UK Debt Management Office
‘CPI-linked Gilts:
A Consultation Document’

NAPF Response

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NAPF recommendations

- The National Association of Pension Funds (NAPF) reiterates its call for increased issuance of long-dated gilts, and in particular long-dated index-linked gilts, to provide assets that better match its members' liabilities. Such a strategy will deliver a triple bonus:

  - it will help support occupational pension schemes by providing assets that better meet their liabilities;

  - it will support corporate Britain by reducing the amount companies put into occupational pensions, freeing up resources available for investment and growth; and

  - by issuing at the long end of the yield curve it will help the government with its deficit reduction strategy.

- The DMO has had no difficulty in finding buyers for long-term index-linked gilts even at current depressed yields. Demand for these is likely to increase considerably as yields rise and as pension schemes look for the opportunity to de-risk. So, there is no reason for the DMO not to issue more long-linkers. Demand from pension funds could be considerable as schemes continue to mature rapidly and continue to close, and the regulator and accounting standards push schemes towards a gilt-based investment strategy. Additional demand will also come from the Pension Protection Fund, whose liabilities are now linked to CPI, and NEST, whose default fund is based on performance above CPI.

- Pension schemes would welcome a choice of index-linked gilts that allows them to match pension liabilities more exactly. We recognise it is important to ensure that this does not have a negative impact on the functioning of the index-linked gilts market because of fragmentation. We therefore recommend that the DMO issue a pool of CPI-linkers within an overall increase in the pool of long-dated and index-linked gilts. There is likely to be substantial demand for CPI linkers: liabilities of private sector and local authority schemes that can switch to CPI for **both** indexation and revaluation could be in the order of £300 billion.

- This will allow room for benchmark CPI-linked gilts to be built up rapidly without a damaging reduction in RPI-linked issuance.

1 The National Association of Pensions Funds (NAPF)

The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 Defined Benefit (DB) and Defined Contribution (DC) 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.

2 The context: pension schemes and their asset needs

2.1 DB pension schemes are set up under trust by employers (scheme sponsors) to provide for pension obligations to their employees, which are long-term and inflation-linked. DC arrangements, where investment and longevity risks are borne by the employee, can be either trust or contract-based; while there is no commitment on the part of the employer to any particular level of benefit in DC schemes, DC schemes' investment strategies are directed at delivering pension benefits that are long-term and escalate in line with inflation.

2.2 The traditional model of occupational pension provision has been based on investing in risk-seeking assets. Increased costs resulting from the imposition of additional statutory obligations and increased life expectancy have led to more defensive investment strategies. This has been further encouraged by the way the pensions obligation is accounted for in the sponsor's accounts; this gives rise to volatility that in no way reflects the economic reality that pension liabilities change only gradually over time and that pension assets are held for their income flows over the long term.

2.3 Concerns about cost and volatility have led to a closure of DB schemes, first to new members and then to future accrual, further 'hardening' the liability and encouraging the focus on risk mitigation. The pace of scheme closures that had begun in the mid-1990s has hastened. The proportion of schemes open to new members halved between 2000 and 2005 and halved again between 2005 and 2009. The NAPF's most recent Annual Survey shows that just over a fifth of private sector DB schemes remained open to new members in 2010, while just under a fifth were closed to accruals

