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UNITED KINGDOM

DEBT MANAGEMENT OFFICE

Supplementary Methods for Distributing Gilts: Response to Consultation

18 March 2009

The *United Kingdom* **Debt Management Office** is an Executive Agency of HM Treasury

UK DEBT MANAGEMENT OFFICE

SUPPLEMENTARY METHODS FOR DISTRIBUTING GILTS: RESPONSE TO CONSULTATION

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A. Executive summary

1. Gilt auctions have been the key means by which the Government has implemented its debt management strategy since the joint HM Treasury/Bank of England Review of Debt Management conducted in 1995[1] and have also successfully delivered the Government's gilt financing needs each year since the UK Debt Management Office (DMO) was established in 1998 as an executive agency of HM Treasury. The Government remains confident that this will be the case going forward. Auctions will remain the Government's preferred means by which to issue gilts.

2. However, in the context of the Government's medium term strategy for gilt issuance[2], the DMO launched on 17 December 2008 a public consultation[3] to explore whether other distribution methods might be introduced as a supplement to auctions in order to facilitate the primary market distribution process at a time of significantly increased levels of gilt issuance in 2008-09, 2009-10 and in the medium term. This document, published on 18 March 2009, presents the provisional outcome of the consultation process, and should be read in conjunction with the consultation paper published on 17 December 2008.

3. The DMO received 35 written responses to its consultation, including from all Gilt-edged Market Makers (GEMMs), companies which invest in gilts either on their own behalf or on behalf of other institutional investors (e.g. investment managers), companies which advise pension funds and/or insurance companies and industry bodies. The DMO also received responses from an academic institution and from individuals. A full list of respondents is provided in the Annex. The opportunity to feed in views via the consultation process was widely welcomed by respondents. The DMO is grateful for the constructive feedback that it has received through this consultation, which has helped inform its views on supplementary distribution methods.

4. In general, respondents agreed that the current auction process is working well and has helped deliver record amounts of financing in a relatively smooth way in 2008-09. However, respondents agreed with the assessment set out in the DMO's consultation paper that the elevated levels of volatility and a more risk-averse market environment, combined with the high financing

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[1] 'Report of the Debt Management Review', HM Treasury and the Bank of England, July 1995. The Report can be found on the DMO's website at: http://www.dmo.gov.uk/documentview.aspx?docname=remit/report95.pdf&page=Remit/full_details

[2] The Government's medium term strategy for gilt issuance was set out by the then Economic Secretary to the Treasury in the foreword to the Debt and Reserves Management Report (DRMR) 2007-08. It was stated that: "It is likely that strong demand for long-conventional and index-linked gilts will persist in the medium term and continue to influence the shape of the yield curve. Should that be the case, our policy of skewing issuance towards long maturities would continue." The DRMR 2007-08 can be found on HM Treasury's website at: http://www.hm-treasury.gov.uk/bud_bud07_dmo.htm

[3] 'Supplementary Methods for Distributing Gilts: A Consultation Document', can be found on the DMO's website at: http://www.dmo.gov.uk/documentview.aspx?docName=/publications/giltsmarket/consultationpapers/cons171208.pdf

requirements which are projected to continue for the next few years, could affect the Government as issuer of debt instruments and increase the 'execution risk'[4] associated particularly with long-dated conventional and index-linked gilt issuance. It was felt that there is a case, in current conditions, to add supplementary distribution methods to support the auction process, so long as they do not interfere with the smooth functioning of the auction process or undermine the general principles of predictability and transparency, at least for the largest part of the issuance programme.

5. Taking into account the feedback received, the DMO has drawn the following provisional conclusions in respect of supplementary distribution methods in 2009-10. The Government will announce details of any new supplementary distribution methods in Budget 2009.

