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Credit Ratings and the Covid-19 Crisis

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Two main topics

- Long-standing issues regarding the role of credit ratings and the agencies (CRAs)
- Macroprudential concerns about the procyclical impact of a wave of downgrades in the Covid-19 crisis

Qui custodiet ipsos custodies?

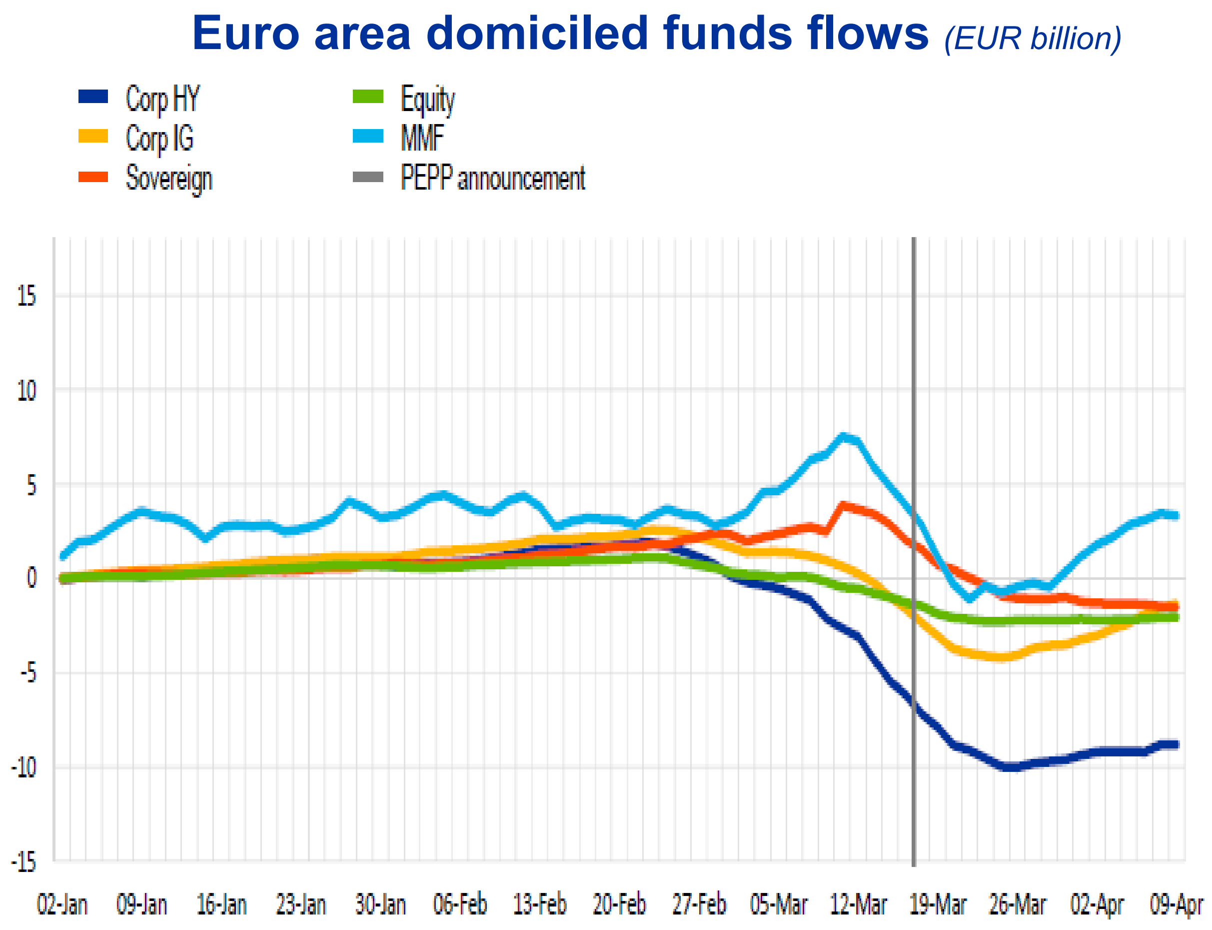
- ESMA (in Europe) is the regulator
- And CRAs must make their methodologies and assumptions public
- But there is a major role for subjective factors – regulator can't control that, nor can it deal with the incentive (agency) issues inherent in 'issuer pays'
- Empirical studies find fundamentals-based models using only public information predict as well as ratings – and CDS spreads show problems more quickly
- In the past, CRAs have heavily underestimated default correlations (Griffin and Nickerson, *JFE* 2017)