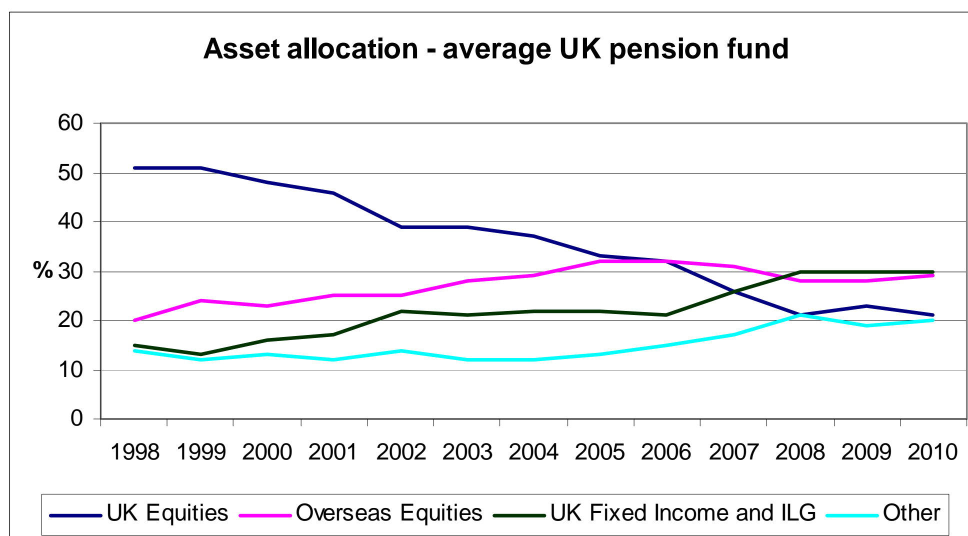
2.4 The NAPF has been pressing for a long time for increased issuance of long-term conventional and, particularly, index-linked gilts to provide assets that more closely match our members' liabilities. The existence of a deep and efficient long-term index-linked gilts market also provides a reference point for of the pricing of other assets through which our members can gain inflation exposure.

2.5 We are supportive of the DMO's work in developing a market in index-linked government debt. But we believe that UK pension schemes can absorb much more long-term index-linked issuance as is offered to them. The DMO has had no difficulty in finding buyers for long-term index-linked gilts even at current depressed yields from pension funds and insurers. We envisage that there would be a considerable further increase in demand at

higher yields as pension schemes for whom de-risking had become prohibitively expensive take the opportunity to do so.

2.6 Pension schemes do not hedge all of their inflation risk, nor are purchases of index-linked gilts the only way of obtaining protection against inflation. For much of the post-War period, the pensions funding model was based on seeking out-performance from risk-seeking assets held for the long term. Regulatory pressures and the closure of DB pension schemes that had the effect of 'hardening' pensions liabilities have led to a more defensive approach to investment. Pension scheme holdings of equities as a proportion of total assets peaked at just over 80 per cent in 1993. Over the past ten years pension funds have continued to shift their assets away from equities to fixed income and index-linked securities. Figure 1 shows pension scheme allocations to UK fixed income securities and index linked gilts almost doubling to 30 per cent between 2000 and 2010. This increase was matched by a further fall in their allocation to equities from just over 70 per cent to 50 per cent, partially offset by an increase in allocations to other asset classes[1]. Self-administered pension schemes' allocations to index-linked gilts, having dipped below 5 per cent of their total assets in 2005 and 2006, subsequently rose to 6.3 per cent of total assets at end-2009, taking their holdings of index-linked gilts to £70.3 billion[2].

Figure 1: Asset allocation, 1998-2010



Source: UBS Pension Fund Indicators

2.7 Pension schemes may gain protection from inflation through assets other than index-linked gilts. Equities, being claims on real assets, have traditionally been seen as offering inflation protection. Pension schemes invest, either directly or indirectly, in assets like property and infrastructure that offer the prospect of returns that increase with inflation. A number of companies with inflation-linked cash flows (for example utilities) have issued inflation-linked

[1] Much of the increase in 'Other' asset allocations was to alternatives.
[2] Office for National Statistics 'MQ5: Self-Administered Pension Funds' Balance Sheet at Market Prices', lines AHWC (Index-linked British government securities denominated in sterling) and RYIR (Total assets).

bonds. And pension schemes are also able to obtain protection from inflation through a well developed swaps market. An effective inflation swaps and index-linked corporate bond market depends on a well functioning index-linked gilts market that can provide opportunities for hedging and a reliable and transparent basis for pricing. The index-linked gilts market stands behind and provides support to the inflation swaps market and the corporate index-linked issuance market, and without it these markets would probably not have been able to develop. With government policy directed at increasing the use of CPI as the basis for inflation adjustment, there will be a greater need for CPI-linked instruments to match an increasing range of CPI-linked commitments. CPI-linked gilts can provide this protection not only in themselves but by providing the basis for the development of private CPI-linked markets.

