Legal and Regulatory Updates

11/05/2020 – 15/05/2020

Key Highlights:

- This Legal & Regulatory Update covers the week commencing 11/05/2020.
- FCA issues statement on how firms should handle post and paper documents.
- FCA explains the financial services exemptions in the forthcoming Corporate Insolvency and Governance Bill.
- UK Government announces that it will temporarily guarantee business-to-business transactions covered by Trade Credit Insurance.
- European Systemic Risk Board publishes an issues note on liquidity in the corporate bond and commercial paper markets, the procyclical impact of downgrades and implications for asset managers and insurers. The ESRB also published its recommendations on liquidity risks in investment funds and a third statement on the importance of investment funds using liquidity management tools.
- ESMA highlights the challenges for rating Collateralised Loan Obligations, which we summarise below and analyse in more detail at the end of this update.
- EBA publishes its inquiry into dividend arbitrage trading schemes and announces a 10-point action plan to enhance the future regulatory framework.
- Swiss National Bank announces the expansion of accepted collateral for the COVID-19 refinancing facility.
- Central Bank of Ireland publishes economic letter on bank credit conditions & monetary policy.
- CSSF launches new eDesk portal to report fund issues and large redemptions.
- ICMA issues high-level definitions for sustainable finance.
- In this update, we also cover some of the most important news on leveraged finance published by the Financial Times during the week.
- Finally, we analyse some of the most important updates in more detail at the end of the update.

Bank of England (BoE)

14 May 2020: PRA publishes Policy Statement PS11/20 – Credit risk: Probability of Default and Loss Given Default estimation

The PRA published Policy Statement PS11/20 – Credit risk: Probability of Default and Loss Given Default estimation. This Policy Statement provides feedback to responses to Consultation Paper (CP) 21/19 'Credit risk: Probability of Default and Loss Given Default estimation', which consulted on proposals to implement the European Banking Authority's (EBA's) regulatory products that relate to Probability of Default (PD) estimation and Loss Given Default (LGD) estimation. It also contains the PRA's final policy in an updated Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches'. This PS is relevant to UK banks, building societies and PRA-designated UK investment firms.

11 – 15 May 2020: Other publications

During the week, the BoE released the following publications that might be of interest to our readers:

- One Bank Flagship Seminar – Lord Deben
- The UK economy: Insights from the Bank of England's Citizens' Panels
- Bank of England Weekly Report 13 May 2020
- The interbank market puzzle
- Quality is our asset: the international transmission of liquidity regulation
- Foundations of system-wide financial stress testing with heterogeneous institutions

Financial Conduct Authority (FCA)

13 May 2020: FCA issues statement on how firms should handle post and paper documents

The FCA issued a statement on how firms should handle post and paper documents. The FCA recognises that during the coronavirus (Covid-19) pandemic there will be some important functions, such as processing post, that will be more difficult for firms to do in a timely way. While the FCA makes it clear that it continues to expect firms to comply with the requirements for post and paper-based processes (both incoming and outgoing), the FCA also understands that in the current circumstances some firms may not be able to comply fully with them. Where this is the case, the FCA expects firms to notify it as soon as possible. In this statement, the FCA provides advice to firms and proposes a number of arrangements to help them comply.

13 May 2020: The Working Group on Sterling Risk-Free Reference Rates (RFRWG) updates its statement on the impact of Coronavirus on the timeline for firms' LIBOR transition plans

Further to the joint statement made on the 29th of April, the PRA and FCA updated their statement and announced that they have suspended transition data reporting at the end of Q1 for dual regulated firms, and cancelled some Q1 firm meetings. In light of the developments since, including the FSR statement on LIBOR published on 7 May 2020, the PRA and FCA decided to resume full supervisory engagement with these firms on their LIBOR transition progress from 1 June 2020, including data reporting at the end of Q2.