Qui custodiet…

- CRAs are ‘gatekeepers’ – like journalists (and they claim legal immunity on freedom of speech grounds)
- But they are much more profitable than newspapers – why?
- The ‘regulatory license’ (Partnoy 2017) conferred by official endorsement → barriers to entry → oligopoly (reinforced by network effects) → rents
- Despite some efforts to remove from financial regulations specific references to ratings issued by CRAs, they remain – and the mechanistic application of ratings may create systemic problems, as discussed below

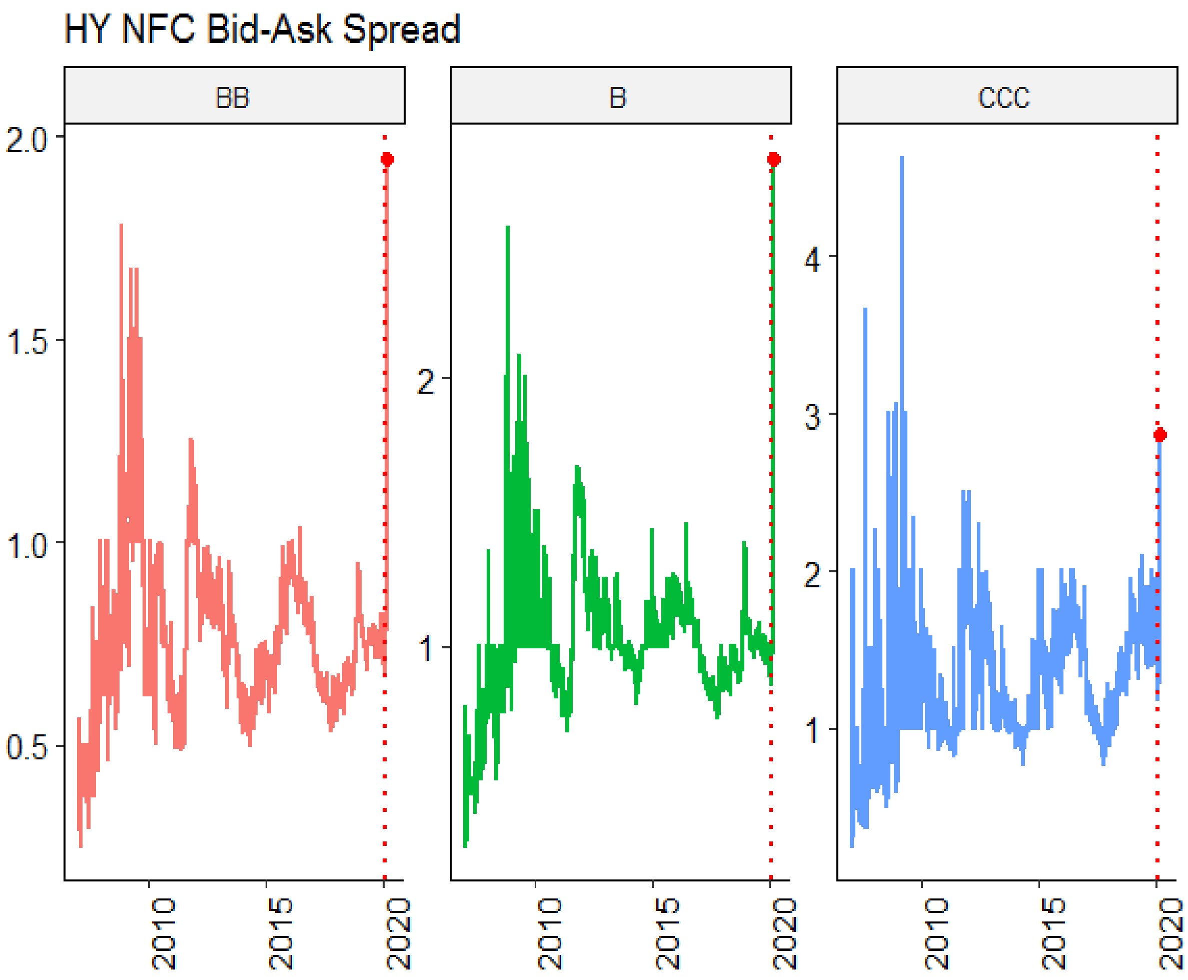
The crisis: Deterioration in corporate bond market liquidity, especially high-yield segment