2.8 An increased focus on prudential regulation following the financial crisis will further increase pressures on both pension schemes and insurance companies to de-risk. The Solvency II Directive, by raising the capital requirements on insurance companies' unmatched positions, will increase their demand for index-linked gilts to match their index-linked liabilities. It will also put further pressure on pension schemes through the increased cost of investments (particularly annuities and bulk annuities) that they buy from insurance companies. There is also likely to be a greater prudential focus in pension scheme regulation following the European Commission's review of the Pensions Directive (IORP Directive) that will further incentivise risk mitigation and increase pension scheme demand for index-linked gilts. In view of the role of regulation in increasing the demand for index-linked paper, we feel that the Government – as the main source of supply – has a particular responsibility to ensure that there is adequate index-linked issuance to meet pension schemes' and insurance companies' need for assets with which they can match their liabilities.

3 Criteria for CPI-linked gilt issuance

3.1 The Consultation Document sets out four criteria on which the Government will base its decision whether to issue CPI-linked gilts:

- consistency with the debt management objective and the principles on which debt management policy is based;
- impact on liquidity and the functioning of the gilt market;
- likely demand for the new instrument; and
- cost and resource commitment required.

For the NAPF the key issue is the balance between the need for an instrument that more exactly matches our members' liabilities and concerns about the impact of CPI-linked gilts issuance on the functioning of the wider index-linked gilts market, for example because of fragmentation.

3.2 The cost and resource required to introduce CPI-linked gilts (the fourth criterion) is a matter for the Government and the DMO. Our comments on the other three criteria are set out below (sections 4-6 of our response). In the course of these comments we have sought to provide extensive evidence, particularly on the likely demand for the new instrument. In section 7 we answer the specific questions on pages 19-21 of the Consultation Document.

4 Consistency with the debt management objective

4.1 The issuance of new instruments that more exactly meet investors' requirements is consistent with the debt management objective[3], provided it can be done without impeding the smooth functioning of the gilts market. It should increase demand and allow finer pricing, thus reducing the costs of meeting the Government's financing needs. With the Government increasingly using CPI for inflation adjustment, CPI-linked gilt issuance could also be seen as reducing the Government's funding risk.

4.2 We believe that long-term and index-linked gilts represent excellent value for the Government and would remain good value even at higher yields. The ability to lock into long-term real yields of well under 0.5 per cent is very much in line with the DMO's remit of minimising the costs of meeting the Government's financing needs.

5 Impact on liquidity and the functioning of the gilts market

5.1 The impact on liquidity and the functioning of the gilts market is, of course, a concern for the NAPF. Like the Government, we believe that the debt management objective is achieved by developing a liquid and efficient gilt market and we support the debt management policy principles of openness, transparency and liquidity[4]. Pension schemes should welcome a choice of index-linked gilts that allows them to match pension liabilities more exactly. However, it is important to ensure that this does not have a negative impact on the functioning of the index-linked gilts market because of fragmentation. **The NAPF recommends that the DMO issue a pool of CPI-linkers within an overall increase in the pool of long-dated and index-linked gilts**.

5.2 Most buyers of long-term index-linked gilts buy to match liabilities and therefore 'buy and hold'. Increased issuance could encourage the development of a better two-way market that would further increase the transparency and reliability of the price determination process.

[3] 'to minimise, over the long term, the costs of meeting the Government's financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy' (DMO Consultation Document, paragraph 13).
[4] HM Treasury 'Reserves and debt management report 2011-12', pages 7-8.

6 Potential pension fund demand for CPI-linked gilts

6.1 *Statutory requirements for the revaluation and indexation of pension benefits*

6.1.1 Since the mid-1980s the Government has required certain pension benefits to be increased in line with inflation, subject to caps (see Box 1). The impact of this has been to push up pension scheme liabilities. Schemes may increase benefits by more than the statutory minimum where the scheme rules provide for higher increases or allow trustees discretion to pay higher increases.

Box 1: Statutory requirements for revaluation / indexation of pension benefits

- Revaluation of deferred pension rights
  - for service before 6 April 2009 – inflation subject to 5% cap
  - for service from 6 April 2009 – inflation subject to 2.5% cap
- Indexation of pensions in payment
  - for service before 6 April 2005 – inflation subject to 5% cap
  - for service from 6 April 2005 – inflation subject to 2.5% cap
- Guaranteed Minimum Pensions (GMPs)
  - inflation subject to 3% cap

6.1.2 For inflation reference periods ending 30 September 2010 and for subsequent reference periods the statutory minima will now be expressed in terms of the Consumer Price Index (CPI) rather than the Retail Price Index (RPI)[5]. This has further complicated the arrangements for the revaluation and indexation of pension benefits. Depending upon their schemes rules, some schemes will automatically switch to CPI for some (but not necessarily all benefits), others will have the option to do so while yet others have RPI hard-wired into the scheme rules – again not necessarily for all benefits.

