# THE STERLING RENAISSANCE

PENSION FUNDS ARE REVIVING THE UK STERLING BOND MARKET AS CHANGES TO LEGISLATION BRINGS THEM OUT OF THE GILT DOMAIN. **PAUL STANWORTH** OF RBS TRACKS THE CHANGES.

The sterling bond market has seen unprecedented growth in supply over the past five years. From a relatively sleepy beginning, it has become an eclectic market demanding a broad range of skills from fund managers. The environment at the end of the 1980s looked bleak and the sterling corporate bond market was moribund. The UK economy was entering a severe recession that almost killed off the sterling corporate bond market. However, it was rekindled and the eurosterling market quickly flourished into the main long-dated non-dollar fixed market for corporates. With the advent of the euro corporate bond market as a serious competitor to sterling, the eurosterling market changed its spots and became an increasingly complex market. However, the renaissance in sterling bonds has started as pension funds are becoming major buyers, threatening to overwhelm supply and propel the corporate bond market into an asset class in its own right. The days of corporate bonds being the poorer sibling to the gilt market look to be over. This article looks at these changes and seeks to identify the path for the market.

**CHANGING PATTERNS.** The first evidence of change emerged in the mid-1990s when the eurosterling market witnessed an alteration in the pattern of issuance. Each successive year saw market issuance move towards the longer maturities, as sterling increasingly became a long-dated market. As *Figure 1* shows, long-dated issuance has become the dominant proportion of the primary market, with over 15-year issues increasing from less than 20% of primary activity to more than 50% now. This pattern was accelerated by the anomalous inversion in the gilt curve persisting between 1998 and now.

Furthermore, the type of issuer changed. In the early 1990s industrial and bank issuers dominated the long-dated market, with the secured market manifesting itself as simple property debentures. However, by the mid-1990s, the market took its first look at securitsations. These were in a variety of guises and from various industries. While they started as AAA structures, or AAA credit enhanced deals, they quickly developed into higher yielding fixed rate structures by the end of the decade. Industrial issuance also accelerated with utilisation of the long-dated sterling market by industrial names, increasingly from non-UK territories such as the US. Finally, following the unprecedented sterling swap spread widening in late 1998, the levels of Libor sensitive supranational and agency issuance has come to dominate the long-dated market representing more than 40% of the market currently.

The major pattern in the sterling bond market now is the increasingly long term nature that has emerged over the last decade and sterling has become most active long bond market outside of the US. In addition, the nature of the market has split into two: one the high quality 'swap-sensitive' market dominated by frequent borrowers such as the European Investment Bank; and, the second, an increasingly complex industrial secured and unsecured market. But where has the demand for such assets come from and how are investors managing their assets?

**INVESTOR METAMORPHOSIS.** Life as a sterling bond investor at the start of the 1990s was one filled with views on Government bond markets and central bank interest rates. Economics and currency views dominated the decision-making and discussions used to centre on subjects such as the the electoral cycle in the UK. The small and relatively simple corporate bond market was the domain of the insurance industry which utilised these assets to back life assurance liabilities. Typically, fixed income teams employed (at most) two or three corporate bond specialists and, as far as discussions were concerned, were often secondary to government bond markets. Since then, the landscape has changed out of recognition as talk of subjects such as event risk, swap spreads and asset securitisation are now the focus of most sterling fixed income fund managers. Corporate bonds are the primary asset class in UK bond teams and credit is the latest 'traded risk'.

Several well-documented factors have led to the emergence of credit as the main focus. These include the fusion of European government capital markets, increased currency and bond market stabilisation and the disintermediation of company borrowing away from banks to capital markets. More recently, the UK's Accounting Standards Board adopted AA corporates (through FRS 17) as the benchmark from which to measure all liabilities. Together with the abolition of advance corporation tax (ACT) tax

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credits from equities and the poor equity performance in 2001, asset allocation has pushed pension funds significantly towards corporate bonds.