14 May 2020: FCA explains the financial services exemptions in the forthcoming Corporate Insolvency and Governance Bill

On 28 March 2020, Business Secretary Alok Sharma announced new insolvency and corporate governance measures to help businesses affected by the coronavirus (Covid-19) pandemic. These measures are expected to be included in the Corporate Insolvency and Governance Bill (Bill). The FCA released a statement explaining the measures and the financial services exemptions in the forthcoming Bill. It is expected that the Bill's measures will not be available for some financial services firms and contracts. The list of exclusions from the measures is expected to include banks, investment firms, insurers, payments and e-money institutions and certain market infrastructure bodies. Firms that safeguard client assets are also expected to be excluded from the company moratorium during the coronavirus period and temporary suspension of wrongful trading provisions. In addition, the Bill proposes to provide a new Restructuring Plan which is expected to be available to financial services firms, through the appropriate safeguards including a role for the FCA and PRA. The Bill is sponsored by the Department for Business, Energy and Industrial Strategy and is due to be begin passage through Parliament shortly.

15 May 2020: FCA issues statement on its business interruption insurance High Court test case

The FCA issued a statement setting out how it is engaging with policyholders and insurance intermediaries on business interruption (BI) insurance. The FCA is inviting policyholders and insurance intermediaries who are aware of unresolved disputes with insurers over the terms of BI policies to engage with the FCA. Furthermore, the FCA intends to engage with policyholders at key stages of the court action.

The FCA had previously announced that it intends to obtain court declarations aimed at resolving contractual uncertainty in selected BI insurance policies. Acting in the public interest, the FCA will put forward policyholders' arguments to their best advantage. The FCA is aiming to obtain legal guidance in this way more quickly and at a lower cost to policyholders than would be the case if they took their own court actions. The result of the test case will be legally binding on the insurers that are parties to the test case in respect of the representative sample considered. It will also provide persuasive guidance for the interpretation of similar policy wordings and claims, that can be taken into account in other court cases, by the Financial Ombudsman Service and by the FCA in looking at whether insurers are handling claims fairly.

11 – 15 May 2020: Speeches, Letters & Other Publications

During the week, the FCA released the following publications that might be of interest to our readers:

- Coronavirus and customers in temporary financial difficulty: guidance for insurance and premium finance firms
- FCA confirms measures to help insurance customers who may be suffering financial difficulties as a result of coronavirus
- FCA and HMRC announce their collaboration to provide Single Point of Contact (SPoC) services

UK Government

13 May 2020: UK Government announces that it will temporarily guarantee business-to-business transactions covered by Trade Credit Insurance

The UK Government announced that it will temporarily guarantee business-to-business transactions covered by Trade Credit Insurance. This is aimed at supporting business supply chains which rely on this insurance and are having problems maintaining insurance cover because of COVID-19, either because credit insurance is being withdrawn or premiums are increasing to unaffordable levels. Trade Credit Insurance provides cover to hundreds of thousands of business to business transactions, particularly in non-service sectors, such as manufacturing and construction. It insures suppliers selling goods against the company they are selling to defaulting on payment, giving businesses the confidence to trade with one another. The government's guarantee will be delivered through a temporary reinsurance agreement with insurers currently operating in the market. Full details of the scheme have yet to be finalised, but the government will work with businesses and the industry on the full details of the scheme to ensure firms are supported and risk is appropriately shared between the government and insurers. The guarantees will cover trading by domestic firms and exporting firms and the intent is for agreements to be in place with insurers by end of this month. The guarantee will be temporary and targeted to cover CV-19 economic challenges, and will provisionally last until the end of the year. It will be followed by a review of the Trade Credit Insurance market to ensure it can continue to support businesses in future. Further details will be announced in due course.

European Systemic Risk Board (ESRB)

14 May 2020: ESRB publishes an issues note on liquidity in the corporate bond and commercial paper markets, the procyclical impact of downgrades and implications for asset managers and insurers. The ESRB also published its recommendations on liquidity risks in investment funds and a third statement on the importance of investment funds using liquidity management tools.

Following its meetings on 2 April 2020 and 6 May 2020, the General Board of the European Systemic Risk Board (ESRB) published a press release announcing that it has adopted a first set of actions in five priority areas to address the impact of the COVID-19 outbreak on the financial system from a macro-prudential perspective.

The actions in those five priority areas are:

1. Implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy: The ESRB sent a letter to the Economic and Financial Affairs Council (ECOFIN) about the work it has begun on identifying financial stability implications of the guarantee schemes and fiscal measures that have been introduced to protect the real economy in response to Covid19.

2. Market illiquidity and implications for asset managers and insurers: The ESRB adopted a recommendation to ESMA to co-ordinate with the national competent authorities in undertaking a focused piece of supervisory engagement with investment funds that have significant exposures to corporate debt and real estate assets. The ESRB also published a statement about the importance of investment funds using liquidity management tools.