- <u>Mini-tenders</u> – the DMO sees merit in the continued use, for a small part of the total issuance programme, in 2009-10, of mini-tenders to support the auction process in meeting the financing requirement, by allowing the Government to issue into pockets of demand identified by the DMO closer to the time that they emerge.
- <u>Syndication</u> – the DMO sees merit in the use of syndication in 2009-10, alongside the auction programme, in particular, to issue larger volumes of long-dated conventional and index-linked gilts per operation than it judges would be possible via auction. It is anticipated that syndicated issuance would occur no more frequently than once in any quarter, following the usual quarterly consultation process with market participants.
- <u>Direct placement</u> – the DMO does not see merit in issuing gilts via direct placement.
- <u>Bidding format</u> – the DMO is not currently minded to make changes to the bidding format for gilt auctions (bid-price for conventional gilts and uniform price for index-linked gilts), but this will be kept under review.
- The DMO sees merit in – and wishes to explore further – the possibility of introducing a facility to issue GEMMs with an option to purchase a small additional amount (e.g. 10%) of stock for a short time after the close of each auction at the average accepted price (conventional gilts) or the strike price (index-linked gilts). The box on page 10 sets out one possible way for operating a system of allowing the GEMMs a non-competitive option facility which would be available for a short time after each auction. The DMO will consult market participants on the detail of such a facility and market participants are invited to contact the DMO's dealing desk by Thursday 9 April if they wish to provide feedback on this issue. The DMO will announce a final decision on whether it will introduce such a facility alongside its financing remit at Budget 2009, on 22 April 2009.
- The DMO does not see merit in changing any other aspect of the auction process.
- The Government has no current plans to launch any <u>new types of instrument</u>, but will keep this under review.

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[4] Execution risk is the risk of an uncovered auction (where the amount of bids is smaller than the amount of the gilt on offer at that auction) or one that is covered at an unacceptably deep discount to the prevailing market price.

6. Section B considers each of these provisional conclusions in more detail.

B. Response to consultation

7. The DMO received a wide range of views and suggestions in response to its consultation. This section sets out an overview of the responses focussing on key themes and covering views and suggestions where a number of respondents raised similar issues.

Government's approach to issuance policy

8. The vast majority of respondents attached importance to the continuation of transparency in the Government's approach to debt issuance, at least to the major part of the issuance programme. There were varying views on the extent to which any supplementary operation should be either more flexible or more predictable, but it was generally felt that the introduction of any new method should not be at the expense of maintaining high standards of transparency and predictability for the core gilt auction programme.

9. A minority of respondents thought that the DMO's remit is too narrowly focussed (given the wider importance of gilt issuance to pension funds, other institutional investors and government). It was argued that the remit should be more flexible and allow the DMO to respond opportunistically to developments in the market and that the DMO should take into account wider economic benefits arising from gilt issuance.

10. **DMO's response**. Transparency about and predictability in debt management operations increases the degree of certainty that the market has about issuance, which puts market participants in a better position to plan their investment strategies. This in turn should reduce the risk premium in yields to the benefit of the Exchequer. Consistency with these principles is, therefore, of benefit to both the Government and all other gilt market participants.

11. The Government places a great deal of importance on maintaining its high standards of transparency and predictability in the conduct of debt management policy, in accordance with the debt management objective of minimising cost over the long term, taking account of risk, whilst being consistent with the aims of monetary policy. Therefore these considerations will need to be weighed up carefully when the Government announces detailed plans for any supplementary distribution methods at Budget 2009.

Participation in the auction process

12. The majority of respondents felt that the current auction system works well and should only be amended at the margin, if at all. Rather, any changes to the current framework should concentrate on the design and implementation of supplementary distribution methods, whose purpose should be to support the core auction programme and, in particular, to facilitate delivery of a higher volume of long-dated conventional and index-linked gilts than might be feasible via auctions alone.

13. Those particularly involved in Liability Driven Investment (both advice and implementation) generally agreed that pension fund demand for long bonds tends to be lumpy and sporadic, which is primarily driven by factors such as the frequency/timing (triennial or other) of fund valuations, funding level, market level or simply opportunism[5]. Hence, the timing of demand from pension funds is not necessarily aligned with the DMO's gilt auction calendar. However, a view was also expressed that having an auction schedule set out far in advance helps with planning flows for pension fund clients, and that the use of available discretion to time transactions to coincide with auctions was facilitated by a fixed auction schedule.

14. Those investors who cited potential barriers to participation in the auction process referred to the volatility of pricing leading into and coming out of auctions, and the time lag between auction timing and close of business leading to a perceived lack of participation by tracker funds.

15. A small number of respondents from the pension industry indicated that the biggest barrier to pension fund participation in the gilt market (regardless of the issuance process) is the current low level of yields (in particular in the index-linked sector), and called for measures to make long dated conventional and index-linked bonds more cost-effective or higher yielding for the pension industry, perhaps by skewing issuance to these sectors very heavily in 2009-10.

