Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

March 2016

Last Month in Brief

The Pound Sterling faced continued pressure in February, at times touching seven year lows, following falls that stretch back to mid-2015. This coincided with news that the UK Government would hold a referendum on the UK's membership of the EU on June 23rd. The Bank of England again voted for no change to monetary policy with an unexpected 9-0 vote. It also published its Inflation Report which showed a cut in its forecast for UK growth in 2016 from 2.5% to 2.2%, with a similar cut for 2017. Later in the month, the ONS said that annual CPI inflation had reached a twelve month high in January of 0.3%.

Elsewhere the US Federal Reserve signalled a more dovish outlook, noting that "uncertainty had increased" since rates were raised in December, meaning the path of interest rate rises is set to be more gentle. European banking stocks continued their volatile run, with worries around CoCo bonds increasing (see back page). ECB President Mario Draghi sought to reassure investors hinting that the ECB may push interest rates into negative territory and expand the ECB's programme of quantitative easing. China appeared to be continuing its growth slowdown, with February industrial data at its weakest since early 2009. Beijing responded by announcing further cuts in bank reserve requirements, in an attempt to revive economic growth by encouraging lending.

Chart 1: Equity Indices

Equity markets had a volatile month

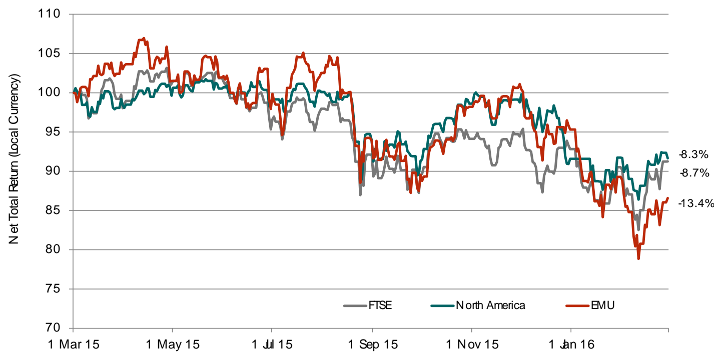


Chart 2: Sterling Credit Spreads

Credit spreads increased significantly during February

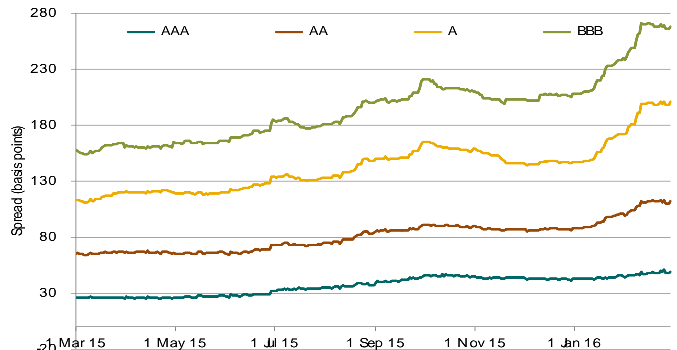


Chart 3: Gilt Yields

Gilt yields fell for shorter durations

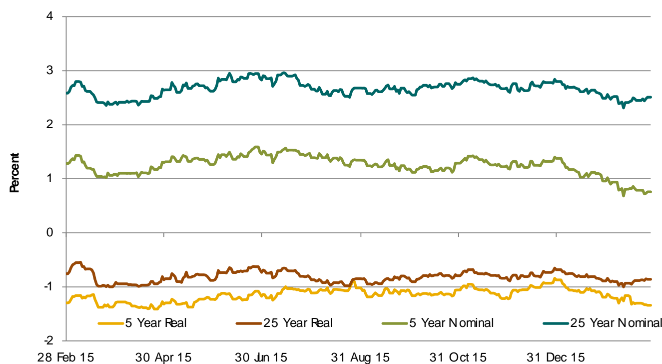
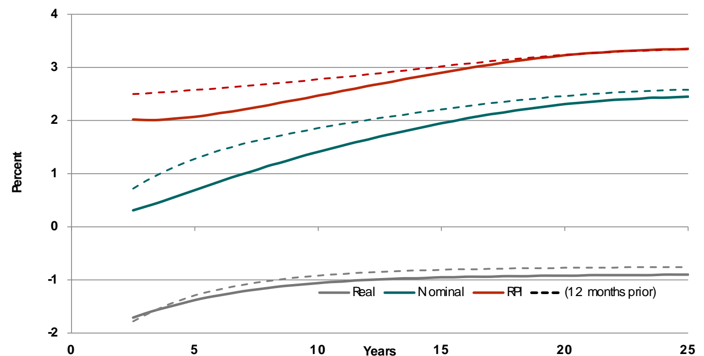


Chart 4: Gilt Spot Curves

Yield curves remain upward sloping



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

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.3%	0.2%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	80.5%	84.9%	**$/£ exchange rate**	1.40	1.42
Halifax house prices (monthly change)	1.7%	1.7%	**VIX (volatility) index**	20.55	20.20

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

Government Actuary's Department, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB Telephone +44 (0)20 7211 2601

Contingent Convertible Bonds and the Banking Sector

We introduced contingent convertible bonds (or 'CoCo bonds') in our update dated 3 December 2013. These are bonds that convert into equity or suffer a write-down to the loan amount and/or coupon payments if a pre-specified trigger event occurs (see box 1). As we noted at that time, CoCo bonds were increasingly being issued by banks to provide a form of loss absorbing capital, which was particularly desirable following the global financial crisis.

What is happening in the CoCo bond market?