3. Impact of large-scale downgrades of corporate bonds on markets and entities across the financial system: The ESRB published an issues note that discusses liquidity in the corporate bond and commercial paper markets, the procyclical impact of downgrades and implications for asset managers and insurers. In addition, it has decided to co-ordinate a top-down analysis to assess the impact of a common scenario of large-scale downgrades across all parts of the financial sector (banks, investment funds, insurers, pension funds and financial markets).

4. System-wide restraints on dividend payments, share buybacks and other pay-outs: The ESRB announced that it supports the measures taken by member countries and EU institutions to encourage banks and insurers in the EU to restrain voluntary pay-outs. The ESRB supports the actions taken so far and stresses the value of applying pay-out restrictions in times of crisis.

5. Liquidity risks arising from margin calls: The ESRB stressed the importance of (i) mitigating procyclicality that could be linked to the provision of clearing services and to the exchange of margins in bilaterally cleared markets; (ii) enhancing central counterparty stress test scenarios for the assessment of liquidity needs; and (iii) limiting excessive liquidity constraints related to margin collection

European Securities and Markets Association (ESMA)

13 May 2020: ESMA highlights challenges for rating Collateralised Loan Obligations

ESMA published a Thematic Report on Collateralised Loan Obligations (CLOs) credit ratings in the European Union (EU). The report provides an overview of CLO rating practices and identifies the main supervisory concerns, and medium-term risks, in this asset class which include credit rating agencies' (CRAs) internal organisation, their interactions with CLO issuers, operational risks, commercial influence on the rating process and the need for proper analysis of CLOs.

Please read our more in-depth report (Report 1) at the end of this update for a comprehensive summary and analysis of ESMA's Thematic Report on CLOs.

14 May 2020: ESMA supports ESRB actions to address COVID-related systemic vulnerabilities regarding liquidity risks in investment funds

ESMA published a statement supporting the recommendations issued by the General Board of the European Systemic Risk Board (ESRB), discussed above. ESMA expressed its support to the ESRB Recommendation, which suggests that relevant NCAs across the European Union (EU), coordinated by ESMA, undertake focused supervisory engagement with investment funds that have significant exposures to less liquid assets, focusing on corporate debt and real estate. In this context, ESMA also welcomed the ESRB public communication around the importance of the timely use of liquidity management tools by investment funds and insurers with exposures to less liquid assets.

14 May 2020: ESMA sees potential decoupling of financial market performance and underlying economic activity

ESMA published the first complete risk dashboard for 2020, which highlights the very high risks in all areas of ESMA's remit. According to this analysis, the potential decoupling of financial market performance and underlying economic activity leads ESMA to see a prolonged period of risk to institutional and retail investors of further – possibly significant – market corrections and very high risks across the whole of the ESMA remit. The extent to which these risks may materialise will critically depend on two drivers: the economic impact of the pandemic, and any occurrence of additional external events in an already fragile global economic environment.

15 May 2020: ESMA announces open hearing on Benchmarks Consultation Paper

ESMA announced it will hold an open hearing for its Consultation Paper on draft Regulatory Technical Standards (RTS) under the Benchmarks Regulation (BMR) on Friday 29 May via conference call. The consultation paper, which was released on the 9th of March 2020, seeks the views of interested parties on the proposed draft RTS covering the governance of administrators, methodology of benchmarks, reporting of infringements, mandatory administration of critical benchmarks and the compliance statement. The consultation period will end on 8 June 2020.

This open hearing will primarily be of interest to administrators of benchmarks, contributors to benchmarks and users of benchmarks, but responses are also sought from any other market participant, including trade associations and industry bodies, institutional and retail investors, consultants and academics. Please register online to participate in this hearing.

European Insurance and Occupational Pensions Authority (EIOPA)

15 May 2020: EIOPA publishes weekly information for Relevant Risk Free Interest Rate Term Structures and Symmetric Adjustment to Equity Risk with reference to 12 May 2020

Due to COVID-19 outbreak, EIOPA announced that it will carry out extraordinary calculations on weekly basis to monitor the evolution of the relevant risk-free interest rate term structures (RFR) and the symmetric adjustment to equity risk (EDA). EIOPA is publishing this information in order to support insurance and reinsurance undertakings in the monitoring of their solvency and financial position. The information will be published weekly on a specific area of the website created for this purpose for both RFR and EDA named "Extraordinary weekly updates".

