BANK OF ENGLAND

Speech

The Development of the Non-Gilt Sterling Bond Market

Speech given by

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I have been asked to offer some preliminary comments on the research report on the development of the non-gilt sterling bond market prepared for the Association of British Insurers (ABI) by Ruben Lee of the Oxford Research Group.

Let me begin by applauding the ABI very warmly for commissioning this timely review and Ruben Lee for writing such a thought-provoking report. It is full of flavour, contains, as far as I can see, no artificial additives and very little gristle, and provides plenty of food for thought. I hope, starting today, we can all get our teeth into it!

The reason I am here, not as the naked chef, but as the Executive Director of the Bank of England responsible for financial market operations, is that we at the Bank take a very close interest in the development of the financial markets. For our monetary responsibilities, in pursuing low inflation in line with the government's target, the sterling bond market is part of the transmission mechanism for our monetary actions, but also an important indicator of inflationary expectations and of the monetary impact of our interest rate decisions. In parallel, we have responsibility, too, for financial stability - the soundness of the financial system, of which a healthy bond market is a key component. And we also have a front-line concern for the effectiveness of the UK's financial services. The Bank wants a financial system that offers opportunities for firms of all sizes to have access to capital, on terms that give adequate protection to investors, and in a structure which enhances the international competitive position of the UK's financial services sector. It should therefore come as no surprise that the Bank takes a keen interest in the development of the sterling bond market.

Development of the sterling bond market

Let me first touch on the current state of development of the sterling non-gilt bond market. Leaving aside some of the data quality and coverage problems mentioned in the report, I think we can all agree that the market has grown rapidly in the past five years. The available information suggests that the average increase in gross issuance has been more than 30% per year in the period since 1995. As Ruben Lee points out, the result of this rapid expansion, combined with the contraction in the size of the gilts market, is that the outstanding stock of sterling non-government bonds is now almost equal to the outstanding stock of gilts, and may overtake it during the course of this year.

However, this rapid growth does not mean that the sterling corporate bond market is yet either a fully 'mature', or even especially 'large', market. Putting things into perspective for a moment, the sterling non-government bond market is only around 3% of the size of the dollar private securities market and about 10% of the size of the euro private securities market. Reflecting its relatively small size, the sterling market still has quite a few signs of local flavour that distinguish it from the dollar and euro markets. For instance, there appears to be less diversity amongst both issuers and investors in the sterling market. Almost 90% of sterling non-government bond issuance originates from financial institutions, with a particularly large part of this coming from supranationals such as the EIB, IBRD, and KfW. In contrast, only around a half of the bonds in the dollar private securities market are issued by financial institutions. Similarly, as Ruben Lee's report highlights, on the investor side, the vast majority of sterling non-government bonds are held by UK pension funds and insurance companies.

On the face of it, therefore, it would appear that, while AAA and AA-rated non-government institutions have been stepping in to provide substitutes for the declining supply of gilts, this has not yet contributed to a significant broadening of the range of participants in the sterling market. In parallel, while the liquidity of the sterling corporate bond market has increased in recent years, the extent of this improvement has not yet matched the increase in the size of the market.

These are developments clearly brought out in Ruben Lee's paper and are undoubtedly true. But to put them in perspective, I think one has to recognise that there has been a sizeable parallel activity by issuers raising sterling capital by issuing bonds in foreign currency - notably dollars and euro - and swapping into sterling. This is a thoroughly healthy development, because it reflects, and capitalises on, the global integration of modern-day capital markets; and, of course, much of the business is organised in London, whatever the currency, so that it benefits the UK financial services sector as well as UK issuers. But it does mean that, to get a handle on the scale of capital market financing in sterling, you have to look at funds raised in foreign currency and swapped back into sterling, as well as direct issuance in sterling.

Prospects for future growth

Looking now ahead at prospects for future growth, the scope for enhancing the functioning of the market will need, as Ruben Lee's paper recognises, to seek ways to broaden the spectrum of active investors and issuers, ie, both sides of the market.

On the supply side, it perhaps makes sense to consider two types of institutions: (a) firms that have no access to the swap markets and who do not have international name recognition; and (b) larger firms, who can access the swap markets and which therefore have a genuine choice about which currency to issue their bonds in.

Firms that have little or no access to foreign capital naturally need to focus their financing requirements on the domestic capital markets. This suggests that one of the determinants of the relative sizes of bond markets should be the gross domestic product of the various currency areas. The UK is around 15% the size of the United States and of the euro area. As I mentioned earlier, however, the sterling corporate bond market is only around 3% the size of the dollar market and 10% the size of the euro market. These simple figures suggest that there may be scope for the sterling non-gilt market to continue to expand its domestic issuer base. But of course, at present, around two-thirds of the liabilities of non-financial companies are currently in the form of shares; bank loans account for around a quarter of their liabilities; and, bonds make up only around 6 or 7%. Any expansion of the domestic issuer base in bonds will therefore need to be on the basis of an increase in the attractiveness of bond-financing relative to the financing through share issuance and bank loans. What is important in the long run is that all three sources should provide adequate opportunities for the financing needs of issuers.

