*United Kingdom*
**Debt**
**Management**
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# UNITED KINGDOM

# DEBT MANAGEMENT OFFICE

# CPI-linked Gilts:

# Response to Consultation

**29 November 2011**

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## A. Executive Summary

After careful consideration and taking into account the feedback received to the DMO's consultation, the Government has taken the decision **not to issue CPI-linked gilts in 2012-13**. The Government judges that issuance of CPI-linked gilts in the near-term would be unlikely to be cost-effective and would involve a number of risks, although it is possible that this could change over time. The decision not to issue CPI-linked gilts in 2012-13 does not preclude CPI-linked gilt issuance in the medium term, should there be a case to do so. The Government will therefore keep the case to issue CPI-linked gilts under review.

For issuance to occur at some point in the future, the Government would need to come to a judgement that the potential benefits of issuance outweighed the potential costs and risks, both for itself as issuer and for the gilt market. In particular, once the key uncertainties around the future composition of the Consumer Prices Index (CPI) are resolved, the Government would need to be satisfied that any demand for CPI-linked gilts would be sufficiently strong and sustainable and that issuance would be cost-effective. Were the Government to take the decision to issue CPI-linked gilts in the future, it would announce this in a manner consistent with the principles of transparency and predictability; and it would allow sufficient lead time between making an announcement and inaugural issuance to give the market time to prepare for the event.

1. On 29 June 2011, the DMO launched a consultation on CPI-linked gilts. In total, 51 written responses were received. The consultation attracted varied responses; views were expressed both for and against CPI-linked gilt issuance. Many of the responses highlighted some of the potential benefits of CPI-linked gilts, but tempered this with an appraisal of the uncertainty over whether demand would be sustainable over the long term, and/or an appraisal of the risks, costs and challenges around issuance, which led them either to

favour waiting until some of these issues were resolved, or to arrive at an inconclusive view overall.

2. A number of respondents emphasised the benefits of CPI-linked gilts, primarily from an investor perspective, suggesting that they would be a desirable asset with which to hedge CPI-linked liabilities. In general, however, the majority of respondents who commented on the cost-effectiveness of issuance indicated that they felt that it would be unlikely that investors would be prepared to pay a premium to buy CPI-linked gilts over gilts linked to the Retail Prices Index (RPI), at least at this point in time.

3. The consultation responses also highlighted several uncertainties and risks that suggest that the decision as to whether the Government should issue CPI-linked gilts is not straightforward. These uncertainties and risks, which are discussed in section C, are primarily related to:

- the depth and sustainability of CPI-linked gilt demand;
- the potential inclusion of owner occupiers' housing (OOH) in the CPI and the prospects for the index that will be used over the medium term to determine the annual Revaluation Order for pensions uprating[1]; and
- fragmentation in the index-linked gilt market, and associated illiquidity.

4. Some respondents expressed a concern over the depth and sustainability of demand for CPI-linked gilts over a longer-term horizon due to (i) the majority of CPI-linked liabilities from Defined Benefit (DB) pension schemes occurring in respect of deferred benefits, with the majority of pensions in payment remaining indexed to the RPI; and, therefore, (ii) the average duration of DB schemes' CPI-linked liabilities shortening as a result of a significant proportion of occupational pension schemes being closed to future accrual. On the other hand, a number of respondents pointed to other

[1] Legislation governing statutory revaluation and indexation of occupational pensions requires the Secretary of State each year to publish an Order setting out a percentage figure based on "the percentage which appears to the Secretary of State to be the percentage increase in the general level of prices in Great Britain" over the relevant reference period (i.e. the year to the preceding 30 September). In broad terms, the Revaluation Order sets out the minimum rate at which occupational pension schemes should generally revalue deferred pension rights and pay increases on pensions in payment.

potential sources of demand for CPI-linked gilts in the future, such as insurance buy-in/buy-out funds, defined-contribution pension schemes and funded public sector pension schemes, although some expressed reservations around the latter two.

