ESRB
European Systemic Risk Board
European System of Financial Supervision

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Procyclical impact of downgrades of corporate bonds on markets and entities across the financial system

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Dear Vice-President Dombrovskis, Dear Chairman Maijoor,

The outbreak of the coronavirus (COVID-19) pandemic and the subsequent enforcement of necessary containment measures are a severe shock to European economies. At its meeting on 2 April 2020, the General Board of the European Systemic Risk Board (ESRB) decided to focus its attention on five priority areas, where co-ordination amongst authorities or across the EU is likely to be particularly important to safeguard financial stability. One of the five priority areas relates to the potential procyclical impact of downgrades of corporate bonds on markets and entities across the financial system. The ESRB has analysed the market impact linked to large-scale corporate bond downgrades as well as the potential transmission of risk to financial institutions. Over the past ten years, there have been considerable efforts at European and international level to reduce reliance on external ratings from credit rating agencies in prudential frameworks in order to avoid mechanistic effects, while still acknowledging increases in credit risk in a timely manner. The ESRB proposes to continue these efforts and focus on unintended effects that might materialise during crises.

Large-scale downgrades by credit rating agencies (CRAs) can amplify the initial fall in asset values due to the deterioration of fundamentals. In particular, the ESRB is concerned about cliff-effects linked to BBB-rated issuers (or bonds) losing their investment grade status (and becoming ‘fallen angels’). As pointed out in the ESRB note published on 6 May, most of the BBB-rated bonds in Europe are held by investment funds (51%) and insurers (32%)[1]. The non-financial corporation (NFC) BBB market segment represents between 50% and 60% of the investment grade (IG) universe and, in the EEA, stood at €736 billion at the end of 2019[2]. This is three times bigger than the EEA high-yield (HY) market. To assess whether that market could absorb a large volume of sales of fallen angels, a technical top-down analysis, which also covers financial sector bonds, was conducted in cooperation with the staff of the European Central Bank and of the European Supervisory Authorities. The results of this analysis show that in a severe downgrade scenario with corresponding yield shock, EU financial institutions would suffer EUR 150 to 200 billion market losses stemming from repricing effects when considering bonds issued by financial and non-financial corporations. Losses due to assets sold at distressed values in the context of very low market liquidity might add another 20 to 30% to this, while additional second-round effects leading to further losses cannot be excluded. Under the assumptions tested, while all financial sectors suffer losses due to (forced) sales, the insurance and investment fund sectors are more affected than banks and pension funds as a result of the above-mentioned bond holdings. The results are detailed in an ESRB Technical Note published on 23 July[3]. The ESRB will focus here on two channels through which these (forced) sales could occur and hence also through which they could be limited.

The first channel relates to index-tracking funds and asset management. When fallen angels are removed from the reference basket that passive investment funds track, these funds have to sell the fallen angels they hold. More generally, external ratings continue to be widely used in investment mandates as a “common language” between investors and asset managers, and the use of ratings in investment mandates is still driven by investors’ preferences or internal rules and sectoral legislation applicable to investors. This was already noted in a European Commission 2015 report[4].

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1 ESRB Issues note on liquidity in the corporate bond and commercial paper markets, the procyclical impact of downgrades and implications for asset managers and insurers: https://www.esrb.europa.eu/pub/pdf/reports/esrb.report200514_issues_note~ff7df26b93.en.pdf

2 *Ibid*

3 A system-wide scenario analysis of large-scale corporate bond downgrades: https://www.esrb.europa.eu/pub/pdf/A_system-wide_scenario_analysis_of_large-scale_corporate_bond_downgrades.en.pdf