The financing choices faced by larger firms with access to the swap markets are slightly different. As well as being able to raise capital in the sterling markets, these firms, as I have indicated, can also tap the foreign currency bond markets, and do so. Hence, in order for the sterling bond market to attract more issuance from these firms, it will need to ensure that it offers at least as favourable terms as those available in the dollar and euro bond markets; and this may reflect not only straight differences in the costs of finance, but also differences in liquidity, in investor base, and in contractual terms.

Turning to the demand side, I find it harder to know what factors might help to expand the investor base in the sterling bond market. No doubt, the mysterious 'Walrasian auctioneer' that economic text books refer to will ensure that any increase in supply creates its own demand via adjustments in the relative prices of financial assets after taking account of relative risks. However, I cannot help feeling that there are likely to be other considerations that will help. For instance, I tend to agree with Ruben Lee that any increase in the availability of prices, turnover figures and bond indices will help to broaden the investor base. In addition, there may be greater retail interest in non-gilt bonds; and a greater range of indices, and indeed of maturities of individual issues, might help to broaden demand.

Viewed overall, the prospects for further strong growth in the sterling non-government bond market over the next few years appear to be good. One factor which should continue to help is that it seems unlikely that the available stock of gilts will increase significantly. At the same time, the demand for fixed income non-government securities from the largest investor class¾pension funds¾looks set to continue to grow in the coming years due to the ongoing influences of our ageing population and the combined effects of the Minimum Funding Requirement reform and the introduction (from June 2003) of the FRS17 accounting standard for pension funds. This makes Ruben Lee's report, and the ABI's initiative in commissioning it, extremely timely.

The report contains a host of suggestions and ideas which I hope will stimulate debate and discussion. They are points on which I think it is very much for market participants to take the lead: I agree strongly with Ruben Lee that, in many of these areas, it is far more effective for market participants to develop the way forward that will best serve the market's interests, rather than for the authorities to try to lay down a blueprint from on high. So I hope very much that market participants will give thought to the proposals in the paper and debate their merits constructively. As a contribution to that debate, there are two particular areas where I might offer some views at this stage.

Covenants

First, it seems sensible that we should try to ensure that any changes that are made to the arrangements in the sterling bond market do not limit its appeal amongst international issuers. In this regard, I have some concern about the suggestion in Ruben Lee's report that the covenants on sterling bonds should be expanded. Our impression, from contacts with a number of domestic issuers, is that the widespread use of restrictive covenants in the sterling markets reduces the attractiveness of issuing sterling bonds. Equally, it seems likely that these covenants may also be discouraging for foreign investors who are unfamiliar with them. Essentially, it seems to me that multiplication of different covenant clauses works against the grain of the inherent nature of bonds - that they are a standardised set of liabilities that can be traded one against another on the basis of judgements about the relative credit-standing of different issuers. My feeling, therefore, is that we should be trying to eliminate the contractual differences between sterling bonds and bonds issued in the dollar and euro markets. I therefore agree with Ruben Lee that the aim should be to develop a standardisation in this area, but I feel this should be a common international standard, rather than just a domestic one.

Liquidity

Secondly, on the subject of liquidity, I agree with Ruben Lee that the amount of capital devoted to market-making in sterling non-government bonds has diminished in recent years. This is true of a number of markets. But, as also in a number of markets, this development has not necessarily led to a deterioration in the liquidity conditions faced by market participants. Rather, it appears to me that liquidity has moved away from the provision of two-way price quotes to all-comers and towards providing liquidity more selectively to customers. The main reason for this development is likely to have been that quoting two-way prices in the sterling non-gilt market was not regarded as a sufficiently profitable activity for the risks it entailed. In particular, the illiquidity of the market and the lack of diversity amongst investors makes going short a bond a relatively risky activity. One way of addressing this problem might be for the major institutional investors and market makers to develop and actively participate in a stock lending market for sterling non-gilt bonds. Other options could also be considered. For instance, the largest issuers in the sterling market could consider arrangements which might encompass both the size and structure of bond issues by issuers and the commitment to market-making in such benchmark issues by market makers, as has been done in other markets at various times.

I believe some steps in these directions are already being taken. No doubt, however, there is scope for more to be done.

What can the Bank do?

Let me end with a word about the contribution we at the Bank can offer. We share your desire to see further improvement in the structure and functioning of the sterling bond market. We have, of course no formal regulatory oversight over the sterling bond market nor over the participants in it. But as a central bank with a strong interest in promoting good market structure, we are keen to see discussion of the various alternatives and to do what we can to help you find the best way forward. It is up to you, the main participants in this market, to reach a consensus on the best way forward and to implement it, but we are keen to help where we can. And in the meantime there is one very practical area where we can give assistance. Our main contribution towards maintaining the growth of the sterling bond market is to continue to ensure a low and stable inflationary background, consistent with the government's inflation target. That we shall continue to do, and that should help to increase the relative attractiveness of holding sterling bonds for both domestic and overseas investors.

I look forward very much to hearing the rest of the debate today and to joining with all of you, on the basis of this excellent initiative by the ABI, in endeavouring to broaden the appeal of the sterling bond market.