

010
TELEPHONE
01-601 4444

cc *My Willets*
BANK OF ENGLAND
LONDON EC2R 8AH

7 January 1985

Mr Turnbull

8/1

T Flesher Esq
10 Downing Street
London
SW1

Dear Tim

In your letter of 14 November to Ruth Thompson at the DTI, you indicated that the Prime Minister would be interested in an account of the thinking underlying the Bank of England's consultation document on gilt dealing. I enclose a note that has been prepared here and which I hope will meet your request.

I am sending a copy of this letter with enclosure to Ruth Thompson and to David Peretz.

Yours sincerely

John Bartlett

John Bartlett
Private Secretary
to the Governor

THE THINKING UNDERLYING THE BANK OF ENGLAND'S
CONSULTATION DOCUMENT ON GILT DEALING

(Paragraph references in brackets refer to the respective paragraphs in the consultation document.)

1 The Bank's thinking on the future structure of the gilt-edged market has been directed to three basic objectives -

- (i) to open up the market to greater effective competition;
- (ii) to ensure as high a degree of investor protection as possible, consistently with (i); and
- (iii) to ensure that the continuous liquidity of the market is preserved, in the interests both of investors and of the Government as borrower.

These basic objectives and the way in which they have been addressed are discussed in turn below. In seeking to achieve them, certain fundamental steps (eg the switch from single to dual capacity) have to be taken by a particular date in the future ie "Big Bang Day". This abrupt transition will involve substantial but inescapable risks and uncertainties. Given this, the Bank is endeavouring, as a supplementary aim, to avoid, over the period of transition, adding further risks associated with other changes, which may in due course be desirable but which are not immediately necessary to bring about the essential restructuring of the market.

Competition

2 The present gilt-edged market structure centres upon two dominant (and six much smaller) single capacity jobbing firms which perform the key market-making role. There are a considerable number of other British and foreign firms (mostly banks and securities houses) which would wish to participate in this role, and which - in terms of capital, and of management and trading capability - could make a positive contribution to it, but which are at present effectively precluded from doing so by the rules for Stock Exchange membership (including single capacity).

3 The Bank is seeking to open this structure up to greater competition (paragraph 32) by offering technical market-making facilities (paragraphs 12-22) hitherto confined to the gilt-edged

jobbers, in principle, to all those willing (and having the capacity) to assume a continuous market-making obligation (paragraphs 5-7). This freedom of access should, as a matter of general principle, contribute to greater market efficiency - though it has to be said that the existing structure is in itself highly effective from many points of view. In particular -

- (i) the change should make for a more robust structure, less dependent on just two key firms in a high risk business; and
- (ii) it should, by making our securities trading structure more compatible with structures overseas, assist British securities firms in competing internationally.

4 Notwithstanding this basic commitment to openness the Bank has reserved the right to limit the number of participants in the initial, transitional, phase if it appears that there would otherwise be a serious risk of disorder which would damage confidence in the new structure from the outset (paragraph 33). Thereafter freedom of access would be restored.

5 Although not directly relevant to the consultation paper, which is concerned exclusively with the gilt-edged market, the Prime Minister will wish to be aware that the Bank is adopting a similar open approach in relation to the discount market. We have made it plain to the discount houses and to the market generally -

- (a) that we are not opposed to ownership links between discount houses and other financial companies, subject only to prior agreement with the Bank on any necessary conditions to ensure that the facilities made available to discount houses (to enable them to perform their function as bill market-makers and as intermediaries between the Bank and the rest of the monetary sector) are confined to that purpose, and are not used simply to benefit the treasury operation of the associated company; and
- (b) that we will be prepared to establish a full discount house relationship with newcomers, once they can demonstrate to us an adequate track record as bill market-makers.

- Catch 22?

It will be possible, in principle for all-comers, from the outset under (a) above, or after a year or two following "Big Bang Day" under (b) above, to run gilt-edged and bill market-making activities alongside each other, enjoying a trading relationship with the Bank in both areas, against acceptance of the related market-making obligations. The more evolutionary approach under (b) above, compared with the discrete change in the arrangements for gilt-edged market-making reflects the fact that there is no equivalent of "Big Bang Day" in the discount market area, and the supplementary aim described in paragraph 1 above.

Investor protection and liquidity

6 These two objectives are, in the Bank's view, inter-connected. Arrangements for investor protection which engender confidence in the market will contribute to its liquidity; and arrangements to ensure the liquidity of the market will contribute to investor protection by helping to ensure that the investor receives not only a "fair" market price but a "good" market price.

7 Investor protection in the gilt-edged market is currently ensured by the Stock Exchange, both generally through its insistence on high professional standards in its membership, and more specifically through the system of single capacity trading.

8 The Bank's proposals aim to preserve as far as possible the benefits of the Stock Exchange's tradition for effective investor protection in this sense in the new market structure. It is for this reason that we have stated our intention to confine our own dealings in gilt-edged to market-makers, who are Stock Exchange member firms (paragraph 8). But we have made it clear to the Stock Exchange from the outset that we will be unable to maintain that position unless their terms of access to Stock Exchange membership are seen to be "reasonable" in general market perception. The Stock Exchange authorities recognise this. On the assumption that the gilt-edged market does indeed remain within the Stock Exchange on this basis, the Exchange authorities will monitor all bargains with non-members for "fairness", and will pursue, and initiate, complaints if bargains are outside the normal trading range at the time.

