The end of the war

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Key points:

War Loan might be called in late February, for both economic and political reasons.

The effect on the 15+ indices could be slightly messy.

■ **To call or not not call.** There are eight outstanding perpetual gilts, each of which is now callable at par on a coupon date. Most are historical remnants of no consequence to markets.

But the largest of the perpetuals, 3½% War Loan (a refinancing of 5% War Loan which was called eighty years ago), has £1.9bn outstanding.

Will it be called?

— Calling War Loan and refinancing it entails giving up the right to call it again. So it would not be economical to call it if long yields were only an edge below 3½%. However, this guidance is only approximate, as the DMO does not hedge its implied option exposures.

This also assumes that the primary motivation for a call would be to lower financing costs: to borrow at the current yield of the 4% Jan 2060 (3.07%) rather than at 3½%.

— But there is another motivation: a micro-'QE'.

War Loan has many holders, most of whom own only a small quantity. Data obtained by the DMO from the registrars are as follows:

Holding size	Num.	Total	Average
≤£1k	106,096	26,023,764	£245
>£1k, ≤£5k	18,406	39,733,535	£2,159
>£5k, ≤£10k	2,309	16,371,862	£7,090
>£10k, ≤£100k	2,454	67,239,699	£27,400
>£100k	386	1,789,227,179	£4,635,304

Combining the top three rows, there are 126,811 holdings of ≤£10k, averaging £647.

The Chancellor of the Exchequer read modern history at University. So he would surely appreciate and enjoy the idea of repaying those who funded WW1. And he can 'give' a 'present' to over a hundred thousand families. Many of these presents will be £100, but some larger. And the Chancellor can do so in a manner that saves money. What's not to like?

What would happen to the £82 million of principal paid to those with holdings ≤£10k? Possibility 1 is that UK retail would portfolio rebalance, re-acquiring the lost duration by buying long-dated fixed-income assets. Possibility 2 is the pub, thereby boosting the local economy and paying taxes to the government. Readers should judge for themselves which would be thought more likely by the economists in Her Majesty's Treasury.

Bearer bonds

■ In about the late 1980s new gilts ceased to be exchangeable into bearer certificates. But there are still outstanding bearer holdings of the perpetuals (e.g., picture overleaf), and the DMO's data are reproduced in the following table.

	Size	3½% War	2½% Consols	2¾% Ann.	2½% Ann.	3½% Conv.
A	£50	154	23	0	1	2
B	£100	974	19	† 1	0	0
C	£200	69	1	0	0	0
D	£500	134	2	0	0	0
E	£1000	627	24	5	0	0
F	£5000	90	0	0	0	0
	Total:	1,262,900	28,250	5,100	50	100

(† Owned by the author since the mid-1990s.)

So bearer bonds are small cheese, being about 0.065% of War Loan's outstanding. And some of these will have been destroyed, lost or forgotten.

A possible course of action

■ **When?** War Loan pays its semi-annual coupons of £1¾ on 1 June and 1 December. A call must be announced in the London Gazette at least three months in advance, so before the late-March Budget. It seems that the London Gazette needs to receive the notice two business days ahead of publication, so a decision would need to be taken in mid-to-late February (or mid-to-late August).

Given the historical nature of the announcement, and the seeming 'giveaway' within it, it is very possible that the Chancellor himself would announce this, perhaps in a speech in late February. (The Chancellor's calendar is not published in advance, so we cannot pick a particular speech on a particular date at which this is most likely.)

Indices

■ The following paragraphs come from the Ground Rules for the Management of the FTSE Actuaries UK Gilts Index Series:

4.2.4 "Sliders": a gilt that has a spread of redemption dates is treated as if it were to be redeemed on the earliest possible or latest possible date, depending on which date gives the lower redemption yield. This is equivalent to using the earliest date if the (dirty) price is above the "equilibrium price" (see Rule 9.2), and the latest date if the price is below the equilibrium price. As its price moves above or below the equilibrium price, so that the applicable redemption date changes, a gilt may move from one sector to another (either shorter or longer). "Sliders" are moved from one sector to another after the close of business on the day their sector changes, and are moved at the equilibrium price, but in a calculation that allows for intermediate prices at the same time for other gilts (see Rule 11.4.10).

