The development of the sterling bond market

Mr Ian Plenderleith, an Assistant Director and Head of the Bank's Gilt-Edged Division, reviews[1] *the evolution of the sterling bond market into an integrated and highly diversified capital market over the past ten years and details some of the ways in which the UK authorities have sought progressively to encourage this process. He goes on to consider a number of areas where further work to improve the market's basic infrastructure might help to promote its development.*

As has been evident recently to the most casual reader of newspapers, 10th anniversaries are very much the flavour of the month. I am delighted that the Association of Corporate Treasurers has not been shy of joining the bandwagon, and I am honoured to be the first of today's speakers to offer the Association warmest congratulations and many happy returns.

It is indeed remarkable to think that the Association is only now approaching its 10th birthday when one considers the range of activities that you have managed to develop in the past decade. Not only has the Association become accepted and respected as the representative body for corporate treasurers and the forum for debating current issues of concern in the field of corporate treasury management. It has also developed a major educational role, through 'The Treasurer' magazine, through conferences such as this, through meetings of the Association's regional groups, and notably through the Association's educational programme. More recently, the Association took a new initiative in sponsoring the first 'Treasurer' debate—a notable event which we had the honour of hosting in the Bank. The Association has also been able to make a most valuable contribution on a number of other public policy questions: I recall particularly the important role the Association played in helping us to develop the initial framework for sterling commercial paper just three years ago.

This birthday party therefore seems well merited. And it seems particularly appropriate that the conference should be directed to the corporate debt market, since it was another event just ten years ago—the ending of exchange controls in 1979—that initiated the modern phase of the sterling bond market. Exchange controls were not, of course, an impediment to domestic borrowers issuing bonds in the sterling capital market. Nor did they totally exclude capital market issues by overseas borrowers. But it was the lifting of exchange controls in 1979 that re-opened the London market to a regular flow of issues by overseas borrowers; and it was the policies that enabled exchange controls to be lifted—the continuing commitment to fiscal and monetary restraint—that have progressively, and now on a substantial scale, brought domestic borrowers back into the sterling capital markets.

I would like in this talk to look at the development of the sterling bond market from three perspectives. First, I would like briefly to look at the way the market has grown, in size and in breadth, over the past ten years. Then I would like to look at the role the UK authorities, including the Bank of England, have endeavoured to play in promoting the development of the market. Finally, I would like to stand back a little, to try to assess the current state of the market and, looking to the future, to suggest a few specific areas where further work might help to develop the market's infrastructure.

Growth and broadening of the sterling bond market

It is worth beginning with some appreciation of the pace at which new issues in the sterling bond market have grown over the past ten years. The market has over this period expanded very rapidly indeed, and it has done so, moreover, not in intermittent bursts, but through a decade of sustained growth which has brought a progressively broadening range of borrowers and instruments into the market.

In 1980, the first full year after exchange controls were lifted, total sterling new issues (other than by the UK public sector) of bonds (including FRNs, convertibles and preference shares) amounted to just over £¾ billion. Two years later, in 1982, the total flow of new issues had more than doubled, to just over £2 billion. Two years later again, in 1984, the annual flow had more than doubled again, to nearly £4¾ billion. Two years later, in 1986, the flow had nearly doubled again, to £8½ billion. And two more years on, to last year (1988), saw the flow again nearly doubled to some £16¼ billion. At that scale of activity, internationally-distributed sterling bond issues accounted for over 11% of the international bond market, third only to issues in US dollars and Swiss francs. It is hard to think of many businesses, or markets, that, consistently through a decade, have doubled the scale of their activities every two years. At its current level, the

(1) In a speech to the 10th Anniversary Conference of the Association of Corporate Treasurers on 'The UK corporate bond market—is it alive and well?', on 9 May.

flow of new issues is significantly greater than the scale of funding achieved through issues of gilts even in the years when the PSBR was at its height.

This is a remarkable record, and I highlight it because it is not always appreciated, even by those most closely involved in the market, quite how substantially the market has grown and how sustained that growth has been over the past decade. The story these figures tell is that, at a time when new businesses have achieved rapid growth in a number of different areas of the economy, the sterling new issues business has been well up with the leaders on the fast growth track. This suggests that—to answer the (perhaps rhetorical) question posed in the title to this conference—the sterling bond market is not only alive and well, but positively blooming.