In response, the investor base has widened considerably as the market expanded. Despite mega-mergers in the fund management industry, new entrants into the sterling corporate bond markets have replaced these lost investors and more. Unit trust managers joined the small group of insurers which dominated the market in the early 1990s. They were spurred on by the introduction of tax-free corporate bond funds in the shape of personal equity plan (PEP) savings vehicles. Lately pension funds have joined the market searching for enhanced returns and more recently due to regulatory change.

As a consequence, UK fixed income departments (from insurers to mutuals to pension funds) have battled over the past five years to cope with the need to acquire credit skills within their teams. The experienced corporate bond manager has become a scarce commodity. Increasingly, investors have turned to the banking credit and rating agencies for credit analysts, who are leaving shrinking banking departments. Many of the corporate bond specialists today started their careers in clearing bank credit departments and not via the traditional fund managers apprenticeships. Typically, a fund manager's fixed income department today is looking more and more like their US counterparts – predominantly resourced by a team of credit analysts advising portfolio managers. The sterling market is increasingly becoming the domain of long bond investors with strong credit skills.

**WHAT ABOUT THE EURO?** A threat, however, to the sterling market is the euro capital market. Increasingly, UK companies are attracted to the liquidity offered by the euro market and, geographically, the short hop across the Channel presents finance directors with a desirable new investor base. Investors in the euro have not demanded the level of covenant protection required by the long-dated sterling investors, and borrowers, are increasingly moving their target lending into euros for greater liquidity and lower constraints on their activities. The use of swaps now gives these borrowers an equivalent outcome with issues launched in euros offering greater liquidity, and cross currency swapped to the rate in sterling terms. The sterling market is beginning to struggle to attract these names.

The typical pattern of euro primary issuance has, however, been very short dated. Euro investors are focused on short-dated deals for mutual funds and banks, with virtually no demand for longer-dated debt. This is unlikely to change in the short term. With the exception of some northern European countries, pension schemes in Europe are virtually unfunded. Denmark, Sweden and the Netherlands have between 100% and 140% of the annual GDP in pension assets, whereas the figures for France and Germany are below 5%. Despite their funding, if Nordic countries are combined with France and Germany, they still have collectively less than the UK's £1trn pension asset base. Any demand that does exist comes predominantly from insurers which generally do not seek maturities greater than 10 years.

The typical long-dated bond investor seen in the US and the UK does not exist in nearly the same proportion in Europe. The idea of long bond investment in credit is as alien to euro investors as credit was to UK investors in the early 1990s. There is always the possibility of sterling joining the euro in the medium term. If that were the case, the circumstances and demographics, which have led to sterling investors being focussed on long-dated bonds, will persist. The UK investor base, whether in sterling or euro form, will be the major long-dated bond investors this side of the Atlantic for the next few years at the very least.

**WHERE ARE WE GOING FROM HERE?** The UK long bond investors are going to grow their investments considerably in sterling corporate bonds in the short term. As changes to UK pension legislation (including FRS 17 and the MFR abolition) permeate the market over the next few years, pension schemes will be released from the grip of long gilt ownership. This is likely to be the biggest source of new investors entering the sterling corporate bond market in the coming years. Estimates of new investment are huge and vary from £70bn new net investment upwards to £100bn.

**FIGURE 1**
ISSUANCE SPLIT BETWEEN UNDER AND OVER 15-YEAR MATURITIES.

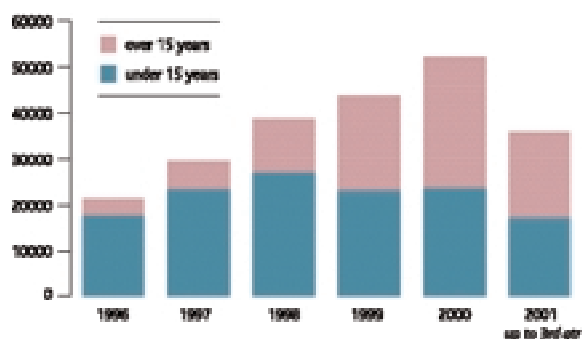
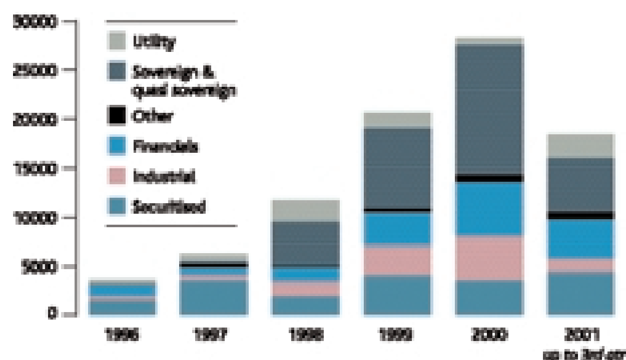