16. **DMO's response**. In circumstances where difficult market conditions persist and continue to influence the behaviour of gilt market participants, the DMO sees merit in introducing supplementary gilt distribution methods into its financing remit that will support the main auction programme. These supplementary methods could be used in particular to issue long-dated conventional and index-linked gilts in large volume and/or large size per operation relative to auctions.

Auction design

17. Some respondents took the opportunity to suggest some marginal modifications to the design of auctions. Of these, the issue raised most frequently was the bidding format for conventional gilt auctions – i.e. whether or not to change this from the current bid price format to the uniform price format used in index-linked gilt auctions.

18. There was some support for the DMO to give consideration to changing the format of (either long-dated or all) conventional auctions to uniform price, suggesting that this would encourage greater participation due to the removal of the 'winner's curse'[6]. However, others argued against changing the format to uniform price, cautioning against tampering with an auction format which is working successfully. Furthermore, one of the disadvantages cited with the

[5] Active fund managers indicated a more consistent participation in the auction process.
[6] The 'winner's curse' would be an outcome where the highest bidder overpaid for the bond on offer. This outcome is prevented in a single price auction because all successful bidders would pay the same price.

uniform price format was the level of volatility that this could introduce to the auction process, since it would be possible for a small volume of bids to affect the clearing price for the whole auction.

19. Other suggestions for marginally changing the auction format to incentivise greater participation included raising the non-competitive allowance for GEMMs and/or adopting the practice used by some other European sovereign issuers of granting primary dealers options to purchase more of the auction bond at the non-competitive auction price for a short time after the auction.

20. A small number of respondents suggested that the auction process, whilst remaining entirely predictable as a fully scheduled form of issuance, could be made slightly more flexible by allowing multiple bonds to be issued in each operation (reference was made to the French system of auctioning multiple bonds in a single operation). This would allow the market to determine the precise quantities of each bond that it valued and wished to obtain via the process. Parameters could be placed around the bonds and size limits offered in each auction to retain some control (although it was also suggested that such a process could be open to bonds along the entire yield curve, only specifying that the auction would be for conventional or index-linked gilts). An additional advantage cited was the possibility to reduce auction 'fatigue' by concentrating issuance into (say) one multiple auction day per week. One respondent suggested that multiple bond auctions could replace the current single bond auction system.

21. Another suggestion put forward by a small number of respondents was the possibility of announcing auction schedules monthly (rather than quarterly), given the large number of auctions set against a volatile market and demand environment. These respondents suggested that this would allow an appropriate balance to be struck between being too rigid and being too reactive or unpredictable.

22. One respondent advocated issuing gilts by splitting each auction into a series of multiple 'auctionettes', each of which would be held one minute apart. The advantages of the proposal, it was suggested, would be to improve the price discovery process and reduce the execution risks faced by both GEMMs and the DMO.

23. Finally, there was no consensus on the desirability of increasing auction sizes and holding fewer auctions versus holding smaller and more frequent auctions.

24. **DMO's response**. On the whole, most respondents felt that the current auction process works well and that if changes are to be made they should be marginal. The DMO agrees with this assessment. Whilst it recognises the potential benefit in changing the format of conventional gilt auctions to uniform price, it also acknowledges the potential downsides, including possible elevated levels of volatility around auctions and greater difficulty for market

participants to judge the clearing price. The DMO is not currently minded to change the bidding format for auctions, but will keep this under review.

25. The DMO judges, however, that there could be merit in introducing a dealer non-competitive option as part of the auction process. A dealer non-competitive option is an option available to a GEMM to purchase a small amount of a gilt that has been offered at auction in addition to the total amount sold via the auction. The option would have to be exercised within a pre-set period after the auction (not least so that the new amount in issue could be accounted for in relevant gilt indices). The maximum amount that an individual GEMM could purchase via the option could be set by reference to its successful allocation at the auction itself (thereby further incentivising participation) and would be sold at the average accepted price (conventional gilts) or the strike price (index-linked gilts). Such a facility could enhance the auction process by reducing the execution risk for the DMO and market participants. Moreover, it could increase the amount of gilts sold at individual operations, potentially reducing the number of operations needed in any one year (all other things being equal) if the cumulative total additional issuance via the option was sufficiently large.