…

7.2.1 Gilts are removed from the indices on their redemption dates at the closing price on the previous day. If a gilt with a spread of redemption dates is redeemed early it too is removed from the indices on the announced redemption date at the closing price on the previous day; the two redemption dates for such a gilt are both altered to the announced redemption date when such an announcement is made.

There are multiple possibilities. If the call of War Loan is fully anticipated, then it will have a clean price over £100¾, so for index purposes it would already be treated as if it were to be called on the "earliest possible" date. It would already be a short.

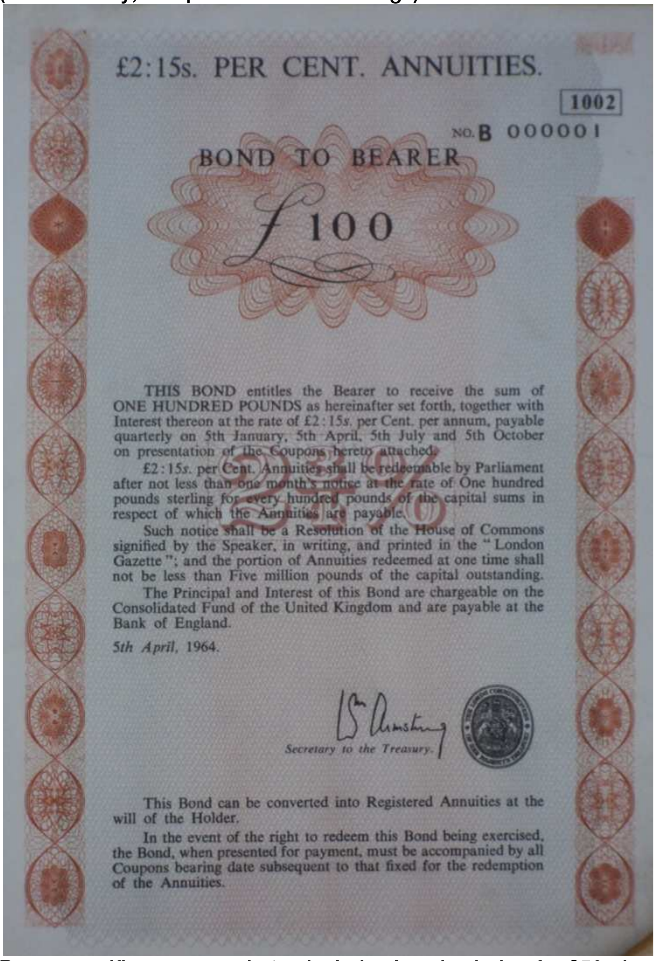
But if the announcement were enough of a surprise, then War Loan would be "moved from one sector to another after the close of business on the day their sector changes". For a daytime announcement that would work in the obvious way.

But if the Chancellor were making a speech in the evening, the effect would be retrospective. It seems that an 11pm announcement would be deemed to take effect at 4:15pm on the same day. Investors benchmarked to 15+ would find that they had been holding, overnight, a ≈3-month instrument. **A prompt switch into the 15+ would be wanted.**

For many years the practice of the DMO has been to maintain a bid for any gilt in its last coupon period, thereby slightly smoothing the redemption profile. The yield of the DMO's bid is typically equivalent to that of repo against gilt collateral: so fair but not generous. If War Loan had been called, it would be in its last coupon period, so even if dealers did not want it the DMO could take it.

But those same investors selling War Loan would need to buy the 15+ index. The longest conventional auction in February is of the 4½34, on Thursday 16 February, which has a duration about 10% shorter than the 15+ index. Depending on the timing of the announcement, this auction could go very well, or have happened too soon.

