NAPF Response to the UK Debt Management Office's Consultation Document 'Supplementary Methods for Distributing Gilts'

1 About the NAPF

1.1 The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector. Because of the long-term nature of their liabilities, pension schemes have a natural demand for long-term conventional and index-linked gilts.

2 The benefits of increasing the supply of long-dated gilts

2.1 The NAPF welcomes the Government's medium term strategy to skew gilt issuance towards long-dated securities and the Debt Management Office (DMO)'s commitment to explore supplementary distribution methods.

2.2 The NAPF is strongly of the view that greater issuance of long-dated gilts will have a number of benefits to investors, corporates and Government.

Pension Funds

2.3 Pension funds would benefit significantly from a greater availability of a strategic asset. Due to Government legislation introduced over several decades, around 85 per cent of defined benefit pension liabilities are now inflation linked. Although scheme sponsors are not explicitly required to match their pension liabilities with assets of the same duration and nature there are considerable regulatory and accounting pressures to do so:

- **Regulation**: While the specific mix of assets required is not specified in law, The Pension Regulator expects trustees and sponsors to make a 'prudent' choice of assets. This regime has encouraged a marked move out of equities and into corporate and government bonds over recent years.

- **Accounting**: As corporate accounting requires companies to use current market values for pension scheme assets and to quantify their liabilities by reference to the return on AA rated corporate bonds, if they do not invest in corporate or government bonds of a similar duration and nature to their pension liabilities, they are faced with unacceptably high levels of volatility in their corporate accounts.

2.4 As yields increase (albeit incrementally) with increased supply, the pressure on corporate pension scheme sponsors' balance sheets would reduce. At a time when scheme sponsors are re-examining their pension arrangements, this is likely to be an important factor in companies' decisions to retain their schemes for new and/ or existing employees.

2.5 Pension funds seeking to de-risk, either through the scheme's own investment strategy or through a specialist buyout company, for example, would also be better able to do so at a more affordable price.

Government

2.6 The NAPF believes that raising long-term funds at low interest rates is consistent with the Government's debt management objective of minimising its financing cost over the long term. With long-term yields artificially low, Government would obtain access to funding at lower rates of interest than those available at shorter maturities. However, low yields are only helpful to Government if it takes advantage of them. It is much better, surely, to obtain funding at low long-term rates – even if those rates gradually rise – than to pay higher rates for shorter-term funding. The current favourable funding opportunities for Government may not persist into the future. If the natural buyers of gilts cannot access appropriate supply from UK government, they may invest in the bonds of overseas countries instead.

2.7 As companies find themselves under less pressure to put additional funds into their pension schemes, the Government's tax take is likely to be boosted by improved corporate profitability.

Corporates

2.8 Companies would have access to short and medium term debt with less 'crowding out' by government borrowing. Many companies seeking to recapitalise over the next few years will seek to do so by issuing corporate bonds. It is essential that they have the space in the market to operate.

3 Pension funds' demand for long-dated gilts

3.1 Over the past decade the UK has been almost unique among developed countries in having an inverted yield curve in the government bond market, and even after recent falls in short term interest rates, the yield curve remains inverted at the very long end. In the NAPF's view the inverted yield curve is evidence of a large and unsatisfied demand for long-dated gilts, particularly indexed linked. Skewing issuance at the long-end, thereby improving relative long-term yields and helping to establish a more normal yield curve, would do much to meet this pent-up demand.

3.2 One reason for a significant demand from pension funds for long-dated gilts is the positive impact on scheme liabilities, as the example below shows:

A one percentage point rise in interest rates will decrease schemes' reported accounting liabilities for a young, a medium and a mature scheme by the following amounts:

- Young scheme: 30 per cent
- Medium scheme: 25 per cent
- Mature scheme: 15 per cent

(Punter Southall figures as at end-December 2007).

3.3 Pension funds are particularly interested in index-linked gilts as better matching their liabilities. Index-linked issuance could be made even more attractive through upwards only indexation (that is, a floor of zero inflation), which would better match pension liabilities that cannot be adjusted downwards in deflationary times, as pension schemes cannot adjust pensions in payment downwards.

3.4 As we have indicated at the Economic Secretary's annual meeting with end-investors to discuss the DMO's remit, the NAPF would be happy to support the DMO through a supportive PR campaign. This would include:

- A supportive press release for on any changes and provision of a quote for inclusion on a DMO press release.
- Use of data from our Pensions Provision and Economic Crisis research, which showed 67 per cent of schemes want the Government to issue more long-dated index-linked gilts.
- Highlighting new issuance as the main headline on Policy Watch, and an article on our Finance Director hub and in our regular CEO bulletin.
- One of our regular editorial pieces on the issue.

4 Supplementary distribution methods

4.1 We are keen to work with the DMO to develop distribution methods that meet the needs of NAPF members and which also deliver for DMO efficiently executed and well covered issuances. In this context, we believe the adoption of supplementary gilts distribution methods could make a substantial contribution to matching supply to pension funds' demand for long-dated conventional and indexed-linked gilts. In particular, supplementary distribution methods could helpfully take account of the lumpy demand from pension funds.

