Government Actuary's Department

Investment News

Monthly Bulletin from the Insurance & Investment Team

June 2016

Last Month in Brief

Last month saw the announcement that British inflation had slipped for the first time since September last year, reflecting a drop in airfares and lower clothing prices. A further announcement declared UK business investment had fallen during the first quarter, which some interpret as a sign that uncertainty caused by the country's impending referendum on European Union membership is affecting the investment decision making of companies. However, the labour market in the UK improved slightly with the number of people unemployed falling by 2,000 in the first quarter of the year. Wage growth continues to lag behind the broader economic recovery with companies taking a cautious stance.

The price of Brent Crude oil rose above $50 per barrel for the first time since early November. This rise represents an 80% increase since the 13 year low of $28 per barrel that was observed at the start of the year. The UAE's economy minister Sultan Bin Saeed Al Mansoori expects the upward trend to continue with the possibility of oil prices reaching $60 or more during the summer of this year.

Elsewhere India's economy grew by 7.6% in 2015-16 to maintain India's position of having the world's fastest growing major economy. This was driven by strong growth in the financial, professional services and manufacturing sectors of India's economy.

Chart 1: Equity Indices

Equity markets were a little higher than the previous month

Chart 2: Sterling Credit Spreads

Credit spreads fell slightly during May

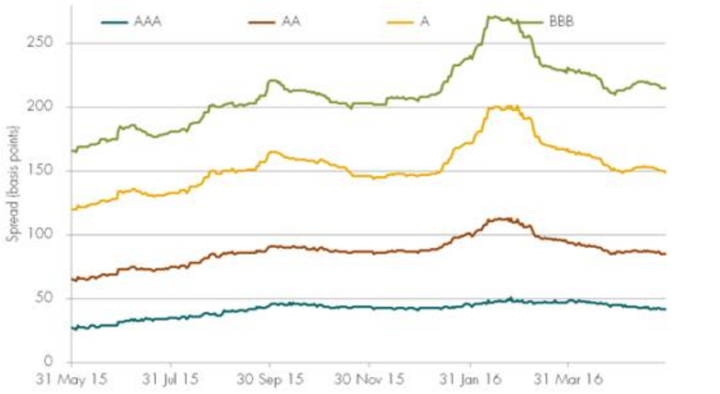
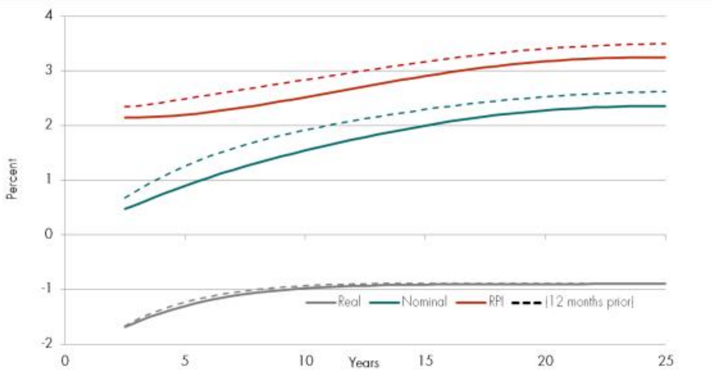


Chart 3: Gilt Yields

Gilt yields remained steady over the month

Chart 4: Gilt Spot Curves

Yield curves remained upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.3%	0.5%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	82.6%	81.0%	**$/£ exchange rate**	1.46	1.47
Halifax house prices (monthly change)	-0.8%	2.6%	**VIX (volatility) index**	14.19	15.70

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Dark Pools

What are dark pools?

Dark pools are private exchanges or forums used for trading securities. These vary in their transparency but all limit the disclosure of information until after the transaction has been executed. Dark pools have been around since the 1980s, however, their popularity has surged in recent years.

Why use dark pools?

Dark pools by their nature limit pre-trade transparency. This lack of transparency can be beneficial to large investors who wish to buy or sell a large block of shares. By avoiding revealing their identity and the size of their order it is hoped that the adverse market impact of the trade can be limited.