26. The DMO wishes to explore with market participants whether such a facility should be introduced and to examine the detail of how the option might be designed. One possible model for discussion is set out in the Box on page 10. Participants who wish to comment are encouraged to contact the DMO's dealing desk by Thursday 9 April. A final decision on whether such a facility will be introduced (including operational details if appropriate) will be announced as part of the DMO's remit announcement on 22 April 2009.

27. The DMO is also grateful to respondents for raising the issue of the DMO potentially offering multiple bonds at a single operation. The DMO has considered carefully this suggestion for amending the auction process but is not minded to offer multiple bonds at a single operation at present.

Box: Dealer non-competitive options at auction

This box sets out one possible way for operating a system of allowing the GEMMs a non-competitive option facility which would be available for a short time after each auction. Market participants are invited to contact the DMO's dealing desk by Thursday 9 April if they wish to provide feedback on this issue.

An option could be made available to each GEMM, the size of which would be linked to its successful allocation at the auction itself, to purchase a small additional amount of the auctioned bond at the average accepted price (conventional gilts) or the strike price (index-linked gilts). The total amount of additional stock that would be available in this way would be small, say 10% of the overall auction size. Therefore, each GEMM would have available an extra 10% of their successful auction allocation through the option. Take-up of this facility would not affect the calculation of the cover ratio for the auction, which would continue to be set with reference to bids received at the auction alone. GEMMs would be expected to pass on access to this option to successful client bidders, but in the event that any such client did not wish to take it up, the GEMMs could take the additional stock for their own accounts.

It is envisaged that such an option would be open for a fixed short period of time after the publication of the auction results – for example, until 12.00 noon on the same day (the option 'window'). If a GEMM wished to apply for additional stock it could do so by contacting the DMO's dealing desk in the time between the publication of auction results and the end of the option window. Each GEMM would be allowed to make one such request, for any amount up to its individual limit. Only the additional amount actually taken-up by the GEMMs, rather than the potential maximum amount, would be created and this additional amount would affect the relevant gilt indices.

The DMO would then publish the additional amount of stock created in this way a few minutes after the close of the option window. Settlement of this facility would occur on a T+1 basis as with the auction itself.

Such a facility would not be available following any uncovered auction.

Any additional issuance via this facility would not be taken into account in the design of the issuance programme at the start of the financial year. As the programme progressed this could allow (all other things equal) the DMO to reduce future auction or mini-tender sizes and/or remove auctions from the calendar (e.g. at the time of the restatement of the financing arithmetic at the Pre-Budget Report) depending on the amount of additional financing raised through this option.

Mini-tenders

28. The use of mini-tenders as a financing operation alongside the scheduled auction calendar was introduced into the DMO's financing remit in Q3 2008-09 following the announcement of the Government's plans for the Bank Recapitalisation Fund. The use of mini-tenders was subsequently extended to Q4 2008-09 at the 2008 Pre-Budget Report.

29. There was very strong support (from both GEMMs and non-GEMMs) for the continued use of mini-tenders in a similar way to that in which they were used in the second half of 2008-09 to complement the auction programme. Proponents highlighted the flexibility of this issuance method as an advantage in the current market environment because it facilitates issuance into targeted pockets of demand identified by the DMO in a relatively timely way, in smaller

sizes than a 'full blown' auction, whilst minimising the risk of causing market volatility or disruption (or problems for index trackers). At the same time mini-tenders were seen as a relatively transparent form of issuance in that market participants know at the time of the quarterly issuance announcement that such issuance is planned, the broad parameters around the planned issuance and that the tenders will be an open process accessible to all participants via the GEMMs.

30. There were mixed views as to whether mini-tenders were more suited to conventional or index-linked gilt issuance, or equally suitable for both.

31. There were some suggestions about how the process for mini-tenders could be improved, although there were differences in relation to the degree of flexibility that should be available. On the one hand, there were some calls for greater formalisation of parameters around the use of mini-tenders, such as size, type of bond, bidding format, frequency and timing. Others, however, suggested that mini-tenders should be made even more flexible by removing the sectoral splits from the quarterly issuance announcement and retaining the ability to increase the size in response to stronger than anticipated demand. Some even suggested having the option to add new mini-tenders at short notice in addition to any tenders set out in the quarterly announcement.