The figures which I have just quoted give a broad picture of the increasing size of the market. But to understand what has been happening one needs to look inside the figures and see how different types of borrowers, and investors, and instruments, have increased the breadth and diversity of the market. What emerges, interestingly, is that the market has not grown in any monolithic or narrowly-based fashion, but that the different sectors of the market—that is, different types of borrower, different kinds of investor, different forms of instrument—have at various times over the past decade taken up the slack, so that the flow of issues in the present-day market represents a fusion of many different tributaries.

To identify only the most significant of these streams, one can recall that in the early 1980s the market's expansion began with the arrival of bulldog bonds—one of the happier choices of name by a market whose taste in christening its offspring often tends to the melodramatic. By 1984, bulldog bonds were joined by an increased flow of sterling eurobond issues and by the emergence of sterling FRNs. UK corporate borrowers produced a brief run of issues during the strong market rally in 1982, but only began to appear in volume in 1985, initially in the form of secured debentures, but soon with a wider range of companies issuing unsecured loan stocks, and with the financial sector—banks and building societies—quickly joining the lists alongside industrial corporate borrowers. Progressively from the mid-1980s the market received a major boost from another source—interest-rate swaps. Interest-rate swaps have significantly expanded the scale of the market in two ways—by bringing into the fixed-rate bond market companies whose primary interest is in floating-rate financing, and by enabling companies who may not be able to make bond issues in their own name to have access indirectly to fixed-rate financing. In the past three years we have seen this range of capital market activities expanded significantly in three further directions—into sterling commercial paper, into convertible bonds and into mortgage-backed securities.

In the process of fusion of these different streams into a substantial continuing flow of issues, a significant change in the character of the market has become apparent over the past two years. This is that from a variety of parallel streams the market does now seem to have integrated into a single capital market offering an extensive choice of instruments to a broadly-based constituency of borrowers and investors. It has thus reached the stage of development in which it is an integrated market, but also a highly diversified one.

Role of the UK authorities

I would like now to turn to the role that the UK authorities, including the Bank of England, have endeavoured to play in promoting the development of the market.

Perhaps the first, and most important, point to make is that the growth of the sterling bond market, and the increasing diversity of borrowers using it, is a development which the UK authorities unreservedly welcome. We think the revival of the market is an important and highly beneficial event, and it is one which we have sought over the years to promote and encourage. We take this positive view for three main reasons. First, in relation to corporate bonds, it seems to us important that there should be a flourishing market to enable companies to have regular access to capital market finance as part of the range of financing opportunities available to them. Second, we think that a healthy sterling bond market is an important feature in the range of markets available in London and hence contributes to the attractions of London as an international financial centre. Third, to the extent that companies and others finance themselves by bond issues sold outside the monetary sector in substitution for bank borrowing, this process of disintermediation should be helpful to monetary control. For these reasons we have, as I say, sought to promote the market's development over the past years and we very much welcome the progress made. I would like to touch briefly on some of the ways on which we have tried to contribute to this process.

Perhaps the major contribution that the UK authorities have been able to make has been through the macroeconomic policies that have been pursued. By maintaining a prudent fiscal stance, the authorities have been able to reduce progressively the UK public sector's own borrowing requirement and move to a position in which the public sector is making net repayment of debt: the PSBR has become the PSDR. The reduction in public sector calls on the market has left greater scope for other borrowers to move into the space—a process sometimes inelegantly described as crowding-in. In parallel, by maintaining a firm monetary stance, the authorities have been able to promote conditions in which bond issues become a more attractive form of finance for a wider range of borrowers.

Macroeconomic policies have, of course, to be directed to macroeconomic objectives, on a wider perspective than the development of a single market, but the revival of the sterling bond market is nonetheless a welcome benefit. In parallel, however, we have tried in a number of ways to take steps directed specifically to improving the functioning and infrastructure of the sterling bond market, so that as the macroeconomic climate became more conducive to bond issues the structure of the market would be in good shape to handle the business. It was with this in mind, and particularly to try to encourage the maximum flow of issues in an orderly and efficient manner, that the Bank of England has from time to time issued guidelines for capital market issues in sterling. Such guidelines were first issued in 1980, when the market began to expand following the ending of exchange controls, and we have adapted them on a number of occasions since then as the market has developed.

