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Debt
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PRESS NOTICE

DMO LAUNCHES A CONSULTATION ON CPI-LINKED GILTS

The United Kingdom Debt Management Office (DMO) announces the launch today of a consultation to help build an evidence base to inform the Government's consideration of whether to issue gilts whose coupon and principal payments would be linked to the Consumer Prices Index (CPI). The formal period of consultation will close on 22 September 2011.

In reaching its decision, the Government will weigh the expected benefits, costs and risks of issuing CPI-linked gilts for itself as issuer and for the gilt market. In particular, the Government will assess the case for the launch of a new instrument with reference to:

(i) consistency with the debt management objective (i.e. minimising the long-term costs of meeting the Government's financing needs, taking into account risk) and the principles on which debt management policy is based;
(ii) the impact on liquidity and the good functioning of the gilt market more generally;
(iii) the likely size of demand for the new instrument; and
(iv) an assessment of the cost and resource commitment required for implementation in comparison with the potential size of demand.

In that context, the decision as to whether the Government will introduce CPI-linked gilts will need to take account of a range of factors including:

- the depth of investor demand for such instruments both in an absolute context and also relative to RPI-linked gilts and the extent to which potential investors would be prepared to pay a premium for such gilts. In particular, given that the UK pensions sector represents a key investor group for index-linked gilts, understanding the extent to which the shift to CPI as the statutory minimum for regulating occupational pensions will affect the preferred choice for pension fund Liability Driven Investment (LDI) purposes will be very important.

- the Government's assessment of the impact of any CPI-linked gilt issuance on the smooth functioning of the market in inflation-linked UK Government debt: for example, the Government is not inclined to issue a new type of debt instrument that is likely to appeal only to a very limited group of investors (or for a temporary period); and

- the potential risks associated with the introduction of CPI-linked gilts, including risks of market fragmentation and damage to liquidity (and how these risks might be managed).

The consultation document can be accessed at:
http://www.dmo.gov.uk/documentview.aspx?docname=publications/giltsmarket/consultationpapers/cons20110629.pdf&page=Gilts/Consultation

NOTES TO EDITORS

As at 31 March 2011 the inflation uplifted value of the index-linked gilt portfolio was £233.7 billion (22.6% of the overall gilt portfolio in uplifted terms). All existing index-linked gilts have their coupon and principal payments linked to the RPI. The UK pension and insurance sectors are key investors in and holders of index-linked gilts (and particularly long-dated maturities). Predominantly, index-linked gilts are held by pension funds as assets to match the nature of their liabilities.

In July 2010, the Government announced its intention to use the CPI as the measure of price inflation for determining the statutory minimum percentage increase for revaluation and indexation of private sector occupational pensions[1].

In December 2010, the Department for Work and Pensions (DWP) published a consultation document setting out the Government's preliminary views, in the form of a series of proposals, on whether there should be legislative provision to enable schemes to adopt CPI as their preferred inflation measure if they are currently unable to do so; and the case for legislation to avoid schemes having to pay the higher of RPI or the CPI.

[1] http://www.dwp.gov.uk/newsroom/press-releases/2010/july-2010/dwp088-10-120710.shtml

On 16 June 2011, the Government published a response to the consultation document[2]. In summary, the Government is not: (i) introducing legislation that would directly override the rules of occupational pension schemes without the consent of trustees or employers; or (ii) introducing a modification power to allow schemes to use CPI as the basis for revaluation and indexation of members' benefits.

As a result of this shift to CPI, the Government is aware that the availability of CPI-linked gilts may afford some pension funds an instrument with which better to hedge some of their liabilities. Pension scheme Liability Driven Investment (LDI), where investors seek to match the characteristics of their liabilities with specific investments, is a significant source of investor demand in the index-linked gilt market. The change from RPI to CPI for the purpose of indexing occupational pension schemes may affect the value of many pension schemes' liabilities and the preferred mix and type of hedging instruments schemes use to manage liabilities.

Given these changes the DMO is consulting now to help build an evidence base to inform the Government's consideration of whether to introduce CPI-linked gilts.

Comments on the subject matter in the consultation should be sent by close of business on 22 September 2011 to:

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

[2] http://www.dwp.gov.uk/docs/cpi-private-pensions-consultation-response.pdf