6.2 *NAPF survey of potential DB pension scheme demand for CPI-linked gilts*

6.2.1 In late April and early May we surveyed members to ascertain potential DB pension scheme demand for CPI-linked gilts. The survey results[6] are attached as Annex A. The survey provides a starting point for estimating an upper bound on DB pension schemes' need for protection against CPI and RPI measures of inflation.

6.2.2 The survey suggests that, following the move to CPI for the determination of the statutory minima for revaluation and indexation increases:

- 80 per cent of schemes would be allowed to switch to CPI for deferred benefits;

[5] Where schemes continue to use RPI for indexation or revaluation of benefits, they will not be obliged to use the CPI when it is higher than the RPI.

[6] 'DB Pension Scheme Demand for CPI-indexed Gilts', NAPF, June 2011. The survey results have already been forwarded to the DMO but are included as an Annex for convenience.

- 30 per cent would be allowed to switch for pensions in payment; and

- a high proportion of schemes that could switch would do so (almost 90 per cent for deferred benefits, 75 per cent for pensions in payment).

The survey figure for the proportion of schemes that would be allowed to switch to CPI for pensions in payment is line with an earlier NAPF survey and with research undertaken for the DWP, but the earlier NAPF survey suggested that 30 per cent of schemes (rather than 20 per cent) were tied to RPI for deferred pensions[7]. Requirements to increase benefits in line with inflation – whether RPI or CPI – are subject to a cap for over three quarters of the respondents to the NAPF's survey, implying that in an inflationary environment neither CPI nor RPI indexation would provide an exact match for most pension schemes' liabilities.

6.2.3 Schemes were more or less evenly split on whether RPI index-linked gilts provided an acceptable hedge for CPI-linked liabilities (52 per cent 'yes'; 48 per cent 'no'). Not surprisingly in view of the uncertainties about pricing and arrangements for conversions, many schemes – about a third of total – were undecided about whether they would invest all or part of cash inflows in CPI-linked gilts, and/or switch all or part of existing holdings into CPI-linked gilts. Two-fifths of schemes that could switch to CPI would invest some or all of new inflows in CPI-linked gilts; 30 per cent felt that they would switch all or part of their existing holdings.

6.2.4 In a final salary DB scheme, accrued benefits for active members increase in line with pensionable pay. Box 2 combines this with the survey responses to provide an estimate of how liabilities for different kinds of benefit are linked to different measures of inflation.

Box 2: Inflation measures for revaluation / indexation of pension liabilities

- Active members' accrued service – pensionable pay
- Deferred liabilities
  - 20 per cent – RPI or Limited RPI
  - 80 per cent – CPI or Limited CPI
- Pensions in payment
  - 70 per cent – RPI or Limited RPI
  - 30 per cent – CPI or Limited CPI

6.3 ***Punter Southall research***

6.3.1 Punter Southall has provided us with estimates of the value of funded pension liabilities (private sector DB schemes and local authority schemes) that could switch to CPI indexation for revaluation of deferred benefits, indexation of pensions in payment or both. The

[7] NAPF 'CPI: The view of pension schemes', December 2010. For the research undertaken for the DWP, see Department of Work and Pensions 'The impact of using CPI as the measure of prices increases on private sector occupational pension schemes: Consultation on Government proposals', December 2010, page 14. The DWP writes 'We believe that there may be as many as 70-80% of schemes tied to RPI for the indexation of pensions in payment, and many of them would find it hard to move to CPI'.

estimates for private sector pension liabilities are based on Section 179 liabilities that have been adjusted to provide an estimate on a scheme specific funding basis, the measure on which pension schemes are most likely to target their investment and risk mitigation strategies. The estimate for local authority pension schemes, which – unlike most other public sector schemes – are funded, is a CIPFA survey figure[8]. The estimates are set out in Box 3. Local authority pension schemes have switched to CPI indexation for both revaluation of deferred benefits and indexation of pensions in payment, as has the Pension Protection Fund (PPF).