32. A small minority of respondents cautioned the DMO not to take such flexible issuance too far, arguing that adding much more flexibility to the process could undermine the transparency and predictability in gilt issuance that they particularly value. One respondent strongly preferred all issuance to be scheduled in the quarterly calendar as a means to support its ability to give advice to its clients on the timing of transactions sufficiently far in advance.

33. **DMO's response**. The DMO sees merit in making mini-tenders a permanent addition to the issuance toolkit to be activated in each annual financing remit as appropriate, depending for example on the size of the financing requirement and the desired split of issuance between different maturities in a given year. The Government intends that the DMO will operate tenders in 2009-10 broadly as it has done in the second half of 2008-09, as set out in Table 1 below. One change will take place which is that the maturity area of the gilt to be issued will not be set out in the quarterly announcement; the identity of the precise bond will, however, be announced with the same degree of notice as it is currently (i.e. at least a week before).

Table 1: Mini-tenders as part of the debt issuance toolkit

Purpose	Flexible contribution to meeting the financing requirement, for a small part of the overall issuance programme, as a complement to auctions
Contribution to meeting 2009-10 financing requirement	Up to around 10%, but this will be a function of the total amount of financing announced at Budget 2009
Quarterly issuance announcement	Number of tenders and week in which each tender will take

	place
Friday of the week which is two weeks prior to the week in which the tender will occur	Precise bond to be issued (announced at 3.30pm)
24-48 hours in advance	Date and size of operation
Size	Typically half the size of an equivalent auction
Frequency	Broadly even flow per quarter
Type of bond	Conventional or index-linked
Maturity sector	Any bond not maturing in the same financial year
Format	Usually uniform price
Individual GEMM allocation limits	None

Syndication

34. The supplementary distribution method which received most widespread support was syndication[7], as a complement to the auction system alongside mini-tenders. It was felt that such an issuance 'package', if designed correctly within the principles of 'constrained discretion', would allow an optimal balance to be struck between predictability on the one hand and flexibility on the other.

35. The majority of GEMMs supported the use of syndication in 2009-10. This included those GEMMs that strongly advocated adherence to a pre-defined and fixed auction schedule, although these respondents also stressed that auctions should nonetheless remain the cornerstone of the distribution process. Of those end investor institutions which commented on the use of syndication views were divided as to whether or not this method should be re-activated. The main advantages of syndication set out by those (GEMMs and non-GEMMs) in favour were as follows.

(i) It allows the launch of a new bond in larger size than would be possible via auction, hence building new bonds to benchmark size more quickly. A corollary would be that syndication would allow the removal of some auction slots in a crowded calendar, all other things being equal.

(ii) It increases the likelihood that supply will be aligned with demand peaks in riskier parts of the real and nominal yield curves leading to lower execution risk and a reduced pre-supply concession (and hence better value for money for the Government).

(iii) It incentivises GEMMs to market the issue more widely, raising the profile of the transaction and hence possibly reducing the cost of issuance.

(iv) It facilitates pricing, in particular for points on the curve where no appropriate pricing references exist.

[7] In particular for launching new long conventional and index-linked bonds, but not exclusively so.

(v) It provides greater comfort for investors in having a duration manager minimising the volatility around the issuance process.

(vi) It greatly increases end investor participation in the issuance process and encourages a greater breadth and depth of demand. A corollary would be reduced reliance on the GEMMs to take down the majority of an issue.

(vii) It facilitates a better understanding of the investor base for the issuer.

(viii) The possibility of a lead manager mandate creates incentives for GEMMs to participate more actively in auctions.

(ix) It is already part of the debt management 'toolkit'[8], has been used before, so its re-activation would be relatively simple.

36. Respondents set out detailed proposals for how syndication could be activated in 2009-10. A summary of respondents' principal recommendations is set out in Table 2 below. <u>Note that inclusion in this table does not mean that any or all of these features would necessarily be adopted</u>.