There was record issuance of CoCo bonds in 2015, with 160 CoCo bond launches globally, up from 109 in 2014, according to data from Dealogic. However, in the first two months of 2016 European banks have failed to launch any new CoCo bonds, despite plans to issue €40bn during the year according to Dealogic.

During 2016, the value of many bank CoCo bonds has fallen dramatically. Several issuers have seen the price of their CoCo bonds fall 20% or more, and this investor uncertainty is affecting the ability of banks to launch new bonds.

Why has this happened?

CoCo bonds rose to prominence following the global financial crisis of 2007/08, as a way for banks to raise capital whilst protecting against poor experience. Interest in these bonds was high as they offered significantly higher yields than available on most bonds, which was particularly attractive in the pervading low interest rate environment.

Continuing pressure on European banks' capital levels, exposure to energy sector loans and weak results have all contributed to pressure on bank share prices. This in turn has raised awareness, and concerns, within the markets that some banks may experience events that trigger a pause in coupon payments, write-downs and/or conversion to equity on their CoCo bonds. These concerns have reduced the attractiveness of these bonds in the market and caused investors to lower their views on the value of the bonds.

What does this mean?

Banks in the EU need further equity or CoCo bond issuance to support capital requirements and enable them to continue lending, whilst providing some protection for the banks against poor experience. At a time when both of these markets are suffering value write-downs it becomes increasingly difficult for banks to raise additional capital in this manner. Such a situation may lead banks to consider:

a) Reducing lending, hence reducing capital requirements

b) Issuing additional equity

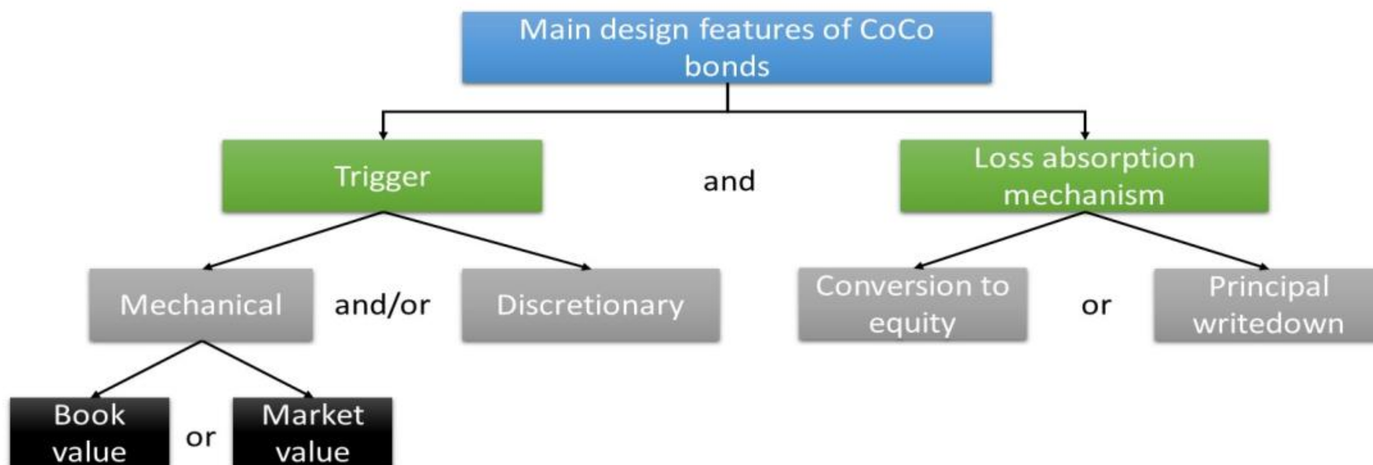
c) Issuing non-CoCo bonds

Option (a) is unlikely to be popular with the banks or relevant governments as it may put pressure on economic growth. Option (b) may suffer from weak demand when the bank's equity price is under pressure. Option (c) may be preferable to potential investors but will increase the risk of bank failures, such as those seen, or narrowly averted, during the global financial crisis.

A paper by the Bank for International Settlements notes that the bulk of demand for CoCo bonds has come from retail investors and small private banks in Asia and Europe. These investors may have suffered significant reductions in the value of their CoCo bond holdings, but it should be noted that so far these bonds have not yet triggered a contingent action. Therefore, the financial implications for these investors will depend upon their ability to retain the bonds to see if values recover, and the extent to which future events lead to contingent actions being taken. However, the lack of major European financial institutions investing in CoCo bonds should help avoid losses on one bank's CoCo bonds triggering systemic losses across the banking sector.

There is, however, one further risk for banks whose CoCo bonds convert to equity when their equity price falls to a certain level. In these cases the CoCo bonds increase the total number of shares available, thereby diluting existing equity holdings. This would typically be expected to reduce the equity price and could potentially be seen as a negative signal in the market, causing further equity price falls. This process itself could trigger similar reaction in the share prices of other banks with outstanding CoCo bonds, thereby resulting in contagion in the banking sector. This remains a relatively new asset class and there are therefore many uncertainties about what will happen in practice.

Box 1: Structure of CoCo bonds



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Contact Information

Colin Wilson
Deputy Government Actuary
T: +44 (0)20 7211 2672
E: colin.wilson@gad.gov.uk

Matt Gurden
Investment & Risk Actuary
T: +44 (0)20 7211 3498
E: matt.gurden@gad.gov.uk

Andrew Jinks
Investment & Risk Actuary
T: +44 (0)20 7211 2655
E: andrew.jinks@gad.gov.uk

Chris Bull
Investment & Risk Actuary
T: +44 (0)20 7211 2739
E: christopher.bull@gad.gov.uk