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UNITED KINGDOM DEBT MANAGEMENT OFFICE

Response to DMO Consultation Document on 'Special' Gilt Repo Operations

February 2000



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Introduction

On 17 September 1999, the DMO issued a statement on 'special' gilt repo operations.¹ The statement clarified the DMO's approach to intervention in the gilt repo market and gave more information about the circumstances under which it would engage in a special repo operation. In addition, the paper consulted the market on the possible introduction of a non-discretionary or 'standing' repo facility. This would relieve some of the difficulties in determining precisely those circumstances when it would be appropriate for the DMO to intervene. The formal consultation period ended on 8 October. However, comments on the proposals outlined in the consultation document were accepted up to the end of 1999.

The DMO received fourteen written responses along with a number of oral comments. Written responses were received from eight GEMMs, the London Stock Exchange, LIFFE, the Financial Services Authority, two repo market participants and the British Bankers' Association (BBA). The BBA's response reflected comments from four of its members. Respondents generally welcomed the proposal to establish an automatic non-discretionary gilt repo facility as a market management tool, although there was some disagreement on the precise terms and the accessibility of the facility.

The DMO will introduce the changes outlined below on 1st June 2000. However the previously announced discretionary special repo facility will be available to the DMO in the intervening period if the DMO feels it is necessary.

The general terms under which any special or standing repo operation would be undertaken are outlined in the annex.

¹ "DMO Policy Regarding 'Special' Repo Operations", September 1999.



‘Special’ Discretionary Repo Operations

All respondents recognised the need for the DMO to have the ability to carry out such an operation in exceptional circumstances. The DMO reserves the right to undertake such an operation at its own discretion but it will only do so at times of severe gilt market dislocation and disruption. The DMO would envisage using this discretion even more infrequently once the standing facility is in operation. As the special repo facility will focus on situations of extreme dislocation in the cash gilt market, this facility will be open only to GEMMs who have signed the necessary legal documentation.

The rate at which these operations would be carried out would be decided on a case-by-case basis and would reflect the particular market circumstances necessitating DMO intervention. However, the maximum penalty charged will be that associated with the automatic non-discretionary repo facility outlined below.

Non-discretionary Standing Repo Facility

The original consultation paper asked a number of specific questions with regard to an automatic non-discretionary facility. These are addressed below.

- ***Is the introduction of such an automatic facility necessary or warranted?***

The majority of respondents indicated that an automatic ‘standing’ repo facility would be welcome, as it would be transparent, predictable and impartial. But there was some concern that such a facility should not interfere with the ‘normal’ workings of the repo market and should not prevent the development of a ‘specials’ market. If anything, the widespread perception of a lack of liquidity in the cash gilts market makes the existence of such a facility even more important in order to give liquidity providers some comfort that they will be able to cover short positions. Consequently, **the DMO intends to make such an automatic facility available from 1st June 2000.**



- ***Given the need for the automatic facility to be penal (to avoid substituting for normal market mechanisms), how penal should the rate be and how should it be expressed?***

Views on whether the rate should be a fixed number of basis points below a reference rate, a fixed proportion of a reference rate or a specific rate were fairly evenly split. However, the DMO believes that setting the penal rate at a fixed proportion of some reference rate has a number of advantages. First, the rate will always be positive. Respondents firmly believed that the rate should always be greater than 0% in order to give market participants an incentive not to fail on a trade. (One possible undesirable effect of setting the rate as a fixed discount to the reference rate is that it could, under certain circumstances, be negative.) This method is also independent of the current level of rates in the market. Therefore, unlike fixing a specific penal rate (e.g. 0.50%), a proportionate penal rate changes with market conditions.

The DMO was also keen to set a rate that was sufficiently penal so that the existence of the facility would not interfere with the 'normal' workings of the repo market. The DMO believes that this facility should only be triggered in very extreme market conditions. Therefore the DMO has set the rate at 10% of the reference rate.

A number of possible reference rates were mentioned by respondents, including the British Banking Association's repo fixing and the General Collateral (GC) rate. However, after consideration, the DMO has decided that the reference rate should be the Bank of England's repo rate.

