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PRESS NOTICE

INTERIM UPDATE ON FUTURE PROVISION OF GILT AND TREASURY BILL REFERENCE PRICES

Further to the announcement on 21 January 2015 regarding the future provision of gilt and Treasury bill reference prices, the DMO is now providing an interim update to keep stakeholders informed of progress to date and of matters arising.

Market engagement process

The DMO is currently part-way through a first phase of engagement with the market, which it anticipates will finish in April 2015. It has met a range of stakeholders to date, including market participants and market infrastructure providers, as well as some potential new price providers. The engagement process has included bilateral contacts as well as two large roundtable discussions, one with Gilt-edged Market Makers (GEMMs) and one with end investors. The agenda has been to explore the market's future requirements for gilt and Treasury bill prices.

Following the initial engagement period, the DMO anticipates that it will provide a more comprehensive update to the market, probably in May 2015.

Matters arising

During the engagement process, the potential for ongoing price contributions by the GEMMs for conventional and index-linked gilts (either on a submitted or streaming basis) has been highlighted as a possible determinant in the development of any future pricing solutions. Following transition, arrangements between any price submitters and price providers will be likely to be a matter to be agreed between those parties but there is no formalised DMO position on this at this stage. In the meantime, potential price providers are free to discuss possible arrangements directly with any price contributors, including GEMMs. In the interests of efficiency and transparency, the DMO will for now provide a simple post box service so that potential providers can if they choose ensure their messages are forwarded simultaneously to all GEMMs. Price providers can access this by e-mailing RefPrices@dmo.gsi.gov.uk.

Another issue of relevance to potential new price providers is likely to be the development of an appropriate methodology to use for constructing reference prices in order to best meet stakeholder needs. In practice there is a range of pricing methodologies that could be employed and stakeholders might have a preference for methodologies that differ from the existing approach. Nonetheless, for transparency, the Annex to this document provides an outline of the current pricing methodology used on behalf of GEMMA by the DMO.

NOTES TO EDITORS

The DMO announced on 21 January 2015 its strategic intention to withdraw in due course from the provision of daily end of day Gilt-edged Market Maker Association (GEMMA) and Treasury bill reference prices. As part of this process, the DMO is engaging with market participants to explore the requirements for gilt and Treasury bill prices, to build stakeholder consensus around the conditions for the DMO ceasing to provide reference prices, and to help stakeholders to identify potential alternative ways that requirements can be met. The DMO will continue to provide reference prices during the engagement and transition process.

The DMO currently publishes reference prices in all gilts formally on behalf of the Gilt-edged Market Makers Association (GEMMA). GEMMA reference prices were introduced in July 1996 and were published by the Bank of England until April 1998, when the responsibility transferred to the UK Debt Management Office. The DMO currently requires all GEMMs to contribute closing reference prices in all liquid gilts. Every evening the DMO uses these contributions to produce end of day reference prices and associated redemption yields for each gilt. It also derives and publishes prices for the less liquid gilts (including strips) on behalf of GEMMA.

The DMO has been publishing reference prices for Treasury bills since September 2003 and these are intended to provide indicative prices for the purpose of CREST valuation of collateral transfers. These prices are calculated by the DMO from prevailing GC repo rates adjusted by a spread which reflects the results from recent Treasury bill tenders.

The gilt and Treasury bill reference prices, including those derived by the DMO, are published to the DMO’s wire services pages, on the DMO’s website, and transmitted directly to various stakeholders.

This press notice will be appearing on the DMO’s website at: www.dmo.gov.uk

ANNEX: Current methodology for calculating Gilt and Treasury bill reference prices

Each evening the DMO publishes on behalf of the Gilt-edged Market Makers Association (GEMMA) reference prices and associated gross redemption yields for each gilt on its wire services pages and its website. It also publishes the equivalent information for Treasury bills on behalf of CREST. This annex explains how prices and yields for different types of instrument are currently calculated.

Gilt prices

Conventional and index-linked gilts

Members of GEMMA provide clean, mid-market prices for all conventional gilts and index-linked gilts. The median value of prices contributed for each gilt is first derived; any outlying prices are then excluded and the arithmetic mean of the remaining prices is then calculated. For conventional gilts, the margin for outliers is 15 pence and for index-linked gilts it is 20 pence. The averaged clean prices for conventional gilts and index-linked gilts are first rounded to 2 decimal places (consistent with the normal trading convention) and then adjusted to provide dirty prices for settlement the following business day. Dirty prices are rounded to 6 decimal places.

Rump gilts

Rump gilts are small gilts (in terms of nominal amount outstanding) for which the GEMMs are not required to make a market, but for which the DMO will be prepared to provide a bid price if requested. At present, rump gilts are those gilts with a nominal size that has been reduced to less than £850 million. There are currently four rump gilts[1], all of which are undated. The prices for these rump gilts are derived by the DMO from the price of a benchmark conventional gilt adjusted to reflect differences in factors such as maturity, optionality and liquidity. Prices are rounded as per conventional gilts.

Gilt strips

The prices for strips are calculated using the DMO's theoretical yield curve model fitted to conventional gilts. The yield curve model used by the DMO is the Variable Roughness Penalty (VRP) model developed by the Bank of England and employed by the DMO since 2007[2]. Under this approach, for a given maturity principal strip the price will be set to be identical to the price of the corresponding coupon strip regardless of whether these securities are trading at different levels in the market. Strip prices are rounded to 6 decimal places.

Gilt yields

All yields are calculated from prices using the DMO yield formulae, which are set out in "Formulae for Calculating Gilt Prices from Yields"[3]. This includes the use of a 3% inflation assumption for the calculation of yields on index-linked gilts with an 8-month indexation lag. Yields are calculated from the rounded averaged prices for each gilt, and the yields are rounded to 6 decimal places.

Treasury bill prices and yields

The CREST reference prices for UK Treasury bills are published by the DMO at the end of each business day. They are based on a money market yield to maturity calculation priced around prevailing GC repo rates, adjusted by a spread reflecting recent Treasury bill tender results and, if applicable, any specific supply and demand factors. These reference prices provide indicative mid prices for the purpose of CREST valuation of collateral transfers. Treasury bill prices are rounded to 6 decimal places. Yields are calculated from these prices using the standard money market price/yield formula.

[1] Excluding the two undated gilts for which a redemption date has been announced.

[2] See: http://www.bankofengland.co.uk/statistics/yieldcurve/index.htm

[3] See: http://www.dmo.gov.uk/public/technical/yldeqns.pdf