In search of a cheaper source of finance

Limited price-indexed bonds could be just what the pensions industry is looking for but it needs a lot of careful thought, says Andrew Wise of Watson Wyatt.

First, the bad news. The world of UK pensions funding is changing dramatically. A combination of new accounting standards, more transparent market value methods of assessing solvency and the now-doomed Minimum Funding Requirement (MFR) have all served to remind pension funds that financing annual pensions linked firmly to inflation by investing in volatile equity markets is a tall order.

The expected long term benefits of equity investment need to be weighed against the risk of large cash calls on the parent company if equities significantly underperform for more than a short period. A number of pension funds – particularly the oldest and largest, with substantial current outgoings – have been reassessing their attitude to investment risk over the past few years and looking to invest more in bonds.

Meanwhile, the UK Government has been issuing fewer gilts. This has led to a supply-squeeze in the gilts market and created opportunities for record issuance of long-dated sterling bonds by non-government borrowers in 2000 to take advantage of pent-up demand from pension funds and other institutional investors.

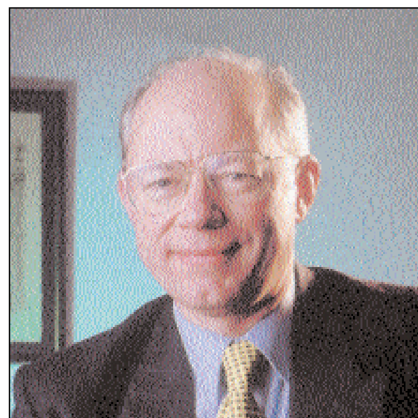
But corporate issuance has so far had little influence. The type of bonds that pension funds need are those which match their inflation-linked liabilities. Current market conditions suggest that pension funds are willing to accept anything up to 0.5% less yield in exchange for the assurance that the yield will be indexed to inflation. This makes index-linked gilts a very cheap source of finance for the UK government. But governments, after all, are in some position to influence inflation and, if they get it wrong, the taxpayer has to bail them out anyway. So the UK Government can benefit from lower long-term borrowing costs on an index-linked basis, whereas corporate borrowers – apart from a few utilities whose income-stream is protected by Government against RPI – seem confined to the more expensive fixed or floating rate markets. Or are they?

> From a pension fund's point of view, a limited price-indexed bond is a better match to liabilities than a Government RPI index-linked gilt

The good news

Most pension funds do not need protection against hyper-inflation. The Pensions Act limits the obligation to give inflation-linked increase to 5%. A few pension funds have rules which provide for higher inflation-linking, but the great majority of pension fund investors who are seeking to match more of their liabilities would be quite content investing in index-linked bonds where the return is capped at 5% inflation. They would be even happier if the inflation linking had a floor of 0% inflation – a little-advertised feature of index-linked gilts is that, in a period of deflation, they would actually subtract value, even though the Pensions Act would not allow pensions to be decreased.

So, from a pension fund's point of view, a limited price-indexed (LPI) bond, with the inflation protection subject to lower and upper limits of 0% and 5%, is actually a better match to liabilities than a Government RPI index-linked gilt – and so just as much worth accepting a lower yield.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What's in it for borrowers?

From the borrower's viewpoint, a positive aspect is the lower long-term yield expectation of an LPI investor. But companies considering exploiting this opportunity will want to think through how such bonds are likely to behave over the economic and interest-rate cycle – presuming that we still have such cycles.

First, consider what might happen if inflation started to pick up significantly. The Bank of England would probably respond by raising short-term interest rates quite sharply. In these circumstances, clearly fixed borrowers will do best, but an LPI bond which yields of, say, 1% more than the equivalent index-linked gilt would pay only 3% a year real interest and would also benefit from an

absolute cap of 8% – even if inflation ran away above 5%. Therefore, LPI might fare better than floating-rate finance in such an inflationary scenario.

Next, consider a slowdown scenario with very low (or even negative) inflation. The Bank of England would presumably cut short-term rates to head back towards the long-term 2.5 inflation target. Floating-rate finance would do best and short-dated fixed would might be quite painful, but long-dated fixed would remain good value so long as the UK yield curve remains inverted. LPI bonds would gain some of the benefit from the lower inflation and so should lie partway between the two. Therefore, there is no obvious benefit or disadvantage.

