

FT Mandate, November 1999

I wonder how many readers were, like me, disturbed by the headline “Bond policy costs UK £3bn a year” on the front of a recent Financial Times. It reminded me that the system governing the balance between bond issuers and purchasers really is not as well understood as it needs to be. In this column I want to explain the main problem and suggest a controversial, but practical, solution.

First, a bit of background. Government (and corporate) debt is inextricably linked with the pension funds and insurers needing it to fund for their liabilities. This is a fundamental point of how the UK’s capital market should work, assuming that the Government wishes the UK to continue to operate insurers and pension funds.

Where does the FT headline come in? Well, a recent report by Fitch IBCA criticized the UK for having the moderate amount of long-dated debt that it does. The claim was that other countries in Europe were funding their debt more cheaply, eg through debt of shorter terms. However, the liabilities of institutions in European countries are very different (eg much less funded pension provision), so Fitch IBCA almost certainly did not compare like with like in their report, and as readers may have guessed, I believe our institutional structure means we need to increase the volume of long-dated debt.

A high proportion of the liabilities of UK pension funds and insurers have defined shapes (or “durations”), making particular parts of bond markets much more appropriate than others in terms of identifying ‘minimum risk’ investment portfolios. Risk is a concept whose importance has risen rapidly in recent years, and long maturity bonds are thus an essential part of our system. Note I am not saying that the institutions must always hold these ‘minimum risk’ portfolios, but it is likely that they will move increasingly towards them for their own protection. Readers may be aware that some of these institutions’ liabilities are actually of longer duration than the available appropriate assets, but there’s a bigger worry.

The UK debt market is simply too small. Back-of-the-envelope numbers show that the existing nominal (rather than real) liabilities of UK insurers and pension funds exceed the combined available UK gilts, corporate bonds and index-linked gilts (by £ market value) by some way. Further, both pension fund and insurer liabilities continue to increase (because of ongoing saving and new policies being written), so the conclusion has to be that there needs to be far more long maturity debt, and more of it index-linked, otherwise the scope for unrewarded risk and financial disasters will just increase.

This desire for more long maturity debt is not a popular idea, not least among those who believe that equity investment provides the answer to everything. Some have suggested that the rules for pension funds should be relaxed, “allowing” wider investment in equities when assessing the financial health of a pension fund. But this misses the point that the risk profiles of these funds aren’t changed by rewriting the rules – they continue to warrant a significant degree of bond investment. Others have suggested that investing in the European bond markets will provide a solution, but the problems here include the economic (rather than political) durability of the euro, and (again) the shape of the available bonds.

There is a major need for expansion of the UK’s long-dated and index-linked debt markets. This could be through companies swapping equity into appropriate debt, but I recognize that this would be a major financing change for many companies, and I don’t think this is likely to happen quickly.

A far better and faster, albeit slightly political, solution would be through the Government taking the opportunity to raise capital from relatively willing institutional investors, and then applying it to projects of national benefit, e.g. transport infrastructure.

UK institutions are setting aside money that can be used to the nation’s benefit – so let’s do so!