European Banking Authority (EBA)

12 May 2020: EBA updates data on Deposit Guarantee Schemes across the EU

The EBA published 2019 data relating to two key concepts in the Deposit Guarantee Schemes Directive (DGSD): available financial means, and covered deposits. The EBA publishes this data on a yearly basis to enhance the transparency and public accountability of deposit guarantee schemes (DGSs) across the EU to the benefit of depositors, markets, policymakers, DGSs and Members States.

12 May 2020: EBA publishes its inquiry into dividend arbitrage trading schemes ("Cum-Ex/Cum-Cum"), and announces a 10-point action plan to enhance the future regulatory framework

The EBA published the results of its inquiry into dividend arbitrage schemes, which looked into the actions of prudential and anti-money laundering (AML) and countering the financing of terrorism (CFT) supervisors in dealing with such schemes. The EBA's inquiry showed that national authorities do not share the same understanding of dividend arbitrage trading schemes, due to differences in Member States' domestic tax law. The inquiry concluded that facilitating, or handling proceeds from tax crimes undermines the integrity of the EU's financial system and, therefore, sets out a number expectations of credit institutions and national authorities under the current regulatory framework. The EBA decided on a 10-point action plan for 2020/21 to enhance the future framework of prudential and anti-money laundering requirements covering such schemes.

15 May 2020: EBA consults on technical standards for contractual recognition of stay powers under the BRRD

The EBA launched a public consultation on its draft Regulatory Technical Standards (RTS) for contractual recognition of stay powers laid down in the Bank Recovery and Resolution Directive (BRRD). These RTS support the effective application of temporary restrictions on early termination rights (resolution stays) in relation to financial contracts governed by the law of a third country. These standards are the first EBA mandate stemming from the revised BRRD and aim at promoting the effective application of recovery and resolution powers to banks and banking groups and to foster convergence of practices between relevant authorities and institutions across the EU. The consultation runs until 15 August 2020.

European Central Bank (ECB)

13 May 2020: ECB publishes its March 2020 Euro area securities issuing statistics

The ECB published its data on securities issuing for the month of March. According to the data, the annual growth rate of the outstanding amount of debt securities issued by euro area residents decreased from 3.2% in February 2020 to 2.8% in March. For the outstanding amount of listed shares issued by euro area residents, the annual growth rate was 0.0% in March 2020, the same as in February.

14 May 2020: ECB announces new measures to increase share of female staff members

The ECB announced a new programme to further improve the gender balance of its staff at all levels. The strategy defines target percentages focusing on the annual share of women being appointed to new and open positions as well as targets for the overall share of female staff at various salary levels. The strategy covers the period until 2026, so as to fall within the mandate of President Christine Lagarde.

11 – 15 May 2020: ECB Blogs & Other Publications

During the week, the ECB published the following blogs, speeches & publications that might be of interest to our readers:

- An ECB digital currency – a flight of fancy?
- Loan types and the bank lending channel
- Do non-performing loans matter for bank lending and the business cycle in euro area countries?
- Macroprudential regulation and leakage to the shadow banking sector
- Negative rates and the transmission of monetary policy
- Cyclical systemic risk and downside risks to bank profitability
- The fall in manufacturing and services activity in the euro area: foreign versus domestic shocks
- What are additional credit claim (ACC) frameworks?

Swiss National Bank

14 May 2020: SNB CRF expanded to include cantonal loan guarantees as well as joint and several loan guarantees for startups

The Swiss National Bank announced the expansion of accepted collateral for the COVID-19 refinancing facility (CRF). The CRF will now additionally accept claims secured by loan guarantees or credit default guarantees offered by cantons, provided these have been granted in order to cushion the economic impact of the COVID-19 pandemic.

Central Bank of Ireland

14 May 2020: CBI publishes economic letter on bank credit conditions & monetary policy

The Central Bank of Ireland has published an Economic Letter titled 'Bank Credit Conditions & Monetary Policy'. The research examines the results of the Bank Lending Survey (BLS) of a representative sample of Ireland's banks, which is carried out by the Central Bank of Ireland on a quarterly basis. The most recent BLS was carried out between March 19 and April 3 and banks were asked about changes in credit market conditions in the first quarter of the year and their expectations for the second quarter. As the pandemic only intensified towards the end of the first quarter, banks' expectations for the second quarter will more fully reflect the effects of the virus on the credit market.