The essential purpose of the guidelines has been to respond to questions which market participants have put to us, mainly on matters relating to the structure of instruments and methods of issue. The guidelines have thus been drawn up in close consultation with market participants and have sought in essence to reflect the consensus view of market participants as to how the development of an orderly and efficient market could best be promoted. The importance we attach to maintaining close contact with market participants and listening to their views lies at the heart of our approach to encouraging the growth of the market: we believe very strongly that time devoted to consultation and dialogue with firms actually operating in the market repays ample dividends; and in this context we have particularly valued the dialogue we have been able to maintain with borrowers through our contact with the Association of Corporate Treasurers and its members.

An important and enduring feature of our guidelines from the outset has been our wish that capital market issues in sterling should be managed in the United Kingdom, under the lead-management of a UK-based firm which has the capacity in the United Kingdom to act as an issuing house. We have followed this approach because we think it best helps the development of an integrated and healthy market if sterling issues are managed here in London in the centre of the sterling markets and are the responsibility of an issuing house with knowledge and experience of the sterling capital markets. We believe that this approach has contributed positively to the growth of a healthy market, and continues to do so. Though the issuing house must be UK-based, it can of course be UK-owned or foreign-owned. Many foreign-owned firms do in fact participate actively in the business, though in their case we continue to look for there to be reciprocal opportunities in their domestic capital markets for UK-owned firms to lead manage issues there.

Besides these lead management guidelines, the Bank of England for some years past operated a statutory requirement, under the Control of Borrowing Order, for issuers in the sterling bond and equity markets to obtain our consent to the timing of an issue before it proceeded. This enabled us to indicate to the lead manager if we saw the prospect of an inadvertent clash in timing between issues which might make them more difficult to handle. We believe that this facility served a useful function in the market's development. But as the market has grown, there has been less need for a statutory requirement and, as the Chancellor announced in his Budget speech in March, the requirement for timing consent has now been abolished. We do, however, wish to be notified of the details of issues—both debt and equities—at the time of issue, so that we can continue to monitor the flow of issues and keep track of the development of the market.

In parallel, the Government has taken steps on a number of occasions over the past decade to improve the tax treatment of bonds, particularly corporate bonds. One such step was the decision to exempt qualifying corporate bonds from capital gains tax. Another was the provision to permit UK companies to make coupon payments on eurobonds on a gross basis direct from the United Kingdom. In addition, corporate bonds convertible into another debt security were exempted from stamp duty in 1984—non-convertible bonds were already exempt since 1976; and in the same year tax arrangements were introduced to facilitate the issue of zero-coupon and other forms of deep discount bonds (including index-linked bonds) by companies. In the Budget speech earlier this year it was announced that the exemption for qualifying corporate bonds would be widened to include classes of bonds previously outside the qualifying category; and that the deep discount tax arrangements would be extended to issues of that type of bond by sovereign and other public sector borrowers. These improvements in the tax arrangements have served to remove impediments to use of the capital markets and hence helped to encourage the flow of issues as interest in the market has revived.

Big Bang—the series of structural changes in the London security markets initiated in 1986—also played an important part in facilitating a greater flow of issues. Big Bang increased both the number and the capitalisation of the market intermediaries and it brought a wider variety of firms, domestic and international, into the market. This resulted in a greater commitment to secondary market activity by a larger number of firms; and it brought changes in the methods of distribution. These changes have attracted the greatest attention in the way they have affected the gilt-edged market, but in parallel we have sought to ensure that the same enhanced secondary market structure is available to handle corporate bonds and other non-gilt issues; thus we have provided from the outset that the gilt-edged market makers can deal in non-gilt bonds, including corporate bonds, and money-market instruments, as well as in gilts. This linkage to the gilt market has been an important element in the growth of activity in sterling bonds in the past two years and will remain important in helping the market to expand further in future years.

