Market finance and financial stability: will the stretch cause a strain?

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2008: a market correction leads to a global crisis
The crisis cost everyone in the UK £20,000
2018: a ‘macroprudential’ objective

... to guard against the financial system disrupting growth of the wider economy

Banking system

Standards in place to ensure banks can keep lending through economic shocks

Indebtedness

Limits set on high LTI mortgage lending

Market finance

The next frontier
Companies increasingly rely on market-based finance

Sources: Bank of England and Bank calculations.
(a) Data cover funds raised in both sterling and foreign currency, converted to sterling. Seasonally adjusted. Bonds and commercial paper are not seasonally adjusted.
(b) Owing to the seasonal adjustment methodology, the total series may not equal the sum of its components.
Stretched asset prices can strain the real economy

Stretched market and collateral prices adjust

Corporate debt overhang

Deleveraging

Wider economic impact
Falling commercial property prices lead to lower lending

Net quarterly lending, 4-quarter moving average (£bn)

- Net lending to PNFCs
- CRE price index (right-hand scale)

Index: 2007 Q2 = 100

Sources: MSCI Inc., ONS and Bank calculations.
Stretched asset prices as a danger for the economy, back to our channels:

- Corporate debt overhang
- Bank losses
- Cost of finance rises
- Access to finance falls
- Wider economic impact
Four questions:

Have corporate bond and commercial property prices become stretched?
Yes

Do levels of corporate debt rely on these stretched valuations?
Not in the UK, but global picture shows we can’t take that for granted

Is the banking system exposed to an adjustment?
It can withstand severe adjustments

Are markets prone to amplifying adjustments?
Some developments raise questions that need exploring
Globally, combined premium for interest rate and credit risk is at an historic low...

Sources: ICE BofAML, Federal Reserve Bank of New York, and Bank calculations.

(a) The chart shows USD investment-grade corporate bond yield and the expected risk free rate (based on a risk free rate that has a maturity that is similar to the duration of the corporate bond index over the period shown. The difference between the corporate bond yield and the expected risk free rate is the term premia plus the credit spread.

Sources: ICE BofAML, Federal Reserve Bank of New York, and Bank calculations.
Investors are pricing in downside risks to UK growth...

Sources: Bank of England and Bank calculations.

(a) Calculated from the distributions of external forecasters’ predictions for UK GDP growth two years ahead, sampled by the Bank and as reported in the Inflation Report each quarter.

Sources: Bloomberg Finance LP, Thomson Reuters Datastream and Bank calculations.
Corporate bond market has tilted towards companies with lower credit ratings and bonds of longer duration

Sources: ICE BofAML and Bank calculations.

(a) The chart shows the proportion, as measured by market value, of the ICE BofAML sterling investment-grade index that is rated BBB. This index can be used as a representative measure of the sterling investment-grade corporate bond market. However, the index may not capture all sterling investment-grade corporate bonds and alternative indices may contain different proportions of BBB-rated bonds.
Allowing for this, there is zero compensation for risk in sterling corporate bonds

Sources: ICE BofAML, Bloomberg, and Bank calculations.

(a) The chart shows GBP investment-grade corporate bond yield and the expected risk free rate (based on a risk free rate that has a maturity that similar to the duration of the corporate bond index over the period shown. The difference between the corporate bond yield and the expected risk free rate is the term premia plus the credit spread.
Commercial real estate prices appear stretched

Sources: Bloomberg, Investment Property Forum, MSCI Inc. and Bank calculations.

(a) Sustainable valuations are estimated using an investment valuation approach and are based on an assumption that property is held for five years. The sustainable value of a property is the sum of discounted rental and sale proceeds. The rental proceeds are discounted using a 5-year gilt yield plus a long-run average estimated risk premium, and the sale proceeds are discounted using a 20-year, 5-year forward gilt yield plus a long-run average risk premium. The sale price is determined by rental yields equal to a 20-year, 5-year forward gilt yield plus a long run average risk premium minus long-run average rental growth. Expected rental value at the time of sale is based on Investment Property Forum Consensus forecasts. The sustainable valuations are determined by assumptions about the rental yield at the time of sale: either rental yields remain at their current levels (at the upper end), or rental yields revert to their 15-year historic average (at the lower end). For more details, see Crosby, N and Hughes, C (2011), ‘The basis of valuations for secured commercial property lending in the UK’, Journal of European Real Estate Research, Vol. 4, No. 3, pages 225–42.
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The stock of bonds yielding >4% has all but disappeared.

The difference between spreads on high-yield and investment-grade corporate bonds have shrunk to pre-crisis levels.
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   Some developments raise questions that need exploring
UK corporate debt to GDP has not increased over the decade

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Note: Dark shading denotes a higher debt-to-GDP ratio in 2016 than in 2006. The table shows debt at market values. Advanced economy nonfinancial corporate debt is shown net of estimated intercompany loans where data are available. Data labels in the table use International Standardization Organization (ISO) codes.
Amongst companies investing in commercial property, debt levels are below pre-crisis

Sources: De Montfort University and MSCI Inc.
Developments in the world economy show we cannot take this for granted...

### Table 1.1. Sovereign and Nonfinancial Private Sector Debt-to-GDP Ratios (Percent)

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In the United States, levels of non-financial corporate sector debt nearing previous peaks

Sources: Institute of International Finance and Bank calculations
Note: Q3 2017 figure is an IIF estimate
Record US leveraged lending issuance has been accompanied by an increase in ‘covenant-lite’ loans

Covenant-lite | Total issuance (institutional)
---|---

Sources: LCD, an offering of S&P Global Market Intelligence and Bank calculations.
(a) Based on data for public syndication transactions, and excluding private bilateral deals.
(b) Only includes institutional issuance. It does not include leveraged lending issuance that is pro-rata.
(c) Covenant-lite is defined as loans that have bond-like financial incurrence covenants rather than traditional maintenance covenants that are normally part and parcel of a loan agreement.
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Bank of England 2017 stress test results

A scenario more severe than the financial crisis

- Global and UK recessions: -4.7% UK GDP
- Higher interest rates: 4% bank rate
- Fall in house prices: -33% UK

The UK banking system is resilient
Banks lose £50 billion in the first two years of the test...

...but they are strong enough to keep lending in this scenario.

Banks are three times stronger than they were 10 years ago.

No bank needs to strengthen its capital position as a result of the test.
Banks have been increasing their capital ratios

CET1 ratio
Capital remains almost double pre-financial crisis levels even after the test.
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Stability has been a defining feature across a range of market prices.

*Data starts from January 2000*

Sources: Barclays Live, BBA, Bloomberg, Chicago Mercantile Exchange, NYSE ICE and Bank calculations.

(a) Data starts from January 2000
Low volatility begets low volatility

- Low market volatility
- Increasing supply of insurance
- Low implied volatility
‘Implied volatility’ recently near all-time lows


Sources: Barclays Live, BBA, Bloomberg, Chicago Mercantile Exchange, NYSE ICE and Bank calculations.
(a) Data starts from January 2000]
Low volatility begets low volatility

Low market volatility

Dealers’ hedging activities tend to stabilise markets

Increasing supply of insurance

Low implied volatility
Low volatility begets low volatility

- Low market volatility
- Increasing supply of insurance
- Low implied volatility
- Greater risk taking

Dealers’ hedging activities tend to stabilise markets
A shock can mean the whole thing goes into reverse

High market volatility

High implied volatility

Sharp reduction in risk appetite

Decreasing supply or/and increasing demand of insurance

Dealers’ hedging activities could amplify market moves
A liquidity imbalance in a bond market adjustment?

Dealers have become less active

Higher proportion of corporate bonds held in redeemable structures
Four questions, and my four answers

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