4 European Commission, Study on the Feasibility of Alternatives to Credit Ratings Final Report, 2015

The second channel relates to insurers, banks and pension funds. The ESRB acknowledges the efforts made by the European Commission after the Global Financial Crisis to reduce over-reliance on external credit ratings, based on the CRA III regulation, as well as on the work of European Supervisory Authorities and of the Basel Committee. One major achievement of CRA III was to encourage financial institutions to make their own credit assessment and avoid relying solely or mechanistically on credit ratings for assessing the creditworthiness of an entity or financial instrument. This pushed financial institutions to work on their own forward-looking credit risk assessment and anticipate significant increases in credit risk. This has been reflected already in Solvency II for the standard formula and in the final Basel III package, still to be transposed by the EU, for credit risk under the standardised approach (which requires additional due diligence in assessing the riskiness of exposures). Nevertheless, European laws still contain many references to external credit ratings, which can become problematic in times of crisis when all financial sectors are affected at the same time (the annex of this letter provides an overview of the key references to external ratings in EU law). In a risk-based framework such as Solvency II, the SCR standard formula for insurers stipulates higher risk stresses alongside credit quality steps that can increase materially also for corporate bonds losing their investment grade status. As Solvency II is currently under revision, particular attention should be paid to avoid any ‘cliff effects’ when amending the framework. The Capital Requirements Regulation for banks follows a similar approach, yet assigns the same risk weights for BBB and BB-rated debt securities held until maturity[5]. Some banks still need to use external ratings for the calculation of their capital requirements and to ensure sufficient risk-sensitivity of the Basel III output floor against model risk of the internal-ratings based approach, to compute liquidity requirements and as an input for the calculation of the correlation in their securitisation exposures.

This reliance on CRAs can be problematic during crises like the one we currently face. Significant increases of capital or liquidity prudential requirements may contribute to excessive procyclicality if they happen in time of crisis and affect a large number of financial institutions, in particular when they cannot be handled within day-to-day operations and cannot be offset with the release of buffers. Rating downgrades, in particular and whether or not they correctly reflect changes in firms’ fundamentals, may have a large impact since they cumulate such effects in a single point in time. Moreover they may lead some financial institutions to engage in forced sales.

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5 See Box 3 of the following EBA thematic note (EBA/REP/2020/17): The EU banking sector: first insights into the COVID-19 impacts.

Therefore, in the medium-term, in order to limit unwanted procyclical effects linked to mechanistic reliance on external credit ratings remaining in EU laws or contracts, and in line with current work at the FSB and IOSCO levels, the ESRB proposes two actions targeting each of the two transmission channels.

First, the Commission could, in cooperation with ESMA, assess whether a more systematic monitoring and reporting of contractual references to ratings in investment mandates and prospectus of funds would be feasible in order to provide supervisors with a clearer picture of where systemic issues may arise in stressed market conditions. This could be completed with an assessment of the ways to mitigate the impact of contractual references, should the previous monitoring concludes that it is necessary.

Second, since there is not yet agreement on a credible alternative to CRAs, and given that the CRA market is still dominated by few agencies, the Commission could, in cooperation with ESMA[6], assess the transparency of CRA methodologies in light of the experience of the recent months following the outbreak of the COVID-19 pandemic. In particular, the Commission and ESMA, where consistent with its supervisory mandate, could assess whether CRAs and their determinations are sufficiently transparent, notably on: the definition of rating by CRAs; the extent to which CRAs rate through-the-cycle and the appropriateness of this concept in a crisis as distinct from a business cycle; whether changes in fundamentals are reflected on a timely basis, without creating undue volatility in ratings; the time-horizon for the probability of default; assumptions about the correlation of defaults (especially for CLOs); the extent to which loss-given default is taken into account by CRAs in their ratings; and how CRAs take account of extraordinary public support measures taken by governments and EU institutions. In addition, the Commission could explore setting minimum requirements for the validation of CRAs' methodologies.

In the longer run, the ESRB would suggest that work directed towards limiting undesirable procyclical effects of remaining mechanistic reliance on external ratings could also be part of a broader goal of analysing how to foster countercyclicality in the implementation of EU law. Rating downgrades can lead to simultaneous increases in capital or liquidity requirements for many financial institutions. While changes in credit risk should be reflected in financial institutions' requirements as soon as possible, simultaneous increases can be a serious concern from a macroprudential perspective, in particular when they cannot be offset with sufficient buffers built ex-ante, as they can contribute to excessive procyclical behaviour, especially in times of crisis.

[6] Within the remit of Article 23 of Regulation (EC) No 1060/2009 (CRA Regulation) which defines ESMA powers with regard to rating methodologies.

I am aware that this is a request for a demanding task and that previous and ongoing attempts, also at international level, have not led to a consensus on alternatives. Keeping in mind the progress made since 2008, the ESRB hopes that this letter will encourage the Commission and ESMA to strengthen previous efforts and focus on further limiting unwanted effects of mechanistic reliance on CRAs during times of crisis.

Yours sincerely,

Christine Lagarde

Chair of the European Systemic Risk Board