A bearer gilt: 2¾ Annuities
(in old money, two pounds fifteen shillings)


£2:15s. PER CENT. ANNUITIES.
1002
NO. B 000001
BOND TO BEARER
£100
THIS BOND entitles the Bearer to receive the sum of ONE HUNDRED POUNDS as hereinafter set forth, together with Interest thereon at the rate of £2:15s. per Cent. per annum, payable quarterly on 5th January, 5th April, 5th July and 5th October on presentation of the Coupons hereto attached.
£2:15s. per Cent. Annuities shall be redeemable by Parliament after not less than one month's notice at the rate of One hundred pounds sterling for every hundred pounds of the capital sums in respect of which the Annuities are payable.
Such notice shall be a Resolution of the House of Commons signified by the Speaker, in writing, and printed in the "London Gazette"; and the portion of Annuities redeemed at one time shall not be less than Five million pounds of the capital outstanding.
The Principal and Interest of this Bond are chargeable on the Consolidated Fund of the United Kingdom and are payable at the Bank of England.
5th April, 1964.
Secretary to the Treasury.
This Bond can be converted into Registered Annuities at the will of the Holder.
In the event of the right to redeem this Bond being exercised, the Bond, when presented for payment, must be accompanied by all Coupons bearing date subsequent to that fixed for the redemption of the Annuities.

Bearer certificates come in 'series': the A series being for £50; the B being £100; C = £200; D = £500; E = £1000; F = £5000. This is the only outstanding £100 certificate for 2¾ Annuities, and has the number B000001.

The other perpetuals

■ If the Chancellor announces a call of 3½% War Loan, it is very likely that either the Chancellor or the DMO would also call 4% Consols (outstanding amount £255m) and 3½% Conversion (£16.6m, of which more below). What about the others?

If long yields are below the called perpetual's coupon, the Chancellor can claim that he is "saving money". And as the DMO does not hedge its long option position, even a small saving can be fairly claimed.

Cpn	Name	£ Outstanding
3½	War Loan	1,938,792,323
2½	Treasury	271,800,000
4	Consols	255,600,000
2½	Consols	172,400,000
3	Treasury	37,900,000
3½	Conversion	16,600,000
2½	Annuity	900,000
2¾	Annuity	700,000

Also, if a gilt is really small, it could be argued that a call provides an "administrative saving". If long yields are 3%, the annual interest 'loss' from refinancing 2¾% Annuities (all £700k outstanding) is only £1750.

The 3½% Conversion has an extra complication: a sinking fund, the administration of which might be painful. From the prospectus:

> Commencing with the half-year ending 1st April, 1922, a sum equal to not less than one per Cent. of the amount of the Loan outstanding at the close of any half-year during which the average daily price of the Loan, as certified by the Bank of England, has been below 90 will be set aside as a Sinking Fund to be employed during the succeeding half-year in the purchase of the Loan in the Market for cancellation.

There is about £16m outstanding: the DMO would surely want to ditch this hassle.

However, the three perpetuals with coupons of 2½% have outstanding totalling £445m, of which only a tiny quantity is in bearer form. So we suspect that these would not be called unless long yields were below, or at last very close to, the coupon. That requires 4%60 to rally by another £18!

There is a further hassle for 2½% and 2¾% Annuities, echoed on the bearer certificate on the previous page. This wording comes from the prospectus:

> The Two Pounds Fifteen Shillings per Cent. Annuities and Two Pounds Ten Shillings per Cent. Annuities … will not be redeemable until the 5th day of January, 1905; but, on and after that date, will be redeemable by Parliament after not less than one month's notice, in terms provided by the Act, at the rate of One Hundred Pounds sterling for every One Hundred Pounds of the capital sum in respect of which the Annuities are payable, together with the payment of all arrears of such Annuities, including a proportionate part accrued since the last date for the payment of dividends, in amounts of not less than £5,000,000 Capital Stock of Two Pounds Fifteen Shillings per Cent. Annuities and £14,000,000 of Two Pounds Ten Shillings per Cent. Annuities.

So a call must be for at least £14m / £5m, but the outstanding sizes are only £900k and £700k. Ooops. One could argue that the original purpose of the clause would be wholly fulfilled if it were deemed to mean "… or the whole gilt, if smaller". But HMT's lawyers might be more cautious: the DMO could, immediately prior to a call, issue to itself enough to take the size over the threshold.

Conclusion

- It is quite probable that the higher-coupon perpetuals will be called, perhaps in late February. If that call is unanticipated the effect on the index could be messy; but even so will not be huge.

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