Table 2: Respondents' recommendations on parameters around and operational details for the use of syndication in 2009-10

Feature	Summary of Recommendations
Information to market	
Remit statement	Re-activation of option (but not obligation) and broad parameters, not too specific
Information in quarterly issuance calendar	Announce intention to syndicate, subject to market conditions Set target for issuance week or month
Notice to market regarding specifics of a syndication transaction, including timing	1-2 weeks
Scheduling around auctions	Either insert syndicated deal around scheduled auction dates or replace an existing auction in the schedule
Specific parameters	
Frequency	1-2 per quarter (maximum) Some respondents suggested this will depend on the number of new issues launched per quarter/year
Use only for long-dated bonds (conventional and index-linked)?	Most felt that this is where a syndicated deal will add most value Some suggested leaving the option open to syndicate shorter maturities
New bonds only?	Quite a few respondents suggested not being explicitly bound to use of syndication for new bonds only, but in practice that would be where the greatest bias would be
Issuance size	Conventional (long): £3-5bn (with one respondent suggested £4-8bn) Index-linked (long): £2-3bn
Lead managers	Up to four, chosen on the basis of market share and/or auction performance (e.g. 75% weighting) and qualitative criteria (e.g. 25% weighting). All other GEMMs to be co-leads Some respondents suggested a rotation system, perhaps in combination with the above Some respondents advised the DMO to adopt clear

[8] And is compatible with auctions remaining the primary means of issuing gilts.

	guidelines in the selection criteria
Time for book-build	1-2 days
Pricing to encourage index-trackers	Enter index at re-offer price
Lead time for implementation	From Q1 or Q2 2009-10, subject to at least 1-2 weeks notice of the first transaction

37. A minority of GEMMs argued against the routine use of syndication, including one that preferred the Dutch Direct Auction instead[9], and one that preferred syndication to be restricted to launching new (non-standard) instrument types only. The main concerns set out by these respondents were as follows.

(i) The selection of lead managers distorts a level playing field amongst GEMMs, and in the extreme could lead to a need to review the appropriate role of 'lesser' GEMMs.
(ii) Too much flexibility over timing could compromise the ability of investors to plan ahead for supply events and could undermine transparency and predictability.
(iii) From an investor point of view, the possibility of a large syndicated transaction on the horizon might significantly impair the ability to hold long positions.
(iv) Syndication removes the option of bidding high to increase the likelihood of achieving a full allocation and replaces it with a risk of bids being scaled, which could reduce the participation rate of certain types of investors.
(v) Too much control is given to the GEMMs to ration information flow.
(vi) Lack of investor confidentiality to GEMM group and potential leakage of order information.
(vii) The payment of fees to banks, some of which may be partially nationalised, could create conflicts of interest for Government.

38. **DMO's response**. Syndication as a method for gilt issuance already exists in the DMO's 2008-09 financing remit but this method of issuance currently lies dormant[10]. The DMO is carefully considering the benefits and disadvantages of re-activating the potential use of syndication in the DMO's financing remit for 2009-10 and is grateful for the detailed feedback received from market participants. The DMO will announce any plans to issue gilts via syndication in the Debt and reserves management report 2009-10, to be published alongside Budget 2009 on 22 April 2009.

39. On balance, the DMO sees merit in the potential use of syndication and believes that it could help reduce the execution risk of the overall programme,

[9] As a method similar to syndication but removing the informational advantages afforded to a subset of GEMMs in a syndicated issue.
[10] The DMO has used syndication only once to launch the new 1¼% Index-linked Treasury Gilt 2055 in September 2005. Its use on that occasion was motivated by the need to ensure appropriate pricing of the gilt was achieved in a context where there was no individually adequate price reference in the sterling fixed-income market around that maturity.

in particular by allowing the DMO to launch new long conventional or index-linked gilts in large size quickly, thereby reducing the number of required auctions slots as well as helping to create maximum interest in a new issue from the outset. The use of syndication alongside the auction programme could allow the Government to issue a larger absolute amount of long conventional and index-linked gilts in 2009-10 than might otherwise be the case.

40. The DMO would envisage syndication being used no more than once in any quarter, following consultation by the DMO with market participants. Any intention to launch a syndicated offering, subject to market conditions, would be announced in the quarterly issuance announcement and confirmation of the proposed timing and further details would be announced by the DMO around 1-2 weeks prior to the transaction.