The rate at which the DMO will make its non-discretionary repo facility available will be 10% of the Bank of England's repo rate, charged on an overnight basis. However, the DMO reserves the right to change the degree of penalty if it believes, after considered review, that it is no longer appropriate. Any such change would be announced in advance.



- ***Should the facility only be available to GEMMs who sign the appropriate repurchase agreements with the DMO or should it be extended to other interested counterparties who also sign the relevant agreements?***

This was the most contentious issue raised in the consultation. A number of respondents felt that the facility should remain exclusive to GEMMs, as it impacts on their ability to provide liquidity to the cash gilt market. Others felt that, given its impact on the repo market, non-GEMM participants active in that market should also have access to the facility. On balance, given that the cash gilt market and the repo market are intertwined, the DMO believes it should not limit an operation which has a significant impact on a number of related markets, to market participants primarily active only in one.

Therefore **the facility will be available to all regular dealing counterparties of the DMO who have signed the relevant documentation.**²

Other issues

A number of other concerns were also raised by respondents including the size of potential repo transactions, the timing of transactions intra-day and the impact on gilt indices.

Size of the facility

The minimum size of the facility will be £5 million nominal; however, there would be no maximum limit set. A minimum size is necessary in order to cover the administration costs associated with the operating the facility.

Timing of any operations

Market participants will be able to notify the DMO of their intention to use the automatic facility anytime (from 12.30pm on the previous day) up to 11.30am for same-day settlement of the transaction. This is the latest time at which the DMO can take instructions and undertake the necessary operations to create and issue the stock required, given a variety of operational and settlement constraints.

² The DMO's special repurchase agreement.



Term of the facility

The facility would be an overnight facility with the option of rolling-over the facility indefinitely. However, the DMO does not expect any participant to require the facility to be rolled over for more than a continuous two-week period and would review its use if it did. Any stock created for the operation would then be cancelled.

Inclusion in gilt indices

Following informal consultation with FTSE International, it is likely that any stock created through this route would not be taken into account when the gilt indices are calculated. The DMO will formally put this proposal to the FTSE Actuaries Bond Indices committee at the first available opportunity.

Publication of details of operations

The DMO will publish on the wire services details of the stock, maturity and amount of any repo operations undertaken under this facility and any subsequent cancellation. The identities of any counterparties would remain anonymous, although the DMO reserves the right to share such information with other official regulatory bodies in appropriate circumstances.

Eligible stocks

The DMO also wishes to clarify that the facility would be available in all non-rump stocks and that both principal and coupon strips could be created³ and repoed directly if required. However, the facility would not be available in any stock with less than nine working days remaining maturity⁴, i.e. there must be more than two working days before the stock reaches the beginning of its final ex-dividend period.

³ This will require some changes to the Information Memorandum relating to the Issuing, Stripping and Reconstitution of British Government Stock, November 1999.

⁴ Except for 3½% War Loan and the Floating Rate Gilt, which have non-standard ex-dividend periods.



ANNEX: GENERAL TERMS OF SPECIAL AND STANDING REPO OPERATIONS

Any special or standing repo operation:

- would normally involve the overnight repo of stock at a penal rate of interest charged to the DMO. In the case of a non-discretionary repo, this rate would be 10% of the Bank of England's repo rate. This would be the maximum penalty paid on any discretionary repo operation;
- would entail the DMO requiring to be given general collateral at the Bank of England's prevailing repo rate against the stock being lent to offset the cashflow implications of the repo;
- would entail the DMO announcing the amount and terms at which such a repo operation had been conducted and the amount of stock created and subsequently cancelled but not the counterparties with which it had dealt;
- could be rolled over for a period of time, but the DMO does not expect any participant to require the facility to be rolled over for more than continuous two-week period.

In addition, the special repo facility would be open to GEMMs who have signed the relevant documentation while the standing facility would be available to all those regular dealing counterparties of the DMO who had signed the appropriate repurchase agreements.

