CLIFFORD CHANCE

Briefing note

September 2015

CPI-linked Bonds – a growing opportunity?

Some 5 years after the Coalition Government first announced its decision to move from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) to determine the statutory indexation of pension benefits, the Sterling bond market has finally seen an initial cluster of CPI-linked bonds being issued between May and August of this year. This briefing considers the factors behind this development and the opportunities for the further development of CPI-linked funding.

An adage once levelled at London buses, was that you could wait for ages only for three to come along at once. Perhaps appropriately therefore, a bond issued by the Greater London Authority (GLA) to finance the Northern Line extension was the first of three CPI-linked Sterling bonds to have been issued earlier this summer.

This was swiftly followed by Warrington Borough Council, who issued £150 million of CPI-linked bonds in August of this year, just a couple of days before the Church of England Pensions Board (CEPB) closed its own £100 million CPI-linked issue.

UK Adoption of CPI

Whilst RPI is the UK's longest running measure of consumer price inflation, unlike CPI its formula and method of calculating average prices do not meet international standards. CPI was adopted as the benchmark for the Bank of England's inflation target in 2003, and in 2013 RPI lost its status as a National Statistic.

Differences in the baskets used by the Office for National Statistics to calculate CPI and RPI (and in particular the exclusion of owner-occupier housing costs from CPI), together with an inherent inflationary bias resulting from the RPI formula, mean that RPI inflation can typically be expected to exceed CPI inflation, although there have been periods when these positions have been reversed.

In June 2010 the Coalition Government announced a move from RPI to CPI for the indexation of public sector pensions, a move which had a knock-on effect on a significant number of private sector schemes whose own methodologies are often wholly or partly linked to the statutory indexation employed by the public sector. Where permitted by scheme rules and trustees, many private sector providers will want to follow the Government's lead in switching to CPI, helping to mitigate liabilities associated with defined benefit schemes.

Key issues

- CPI-linked sterling bonds have been much anticipated since the Coalition Government moved to indexing public sector pensions in line with CPI
- After some delay, there have now been three recent CPI-linked issues which point to growing support for the development of this product
- Deal sizes however remain relatively small and bonds have tended to be closely held
- UK Government issuance is still awaited, and will be a critical catalyst for the development of the CPI –linked sterling market

Increased demand

We can therefore expect increasing demand for CPI-linked instruments from pension fund providers with all or part of their liabilities based on CPI, and insurers taking CPI-linked liabilities on pension buy-ins and buyouts, to enable a closer matching

of assets and liabilities than would be possible by holding traditional RPI-linked bonds.

From an issuer's perspective, the possibility of CPI-linked issuance has become more attractive in recent months, as inflation measured by CPI has been significantly lower than the RPI equivalent, reducing potential borrowing costs.

In particular, corporates with CPI-linked revenues may provide further issuance to meet investment demand. In the energy sector, the Contracts for Difference (CfD) strike price is fully indexed in line with CPI throughout the term of the CfD. To date, around 35 CfDs and related investment contracts have been awarded, although the Department of Energy and Climate Change has indefinitely postponed the next allocation round previously planned for next month. Additional issuance could also come from the communications sector, where charges set by OfCom are linked to CPI.

UK Government Issuance

The UK Government has previously issued a significant volume of RPI-linked debt (over £350 billion) and previous consultation on the adoption of CPI-linked gilt issuance in 2011 highlighted a lack of investor appetite and risks of market fragmentation. The consultation feedback also heighted concerns over the sustainability of investor demand, given that many defined benefit schemes are now closed to future accruals, implying a progressive shortening in the duration of related liabilities.

The CPI-linked sterling issues to date have generally been well below benchmark size, with the Warrington and CEPB issues both comprising approximately one third of retained bonds that are held in treasury by their respective issuers for resale at a future date. Although the GLA bond was considerably larger at £200 million, this was initially subscribed by a single investor rather than being widely syndicated.

It therefore remains premature to conclude that the market has conquered the inhibitions highlighted in the Government's 2011 consultation, but a number of investors and commentators have called for a re-appraisal of the case for CPI-linked gilt issuance given the apparent upturn in investor interest and the positive impact that Government issuance would have on both sentiment and the technical market architecture.

Technical Challenges

Private sector RPI-linked bond issuance has always leant heavily on the methodologies adopted by the UK Debt Management Office for RPI-linked gilts, and operating indexation adjustments in CPI-linked deals is made more complex by the absence of an appropriate Government benchmark.

Whilst there are many analogies to be drawn from the broad pool of RPI-linked instruments currently in the market, there remain some technical challenges that may act as a brake on the future development of CPI-linked issuance unless a reliable benchmark curve can be established. Closely held deals, with active bondholder engagement, offer the opportunity to manage these issues through iterative dialogue; a model that may be difficult to replicate in a widely syndicated transaction.

Outlook

The Johnson Report commissioned by the UK Statistics Authority and published in January of this year expressed concerns about the calculation of RPI, and recommended a modified form of CPI (including the cost of owner-occupied housing) should be used as the predominant measure of inflation. As a consequence, the Johnson Report also recommended that the Government should move away from issuing further debt linked to RPI.

With recent transactions indicating that there is investor demand for CPI-linked assets, this combination of technical factors and investor demand may yet provide momentum for the Government to reconsider the conclusions of its 2011 consultation and look again at the possibility of CPI-linked issuance. Continued progress towards Solvency II implementation in January 2016 should also lend weight to this movement, as the capital requirements are designed to incentivise insurers to achieve a closer matching of their assets and liabilities.

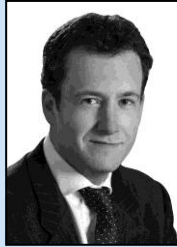
In the meantime, there are likely to continue to be opportunities for bespoke and innovative CPI-linked transactions, driven by demand on the investor side (pension and insurance companies) and from issuers, including those in regulated sectors such as energy and telecoms, whose cashflows are already partly linked to CPI.

Clifford Chance advised the GLA on its bond issue and advised TradeRisks Limited in its capacity as sole bookrunner for the CEPB CPI-linked bonds.

Contacts

Clare Burgess
Partner, London

E: clare.burgess
@cliffordchance.com



Paul Deakins
Senior Associate, London

E: paul.deakins
@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2015

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Jakarta* ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh ■ Rome ■ São Paulo ■ Seoul ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

*Linda Widyati & Partners in association with Clifford Chance.