The final contribution from the UK authorities that I should like to highlight is the most recent—the package of capital market measures announced by the Chancellor in his Budget speech in March. Some of the measures announced in that speech I have already referred to—the ending of the requirement for sterling issues to obtain timing consent, and the extension of the tax provisions to facilitate zero-coupon and other deep discount issues. I want now to describe briefly the background to the remaining elements in the package, ie the measures designed to liberalise and integrate the arrangements for issues of sterling paper of less than five years' maturity.

The measures announced by the Chancellor represent in a sense the completion of a process which began several years ago to allow a wider range of instruments and issuers in sterling in the under-five-year area. It is an area in which we have felt it right to proceed cautiously, testing each step as we proceeded and maintaining a close dialogue with market participants and, most helpfully, with the Association of Corporate Treasurers, so that a collaborative approach can be taken to working out how the market for short-term sterling paper can best be developed. We have proceeded in this way because, though on the one hand we are conscious of the rapid growth of short-term instruments in the euromarkets, in the form particularly of euro-commercial paper, and of the spread of securitisation, on the other hand we have to have regard to the functions of the Banking Act in requiring deposit-taking institutions to be licensed and supervised.

The initial steps we took in this area were in 1985 and 1986, when provision was made for companies meeting certain conditions to be able to issue short-term corporate bonds of 1–5 years' maturity and sterling commercial paper of 7 days–1 year maturity, within a framework and with the benefit of an exemption from the Banking Act designed to ensure that such issues were directed to professional investors, under safeguards for investor protection and in a way that would not conflict with the requirements of the Banking Act. Thus access to the sterling commercial paper market was confined to companies with net assets of at least £50 million whose shares were listed on the International Stock Exchange; the paper had to be issued and transferred in minimum denominations of £500,000; and there were requirements for disclosure of business information about the issuer.

There proved to be relatively little interest in tapping the short-term corporate bond area, but the sterling commercial paper market has grown steadily in the past three years to a total outstanding at present of over £4 billion. Its steady growth has, we think, laid good foundations for the future.

On those foundations, the measures announced by the Chancellor in March now provide a unified and integrated framework for issues in the under-five-year area by a much wider range of borrowers. Specifically, the range of borrowers permitted to issue sterling commercial paper is now extended to include companies with net assets of at least £25 million and with shares or debt listed on any of a range of overseas stock exchanges as well as the International Stock Exchange here in London; and issues are also permitted by unlisted companies meeting the minimum net assets requirement, subject in the case of both listed and unlisted companies to disclosure of appropriate information to UK investors. In addition, banks, building societies, insurance companies and overseas sovereign and public sector borrowers, who were previously excluded from the market, will now be able to issue sterling commercial paper; and the minimum denomination for the paper is reduced to £100,000. In a parallel measure, steps will also be taken to bring the issuing requirements for short-term corporate bonds into line with those for sterling commercial paper, so that the two markets can be merged and the maximum maturity of sterling commercial paper thus extended to five years; this change will take effect later in the year when an appropriate amendment to the Companies Act has been brought into effect. In parallel with these changes, the requirement that sterling bonds and FRNs should have a minimum maturity of five years is being withdrawn, provided the issues meet the requirements of the relevant existing legislation, in particular the Companies Act, the Financial Services Act and the Banking Act.

What this all means is that a wider range of borrowers will now be able to choose among a wider range of instruments in issuing paper with a maturity of under five years, and the new measures provide a coherent and integrated framework for such issues. Borrowers in this area essentially now have a choice between two avenues.

Those wanting to tap the wholesale markets on a regular basis will, provided they meet the requirements for entry to the market, be able to issue sterling commercial paper in minimum denominations of £100,000; and banks and building societies will have the additional alternative, as at present, of issuing CDs. Alternatively, borrowers wanting to raise funds outside the wholesale markets will be able to issue short-dated bonds in smaller denominations, provided they meet the statutory requirements designed to protect investors and depositors. Within this integrated framework, borrowers will thus have greater freedom of choice of instruments and avenues.

Outlook for future development

These are some of the steps that the UK authorities have taken over recent years to try to help the market's development. I would like now finally to stand back a little in order to try to assess what sort of market we now have; and in doing so I would like to suggest for consideration a few specific areas where further work on the market's infrastructure may be beneficial.

