risk management. In addition, it will provide greater transparency in that market, where few prices are currently posted.