4.2 Our views on the distribution methods proposed by DMO are set out below. We do not believe that these methods are mutually exclusive; the DMO should use them all, which may be helpful in identifying the methods most attractive to investors.

Mini-tenders

4.3 We particularly support the use of mini-tenders, with which the DMO is already familiar, and believe that they would provide a useful additional source of supply. We could envisage a situation where the opportunity to tender for a range of different maturities and types of gilt was virtually permanently open. This would also have the advantage of allowing the DMO to gauge better the demand for its main issuance.

Syndications

4.5 Syndications would be particularly appropriate in areas of the yield curve that are illiquid and for indexed-linked issuance, where there is not a good price in the secondary market from which bids can be priced. Likewise Dutch Direct Auction (DDA) type auctions, by eliminating the 'tail' and the threat of the 'winner's curse', could well be effective in similar circumstances.

Direct placement of gilts with investors

4.6 Despite the problems noted by the DMO and the difficulties for pension schemes in accessing the DMO directly themselves, we believe that mechanisms whereby pensions schemes – or investment managers or market makers acting on their behalf – could approach the DMO directly to meet LDI or similar demand are well worth investigating further. We are aware of a reluctance or inability for Gilt-Edged Market Makers (GEMMs) to hold much stock on their balance sheets in the current environment. We believe therefore that any method which allows GEMMs to put together matched bargains, by making clear that Government has stock available as required, would be very helpful. This might take the form of a "shop window", or a signalled willingness to 'tap' stock.

5 DMO remit

In view of the wider importance of gilt issuance to pension funds, other institutional investors and government, we do believe that the DMO's remit is currently too narrowly focussed. A more flexible remit, by allowing the DMO to respond 'opportunistically' to developments in the market, would make a significant contribution to allowing the DMO to match supply and demand. Even more radically, it might well be worth considering whether the DMO should be willing to operate in the derivative (swaps) market as well as in the physical gilts market.

6 Answers to specific questions

(a) Interaction between the pension sector and gilt issuance

1. *Do pension sector respondents perceive that there are difficulties with acquiring gilts that arise as a result of the auction process?*

Pension schemes do not normally participate directly in the markets themselves, but operate instead through investment managers acting as their agents (or as agents of the investment vehicles in which they invest) on the basis of agreed investment mandates. Their long-term investment focus and the strict governance processes according to which, quite rightly, their strategic investment decisions are made necessarily involve some delay between identification of investment needs and their implementation. Major changes in investment direction are most likely made on advice from their actuarial and investment advisers in response to infrequent events (for example, triennial or special valuations) whose outcomes are not easy to forecast. This leads to the 'lumpiness', at least in individual schemes' demand, identified in the Consultation Document and a pattern of demand that will not necessarily match the funding flows provided for in the DMO's remit.

2. *If so, what aspects of the auction process cause these difficulties and what do pension sector respondents' view as the appropriate solutions which would facilitate their participation at auctions?*

Greater flexibility in the DMO's remit would allow it to respond 'opportunistically' to pension scheme demand as it arose. We also believe strongly that difficulties in long-term issuance have caused the Government and the DMO to hold back from issuing sufficient long-term gilts, increasing prices and reducing yields at the long end (which we see as clear evidence of unsatisfied long-term demand) and – paradoxically – choking the demand that the authorities are seeking to access. Pension schemes' investment managers, competing on performance, will clearly hold back from investing in assets whose yield is inadequate.

3. *Do pension sector respondents believe that a supplementary gilt distribution method or methods would more effectively meet their demand for gilts? If so, is there a particular supplementary gilt distribution method that would most effectively address the concerns of the pension sector?*

We believe the introduction of supplementary gilt distributions mechanisms would make a useful contribution to meeting pension schemes' demand for gilts. Such mechanisms would not, however, provide the whole answer. Different mechanisms would work in different circumstances. Mini-tenders – with which the DMO is already familiar – would not only provide a useful additional source of supply but a means for the DMO to gauge investor interest for its main auctions. Syndications would be particularly appropriate in areas of the yield curve that are illiquid and for indexed-linked issuance, where there is not a good price in the secondary market from which bids can be priced. And direct placement of gilts with investors – or with investment managers or market makers acting on their behalf – are well worth investigating despite the problems noted by the DMO in the Consultation Document and referred to by ourselves.

We are aware of a reluctance or inability for Gilt-Edged Market Makers (GEMMs) to hold much stock on their balance sheets in the current environment. We believe therefore that any method which allows GEMMs to put together matched bargains, by making clear that Government has stock available as required, would be very helpful. This might take the form of a "shop window", or a signalled willingness to tap stock.

(b) Potential advantages/disadvantages of introducing supplementary gilt distribution methods into the DMO's financing remit

4. *Do respondents see merit in the Government introducing any supplementary gilt distribution methods for use as appropriate taking into account the quantum of financing to be raised in any year?*

We see considerable merit in the Government introducing supplementary gilt distribution methods.

