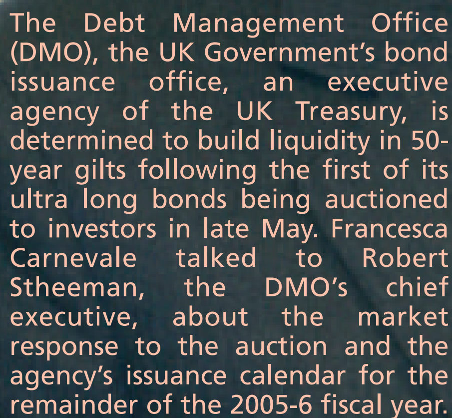


The Debt Management Office (DMO), the UK Government's bond issuance office, an executive agency of the UK Treasury, is determined to build liquidity in 50-year gilts following the first of its ultra long bonds being auctioned to investors in late May. Francesca Carnevale talked to Robert Stheeman, the DMO's chief executive, about the market response to the auction and the agency's issuance calendar for the remainder of the 2005-6 fiscal year.

SMOOTHING THE WAY FOR ULTRA LONG BONDS

AS MAY SLOWLY ground to a close the DMO sold via auction an inaugural 50-year plain vanilla bond which marked the longest dated bond the UK Treasury has brought to the market in more than four decades. At present, the longest issues out in the market with a finite maturity are for around 30 years *(please refer to Table 1)* – there are however some outstanding bonds (£3bn of 'undated' bonds, in fact) some stretching as far back as the nineteenth century.

The new ultra long offering comprised £2.5bn of 2055-dated paper, carrying a coupon of 4.25% and issued at a yield of 4.21% (at the time of issuance, by comparison, the 30-year benchmark bond offered a yield of 4.33%). The bond was in large part deemed attractive by market commentators, given a healthy backdrop of investor

demand and the expectation that UK interest rates will begin to fall in the autumn. The bond also marks only the first stage in the UK's issuance of ultra long-dated bonds, according to Robert Stheeman, the chief executive of the DMO, who expects its success to be followed by at least one further issue later this year and another early next. It could, he acknowledged be extended from the second quarter of the 2005/2006 financial year to include an index-linked offering.

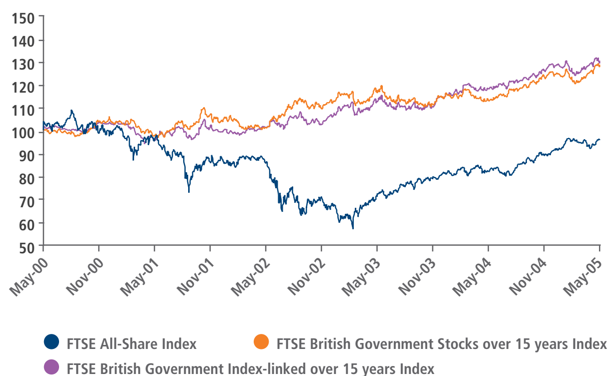
The UK's return to the long term gilt market has highlighted efforts by leading European sovereign issuers to lock-in low interest rates at a time when pension funds and insurers are clamouring for long-term assets. When France's Agence France Trésor (AFT), for instance, issued a similar a €6bn 50-year bond through a syndicated offering it was more than three times oversubscribed, raising €19bn-worth of investor interest following a formal book-building process.

While Stheeman smilingly acknowledges that demand for the UK ultra long bond might have been stronger (the auction was covered 1.6 times), he is sanguine enough to state that the issue was "very normal for a long dated auction. We are always pleased with our issues and this is no exception. We spent a long time building up to it. The French government has issued something of comparable length, but not by auction. I have to say that it [the auction] very much met our expectations." A second intention was to ensure a well-run auction process. "I would stress that for us it was very important to run an open, transparent process", adds Stheeman.

The DMO has long preferred the auction process over syndications. "It is a transparent and predictable way of issuing debt," says Steve Whiting, the DMO's policy advisor, continuing "while maintaining a level playing field for primary dealers and at the same time delivering value for money for the government."

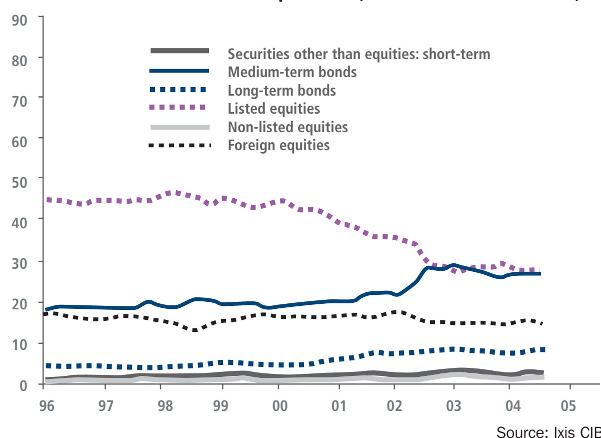
"An auction suited our purpose well in that case" explains Arnaud Mares, who is head of portfolio strategy at the DMO. "There are very good arguments for using syndication [sic], but it also raises issues" he adds.

