

*United Kingdom*  
**Debt  
Management  
Office**

Eastcheap Court  
11 Philpot Lane  
London EC3M 8UD

# **UNITED KINGDOM**

# **DEBT MANAGEMENT OFFICE**

## **Index-linked Gilt Re-design: Response to Consultation**

**15 January 2002**

## UK DEBT MANAGEMENT OFFICE

### Response to the DMO's Consultation Paper on Index-linked Gilt Re-design

#### Introduction

1. The DMO received 32 responses to its consultation paper on index-linked gilt re-design, published on 7 September 2001. The main re-design issue was whether to move from the current eight-month indexation lag to a three-month one. All ten index-linked gilt-edged market makers (IG GEMMs) responded, along with twelve investment funds and their representative bodies. Other respondents included individuals or bodies with an interest in the gilts market. The responses to the main question of whether or not to re-design were evenly split between those for and those against a re-design.
2. **Having received no clear mandate from the market to proceed with the introduction of a new design of index-linked gilt the DMO has decided not to undertake a full re-design.** Instead, the DMO intends to retain the current design for future new index-linked issues, albeit with some changes. These changes relate to the prospectus terms and the rounding convention to be applied to interest and redemption proceeds on new issues. More details of these changes can be found in the main body of this document. The DMO intends to adhere to the timetable set out in the original consultation paper. As such, the DMO would not envisage launching a new index-linked gilt before the third quarter of 2002. The decision on whether to issue a new bond in July to September 2002 will be discussed in June 2002 at the DMO's regular quarterly consultation meetings with the Gilt-edged Market Makers and representatives of end-investors.
3. Any questions on this paper should be addressed to Mark Deacon, UK Debt Management Office, Eastcheap Court, 11 Philpot Lane, London EC3M 8UD; telephone 020 7862 6516; fax 020 7862 6509; e-mail mark.deacon@dmo.gov.uk.



## Index-linked gilt re-design responses

### 1) Should the DMO introduce a new design for new issues of index-linked gilts?

4. The responses to this question were evenly split between those for and those against a complete re-design. This represented a much more positive response to the issue than when it was last aired in 1998. However, in most cases, those that were opposed to re-design had serious reservations over the introduction of a new design. Among the IG GEMMs, replies weighted by each firm's relative market turnover were on balance against a change in design. Whilst respondents welcomed DMO initiatives to improve liquidity in the index-linked gilts market, several thought that re-design would actually lead to a deterioration in liquidity. Respondents feared that the launch of a new design would create a two-tier market and the majority advocated an immediate wholesale conversion programme out of the current design bonds as a potential solution to this problem. It was however recognised that this strategy in itself was likely to be problematic due to uncertainty over the likely take-up rate for any such operations. A wholesale conversion programme would also cause unwelcome disruption in the market. Despite this, few respondents indicated a preference for the more gradual introduction of a new design envisaged in the DMO consultation paper.

5. If a new index-linked gilt design were to be introduced the overwhelming majority of respondents favoured the Canadian design, although several respondents also suggested that the DMO should consider issuing Limited Price Indexation (LPI) bonds as well as standard RPI-linked bonds. That said, most of the firms that mentioned LPI issuance were against re-design because of fears of creating a two-tier market. The DMO would be reluctant to issue LPI gilts alongside standard RPI-linked gilts since this could fragment liquidity in the market. Introducing LPI gilts would also reduce the value to the government of having index-linked gilts in the debt portfolio by reducing their deficit-smoothing properties. One further practical problem associated with LPI issuance would be the choice of level for the cap (and floor) - respondents mentioning four different cap/floor combinations.



6. Having considered the issues raised by the respondents to the consultation process, the DMO has decided not to introduce a new design of index-linked gilt. Instead, for the immediate future new issues of index-linked gilts will be based largely on the current design. The areas in which a new bond would differ from those currently in issue are outlined in the following section of this paper. In the longer term, should there be a change in circumstances or an increase in demand for a change in design, the DMO would consult on the design issue again.