Box 3: Pension scheme liabilities that could switch to CPI indexation

Private sector DB schemes

Liabilities that could switch to CPI (deferred benefits, pensions in payment or both):
£300 billion – £400 billion

of which: CPI for deferred benefits but RPI for pensions in payment:
£200 billion – £265 billion[9]

Local authority pension schemes

Liabilities for both deferred benefits and pensions in payment, which will switch to CPI indexation:
£180 billion

Source: estimates provided by Punter Southall (figures as at 31 March 2010)

6.3.2 Punter Southall's estimates suggest that two-thirds of the private sector pension liabilities that could switch to CPI indexation for revaluation of deferred benefits are tied to RPI for indexation of pensions in payment. While schemes with CPI-linked liabilities for deferred members but RPI-linked liabilities for pensions in payment could have less incentive to match their CPI-linked liabilities, there is still likely to be substantial demand for CPI linked gilts from pension schemes: CPI-linked liabilities of private sector and local authority schemes that can switch to CPI for **both** indexation and revaluation could be in the order of £300 billion.

6.3.3 In due course, both the Pension Protection Fund (PPF) and NEST could also be a substantial source of demand for CPI-linked gilts. Benefits paid by the PPF are linked to CPI[10], while NEST, whose investment strategy will be benchmarked on CPI in its Growth Phase Retirement Date Funds[11], was forecast in the Pensions Bill Impact Assessment 2007 to have around £100-300 billion under management by 2050[12].

[8] http://www.cipfa.org.uk/press/press_show.cfm?news_id=61468
[9] Around £50 billion for active members who could become CPI in deferred but RPI in pensions in payment is included in this figure.
[10] According to the Purple Book, liabilities of schemes in assessment were £9.5 billion on an s 179 basis at 31 March 2010: http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Purple_Book_2010_chapter10.pdf.
[11] A target of CPI plus 3 per cent: NEST 'Developing and delivering NEST's Investment Approach, paragraphs 3.7-3.8.
[12] £100-300 billion in 2007/08 earning terms: http://www.dwp.gov.uk/docs/pensionsbillimpactassessment-final2.pdf.

6.4 *From potential to actual demand*

6.4.1 The question of the extent to which potential demand for CPI-linked gilts will convert into actual demand is more difficult to assess. It will depend on, among other things:

- the extent to which pension schemes are looking for an exact match to their liabilities. If schemes are only partially hedged and are not seeking to match their assets exactly, they will be more willing to adjust in other ways for the basis risk in the difference between RPI and CPI measures of inflation.

- how far schemes see RPI and CPI indexation as matching their liabilities, which, in the majority of cases, are anyway subject to a cap (Limited Price Indexation – LPI). Where inflation is above the cap, either measure of inflation will provide more protection than is needed and schemes that attempt to match their liabilities by investing in assets linked to inflation will end up paying over the odds for protection. Where inflation is above the cap, CPI-linked gilts, linked to what is expected to be the lower measure of inflation, will provide a more cost-effective hedge provided the expected difference between the two measures is properly reflected in the relative price of CPI and RPI-linked gilts.

- the absolute cost of the new instrument and its cost relative both to RPI-linked gilts and to other assets. Demand for CPI-linked gilts will be reduced if the price of the new instrument does not adequately reflect the expected difference between the CPI and RPI measures of inflation. More generally, demand for index-linked gilts will also depend on the relative attractiveness of other asset classes in which pension schemes can invest.

6.4.2 We believe that many schemes will take the opportunity to de-risk further if it can be done at an acceptable cost and we would expect to see increased demand for index-linked gilts if real yields rise. Other things being equal, schemes with liabilities linked to the CPI will buy CPI-linked gilts – but only if CPI-linked gilts are trading at fair price in relation to RPI-linked gilts. Successful CPI-linked issuance thus depends on a commitment by the DMO to establish a viable CPI-linked gilt market.

7 Replies to specific questions

Potential demand for CPI-linked gilts

1 *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)?*

1.1 Section 6 of our response discusses the potential pension fund demand for CPI-linked gilts, focussing mainly – but not solely – on demand from DB pension schemes. The upper bound of demand from DB schemes is set by the extent to which they can switch from RPI to CPI for revaluation of deferred pension rights and indexation of pensions in payment. Estimates kindly provided to us by Punter Southall (see Section 6.4) suggest that liabilities of £300-400 billion could switch to CPI for deferred benefits, pensions in payment or both. Two-thirds of this, however, relates to liabilities that will switch back to RPI for pensions in payment. In addition there are some £180 billion of local authority pension scheme liabilities for deferred benefits and pensions in payment; these will switch in their entirety to CPI.