The research finds that COVID-19 had a limited impact on credit conditions during the first quarter of the year. Banks tightened their credit conditions somewhat due to a perceived increase in the riskiness of lending but banks have so far reported no changes in their credit standards due to a deterioration in their balance sheets or in their cost of funds. The survey shows that banks expect credit demand from businesses to be mixed, they expect demand for short-term business loans to increase, reflecting higher working capital and inventory needs, with demand for longer-term business credit to decrease, reflecting lower investment. On the household side, banks expect a record fall in demand for credit from households in the second quarter. These findings are corroborated by credit applications data that show sharp declines in individuals' credit demand since mid-March and increases in demand for overdraft facilities from firms. Banks expect the recent monetary policy decisions by the Governing Council of the ECB to have positive effects on their balance sheets. These measures could support banks' liquidity, capital and financing conditions and therefore could help mitigate severe credit constraints on households and firms that can arise due to stress on banks' balance sheets, like those experienced in the last financial crisis in Ireland.

11 – 15 May 2020: Speeches, Letters & Other Publications

During the week, the CBI released the following publications that might be of interest to our readers:

- CBI gives speech on digital finance in Europe
- Governor's Blog: Covid-19 and developments in credit

Commission de Surveillance du Secteur Financier (CSSF)

13 May 2020: CSSF launches new eDesk portal to report fund issues and large redemptions

On 10 March 2020, the CSSF implemented a specific monitoring of the largest investment fund managers (IFM) in view of the specific circumstances and risks to which these companies were exposed to as a result of the prevailing market conditions. Since then, these IFMs have had to notify the CSSF of significant developments and issues as well as on related decisions and measures taken by IFMs. On the 13th of May, the CSSF announced that it is further extending the scope of the exercise to a wider number of IFMs and integrated the related notification process into its eDesk portal. The CSSF has already contacted all IFMs concerned by the notification on fund issues and/or large redemptions (IFM Notification).

The CSSF further explained in its announcement that an IFM Notification has to be transmitted to the CSSF via eDesk only if the following events occur:

1. significant events/issues affecting the functioning of the investment funds managed by the IFM;

2. larger redemptions at the level of Luxembourg regulated investment funds (UCITS, Part II UCI, SIF) managed by the IFM (i.e. daily net redemptions exceeding 5% of the NAV, net redemptions over a calendar week exceeding 15% of the NAV and/or application of gates/ deferred redemptions).

In order to give IFMs sufficient time to prepare, the IFM Notification applies as from 2 June 2020.

13 May 2020: CSSF updates its COVID-19 FAQ for fund managers

This updated version of the FAQ provides answers to the following questions:

1. Can the deadlines for the reports to be submitted by UCIs, SIFs, SICARs, investment fund managers, pension funds and securitisation undertakings be extended?

2. Can the deadlines for the submission of the closing documents of specialised PFS be postponed?

11 – 15 May 2020: CSSF Blogs, Interviews & Other Publications

During the week, the CSSF published the following blogs, speeches & publications that might be of interest to our readers:

- Banks are part of the solution to the financial crisis
- Coronavirus (Covid-19): Recommendations to supervised entities on telework and a possible return to the office

International Capital Markets Association (ICMA)

11 May 2020: ICMA issues high-level definitions for sustainable finance

ICMA is proposing high-level definitions building on current market usage and existing official sector terminology for the most commonly used terms in the sustainable finance field, for example climate finance, impact finance, green finance and social finance. The objective is to ensure that all participants and stakeholders are using a common and transparent vocabulary. It is also designed as a contribution to other ongoing efforts in the financial industry to develop a consensus around key terms and definitions in sustainable finance.