The alternative to using a dark pool would be to carry out the transaction via traditional stock exchanges. In this situation a large buy order is likely to be noticed by other investors and the increased demand is likely to lead to a higher price to buy each share.

In addition to the reduced transparency, these alternative trading systems can also offer lower transaction costs than the main exchanges and may offer discounts for larger transactions.

Potential setbacks of using dark pools

Although the lack of transparency may bring benefits it also has its disadvantages. In particular, the lack of transparency increases fears of abuse and predatory behaviour. Instead of places for long-term investors to trade with each other, some pools have been criticised as places where high-frequency traders (HFTs) or banks' own proprietary desks operate to profit from such transactions (see Box 1).

It is also feared that if the amount of trading continues to grow in dark pools then it may adversely affect price discovery and the efficiency of markets which would put public investors at a disadvantage. The increased fragmentation may also increase complexity and costs.

Box 1: Predatory tactics by high-frequency traders (HFTs)

Michael Lewis, the author of *Flash Boys: A Wall Street Revolt,* highlights the fact that despite the benefit of the lack of pre–trade transparency, users of dark pools are still vulnerable to predatory techniques such as pinging. Pinging is where a trading firm carries out a large number of small transactions with the aim of detecting large orders. Once the large order is detected the HFTs will recognise the increased demand for the shares and aim to make a profit at the expense of the dark pool user.

Due to the presence of HFTs some trading systems (such as IEX) have been specifically created with features which aim to block predatory HFTs from gaining the information they require to operate.

Public confidence in the banking sector could also be damaged due to the lack of transparency surrounding dark pools which in turn puts more pressure on regulators to monitor and act on any unscrupulous trading behaviour. Citigroup shut down one of its private trading venues in 2014 following fines from US regulators. More recently Barclays and Credit Suisse have received record fines for misleading clients about their dark pool trading operations.

Types of dark pools

Existing dark pools can be broken down into the following three types:

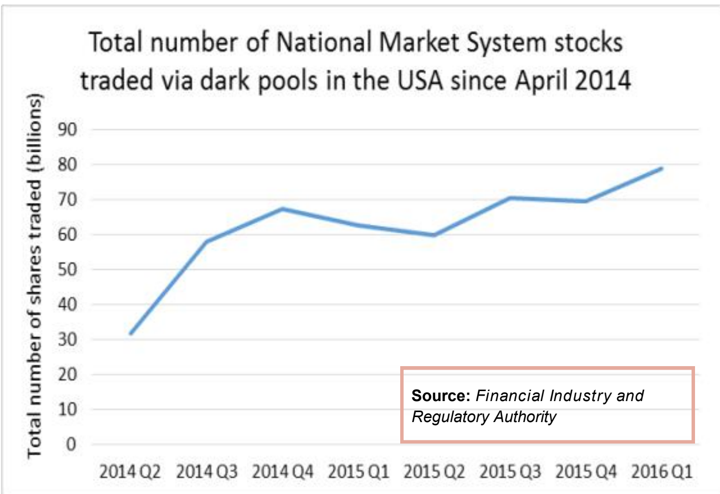
> Agency broker or exchange-owned: These are where the darks pools act on behalf of the parties wishing to trade and prices are derived from transparent stock exchanges.

> Broker-deal owned: These are where large institutions set up dark pools for their clients and own proprietary traders. In this case prices are derived for the shares based on the relative levels of supply and demand and hence may differ from prices on exchanges.

> Electronic market makers: These are dark pools offered by independent operators who act on their own account. As with broker-deal owned dark pools prices are not exchange-derived.

What is the future for dark pools?

Despite the record fines handed out by regulators, the use of dark pools in recent years has grown considerably as shown in the graph below.



However, the implementation of new regulations called MiFID II may restrict the use of dark pools in favour of more transparent transactions. The proposed rules will limit the volume of trading per stock on a single dark pool to 4% and that in all dark pools to 8% of overall trades. However, with the new restrictions not expected until 2018, it is unlikely in the short term, that the increased use for dark pools is likely to subside.

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