Large redemptions from investment funds, in particular those with exposures to corporate bonds



High-yield bid-ask spreads higher than during the peak of the Global Financial Crisis

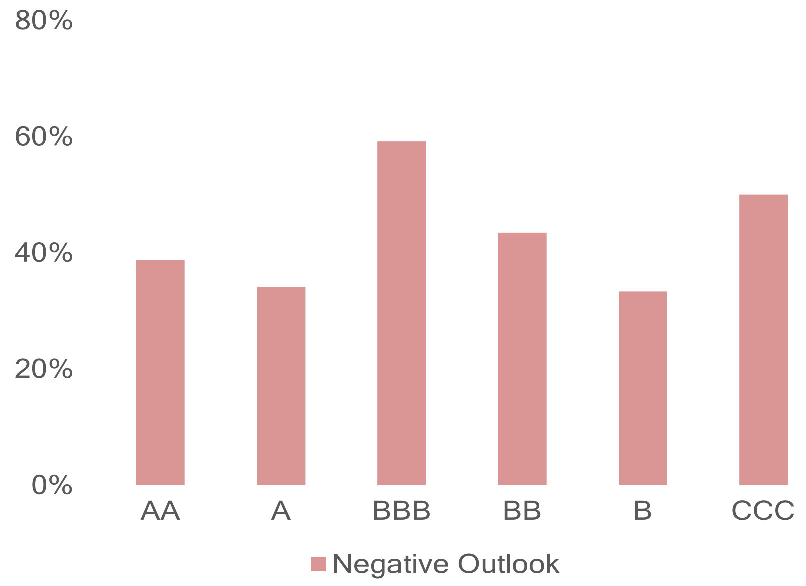
Bid-Ask spread in EUR HY NFC market (%)



Market conditions eased thanks to central banks but could deteriorate further because of a wave of downgrades

A large portion of NFCs are under negative outlook – see in particular BBB segment

Negative outlook per rating category (%)

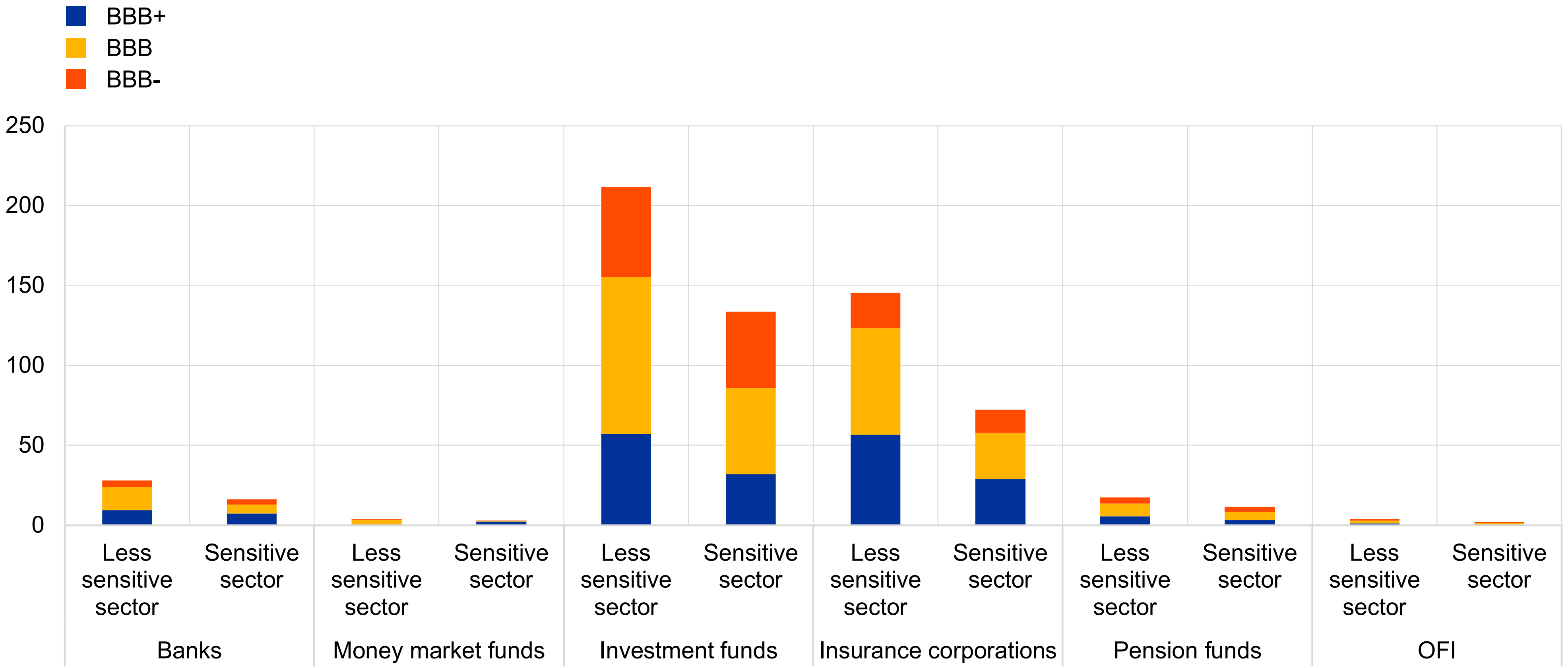


Source: RADAR, ESMA

Note: Corporate non financial instruments (ISINs) with negative outlook rated by the Big 5 (Fitch, Moody's, S&P, Scope and DBRS) by category value over the total outlooks per category value. EU-27+UK instruments. Ratings not withdrawn, as of 4th May 2020

Fallen angels risk triggering (forced) sales given tensions in high-yield market

Outstanding NFC BBB-rated bonds per rating category, split by type of holders (EUR billion)



Source: Source: SHSS, CSDB and ESRB Secretariat calculations
Note: Outstanding amounts as of 2019-Q4. Sensitive sectors are sectors particularly hit by the Coronavirus-related restrictions and include Mining, Manufacturing, Retail and wholesale trade, Transport, Accommodation and food services, and Arts and entertainment

Dangers of corporate bond downgrades

- The volume of marginal investment grade (BBB) corporate bonds expanded dramatically in the past decade – now about half of the entire corporate bond universe.
- With each successive downgrade to GDP forecasts (IMF forecasts of 14 April are now seen as optimistic), CRAs will move to downgrade ratings of corporate bonds and securities like collateralised loan obligations (CLOs).
- There have already been some, especially for CLOs, but the ratings lag – we expect a further wave of downgrades of bonds from investment to sub-investment grade status: 'fallen angels'.
- Rating 'through the cycle' may be untenable: this is a crash, not an ordinary business cycle, and the recovery is unlikely to be 'V-shaped'
- Downgrades could provoke a wave of forced sales by investment funds, insurers, pension funds and others who are constrained by regulations or investment mandates to hold only investment-grade paper or who wish to avoid an un-provisioned increase in their capital requirements or simply to avoid the HY market
- This could amount to more than €150 billion in Europe, half the size of the current high-yield market, putting huge pressure on that market to absorb them.
- The resulting declines in prices will have knock-on effects on asset holders' balance sheets and on the ability of those firms to finance themselves in the markets.

A new ESRB report discusses macroprudential concerns around corporate debt*

- The market situation could deteriorate significantly if there were a wave of downgrades, with effects on the real economy
- Large-scale downgrades by credit rating agencies could amplify the observed fall in asset values due to the deterioration of fundamentals, and cliff effects could lead to systemic risk
- Understandably, CRAs do not consider the aggregate (system-wide) consequences of individual ratings actions and their procyclicality
- So a month ago, the ESRB embarked on a top-down analysis, with the European Supervisory Agencies and the ECB, to assess the impact of a common scenario of large-scale downgrades across all parts of the financial sector.
- Private sector actions, even with coordinated supervisory interventions, may be unable to maintain market liquidity and mitigate other consequences of heavy sales of downgraded securities
- Central banks have taken some actions to mitigate procyclical impact of downgrades (ECB on collateral framework and Fed on asset purchase programme)
- But there remains a risk of market disruption, adverse spillovers, and systemic effects.
- Ratings are still ‘hard-wired’ into the investment universe, with negative consequences

*https://www.esrb.europa.eu/pub/pdf/reports/esrb.report200514_issues_note~ff7df26b93.en.pdf?50f08c5678e88d4ff278b79c5fc1fbfa