5. *What do respondents regard as the potential draw-backs (if any) for the Government and for gilt investors of introducing a supplementary distribution method or methods?*

We understand that there may be concerns that supplementary distribution may increase the likelihood of disruption to the main auction process. We contend that the risks to the UK's credibility of an unsuccessful auction are overstated (especially given sterling's already straitened circumstances). So-called supplementary methods of distribution are more likely to match up buyers and sellers.

(c) Preference between distribution methods

6. *Do respondents have a preference for any particular supplementary gilt distribution method over other alternatives?*

Different mechanisms would be appropriate for different circumstances. We particularly support mini-tenders as a general distribution mechanism. Syndications (and possibly DDA type auctions) would be appropriate in areas of the yield curve that are illiquid and for indexed-linked issuance, where there is not a good price in the secondary market from which bids can be priced. We believe that there is much to be said for mechanisms with which the DMO is already familiar, but that other mechanisms – including direct placements – are worth investigating.

7. *For any distribution method preferred by respondents, what do they see as the benefits both for the gilt market and for the Government as issuer of gilts?*

More reliable issuance, properly matching potential demand, would be beneficial both for the gilt market and for the Government's access to funding over the long term.

8. *If respondents have a preference for a particular supplementary distribution method how do they see that method being implemented in practice?*

The key point is for Government to make clear that it has stock available and some flexibility on price.

(d) Potential size of gilt issuance using supplementary distribution methods

9. *What range of issuance sizes (relative to equivalent auctions) could take place via a supplementary distribution method in a way that would be successful for both the market and the Government as issuer?*

Small but frequent issues, or a willingness to respond to investor demand, are approaches which are likely to be mutually beneficial.

10. *Would a supplementary distribution method be more likely to allow successful issuance in large size (relative to auctions of equivalent maturity/type)?*

Syndications would be particularly appropriate for issuance in size for index-linked gilts and for long-dated conventional issues in parts of the yield curve lacking reliable benchmarks from which bids could be priced.

(e) Range of instruments capable of successful issuance via supplementary distribution methods

11. *Do respondents have views on which types of gilts/maturities it would be most appropriate to issue via supplementary distribution methods (e.g. should usage of supplementary distribution methods be limited to issuance of long-dated conventional and/or index-linked gilts)?*

Supplementary distribution methods would be particularly appropriate for, but should not necessarily be limited to, issuance of long-dated conventional and index-linked gilts.

12. *Should usage of supplementary distribution methods be limited to new issuance rather than re-openings of existing gilts?*

Again, we see supplementary distribution methods as particularly appropriate for new issuance but do not believe that they should be necessarily excluded as a means of re-opening existing gilts.

(f) Appropriate degree of pre-commitment by the Government

13. *Do respondents have views on the extent to which the Government would need to pre-announce specific operations/a programme of issuance using a supplementary distribution method or methods?*

As we said in our answer to Question 5, we feel that a pre-announced ceiling on the amount raised through supplementary distribution methods would allay concerns about market disruption. This ceiling could then be varied in subsequent remits in the light of experience.

(g) Timing and frequency of usage

14. *How frequently do respondents consider that a supplementary distribution method could be used (bearing in mind auctions remain the preferred means for issuance)?*

We do not see frequency as a problem.

15. *The Government will continue to publish an annual auction calendar in the DMO's remit. How should supplementary operations be included in the gilt auction calendar (if at all)?*

As a general comment, we believe that the DMO should be allowed greater flexibility to respond 'opportunistically' to demand as it arises. Supplementary operations should be specified in minimal detail, but we would envisage the remit setting a limit (whether in absolute terms or as a percentage of total issuance) on the amount to be raised through supplementary operations.

(h) Scheduling of operations

16. *How much flexibility should the DMO have around the scheduling of operations using supplementary distribution methods?*

We believe that the DMO should be allowed flexibility in the use of supplementary distribution methods.

17. *Does the appropriate degree of scheduling flexibility depend on the type of supplementary distribution method used? If so, respondents are invited to comment on this point for different types of supplementary operation.*

Market participants are better placed than pension schemes to answer this question.

(i) Lead time for implementation

18. *What would be the lead times that primary dealers and gilt investors would need before issuance via a supplementary distribution method took place within 2009-10?*

We see no reason why supplementary distributions methods (especially those with which the DMO and the market are already familiar) should not be rapidly put into effect.

(j) Mini-tenders

19. *If respondents have a preference for the establishment of mini-tenders for ongoing use in the DMO's remit, what do they see as the key benefits?*

Mini-tenders could provide an extremely flexible means of gilt issuance. One could envisage a number of tenders being simultaneously open for different maturities and types of gilt. This would also have the advantage of allowing the DMO to gauge better the demand for its main issuance.

20. *Do respondents see any improvements that could be made to the approach the DMO has used to mini-tenders during 2008-09 and, if so, what improvements would respondents recommend?*

We would look for greater frequency and a willingness to have open a number of tenders at the same time for different maturities and types of gilt.

21. *If respondents think that use of mini-tenders as a financing operation should be discontinued, what are their reasons?*

N/A. We see mini-tenders as a viable option for supplementary gilt issuance.