Finally, consider a scenario of longer-term inflation higher or lower than current market expectations. LPI might be expected to turn out less painful than floating in the sustained higher-inflation scenario and better than fixed in the sustained lower-inflation scenario. And if the greater appetite of pension funds for these kinds of bonds also tends to give a lower average long-term funding rate, then they look to be a good diversifier in an overall corporate funding strategy.

Current market conditions imply that the most likely scenario is that inflation stays fairly close to the 2.5% target. In this case, the LPI bond will pay out slightly more when inflation is picking up, but many companies might find that their revenues were more buoyant in such economic conditions too, it might be a fair 'swap' for a lower interest bill as the economy slows down.

So, potentially, the classical corporate finance model of 50% fixed:50% floating could, in time, migrate to one-third each of fixed, LPI and floating – which could make the LPI market potentially more than £100bn.

So why isn't there a corporate LPI bond market?

Whereas the arguments in favour of issuing and investing in LPI bonds are strategic, the main obstacles to getting such a market off the ground seem to be essentially practical. Various reasons have been suggested:

- boards with memories of the 1970s hyper-inflation may be reluctant to consider the idea of inflation-linked borrowings, without appreciating the protection which an LPI structure would give;
- some pension plans and/or sponsors may prefer not to have to articulate what they would do if inflation went above the 5% guaranteed by the Pensions Act;
- pension fund investment guidelines tend not to allow for new kinds of investments until they have become established, which in turn deprives the market of its natural buyers in order to get started;
- bond-dealers seem to prefer corporate bonds that can be priced by reference to a government bond, but there are no LPI gilts;
- no one can apparently agree how to value the difference between LPI and full RPI index-linking, although most measures of pension fund solvency would attach little value to it;
- the few index-linked corporate issues so far have been mainly confined to supranationals using the RPI swaps market to achieve a synthetic fixed borrowing. The RPI swaps market in turn seems to be supplied mainly by companies (for example, utilities) whose cashflow is linked to RPI rather than LPI; and
- the potential universe of corporate LPI-linked borrowers seems much wider than of RPI-Linked borrowers, but it seems no one wants the risk of being first.

What's the catch?

Can it really just be that everyone is waiting for everyone else to make a move? Surely this degree of hesitancy indicates that there are some real risks in issuing LPI bonds too. Clearly, there are some catches to be aware of:

- liabilities to pay out current pensions to former employees have a resemblance to corporate debt. Companies having defined benefit pension schemes of well over average maturity (in terms of proportion of liabilities to pensions in payment) probably have enough LPI exposure already via their UK pension fund. (But such pension funds could hedge out the exposure if they could buy LPI bonds of other companies);
- potential issuers need to think through carefully how their business cashflow would be likely to respond in practice to changes in general price inflation. How easy is it to increase sales prices in line with general inflation? How much does sales volume respond to the general UK economic climate? If the oil price rises, would this have significant impact on corporate profitability and cashflow;
- LPI bonds are natural long-term-holds for pension funds and insurance companies offering annuities. This means that LPI bond issues, even if successful, could have relatively low liquidity after the initial issuance period; and
- the 'first movers' in issuing LPI bonds might be well advised to get their investment bank to sound out potential pensions investors first, to ensure that enough of them have authorised this type of investment to give the new issue a fair chance of being placed on good terms.

Writing on the wall

Despite the risks and practical obstacles, there is a growing feeling in parts of the pensions investment industry that the corporate bond market opportunity of the future in the UK is the limited-price-indexed bond, because:

- LPI bonds match risk-averse investors with corporate borrowers who do not want to write a blank cheque for future inflation;
- LPI bonds have many of the defensive characteristics for the issuer of a mixture of fixed-rate and floating-rate finance; and
- pension funds and insurance firms which can match their liabilities with LPI bonds need fewer 'dead' reserves to cover the risk of unexpected inflation and so can justify accepting a lower yield.

So the overall UK economy would allocate capital more efficiently and fund real businesses more cheaply if corporates willing to issue LPI bonds can get together with the pension fund and insurance companies which need more of these kinds of investments.

Pension fund advisers can play their part by encouraging their clients to set guidelines which allow for these investments in advance of a market developing. But where will the initiative come from on the borrowers' side? ■

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