5. The potential inclusion of OOH in CPI, and its timing, was raised by respondents as a concern which may make valuation of any CPI-linked gilts in the near term difficult and may lead to an additional risk premium being demanded in the yield. This uncertainty is likely to become clearer over time; it is possible that an expanded CPI which includes OOH costs could be produced from early 2013[2]. The majority of respondents who identified CPI methodology issues suggested the Government should not issue CPI-linked gilts until the uncertainty over the potential inclusion of OOH has been resolved.

6. Views were divided on how significant the problem of market fragmentation is likely to be. The majority of respondents considered this a non-trivial risk (with the potential for lower liquidity in both the RPI-linked and CPI-linked gilt markets), with varying views on the extent to which fragmentation is likely to be a problem. Approximately one third of respondents did not consider the introduction of CPI-linked gilts as likely to detract from liquidity in the index-linked gilt market. There were also a number of suggestions for ways in which this risk could be mitigated.

[2] In the 2011 Annual Report of the Consumer Prices Advisory Committee (CPAC) to the UK Statistics Authority, published in September 2011, it is stated that: "The completion of the remaining development tasks should remain a top priority for ONS. Once these tasks are completed CPAC will make a recommendation to the Authority on whether OOH should be included in an expanded CPI and the most appropriate method(s) for achieving this. This recommendation should be implemented as soon as possible. This is likely to mean that implementation will take place in early 2013. It is possible that the UK may adopt an approach which will differ from the OOH index being developed by the European Statistical System". A copy of the full report can be found at the CPAC section on the Office for National Statistics (ONS) website.

## B. Introduction

7. Following the Government's decision to move to using the CPI as the measure of price inflation for determining the statutory minimum percentage increase for revaluation and indexation of occupational pensions, the DMO launched a twelve week consultation on the issuance of CPI-linked gilts. The consultation opened on 29 June 2011 and closed on 22 September 2011.

8. The consultation document asked eleven key questions related to the areas of: potential demand for CPI-linked gilts; market fragmentation and other risks; CPI methodology; instrument design; and the lead time for implementation and inaugural issuance. The questions were open-ended and designed to draw-out respondents' views on a variety of issues considered relevant to the decision about whether or not to introduce CPI-linked gilts. Respondents were requested to provide any data and/or analysis in support of their views, taking into account the key criteria that the Government will consider in weighing up the case to issue CPI-linked gilts. These criteria, which would apply to the launch of any new instrument, are:

- (i) consistency with the debt management objective and the principles on which debt management policy is based;
- (ii) impact on liquidity and the good functioning more generally of the gilt market;
- (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.

9. In total, the DMO received 51 written responses to its consultation which comprised 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, industry bodies and one response from an individual. A full list of respondents is provided in the Annex. The DMO is grateful for the

productive and useful feedback that it received throughout the consultation, which helped inform views on CPI-linked gilt issuance.

10. Respondents' views were varied and they raised a number of important considerations relevant to the decision as to whether or not the Government should issue CPI-linked gilts. In summary, responses fell into one of three categories:

(i) Pro CPI-linked gilt issuance – responses that fell into this category were very much in favour of the Government issuing CPI-linked gilts. These responses were characterised by a desire to see the Government issue CPI-linked gilts and tended to emphasise the benefits of CPI-linked gilts, primarily from an investor perspective, including the insurance buy-in/buy-out market, suggesting that they would be a desirable asset with which to hedge CPI-linked liabilities. Responses in this category also tended to place either a low emphasis on the risks associated with the issuance of CPI-linked gilts or they did not consider these risks to be significant enough to deter issuance and/or warrant further investigation.