FTSE All-Share Index vs. FTSE UK Gilts



Data as at June 05. Source: FTSE Group.

United Kingdom: Structure of the assets of pension funds and insurance companies (as % of total assets)



Source: Ixis CIB

Stheeman picks up the theme. "We would have to choose only a few lead managers for instance, so it could suggest we were favouring or giving status to a small group of banks. We try to treat all the gilt edged market makers (GEMMs) in an equal and transparent fashion. It is very important to us," he says.

But while the DMO is happy with the take up of the issue, Stheeman admits he was after rather bigger fish. The DMO was keen not just to sell down one or more ultra long bonds in the year, it was also keen to develop a long term viable market for ultra long dated gilts. "Liquidity is important, and it is something we have focused on very carefully. We had to be sure that whatever we introduced was sustainable," he says. That requirement comes into focus strongly as Stheeman outlines the UK's medium term borrowing requirements. "For the next four years we will average over £50bn – more than last year," says Stheeman, while Arnaud Mares stresses that the DMO "has no particular concerns on the ability of the capital markets to absorb this requirement. The market itself has expanded, turnover has increased and liquidity has improved. We do not sense the market has a problem with the increased level of issuance."

Stheeman's ambitions for the ultra long dated bonds find a receptive audience among pension fund advisers who have warned that issuance of ultra long dated bonds must be substantial to avoid the problem of retirement funds locking away a limited supply of long dated paper and creating an illiquid market. In the late 1990s, for instance, when public finances were in surplus, trading in 30-year gilts became illiquid for a time, producing in turn wide price swings. The US, for another, even suspended issuance of 30-year bonds back in 2001 when its budget was in surplus. The US Government has, however, recently launched a consultation on the resuming issuance of 30-year bonds.

Ultra long dated bonds have a particular appeal to the investment community, for various reasons. Pension funds, for one, have largely been in favour of them.

Interest in them by defined-benefit pension schemes, in particular, is being driven by ageing maturity profiles and legislation which encourages them to match their assets against their liabilities. Consequently as of the beginning of this year demand for long-dated bonds strongly outweighed supply, thereby creating a good climate for the UK via the DMO to return to the ultra long dated market. "It is fair to say that the vast majority of this issue has gone to the domestic market," explains Stheeman, although this assessment is based on anecdotal evidence. It will be some time before the DMO gets a clear picture of the composition of buyers of the paper. "In a syndicated offering you get a better breakdown," he acknowledges.

Historically, UK pension funds and insurance companies have been by far the largest buyers of gilts – in particular index-linked gilts. This trend is likely to continue especially

THE APPEAL OF THE ULTRA LONG BOND

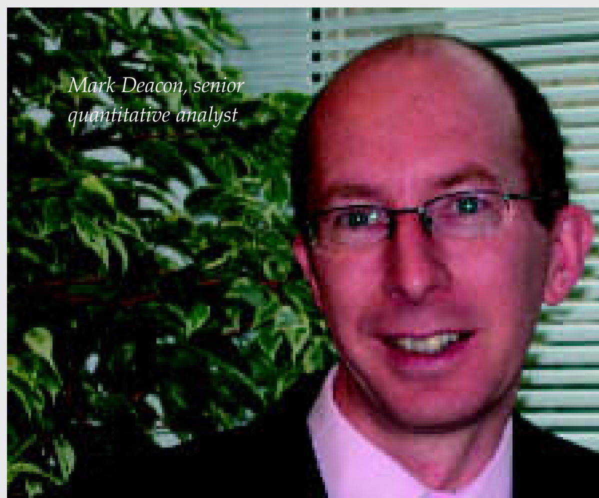
THE IDEA OF a very long-term bond is not brand new, but it has become very popular in recent months. In some part this is because pension funds are undergoing rising regulatory pressure to match long-term liabilities and assets. As well, governments have also acknowledged that current financial conditions make long-term bonds a cheap way to grow funds.

The launch of the longest dated British Government securities ever issued – aside from undated gilts, which have no fixed redemption date – came in the aftermath of World War I. In June 1919 the Government launched two inaugural ultra long gilts on the same day: 4% Victory Bonds, which raised £287m and a further 4% Funding Loan dated 1960-1990 £288m. In today's terms, the issues constituted a considerable operation for the time – equivalent to around £14bn in current money, according to Steve Whiting, a DMO policy advisor.

Issuing authority for the bonds was obtained from the House of Commons by the then Chancellor of the Exchequer Austen Chamberlain on 2 June. "There then followed several days of speculation in the press over the terms and conditions of the bonds prior to their official launch in the Guildhall by the Chancellor and the Lord Mayor, on the evening of 12 June 1919," he explains. Although the Prime Minister, Lloyd George could not be in attendance, he telephoned a message of support, stating that in buying the bonds you "get the premier security of the world". His comments were received with cheers by the audience when they were read out by the Chancellor. As part of the launch of the new bonds, a floral fête was also held in Trafalgar Square in celebration. "In addition, at the Prime Minister's request, over 120 MPs agreed to speak as advocates of the new bonds in their constituencies," says Mark Deacon, senior quantitative analyst at the DMO.