## **2) Design characteristics of a new index-linked gilt**

7. The design of a new issue of an index-linked gilt would have the same features as current index-linked gilts except in the areas outlined below:

### Prospectus indexation clause

8. Several respondents commented on the indexation clause proposed in the consultation paper. Instead of making provision for early redemption of stock affected by an index change it places the onus on an independent institution to propose a satisfactory replacement index should the index cease to exist. Whilst the DMO recognises the concerns expressed over the changes to this clause, these changes are intended to bring the UK more into line with the approach used in other major markets and reduce the potential for disruption if an early offer to redeem had to be made.

9. The clause that the DMO would use in a new prospectus would take the following form:

*"Index-linked gilts will be indexed to the General Index of Retail Prices (RPI), or any subsequent index that, in the opinion of the Chancellor of the Exchequer after consultation with a body that the Chancellor of the Exchequer considers to be independent and to have recognised expertise in the construction of price indices, continues the function of measuring changes in the level of UK retail prices. The selection of the new index by the Chancellor of the Exchequer shall be conclusive and binding on all stockholders".*



### Determination of coupon and redemption payments

10. As indicated in the consultation paper, the coupon and redemption payments of any new index-linked gilt would be calculated by the DMO<sup>1</sup> rather than the Bank of England<sup>2</sup>. The DMO also intends to increase the precision of coupon and redemption payments on any new index-linked gilts. Whereas the cash flows for current index-linked gilts are rounded down to either 2 or 4 decimal places<sup>3</sup>, for new bonds these would be calculated by nearest rounding to 6 decimal places.

### Strippability

11. Few respondents expressed any interest in the DMO permitting current design index-linked gilts to be stripped. Consequently, the DMO has no current plans to introduce such a facility. However, the DMO will consider aligning the coupon dates of new issues in order to help facilitate the introduction of a strips market in the future should demand materialise.

### Coupon dates

12. About one third of respondents had no preferences for coupon dates for a new index-linked gilt. Amongst other respondents a variety of opinions were expressed on this issue. Whilst several respondents thought that the DMO should avoid the conventional strip dates, others favoured these dates in order to facilitate arbitrage between index-linked and conventional gilts. It was also noted that the clearest gaps in existing index-linked coupons were in March, June, September and December but that these are already heavy cash flow months for conventional gilts. Only one respondent was opposed to the use of the January/July coupon dates suggested by the DMO in the consultation paper. Some respondents thought that coupon dates should be spread across the year, both to help match RPI-linked cash flows and to avoid coupon reinvestment shocks. One respondent had a preference for avoiding

---

<sup>1</sup> The prospectus wording would state that the cash flows would be determined by the body which has responsibility for domestic debt management in order to retain flexibility should there be a change in the UK's debt management arrangements or nomenclature in the future.

<sup>2</sup> The Bank of England would continue to fix these payments for existing index-linked gilts.

<sup>3</sup> Only 2% Index-linked Treasury Stock 2006 and 2 1/2% Index-linked Treasury Stock 2011 pay cash flows that are rounded down to 2 decimal places. For all other index-linked gilts the cash flows are rounded down to 4 decimal places.



coupon dates that use RPI observations which are subject to significant seasonal distortions. In the light of these responses, the DMO has decided that a new index-linked gilt issue will almost certainly have January/July coupon dates, although the DMO reserves the right to revisit this when the need arises to issue a new bond.

#### Incorporation in the gilt indices

13. In order to allow a new index-linked gilt to be included in the FTSE gilt indices the price/yield software used by FTSE will need to be modified to cater for the new cash flow rounding convention. FTSE is confident that it will be able to carry out this system change ahead of the introduction of any new index-linked gilt.

#### **3) Timetable for the introduction of a new index-linked gilt**

14. The DMO does not envisage launching a new index-linked gilt before the third quarter of 2002. The decision on whether to issue a new bond in July to September 2002 will be discussed in June 2002 at the DMO's regular quarterly consultation meetings with the Gilt-edged Market Makers and representatives of end-investors.

**UK Debt Management Office**

**15 January 2002**