**FIGURE 2**
PATTERN OF OVER 15-YEAR ISSUANCE.



## 'WITHOUT A CHANGE IN THE SAVINGS AND INVESTING CULTURE IN EUROPE, STERLING WILL REMAIN THE ONLY NON-DOLLAR LONG-TERM MARKET'

In addition, UK pension funds are backing liabilities of an increasingly ageing population. This will lead to increased allocations in bonds for income release which will lead to further long-term corporate bond demand. Although annuity sales have suffered in recent years due to the low yields on bonds, this cash is still accumulating in individuals pension plans to be spent when yields return to their more rational levels. The UK has a funded pension culture and the sterling bond market is the natural home for retirees' cash.

All in all, the existing £220bn sterling corporate bond market is currently well supported by insurers and mutual fund managers. The market is now bigger than the gilt market, which it overtook last year, and annual sterling bond supply exceeds £50bn a year. It is set to receive a further boost as the massive funded pensions industry turns its attention to this growing market.

Borrowers, therefore, requiring long-term funds remain with two main alternatives: dollars or sterling. Last year's record-breaking deals for the leading telecoms companies have shown that – within the global market – borrowers still look to these two markets for long-term finance. In addition, the UK investor has demonstrated an appetite for complex fixed rate asset securitised structures. Over the past two years, sterling bond investors have accepted train leases, pub rent, shopping centre landlord revenues in bond form. In fact, UK investors have even accepted 100% debt funded finance in the form of the £1.8bn financing of the Welsh water utilities organisation, Glas. (See *Deals of the Year, The Treasurer*, December 2001).

In addition, the UK has seen the long-dated RPI-linked bond market flourish as the new pension fund investor base emerge as the new credit investors. Index-linked gilts were always major pension fund assets, however, fund managers have begun to use corporate index-linked bonds to add value and the previous premium on index-linked debt has disappeared. Borrowers have been brought in from the utility, retail and telecom sectors. More are set to debut on the index-linked markets in the near future while new structures are likely to develop, such as limited price inflation (LPI) bonds where payments are linked to RPI limited annually to between 0% and 5%. In summary, without a change in the savings and investing culture in Europe, it is likely that sterling will remain the only non-dollar long-term market for the private sector for some time to come.

**SPECIALIST SKILLS FOR A SPECIALIST MARKET.** All the stakeholders in the market, from investment banks to fund managers, now need to be properly resourced to participate in the long-dated sterling market as never before. Far from the expected exodus of skills into the euro, the sterling primary market is increasingly demanding more and more credit skills of the intermediary. Lead managers for long-term sterling bonds are required to add value through advice, structuring and well-resourced distribution. The generalised intermediary servicing generalist investors are struggling.

The investors, too, demand greater levels of due diligence and require issuers to satisfy substantial cross-examination. Issuing companies require high levels of marketing support and advice to successfully meet the expectation of investors. Increasingly, investors require secondary liquidity across the curve from AAA sovereigns to BBB securitisations to participate in new issues .

As the honeymoon period passes for the euro, the future path of the expanding long-dated sterling market is unfolding. The pattern is one which has two prongs. One is commodity in nature satisfying the borrowing needs of Libor sensitive issuers such as KfW and the European Investment Bank. The other is specialist and complex, where deals requiring significant credit work by both investors and intermediaries are transacted. Like the US, speciality firms will flourish in the long-dated sterling market. It is increasingly becoming a market where companies raising finance will look to the advice of sterling specialists able to offer the most valuable advice and can intermediate between them and the increasingly specialist investor. The sterling bond renaissance has certainly begun.

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