1.2 A survey by the NAPF of potential DB pension scheme demand for CPI-linked gilts (described in Section 6.2 and in more detail in Annex A) suggests that most DB schemes that can switch will switch. The question of how far this potential demand converts into actual demand is more difficult. Section 6.4 outlines the considerations on which decisions about investing in CPI-linked gilts will be made. These include:

- the extent to which pension schemes are looking for an exact match for their liabilities;
- how far they see RPI and CPI as matching their liabilities (inflation revaluation or indexation of which is, for most schemes, subject to a cap); and
- the absolute cost of the new instrument and its cost relative both to RPI-linked gilts and to other assets.

1.3 The NAPF survey gives an indication of pension schemes' intentions on whether they will invest in CPI-linked gilts. Schemes were more or less evenly divided on whether RPI index-linked gilts offered an acceptable hedge for CPI-linked liabilities. Two-fifths of schemes that could switch to CPI said that they would invest some or all of new inflows in CPI-linked gilts and 30 per cent said they would switch all or part of their existing holdings[13].

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[13] This answer has to be interpreted in the context of the very high proportion of 'Don't knows' – over a third of total replies.

1.4 DB pension scheme demand will not be the only source of demand for CPI-linked gilts from occupational pensions. Some £870 billion of pension monies are administered by insurance companies. Pension schemes are also clients of insurance companies for a range of investment products including unitised and with profits policies, bulk annuities and buy-outs (the latter mainly in relation to pensions in payment). Much of the insurance companies' pensions business is for Defined Contribution (DC) pensions where there is no commitment to any given level of benefits in the accumulation phase, but insurance companies will seek to satisfy investors' needs for inflation protection. The provision of index-linked annuities for the decumulation phase is extremely expensive, and insurance companies could appreciate the opportunity to offer annuities linked to the lower CPI measure of inflation, which should be cheaper to provide if there were a CPI-linked instrument to support it.

2. *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?*

2.1 Respondents to the NAPF member survey were more or less evenly divided on whether RPI-linked gilts provided an acceptable hedge for CPI-linked liabilities. The extent to which schemes need an exact match to their liabilities will depend on how far they are down the de-risking route; if only part of their liabilities are hedged, they will be less concerned about the exactness of the hedge. Furthermore, for most schemes indexation or revaluation will be subject to a cap (Limited Price Indexation) and in an inflationary environment capped CPI and RPI could be closer to each other than to the scheme's capped liabilities.

2.2 We believe that private markets will not be able to develop a product to hedge CPI/RPI basis risk at an acceptable cost in the absence of a well functioning CPI-linked gilts market. We see a well functioning CPI-linked gilts market as providing the transparent price discovery process that is needed for the development of a private sector CPI inflation market.

3 *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?*

3.1 We do not see CPI-linked gilts issuance as a substitute for RPI-linked gilts; they should be issued in addition to RPI linkers so there is an overall increase in long-

dated indexed-linked stock. As some 70 per cent of DB pension schemes are prevented by their scheme rules from switching to CPI indexation for pensions in payment, most pension liabilities will remain tied to RPI. The Punter Southall figures provided for the NAPF suggests that two thirds of the pension scheme liabilities for deferred benefits linked to CPI indexation will switch back to RPI for pensions in payment. With most DB schemes closed to new entrants, liabilities for pensions in payment as a proportion of total will increase over time. Our members will continue to need a well functioning RPI-linked gilts market.

3.2 If the Government were to decide to issue CPI-linked gilts it would be important to ensure that the wider index-linked gilts market was not undermined. The authorities should therefore issue more inflation-linked gilts than they would have otherwise have issued, so as to allow room for benchmark CPI-linked gilts to be built up rapidly without a damaging reduction in RPI-linked issuance.

3.3 Because most pensions in payment will remain RPI-linked, higher durations will be needed for RPI issuance than for CPI issuance. We believe that the authorities should concentrate first on building up CPI-linked benchmark gilts in the 15-20 year maturity range.