(ii) Mixed views – responses in this category typically highlighted potential benefits in favour of the issuance of CPI-linked gilts, but also highlighted potential costs, risks and challenges around issuance which would either favour waiting until some of these were resolved, or which resulted in an inconclusive view on issuance overall. Responses in this category tended to raise concerns around the potential issuance of CPI-linked gilts that suggested:

- the respondent was not convinced about the strength of the case to issue CPI-linked gilts (e.g. not convinced about the strength or sustainability of demand for CPI-linked gilts);
- there was uncertainty around the potential inclusion of OOH in the CPI and the index that would be used over the medium term for occupational pensions uprating that should be resolved before the

Government considers further the case to issue CPI-linked gilts; and/or

- the risk and potential cost of market fragmentation from issuing a CPI-linked gilt are relatively high.

(iii) Did not advocate the issuance of CPI-linked gilts – responses in this category either expressed little desire for CPI-linked gilt issuance or suggested that the potential costs and risks outweighed the potential benefits of issuance.

## C. Summary of Responses to Consultation Questions

11. This section sets out an overview of the responses to each of the questions in the consultation document, focusing on key themes, topics and issues raised by respondents.

### Potential demand for CPI-linked gilts

**Q1. What is the potential source, scale and depth of demand for CPI-linked gilts in an absolute context and also relative to RPI-linked gilts? How might such demand translate into cost-effective issuance for the Government? What would be the size of any premium that potential investors would be willing to pay for CPI-linked gilts (e.g. as a spread to RPI-linked gilts)?**

DB pension scheme Liability Driven Investment (LDI) demand

12. Respondents generally acknowledged that the largest potential investor group for CPI-linked gilts is likely to come from the LDI activity of DB pension schemes, where schemes seek to match the characteristics of their liabilities with specific investments. A number of respondents noted that around two-thirds of DB pension scheme liabilities are assumed to remain linked to the RPI, with around one-third of scheme liabilities being linked to CPI.

13. A number of responses made the distinction between the proportion of CPI-linked liabilities in revaluation and the proportion of CPI-linked liabilities in pensions in payment. These supported findings from the Department for Work and Pensions (DWP) survey on the effect of uprating by CPI on occupation pension schemes[3]; namely that the majority of CPI-linked liabilities are in revaluation, with the majority of RPI-linked liabilities in pensions in payment. Responses that estimated the proportion of liabilities linked to CPI calculated that private sector liabilities linked to CPI are likely to be in the

[3] IFF Research conducted a survey on behalf of DWP on the effect of uprating by CPI on occupational pension schemes. The survey consisted of a telephone interview with 200 pension scheme managers representing a cross-section of small, medium and large defined benefit schemes. The results of the survey can by found at: http://research.dwp.gov.uk/asd/asd5/WP102.pdf.

region of around £250bn to £400bn, with RPI-linked liabilities likely to be in the region of around £650bn to £800bn.

14. While most respondents were of the view that the potential demand for CPI-linked gilts could arise from those seeking to hedge CPI-linked liabilities, there were differing views on the amount of that potential demand that would be likely to materialise as actual demand. A variety of reasons were expressed as to why this may be the case, including:

- that a significant number of pension schemes will go from CPI-linked liabilities in revaluation to RPI-linked liabilities for indexation and it is not clear that schemes would chose to hedge in a two-stage process using CPI-linked gilts with forward starting RPI swaps, rather than hedge simply using RPI-linked gilts; and
- that pension schemes often hold equities and other growth assets to back their non-retired liabilities and may be less likely to want an explicit inflation hedge for those liabilities.

Sustainability of demand

15. Some respondents expressed a concern over the sustainability of demand for CPI-linked gilts over a longer term horizon due to the average duration of DB pension schemes' CPI-linked liabilities shortening as a significant proportion of occupational pension schemes are now closed to future accrual. It was suggested by some respondents, however, that there could be potential demand for CPI-linked gilts in the longer term from annuities paid out by defined contribution pension schemes, but that this would be unlikely to be a driver for demand in the short term.

Bulk purchase annuities

16. A number of respondents suggested that there could be potential demand for CPI-linked gilts from insurance companies in the pensions buy-in/buy-out market. Some respondents commented that insurance sector participants involved in the buy-in/buy-out business have a more stringent need to match assets with liabilities. It was reported that the lack of available

CPI hedging assets was being factored into the pricing of CPI pension buy-in/buy-out by insurers, and that the pricing was, therefore, prohibitively expensive. As such, CPI-linked gilts would be a preferred asset for insurance companies hedging CPI-linked liabilities.

17. It was also reported that bulk purchase annuities tend largely to occur for schemes which are relatively mature, i.e. in the pension payment stage, and that these would be more likely to be paying benefits linked to RPI.

Funded public sector pension schemes

18. Whilst no public sector schemes responded to the consultation, a small number of respondents mentioned funded public sector pension schemes as a potential source of demand for CPI-linked gilts. However, these responses also expressed caution with respect to how much potential demand may materialise as actual demand because of the fact that funded public schemes have to-date tended to hedge inflation to a much lesser extent than schemes in the private sector.

Overseas demand

19. A small number of respondents suggested that there may be potential additional demand for CPI-linked gilts from overseas investors who are more familiar with CPI as a measure of inflation (as it is a more universally used and recognised measure of inflation compared with RPI), but they believed that any such additional demand is likely to be marginal.

Cost effectiveness

20. Most respondents that discussed the potential cost-effectiveness of CPI-linked gilts suggested that demand would be price sensitive.

21. There were varying estimates from respondents as to the current fair value range of the RPI/CPI spread, with estimates ranging between 50 and 120 basis points, with the bulk of those suggesting that fair value is likely to be around 100 basis points. It was noted that estimating the fair value spread between the CPI and RPI inflation rates is not a straightforward matter as it

requires forecasting average mortgage costs over very long horizons as well as assessing the potential likelihood and impact of methodological changes.

22. A minority of respondents suggested that investors would be willing to pay a premium for CPI-linked gilts relative to RPI-linked gilts.

23. Some responses acknowledged the suggestion in the DMO's consultation document that, in theory, investors should be willing to pay a higher price for the debt instruments that better hedge their particular inflation exposure, all other things being equal. However, it was suggested that in practice investors may not be willing to pay a premium for CPI-linked gilts because of:

- an expected lower level of liquidity in CPI-linked gilts relative to RPI-linked gilts;
- differing views over what is likely to be fair value due to uncertainty over the potential inclusion of OOH in the CPI; and
- medium to longer dated RPI-linked gilts already being perceived as relatively expensive when compared with conventional gilts of equivalent maturity as evidenced through break-even inflation rates[4].

[4] Broadly, break-even inflation is calculated as the difference between the nominal yield on a fixed-rate bond and the real yield on an inflation-linked bond of the same maturity and credit quality.

**Q2. What is the substitutability between potential CPI-linked gilts and RPI-linked gilts? If the Government were to continue only to issue RPI-linked gilts, to what extent would they provide a suitable hedge for CPI-linked liabilities? What are the prospects for CPI/RPI hedging products emerging as an alternative liability management tool to CPI-linked gilts?**

24. There was no uniform view from respondents with respect to the degree of substitutability between potential CPI-linked gilts and RPI-linked gilts. GEMMs, however, tended to view CPI-linked gilts as having more substitutability with RPI-linked gilts than did investors. For example, it was suggested that for pension schemes that will go from CPI revaluation of deferred liabilities to RPI indexation for pensions in payment, it is far from clear that a 20 year CPI-linked bond would be a better hedge than a 40 year RPI-linked bond. In summary, respondents generally viewed RPI-linked gilts as a suboptimal hedge for CPI-linked liabilities, though views on the extent to which they are suboptimal varied amongst responses.

25. Some respondents suggested that the suitability of RPI-linked gilts to hedge CPI-linked liabilities depended on a number of factors, namely that:

- it depends on how well a scheme is hedged. For those schemes that are not well hedged (e.g. those that hold a significant proportion of “risky” assets such as equities) the difference between the change in CPI and RPI will be relatively small and therefore RPI-linked gilts will be a suitable hedge for CPI-linked liabilities. For schemes, however, that are well hedged, the CPI-RPI basis will represent a more significant risk;
- the inclusion of OOH in the CPI would reduce the CPI-RPI basis and, therefore, make RPI-linked gilts a better hedge for CPI-linked liabilities than otherwise;
- buy-in/buy-out terms may be unattractive without the availability of CPI-linked gilts; and
- given that many schemes will go from CPI-linked liabilities for revaluation to RPI-linked liabilities for indexation, the overall basis risk

may not be that great, and, therefore RPI-linked gilts may be a suitable hedge for many CPI-linked liabilities.

26. Respondents were universally of the view that the prospects for CPI/RPI hedging products emerging as an alternative liability management tool to CPI-linked gilts is unlikely in the absence of the issuance of CPI-linked gilts.

**Q3. If the Government were to issue CPI-linked gilts, how would issuance of these gilts fit into the existing index-linked gilt issuance strategy? What would be respondents' preferred split of issuance between RPI-linked gilts and CPI-linked gilts? What maturities or maturity range would be most suitable for hedging CPI-linked liabilities, taking into account the existing range of RPI-linked gilts?**

27. There was a common theme from respondents that if the Government were to issue CPI-linked gilts, then the proportion of total index-linked gilt issuance (i.e. RPI-linked gilts plus CPI-linked gilts) should remain at least at the same proportion of total issuance as in the 2011-12 financing remit. A number of respondents suggested that were the Government to issue CPI-linked gilts, then it should increase the overall issuance of index-linked gilts as this would help to mitigate the risk of market fragmentation.

28. A number of respondents stated that a long term commitment to issue CPI-linked gilts would be of the utmost importance to ensure the success of a CPI-linked gilt market, were the Government to issue CPI-linked gilts.

29. Several respondents suggested that syndication could be used to issue CPI-linked gilts.

30. There were varying views from respondents as to the preferred split of issuance between RPI-linked gilts and CPI-linked gilts. There were calls from some respondents for the Government to split issuance between RPI-linked gilts and CPI-linked gilts commensurate with the proportion of pension scheme liabilities estimated to be linked to RPI and CPI (i.e. two-thirds of

index-linked gilt issuance to be RPI-linked gilts and one-third to be CPI-linked gilts). Some respondents suggested that were the Government to issue CPI-linked gilts, it should consider issuing a proportion of CPI-linked gilts greater than the proportion of pension scheme liabilities estimated to be linked to CPI in order to build liquidity in a CPI-linked gilt market.

31. A number of respondents suggested that the Government would not need to announce a decision on the index-linked issuance split in the annual financing remit, but rather it could allow a degree of flexibility in the remit so that the split of issuance could be determined intra-year based on demand conditions and market feedback (e.g. feedback at the quarterly consultation meetings with gilt market participants). There were, however, some respondents who argued that the Government should announce a decision on the split of issuance in the annual remit because that would better adhere to the principles of predictability and transparency.

Maturities

32. The majority of respondents noted the shorter average duration of CPI-linked liabilities relative to RPI-linked liabilities because of the significant proportion of CPI-linked liabilities being in the revaluation of pensions in deferral rather than in pensions in payment. As such, a number of respondents suggested that the maturity range for hedging CPI-linked liabilities is more likely to be skewed towards medium and shorter-long dated gilts (see paragraph below).

33. A number of investors suggested issuing in the 10-20 year maturity area, commensurate with the average duration of CPI-linked liabilities, while a number of GEMMs tended to favour a broader maturity range in the 10-30 year area. There were some investors and GEMMs who suggested issuing CPI-linked gilts across the curve, similar to the RPI-linked gilt product range. A number of respondents suggested that were the Government to issue CPI-linked gilts, then they should have the same maturity dates as RPI-linked gilts in order better to facilitate basis trading and the development of an RPI-CPI

swap market and also to help mitigate the risk of market fragmentation (see also the summary of the responses to question 5 below).

**Q4. If the Government were to issue CPI-linked gilts, would respondents who hold RPI-linked gilts ideally prefer to shift a proportion of their portfolio from RPI-linked gilts into CPI-linked gilts? If so, what form might this take (e.g. relevant Government support such as conversion/switch operations)?**

34. There were varying views from respondents as to whether they would shift a proportion of their existing portfolio from RPI-linked gilts into CPI-linked gilts. Some investors commented that they would be likely to shift some of their RPI-linked gilts into CPI-linked gilts to hedge CPI-linked liabilities, while others suggested that they would have limited interest in shifting out of RPI-linked gilts into CPI-linked gilts.

35. Those investors who either expressed no or limited desire to shift from RPI-linked gilts into CPI-linked gilts or uncertainty around the degree of shifting referred to one or more of the following themes:

- that most pension schemes remain short of RPI-linked exposure to hedge RPI-linked liabilities even accounting for the changes to the index used to calculate the annual Revaluation Order;
- that switches out of RPI-linked gilts into CPI-linked gilts are only likely to occur if there is relative value (i.e. the degree of switching is likely to be price dependent);
- that it may take some time for an understanding of the required level of switching to be developed by pension schemes, their advisors and investment managers; and/or
- that the amount of switching from RPI-linked gilts into CPI-linked gilts may depend on whether OOH is included in the CPI given that the inclusion of OOH would reduce the basis risk between RPI and CPI.

36. There was an equally diverse range of views on the possibility of Government support to facilitate shifting out of RPI-linked gilts into CPI-linked gilts. Around a third of respondents favoured exchange operations (largely switch auctions rather than conversions) with some of those respondents favouring switches out of eight-month lag RPI-linked gilts into CPI-linked gilts. Some of those respondents who favoured a switch out of eight-month lag RPI-linked gilts into CPI-linked gilts premised their suggestion on taking those eight-month lag gilts to rump status[5]. Around a third of respondents suggested that exchange operations were worth considering were the Government to issue CPI-linked gilts, but that a decision regarding the use of exchange operations could be made in the future after a CPI-linked gilt market had developed. Approximately a quarter of respondents advised against exchange operations out of RPI-linked gilts (including eight-month lag gilts) into CPI-linked gilts, suggesting that this would risk damaging liquidity in the RPI-linked gilt market.

## Market fragmentation and other risks

**Q5. Would the introduction of CPI-linked gilts detract from the liquidity of RPI-linked gilts or otherwise fragment the index-linked gilt market? How might any such fragmentation be minimised?**

37. The majority of respondents suggested that there is a non-trivial risk that the introduction of CPI-linked gilts could detract from the liquidity of RPI-linked gilts or otherwise fragment the index-linked gilt market. There were, however, varying views on the extent to which fragmentation is likely to occur. Some respondents suggested that three different index-linked gilts (i.e. three-month and eight-month lag RPI-linked gilts, and CPI-linked gilts) would not be sustainable, considering that there is already a degree of market fragmentation in the index-linked market with two different types of RPI-linked gilts in issuance. Some respondents suggested that were the Government to issue CPI-linked gilts, there is a risk that CPI-linked gilts may inevitably be

[5] A gilt that has been declared a rump by the DMO is one in which the GEMMs are no longer obliged to make a market (i.e. quote two-way prices).

susceptible to an initial period of infrequent trading and illiquidity. Some GEMMs suggested that market fragmentation may mean that the primary dealers would need to warehouse positions for longer and thus deploy more risk capital and balance sheet capacity to the index-linked gilt market.

38. Some respondents did not consider that the introduction of CPI-linked gilts would be likely to detract from liquidity in the index-linked market with some of those respondents suggesting that trading between RPI-linked gilts and CPI-linked gilts would mitigate the risk of fragmentation. It was also suggested that elevated borrowing requirements in the near term should mitigate the risk of market fragmentation from issuing CPI-linked gilts.

39. There was an array of different suggestions from GEMMs and investors to mitigate the risk of market fragmentation from issuing CPI-linked gilts. A number of respondents suggested issuing CPI-linked gilts with the same maturity dates as three-month lag RPI-linked gilts in order to facilitate trading between the two markets. Other suggestions were:

- use the same design for CPI linked gilts as three-month lag RPI linked gilts to facilitate trading between the two gilts;
- issue a greater proportion of the total remit in index-linked gilts;
- continue issuance of RPI-linked gilts in parallel with CPI-linked gilts;
- wind down the eight-month lag RPI-linked gilt market and exchange for three-month lag index-linked gilts - either CPI-linked or RPI-linked (i.e. have just two types of index-linked gilts available); and/or
- limit the number of CPI-linked gilt issues and build up issuance in these.

**Q6. Are there any other issues and risks that the Government should be aware of in launching a new CPI-linked gilt and developing a market for such gilts? If so, how might any such risks be managed?**

40. A number of other risks were identified by respondents for the Government to take into account when considering the case to issue CPI-linked gilts.

41. Approximately half of all respondents identified CPI methodology and the possibility of inclusion of OOH in the CPI as an issue that the Government needs to take into account when considering, in particular, the timing of launching any CPI-linked gilt. The majority of respondents who identified CPI methodology issues suggested that the Government should not issue CPI-linked gilts until the uncertainty over the potential inclusion of OOH has been resolved. The issues around CPI methodology are discussed in greater detail in question 7 below.

42. Other risks identified by respondents were:

- the potential for legal challenges to the introduction of using CPI to calculate the statutory minimum for pension uprating by a significant number of pension schemes (or their members); and
- the risk that a significant proportion of investors wait until a CPI-linked gilt market develops before investing in CPI-linked gilts, thus making initial issuance relatively risky.

**CPI methodology**

**Q7. Does the possibility of eventual inclusion of owner-occupier housing in the CPI affect the relative demand for a CPI-linked gilt compared with an RPI-linked gilt, and/or the appropriate timing for its introduction?**

43. A significant number of respondents suggested that the possibility of inclusion of OOH in the CPI could have an impact on demand for CPI-linked gilts, with a number of those responses suggesting the impact on demand could be significant.

44. In summary, there were two issues around the potential inclusion of OOH in the CPI that were raised by respondents.

(i) Uncertainty over the inclusion of OOH in the CPI affecting the value of and desirability of a CPI-linked gilt: This issue was raised by most of the respondents who suggested that the potential inclusion of OOH in the CPI could have an impact on demand. Some respondents suggested that the uncertainty around what the CPI basket may contain over the short to medium term could potentially reduce demand for a CPI-linked gilt because it would make it harder to gauge fair value relative to an RPI-linked gilt. A number of respondents suggested the inclusion of OOH in the CPI would reduce the basis risk between RPI and CPI and would, therefore, make an RPI-linked gilt a better hedge for CPI-linked liabilities, other things being equal (i.e. it would reduce the desirability of CPI-linked gilts).

(ii) The risk of two versions of the CPI being published: A number of respondents noted that while the rules underlying the construction of the Harmonised Index of Consumer Prices (HICP, typically referred to as CPI) are decided by the European Statistical System, the Office for National Statistics (ONS) could publish an alternative/additional version of CPI that could include OOH. Some respondents noted that the ONS could, therefore, publish two versions of the CPI. Respondents suggested that this raised a significant risk around the issuance of CPI-linked gilts prior to any clarification from Government around which form of CPI it would use to determine the statutory minimum for uprating occupational pensions, were two versions of the CPI to be published. Some respondents felt that a decision on CPI-linked gilt issuance should be deferred until further clarity on this issue was forthcoming.

## Instrument design

**Q8. If the Government were to issue CPI-linked gilts, it is proposing that they would follow the same design as three-month lagged RPI-linked gilts, unless there was a compelling case to make any modifications. Are there any such modifications to instrument design that the Government should consider? In addition, how should any CPI-linked gilts be distinguished from RPI-linked gilts (e.g. in the naming convention)? Please state the rationale for your comments.**

45. Respondents agreed with the Government's proposal that were it to issue CPI-linked gilts these should follow the same design as three-month lagged RPI-linked gilts. A minority of respondents suggested there may be merit in adding a deflation floor to the design of CPI-linked gilts. Conversely, some respondents specifically stated that were the Government to issue CPI-linked gilts, then it should not include a deflation floor as this could heighten the risk of index-linked gilt market fragmentation.

46. A small number of respondents provided suggestions on a naming convention.

**Q9. If the Government were to issue CPI-linked gilts, do respondents agree with the Government's proposal not to make subsequent adjustments to the nominal value and/or coupon payment on CPI-linked gilts to take account of any revision in the CPI following its original publication? In addition, do respondents agree with the Government's proposal that accrued interest should be calculated using the first publication of the CPI, regardless of any potential later revisions?**

47. All respondents agreed with the Government's proposals.

**Lead time for implementation and inaugural issuance**

**Q10. If the Government were to issue CPI-linked gilts, when should the first issuance be? What would be the lead times required by investors, primary dealers and other interested stakeholders?**

48. There were varying views on when the first issuance of a potential CPI-linked gilt should be. Some respondents suggested the Government could begin to issue CPI-linked gilts as early as the beginning of 2012-13, while a number of respondents suggested there was merit in waiting for clarity about CPI methodology.

49. There was also an array of views from respondents in terms of the lead time required by investors, primary dealers and other interested stakeholders. A number of respondents suggested that from a systems perspective, a lead time of around three months from the point of announcement would be sufficient, providing CPI-linked gilts had the same design as three-month lagged RPI-linked gilts. Some respondents, however, suggested that from a pension scheme investment perspective, a period of six to twelve months from the point of announcement would be more appropriate as: some pension schemes would need mandates to trade CPI-linked instruments; it may take schemes time to calculate the risk they require to be hedged; pension schemes may need time to go through triennial revaluations with their

actuaries; and/or they may need time to review the impact of changes to legislation on cash flow profiles and hedging requirements.

**Q11. Is there a preferred maturity point at which the Government should focus any initial issuance of CPI-linked gilts?**

50. Most respondents suggested a maturity point for initial issuance of CPI-linked gilts in the 10-20 year area.

## Annex: List of Respondents

The Actuarial Profession
AllenbridgeEpic Investment Advisers
Aon Hewitt
Association of British Insurers
Association of Consulting Actuaries
Aviva Investors
Aviva UK Life
AXA Investment Managers
BlackRock
British Steel Pension Fund
BT Pension Scheme Management, Royal Mail Pension Plan & Hermes Fund Managers (joint)
Cardano
F&C Asset Management
Insight Investment
Investment Management Association
Lane Clark & Peacock LLP
Legal & General Investment Management
London Stock Exchange
Mark Capleton
Mercer
MetLife Assurance
The National Association of Pension Funds
P-Solve
Pension Insurance Corporation
Pension Protection Fund
Redington
Smith & Williamson
The Society of Pension Consultants
Standard Life Investments
State Street Global Advisors
Towers Watson

**GEMMs**
Bank of America Merrill Lynch
Barclays Capital
BNP Paribas
Citigroup Global Markets
Credit Suisse Securities
Deutsche Bank AG
Goldman Sachs International
HSBC Bank
Jefferies International
JP Morgan Securities
Lloyds Bank Corporate Markets
Morgan Stanley & Co. International
Nomura International
RBC Capital Markets
Royal Bank of Scotland
Santander Global Banking & Markets UK
Scotia Capital
Société Générale Corporate & Investment Banking
The Toronto-Dominion Bank
UBS Investment Bank