9 Keeping the gilt-edged market within the Stock Exchange will also provide the best chance of preserving a presence on the "floor" of the Exchange, where certain gilt-edged market-makers will operate effectively in much the same way as single capacity jobbers under the present arrangements. This would mean that the smaller, private investor in particular would continue to have the option of having his business transacted on an agency basis through a broker and so, if he so chooses, to enjoy the present form of protection (enhanced by time-stamping of contracts, publication of time-related prices in the Stock Exchange Official List, and by Stock Exchange monitoring of all bargains with non-members of the Exchange as in paragraph 8 above).

10 It is not proposed that there should be a public last trade (price and volume) tape in the gilt-edged market as is proposed for the equity market. The essential reason for this is that, in the gilt-edged market, there is a substantial risk that such information would be damaging to market liquidity.

11 The gilt-edged market is fundamentally different from the market in equities. There are only a comparatively limited number of gilt-edged stocks, essentially similar to one another, and all liable to be influenced in a broadly similar way by the same (mostly macro-economic) market developments. As a result, compared with the equity market, market-makers in government securities tend to be far more dependent for their return on position-taking than on the margin between their buying and selling prices. Such position-taking, which provides the essential liquidity to the market, would be inhibited if the position were to become public knowledge: for example, a market-maker would, in that case, be reluctant to bid for a sizeable amount of stock, because the market would move against him when he sought to sell it again. Basically for this reason there is no last trade tape in any government bond market anywhere in the world; and we have been strongly advised by participants in the US markets, who are generally enthusiastic about a tape for equities, against any equivalent in the gilt-edged market. There will nevertheless - in addition to the arrangements for investor protection in paragraphs 8 and 9 above - be far more price information publicly available in the new gilt-edged market structure than at present (paragraph 22).

12 As a further aspect of investor protection, the Bank is also concerned to ensure that investors are protected against default by the gilt-edged market-makers, and to this end proposes that they should

accept a fairly rigorous form of prudential supervision (including daily reporting of gilt-edged positions) which is the substance of the detailed proposals in Annex 1 of the consultation paper. This supervision, and in particular the requirement for dedicated sterling capital in the UK, should also help to underpin continuous market liquidity. As longstops, the investor will be further protected by -

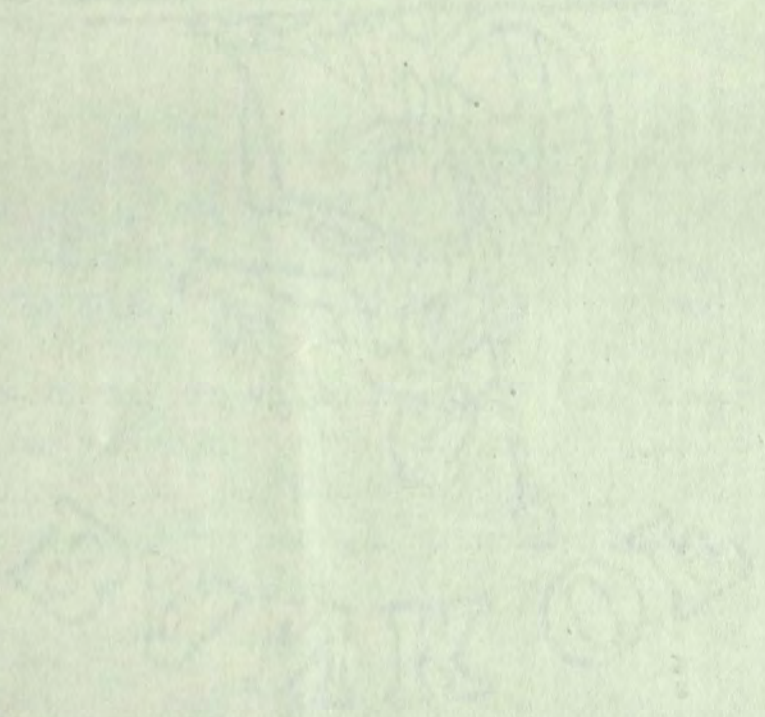
- (i) assurances to be sought from substantial shareholders in any gilt-edged market-making entity that they accept ultimate responsibility for its liabilities; and
- (ii) the Stock Exchange Compensation Fund.

13 The liquidity of the new market structure will be supported by the primary obligation that market-makers will be required to accept, ie "to make, on demand and in any trading conditions, continuous and effective two-way prices" (paragraph 5). In practice we would expect that the real assurance of continuous liquidity will be provided by the intensity of competition between the market-makers; but the explicit market-making obligation will provide additional support to this objective, and provide a yardstick against which the justification for the facilities extended to market-makers can be monitored in each individual case on a continuous basis.

Accountability

14 The proposed arrangements will mean a considerable extension of the Bank's role in supervising the gilt-edged market, and we recognise the desirability of established procedures for external oversight of the manner in which the new arrangements are administered. We have therefore indicated (paragraph 34) our readiness to accept the jurisdiction of the proposed new securities and investment body, which would include, when the new securities legislation is in place, the jurisdiction of the appeals tribunal.

UNITED STATES OF AMERICA



57 JAN 1985

12 1
10 2
9 3
8 4
7 5
6 6