4 *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)?*

Once adequate CPI issuance is built up and a reliable price relativity between CPI and RPI issuance established, the authorities should provide conversion facilities to allow investors to switch between CPI and RPI-linked gilts.

Market fragmentation and other risks

5 *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?*

5.1 The impact on liquidity and the functioning of the gilts market is, of course, a concern for the NAPF. A single inflation index would be the ideal, but with most pension schemes tied to RPI indexation for pensions in payment it is not a practicable option. Maintenance of RPI issuance, with CPI issuance on top of it, would resolve concerns about fragmentation.

5.2 As already noted, fragmentation would be minimised by the authorities issuing more inflation-linked gilts than they would have otherwise have issued, so as to

allow room for benchmark CPI-linked gilts to be built up rapidly without a damaging reduction in RPI-linked issuance.

6 *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?*

We cannot think of issues and risks not already identified in the DMO's Consultation Paper.

CPI methodology

7 *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?*

We have no comment other than to note that the closer the indices, the less the need for separate CPI issuance.

Instrument design

8 *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 were 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.*

8.1 We support the proposal to follow the same design as for the three-month RPI-linked gilts. While CPI-linked gilts should be clearly distinguished from RPI-linked gilts, for example through their naming convention, their design should otherwise match RPI-linked gilts as far as possible so as to allow a transparent and clear basis for determining the relative price of CPI and RPI protection.

8.2 The Government should also consider options for providing conversion facilities to allow a more rapid phasing out of eight-month lagged RPI-linked gilts. We feel that this would lead to a less fragmented and more effective index-linked gilts market.

9 *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?

Yes, we agree with both proposals.

Lead time for implementation and inaugural issuance

10 *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?*

With an announcement of an intention to issue CPI-linked gilts around Christmas (that is, three months before the end of the current financial year), the first CPI-linked gilts could be issued in the 2012-13 financial year.

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

We believe that the authorities should concentrate first on building up CPI-linked benchmark gilts in the 15-20 year maturity range (see our answer to Question 3).

Annex A

DB Pension Scheme Demand for CPI Index-linked Gilts
NAPF Survey: Summary Results

Executive Summary

The NAPF undertook a survey of pension fund demand for CPI index-linked gilts in late April-early May 2011. The key results, based on responses from 67 pension schemes with £104.5 billion of assets, are as follows:

- the survey confirms the results of our earlier survey (December 2010) on the extent to which scheme Rules would allow schemes to switch to CPI indexation. While 80 per cent of schemes would be allowed to switch to CPI for deferred benefits (a higher figure than in our earlier survey), less than a third (30 per cent) would be allowed to switch for pensions in payment.
- a high proportion of schemes that could switch would switch.
- requirements to increase benefits in line with inflation are subject to a cap for over three quarters of respondents – both for deferred benefits and pensions in payment. This means that should we return to a period of high inflation, neither CPI nor RPI indexation would provide a good match for most schemes' pension liabilities.
- schemes were more or less evenly split on whether RPI index-linked gilts provide an acceptable hedge for CPI-linked liabilities.
- schemes are divided on whether they would invest in CPI index-linked gilts, with a large number of 'don't knows'.

Survey Results

The NAPF undertook a survey of its members' likely demand for CPI index-linked gilts in April-May 2011. The results of survey, based on responses from 67 pension schemes with £104.5 billion of assets, are set out in Annex A. These can be summarised as follows:

- Four-fifths (79 per cent) would be allowed by their rules to switch to CPI for deferred benefits; one third (30 per cent) for pensions in payment. This is consistent with an earlier

NAPF survey, undertaken in December 2010, on the impact of the Department for Work and Pensions (DWP)'s proposals for CPI indexation and with DWP surveys[14].

- Of those schemes which are allowed by their rules to switch to CPI, 87 per cent would do so for deferred benefits and 75 per cent for pensions in payment.

- Requirements to increase benefits in line with inflation are subject to a cap for over three quarters of respondents – both for deferred benefits and pensions in payment. This implies that should the UK return to a period of high inflation neither CPI nor RPI indexation would provide a good match for most schemes' pension liabilities.

- Schemes are more or less evenly split on whether RPI index-linked gilts provide an acceptable hedge for CPI-linked liabilities (52 per cent 'yes'; 48 per cent 'no').

- A final question asked whether schemes would invest all or part of cash inflows in CPI index-linked gilts, and/or switch all or part of existing holdings into CPI index-linked gilts. Not surprisingly in view of the uncertainties about pricing and arrangements for conversions, many schemes – about a third of total – were undecided. The majority, but not an absolute majority (40 per cent), would invest some or all of new inflows in CPI index-linked gilts, but only 30 per cent felt that they would switch all or part of their existing holdings.

Conclusions

There clearly will be substantial potential demand from pension schemes for CPI index-linked gilts. Four-fifths of schemes would be permitted by their rules to switch to CPI indexation for deferred benefits and just under a third for pensions in payment. A high proportion of schemes that can switch are likely to do so.

The extent to which this potential demand will convert into actual demand is still unclear. Schemes are divided on whether they would invest in CPI index-linked gilts, with a large number of 'Don't knows'. While most schemes will by now have a good idea about how the Government's proposals on indexation could affect their liabilities, they are probably only just beginning to turn their attention to how they should adapt their investment and risk mitigation strategies. Inflation-linked liabilities are anyway subject to a cap for over three-quarters of schemes, so neither RPI nor CPI indexation would provide an exact hedge. Schemes are more or less evenly divided on whether RPI index-linked gilts are an acceptable hedge for CPI-linked liabilities. And investment demand will depend on the relative price of RPI and CPI index-linked gilts and on the specific arrangements for conversions.

[14] The earlier NAPF survey ('CPI: The view of pension schemes', December 2010) found that 31 per cent had RPI written into their Rules for deferred benefits and 68 per cent for pensions in payment. The new figures suggest greater flexibility for deferred benefits than the earlier survey. The DWP Consultation Paper 'The Impact of using CPI as the measure of price increases on private sector occupational pension schemes' (December 2010) refers to its belief, based on external surveys, that "as many as 70-80% of schemes [are] tied to RPI for the indexation of pensions in payment".

Appendix A: Survey Results

Survey Details

- Based on responses from 67 pension schemes with assets of £104.5 billion.

Q3 Is the scheme:

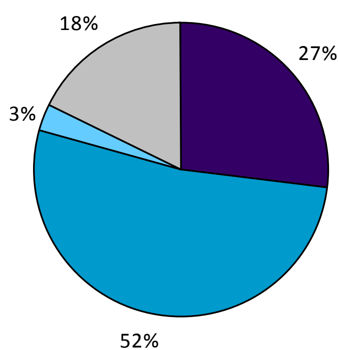
- open to new members (Y/N)
- open to accruals for existing members (Y/N)

Scheme status	
Open to new members	21%
Open to accrual	85%

Scheme rules

Q5 Would your scheme rules allow CPI for:

- revaluation of deferred benefits and indexation of pensions in payment?
- revaluation of deferred benefits only?
- indexation of pensions in payment only?
- neither?



Q6 Are inflation increases in your scheme subject to a cap (e.g. 'Limited price indexation') for:

- revaluation of deferred benefits? (Y/N)
- indexation of pensions in payment? (Y/N)

	Yes	No
Revaluation of deferred benefits	78%	22%
Indexation of pensions in payment	78%	22%

Q7 If your scheme rules allow it, would you switch from using RPI to CPI for:

- revaluation of deferred benefits? (Y/N/Don't know)
- indexation of pensions in payment? (Y/N/Don't know)

	Yes	No	Don't know
Revaluation of deferred benefits?	87%	4%	9%
Indexation of pensions in payment?	75%	0%	25%

Attitudes to CPI-linked gilts

Q8 If the Government were to decide to continue only to issue RPI-linked gilts, would they provide an acceptable hedge for CPI-linked liabilities? (Y/N)

Acceptable hedge?	
Yes	52%
No	48%

Q9 If the Government were to issue CPI index-linked gilts, would you:

- invest all or part of cash inflows into the scheme in CPI index-linked gilts? (Y/N/Don't know)
- switch all or part of your existing RPI index-linked gilts into CPI index-linked gilts? (Y/N/Don't know)

	Invest all or part of cash inflows	Switch all or part of RPI-linked gilts
Yes	40%	30%
No	25%	33%
Don't know	34%	36%