11 – 15 May 2020: ICMA Podcasts

During the week, ICMA released the following podcasts that might be of interest to our readers:

- Electronic signings - an English law perspective in the time of COVID-19
- COVID-19: ICMA Asset Management & Investors Council weekly market update
  Robert Parker, Chairman of ICMA Asset Management and Investors Council, reviews the market events of the last week in the context of the COVID-19 pandemic, with a specific focus on lockdown easing measures, the state of the economic recovery and debt restructuring of some emerging countries.
- FinTech, technology risks and the COVID-19 crisis
  ICMA speaks to Douglas Arner, the Kerry Holdings Professor in Law at the University of Hong Kong and co-author of the paper Digital Finance & the COVID-19 Crisis. They discuss the different roles of the financial system in the COVID-19 crisis compared with the 2008 global financial crisis, including operations and technology, resilience of financial institutions and infrastructures, and the outlook for how FinTech may change the capital markets.

In the News

During the week, the Financial Times published the following news that might be of interest to our readers:

- The ECB must shift to a wholesale acceptance of junk bonds
  “The ECB should not be afraid to lower its credit quality requirements to accept a wider range of junk bonds”
- Fund managers pile into $65bn Covid-19 bond market
  “A new coronavirus bond market has reached $65bn in just a few months and is set to keep growing, as companies and governments rush to issue debt to help ease the effects of the pandemic”
- CLOs made it through 2008. Can they survive the latest crisis?
  “Many of the leveraged-buyout loans that were the darlings of CLO managers are now unravelling in the lockdown economy”
- Pandemic spawns new reporting term ‘ebitdac’ to flatter books
  “When you’re looking at coronavirus, these revenues will never come back; it is literally a fiction,” said Sabrina Fox, executive adviser at the European Leveraged Finance Association”
- German judge warns EU over ‘very difficult to resolve’ legal crisis
  “Germany’s constitutional court, based in Karlsruhe, ruled last week that the government and the EU’s top judges failed to properly scrutinise the ECB’s bond-buying programme and in effect cast aside an earlier European Court of Justice ruling on the issue, in what amounted to the most overt challenge ever posed to the EU’s highest court”
- Deutsche Bank pledges to double green financing to €200bn by 2025
  “First quantitative commitment by Germany’s largest lender follows years of pressure from environmental campaigners”
- CLOs: ground zero for the next stage of the financial crisis?
  “Having boomed over the past decade, these complex securities could be vulnerable if loan defaults spike”
- Deutsche grabs capital from rekindled bank bond market
  “Deutsche Bank successfully sold €1.25bn of new bonds that count towards its capital buffers taking advantage of renewed investor demand for financial institutions’ higher-risk debt following the coronavirus sell-off”

Report 1. ESMA publishes Thematic Report on CLOs - 13 May 2020

ESMA published a Thematic Report on Collateralised Loan Obligations (CLOs) credit ratings in the European Union (EU), which highlights the challenges for rating CLOs. The report provides an overview of CLO rating practices and identifies the main supervisory concerns, and medium-term risks, in this asset class which include credit rating agencies' (CRAs) internal organisation, their interactions with CLO issuers, operational risks, commercial influence on the rating process and the need for proper analysis of CLOs. The report also highlights the impact that COVID-19 may have on CLO methodologies.

Background

In February 2019, ESMA announced in its supervisory Work Programme that credit ratings of CLOs would be an area of focus for its supervisory actions. ESMA subsequently launched a review in May 2019 into the practices of the largest EU registered CRAs with regard to the validation and review of CLO methodologies as well as the CLO rating process, including not only the first issuance of CLO credit ratings but also their ongoing monitoring. In this Thematic Report, ESMA focuses exclusively on the credit rating aspect of CLOs. ESMA has covered other aspects of CLOs and the associated inherent risks in separate comprehensive reports[1].

The focus of this report is on the following credit ratings and rating agencies:

- EU CLOs defined as CLO instruments issued in the EU, including the UK4 , and which are rated by CRA analysts located in the EU, including the UK; and
- The three largest CRAs accounting for the vast majority of CLO credit ratings namely Fitch Ratings (Fitch), Moody's Investors Service (MIS), and S&P Global Ratings (S&P).

Why CLO credit ratings matter

As of Q1 2019, the outstanding global CLO market is estimated to amount to around USD 740bn globally, which implies that CLOs hold approximately 50% of the global leveraged loan market according to J.P. Morgan. Credit ratings remain one of the main pillars of the framework that investors use for their CLO investment decision-making. CRAs deliver an important service to investors by providing information and transparency on CLOs, in particular on their credit risk through credit ratings. Capital markets' reliance on CLO credit ratings is also increased by business practices. For example, asset managers often have investment mandates that specify limits to institutional investments in terms of credit ratings. In short, CLO credit ratings are important signals of credit quality that are widely relied upon. The accuracy of CLO credit ratings is key to the fair pricing of financial instruments and, thus, to sound decision-making on asset allocation. Accurate and timely CLO credit ratings contribute to early detection of financial risks and help to safeguard financial stability.