41. The DMO is mindful of the concerns around the use of syndication raised by some respondents. Subject to the Government's announcement alongside Budget 2009 about the use of syndication, the DMO would work closely with market participants – GEMMs and end investors – in designing the issuance programme to ensure that any potential downsides to the use of syndication were minimised. In particular, the Government believes that a well functioning primary dealer system, where all GEMMs are treated fairly by the Government is crucial to helping meet its debt management objective. Fair treatment of GEMMs will continue to be one of the principles underlying the DMO's relationship with the primary dealer community.

Direct placement of gilts with investors

42. The majority of respondents – including all GEMMs who commented on this option – opposed the DMO operating a system of direct private placements to end investors, even if they were to be channelled through GEMMs. Respondents who opposed direct placement did not like the perceived opacity of these operations, the impact on index-trackers, and the potential impact on secondary market liquidity if GEMMs were bypassed in the primary issuance process.

43. The views of gilt investors were slightly more mixed. Some opposed direct placements on grounds of principle for similar reasons to those set out above, whereas others thought that direct placement might be worth considering, but only if some of the obstacles (such as the timing of changes to the FTSE index, and the ability of GEMMs to participate) could be overcome. One respondent suggested that any method which allows GEMMs to put together matched bargains, by making clear that the stock could be available from the DMO on demand, would be very helpful. Another respondent's preferred supplementary distribution method was the introduction of a series of daily auctions direct to end investors. Some respondents suggested that private placement could be used to issue 'unusual products'.

44. **<u>DMO's response</u>**. As indicated in the consultation paper, the Government considers the gilt market-making system to be an integral component of the overall debt management framework and it is essential that any supplementary gilt distribution method is consistent with the maintenance and good functioning of that system. Whilst a system of direct placement could potentially be designed so that all orders (perhaps driven by reverse enquiry) are channelled through GEMMs, this would need to be an open and competitive process so that any such issuance would be open to all GEMMs and their clients, and the DMO would not be setting the price for new issuance. Mini-tenders fulfil these requirements and they are the Government's preferred method for issuing gilts in a more flexible but equitable way. For this reason, the DMO does not see merit in issuing gilts via direct placement.

Suggestions for new instruments

45. Some respondents took the opportunity as part of their response to the consultation to suggest issuance of new instruments. The general argument put forward was that with a high financing requirement set to continue in the near term, there is plenty of issuance that can be allocated to 'standard' gilts such that liquidity and benchmark building are not at risk whilst also issuing innovative products. Successfully meeting the financing requirement could helpfully be supported by allocating a small percentage of issuance to more niche products, which would not compete with gilts, but could tap into latent demand and lead to a premium being paid to the Government, when compared against "plain vanilla" issuance.

46. Some respondents argued strongly that wider economic benefits would accrue from the introduction of such instruments – in particular longevity bonds and the Government's use of interest rate swaps.

47. Other suggestions included Limited Price Indexation (LPI) gilts, floating rate notes, zero-coupon bonds and exchangeable/convertible bonds. It was argued that such instruments need not necessarily have the same requirements as standard gilts for repeated issuance, large (benchmark) size, sustained demand over the medium to long term, liquidity, transparency and predictability in the issuance process, intermediation/market-making by the GEMMs or trade-ability.

48. **<u>DMO's response</u>**. Whilst not the focus of the consultation, the Government is grateful for the suggestions received in respect of potential new instruments and ways of managing its debt. The Government has no current plans to launch any new types of instrument, but will keep this under review.

Annex: List of respondents

Association of British Insurers
Aviva investors
Barclays Capital
Barclays Global Investors
BNP Paribas
Cardano
Citigroup
Credit Suisse
Deutsche Bank
Dresdner Kleinwort
Goldman Sachs
HSBC
Ignis Asset Management
Insight Investment
Investment Management Association
JP Morgan
Julian Wiseman
Legal and General Investment Management
London Stock Exchange
Mercer
Merrill Lynch
Mike Williams
Morgan Stanley
National Association of Pension Funds
Pearl Assurance
Pensions Institute, Cass Business School
Prudential Plc
Railways Pension Trustee Company Limited
Royal Bank of Canada
Royal Bank of Scotland
Society of Pension Consultants
Standard Life
UBS
Watson Wyatt Limited
Winterflood Securities Limited

In addition, the Government Actuary's Department arranged two breakfast meetings with interested parties.