

AFG Guide on certain aspects of risk monitoring and valuation control relating to the investment of French funds in CoCos¹

Background

Following the AMF's update to its policy on CoCos on 20 June 2017, the AFG has put together a package of good market practices relating to the monitoring of these instruments by risk management teams. Specifically, the AFG has considered the valuation issues arising in relation to implementation of the AMF policy referred to above.

In France, CoCos fall within the AMF category of financial securities embedding financial contracts, where they are complex². Accordingly, management companies must file a request for specific approval, refer in the prospectus to the eligibility of the instrument for inclusion in the fund's assets and set up appropriate risk monitoring, including a counter-valuation process.

As regards the final point, management companies are asked to set up risk monitoring arrangements which encourage the development of certain valuation capabilities. Depending on the type of target CoCo and on the fund's investment strategy, these capabilities will primarily enable driving forces underlying the market/transactional price used for its portfolio valuation to be understood, its consistency to be checked and, where the market price is absent, the security to be valued³. It is essentially a warning tool.

Within the framework of the arrangements put in place by the management company when it wishes to invest in CoCos, it is relevant to note that according to good practice the weight of such instruments in the portfolio must be calibrated in accordance with the fund's investment strategy and its target client base.

Risk monitoring:

■ Factors relating to asset valuation

Although they are considered as "complex" instruments according to the AMF policy in terms of organisation and the human resources to be deployed by the management company, CoCos are listed instruments and management companies generally have multiple contributors and generic contributions from data providers.

1) CoCos (Contingent Convertibles) are subordinated convertible bonds. These hybrid debt instruments are issued by banks to achieve the capital levels required by the Basel agreements.

2) In accordance with Annex 1.9 of Instruction 2008-03.

3) Valuation would for example be based on the estimated variation in the theoretical price to be applied to the latest price observed. The variation is based on an analysis of the changes to the principal variables in relation to evaluation of the instrument's behaviour.

Each management company is responsible for checking when determining the net asset value that the prices contributed are representative of the market (number of contributors, prices movements, price dispersion, etc.).

Evaluation using a theoretical model is useful, notably in the case of absence/disappearance of the market price. The AFG reminds that the valuation of CoCos, like any other asset involved in the portfolio composition, falls within the general scope of the valuation policy of the asset management company, including the procedures for estimating and forcing prices provided for in the regulations on UCIs.

To date, there is no valuation model used universally for CoCos. While no model has been established as a market standard for CoCos, evaluation using a theoretical model is, rather, useful as a warning mechanism, which, for example, enables a more in-depth analysis to be triggered beyond a certain threshold. Indeed, checking the consistency of prices at regular intervals (and at least on a weekly basis) between marked to market and marked to model prices will enable to monitor changes of the spread between the market price and the estimated theoretical model, allowing to identify any significant deviation from the average spread, potentially not negligible, between the two valuation methods. This widening in the differential may primarily appear on CoCos with lower liquidity or lower contributions. The warning threshold, expressed in terms of divergence between marked to market and marked to model prices, can therefore depend on the type of CoCo and model, and notably it does not seem unusual to apply a threshold of 10% in this situation. More specifically, depending on the predominance of the strategy for using CoCos in the portfolio, and in particular where this is one of the principal performance drivers of the fund, the threshold will consequently be tightened.

Additionally the information required for the evaluation is not all directly evident from the markets, although the marked to market prices for CoCos are evident. For example, in the case of Banco Popular, the failure of the CoCo was triggered by the regulator in accordance with the European bank recovery and resolution mechanism. The contributed prices or model/theoretical prices could not anticipate this triggering of a default event.

AFG recommends that management companies set a warning threshold beyond which the security will be subject to the escalated procedures for monitoring valuation of the instruments.

In circumstances where the contributed prices are available and liquidity so permits, evaluation of a theoretical price on a weekly basis would seem to be sufficient. In any event, the management company may decide on more frequent monitoring on the basis of the assessment of the liquidity of the instruments.

As regards the marked to model valuation, by way of example the following approaches may be used to determine the risks of CoCos:

- The equity derivatives model:

The price of the CoCo is obtained by valuing a portfolio of equity derivatives which reproduces the flows of the CoCo (i.e. if this portfolio generates the same cash-flows as the CoCo, then the two prices are identical). The price obtained is broken down in such a way as to enable the credit risk and the equity risk to be quantified.

■ The credit derivatives model:

The price of the CoCo is obtained by using the formula for valuation of an ordinary bond. The risk due to conversion is included in the discount spread of the bond. For calculations of risk indicators, this model does not require too many parameters and a more reliable calibration can therefore be obtained.

As regards counter-valuation abilities, there is currently no universal model or standardised approach. The issues raised demonstrate that this subject is far from being at a mature stage and the practices of management companies are inevitably very diverse. Moreover, the models and approaches described are fairly complex in terms of implementation.

As an example (not exhaustive), a number of variables may be cited which are typically useful in the valuation of both models: the spot level of the underlying asset, the spot level of the underlying asset activating the trigger threshold for the CoCo, the implicit volatilities of the underlying asset, the issuer's spread level (taking subordinate securities into consideration) or the curve for the 3-month or 6-month Euribor rate.

■ Information on the monitoring of market risks

The management company should be able to measure the impact of the investment in these assets on the risk factors identified (and mapped) for the portfolio. Accordingly, it may for example monitor risk indicators for the securities such as interest rate, credit and equity sensitivities, to gauge the effect on the portfolio. It may also be useful to monitor on a line-by-line basis the information relating to issuers and securities, such as, for example, the triggers on each issue, the distance to the trigger as a percentage and amount, the distance to the trigger as compared with the net result (the number of financial years of net losses which would consume capital reserves), forecasts of net result or market capitalisation and the RWA.

■ Options for calculating commitment

In line with the current methods and formulae for calculating commitment in the European Union, a number of solutions exist to enable global risk to be monitored using the net commitment method. For example, a prudent method consists of taking the entire notional value as the commitment. This is a very conservative method. A second method consists of using the delta equity equivalent of the CoCo.

Each management company should use the method of calculating commitment which it considers most suitable, in view of its strategy in particular.

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