Investors could purchase the bonds for cash or by exchanging Treasury bills or other short-dated gilts, "the latter being part of a government drive to reduce the proportion of the government's debt that was in either floating rate or short-dated form," says Whiting. When it was issued, 4% Funding Loan 1960-1990 had a 71-year maturity. However, in practice it was redeemed early in November 1972, making it a 53-year bond. 4% Victory Bonds were redeemed in 1976, giving them a near 57-year maturity.

Other ultra long double-dated gilts were issued after 1919. For instance, in 1954 the government issued 3.5% Funding Stock 1999-2004. This was created as a result of a conversion out of another gilt issue. The yield at issue was 3.62% and so this was consistent with the 3.5% coupon. The highest price for this bond in 1954 was £99 3/16 and the lowest – at the end of the same year – was £95 1/16. Although this gilt was technically a 50-year gilt as its final maturity date was in 2004, it was actually redeemed early in 2003, making it a 49-year bond. Of the gilts currently in existence, the longest dated at issue is 5 1/2% Treasury Stock 2008-2012 which was issued in October 1960, making it a 48-52 year depending on its precise redemption date. "At the time, there was rather a lot of speculation in the press when this particular bond was launched that one of the objectives of the sale was to absorb demand, which was reported as being large and showing signs of increasing," explains Whiting. "The last double-dated gilt was launched in 1980 and nowadays the policy of the UK government is to concentrate issuance on large benchmark bonds with a vanilla bullet structure, in line with the products available in other leading international bond markets," adds Deacon. The demand for bonds is set to continue, thinks Deacon, and to increase as European institutional investors still have a large mismatch between their need for bonds and what they actually have in their books.



Mark Deacon, senior quantitative analyst

as more schemes try to address their matching shortfalls. However, many schemes have liabilities with maturities longer than that of the longest-dated gilts. Index-linked gilts, for example, extend to 2035, with only nine issues available (and, reportedly, most of the UK's pension schemes have liabilities that extend well beyond that date). Further, the implementation of international accounting standards (IAS) as well as more constraining regulations is forcing life insurance companies and pension funds to better match their liabilities. By marking-to-market larger parts of their balance sheets, these institutions are motivated to reduce their duration mismatches if they want to reduce the risk of high volatility in their financial results. The UK market is a powerful indicator of the potential impact this trend towards longer dated investments can have on the bond market. In the UK, the changes in regulation forcing pension funds to better match the duration of their liabilities has resulted in a strong increase of the bond portfolio weight in the asset allocation to the detriment of equities. The share of equities has fallen from 68% in 1998 to 52% in 2004 and the share of bonds has risen from 25% to 39%.

Steve Whiting, Policy Advisor & Press Officer.

Since 2001, the UK institutional investors have been net sellers of equities and net buyers of bonds. The impact of the regulation change has been strong performance of long dated gilts and ultimately an inversion of the yield curve. As of the end of January 30-year gilts traded at a yield of 4.5% compared to 4.6% in the 10-year sector. At the peak of the inversion in January 2000, 30-year gilts yielded more than 1% less than the 10 year maturities.

In the period before the DMO kick-started the ultra long dated bond issuance process, a shortage of long-dated sterling bonds had, in the meantime, encouraged banks and other financial institutions to offer products such as inflation swaps to help retirement funds hedge exposure to future liabilities. But it is/was nowhere near enough to help. No surprise then that the DMO ultra long inaugural bond was snapped up by the local market.

Finally, it was becoming obvious that UK sovereign issuance was on the rise as the shortfall between government spending and tax revenue has widened considerably in recent years. Chancellor Gordon Brown signalled his intent to issue 50-year gilts in his March 2005 Budget speech to the British Parliament, in a move that would "lock in low borrowing costs and simultaneously benefit taxpayers and investors".

Even though it was well aware of this confluence of trends, the DMO had undertaken a lengthy market consultation process well in advance of the March budget to test the appetite of the larger investment community towards longer dated issues. "It is becoming a typical process for us and others are now taking our lead," explains Stheeman. The consultation was spearheaded by Arnaud Marés, and Steve Whiting. "Arnaud and Steve kicked it off in an informal way last summer," explains Stheeman. "We needed to understand the structural needs of the market and our own investor base. The formal consultation began in earnest in December of last year."

Most of the dealers involved in the wide-ranging consultation process (taking in investment advisors, actuaries, pension trustees and market traders) gave preference to a 50-year issue, but some asked for a 40-year bond. Dealers also called for the DMO to re-open conventional bonds maturing in 2032 and 2038, and evinced an interest in launching a 2040 gilt, according to national press reports at the time.

The DMO is likely to come to market with a further ultra long dated bond later this year. Take up on the next gilt issue will be a bellwether of the success of the DMO's effort to stoke up liquidity. A further milestone will also be achieved, if the DMO manages to meet demand for an ultra long dated index-linked bond. "It is fundamentally a different animal," concedes Stheeman, "and so that may take longer to achieve. We will have to take the measure of the market and demand and the technical issues in structuring an index-linked facility over such a long tenor." Knowing the DMO, it will leave nothing to chance.