First, the scale of issues we are seeing suggests that it is already a very large market with considerable potential to contribute to the financing of companies. I say 'potential' because I am sure the process has further to go. But it has already reached a considerable mass.

Second, as I have indicated, the market does seem in the past two years or so to have progressed beyond an agglomeration of separate sectoral markets into a single integrated market. But third, it is also a highly diversified market. Regular borrowers comprise both domestic UK and overseas names, both corporate and sovereign/parastatal; they can borrow in fixed-rate or floating-rate form, in a range of maturities running all the way up to 25 years or longer, with the opportunity to target issues at international investors through a eurobond syndicated distribution, or at UK investors through a domestic placing or offer for sale, or at both; bonds can be issued in bearer or registered form, paying interest annually or semi-annually; equity links can be added through convertibles or warrants; puts and calls and a variety of coupon-adjusting techniques are available to taste; and there is also the opportunity to issue zero-coupon or other forms of deep discount or index-linked debt. Given this varied menu, the crude distinction sometimes made between 'domestic' and 'eurosterling' issues does now seem plainly out of date and no longer to reflect reality. There is a single integrated market, offering a wide variety of ways in which bonds can be distributed.

Fourth, this means that we are now beginning to see the development of a range of parallel capital markets in London. We have become accustomed in London to a structure in which the bond market means essentially the government bond market—the gilt-edged market. We have now entered into a phase in which the government bond market may shrink in size for a while, but alongside it there is developing a corporate bond market, a sovereign bond market and an array of markets in derivatives—futures, options, warrants, swaps and other techniques for capital market financing. The better balance that is developing between these various markets seems to us a healthy process and one that, by enhancing the range of facilities available in the London market, should add to London's attractions as an international financial centre.

However, though the development of the sterling bond market has undoubtedly made great strides in recent years, the process has further to go and there are four areas where I would like to suggest that further work may help to promote the market's development.

First, the pricing of new corporate (and sovereign) bond issues is normally based on a comparable issue in the gilt market. But particularly for longer-dated issues, a close gilt-edged analogue may not be available, leading to imprecision or uncertainty about pricing relativities; and this problem may become greater as the stock of gilt issues progressively shortens in maturity. It is for consideration therefore whether it would not be appropriate for the market to try to develop a composite corporate bond index, based on a selection of sizable recent issues by prime borrowers, as an alternative benchmark which might be accepted by the market as a guide to pricing.

Second, I have referred already to the increased commitment to secondary market trading activity since Big Bang. The basis on which secondary market trading is conducted in the gilt market is fully documented and well understood. It might be beneficial for secondary market trading arrangements for corporate bonds to be reviewed, to improve understanding of how the arrangements function—for example, how investors can quickly identify market makers in individual issues, and obtain prices, and what sort of spreads and size of trades they can expect to be able to obtain.

Third, it may also be worthwhile to review the settlement arrangements for corporate bonds. At present, some bonds settle through Talisman and will be included in the plans currently under discussion for Taurus; others settle through the Euroclear and CEDEL clearance systems. Gilts are principally settled through the Central Gilts Office, which offers the combined advantage of next-day settlement in a book-entry system. We at the Bank are currently considering suggestions which have been made that a facility on the lines of CGO, which already includes some bulldog issues, might be put in place for corporate bonds.

Finally, suggestions have been made that arrangements for 'shelf registration' should be developed in the United Kingdom. Put in these terms, the suggestion seems to reflect some misunderstanding: shelf registration was developed in the United States in order to streamline the process of registering security issues with the SEC, but that is a hurdle which does not exist in the United Kingdom. Those who make this suggestion more probably have in mind some procedure by which the documentation for obtaining listing on the International Stock Exchange might be prepared and cleared in advance, so that the issue can be brought at short notice when market conditions are propitious. Again, this is an area where further work may be needed to identify the precise point behind the suggestions being made.

These are all essentially technical matters, though nonetheless relevant since they could help to improve the market's basic infrastructure. But they do not detract from the picture of a market which has developed strongly and steadily over the past decade and is now a major feature in the London financial landscape. This is a remarkable and encouraging achievement. But, looking to the future, what is even more encouraging is that all the evidence suggests that, in the words of a great American communicator, 'you ain't seen nothing yet'.