According to ESMA, there are three necessary conditions to limit financial stability risks from CLO credit ratings:

- CLO rating models should be adequately calibrated;
- CRAs, investors and public authorities need to have granular information on the sensitivity of CLO credit ratings to key macro variables; and
- Investors and public authorities should be clearly informed on the limits of rating models and the risks from potential tail events.

[1] ESMA Report on Trends, Risks and Vulnerabilities No. 2, 2019

ESMA’s concerns and recommendations

In reviewing CRAs’ practices and methodologies for rating CLOs, ESMA has identified a number of issues which present risks, these relate to:

1. The internal organisation of CRAs - the CLO rating process is segmented between a CLO analytical team and a corporate analytical team in all CRAs. While ESMA does not expect CRAs to adopt a uniform internal organisation, a smooth and ongoing exchange of information between internal teams is key to ensure a holistic assessment of CLO creditworthiness. CRAs should ensure the capacity for the timely identification of all inherent risks to CLOs.

2. The interactions with CLO issuers - as CLO arrangers and managers can identify which CRA may assign the best ratings for each CLO tranche, it is key that CRAs ensure the independence of their rating process from any influence from their commercial teams and/or arrangers;

3. Model/third party dependencies leading to potential operational risks - the dependency on rating models and data provided by third parties, and the high automation of processes, present operational risks which need to be monitored by CRAs to avoid potential errors in credit ratings;

4. Rating methodologies, modelling risks and commercial influence - CLO methodologies are underpinned by assumptions and modelling approaches that can impact credit ratings. ESMA highlights the importance of transparency to market participants on the limitations of methodological approaches. In addition, CRAs should ensure that evolutions in CLO methodologies are not influenced by commercial interests;

5. The thorough analysis of CLOs - some recent evolutions in CLO instruments are a source of potential risk. In particular, ESMA notes that some recent evolutions in CLOs contracts have weakened investor protection by introducing more flexibility for CLO managers and by generally reducing transparency with the addition of unclear clauses, such as on the definitions of loans or tests. In light of this, it is key that CRAs continue to monitor market trends and to perform a thorough analysis of all developments in CLO contractual arrangements.

COVID-19

ESMA’s report is based on information collected until March 2020. It was too early to assess the aggregated consequences of the Covid 19 outbreak since it will depend on the length of the health crisis and on the effects of the associated government interventions. In this context, ESMA highlights certain risks identified as particularly relevant for the medium term. CLO credit ratings can be very sensitive to methodological approaches and to the assumptions on which credit ratings are based. In this regard, the future developments regarding the Covid 19 outbreak will be an important test for CLO methodologies, notably by testing: i) the approaches and the assumptions for the modelling of default correlation among the pool of underlying loans; and ii) the sensitivity of CLO credit ratings to how default and recovery rates are calibrated. Moreover, the surge of covenant-lite loans prevents lenders and investors from early warning indicators on the deterioration of the creditworthiness of the leveraged loans. Future macroeconomic evolutions may also be a test for the expected recovery rates in CRA models for leveraged loans.

In this context, it is essential that CRAs continue to perform regular stress-testing simulations and to publicly provide market participants with granular information on the sensitivity of CLO credit ratings to key macroeconomic variables. These simulations should also include sensitivities of CLO credit ratings to changes in leveraged loans ratings. Reverse stress-tests could also provide relevant information to market participants by showing what kind of scenarios and changes in the key parameters could lead to rating actions, including on the senior tranches.

Following the publication of this report, ESMA will continue to monitor the developments in leveraged loans and CLO markets. It will also closely follow evolutions in credit ratings and rating practices.

Regulators & Associations Monitored

1. FCA
2. BoE
3. The Pensions Regulator
4. ESMA
5. EBA
6. EIOPA
7. ECB
8. European Commission
9. CSSF
10. FINMA
11. CBI
12. ICMA
13. IOSCO
14. FSB

Important Information: