Credit market developments, ratings and regulation in times of crises and pandemics

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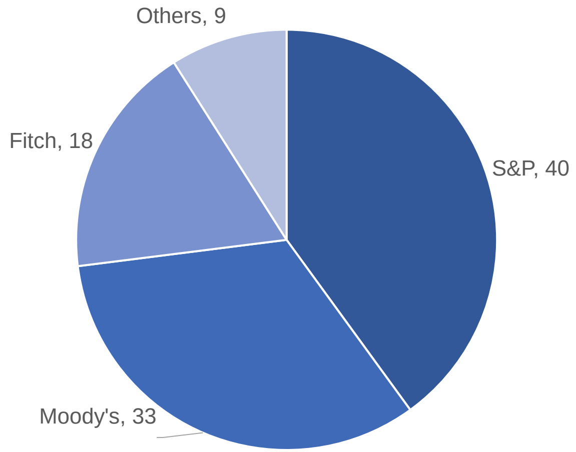
Overview

1. EU credit rating markets
2. EU CRA regulation and supervision
3. Soundness of ratings: COVID-19 market stress
4. Reliance on ratings: Fallen angels during COVID-19
5. Dominance of the Big-3 CRAs: Concentration trends
6. Conclusions

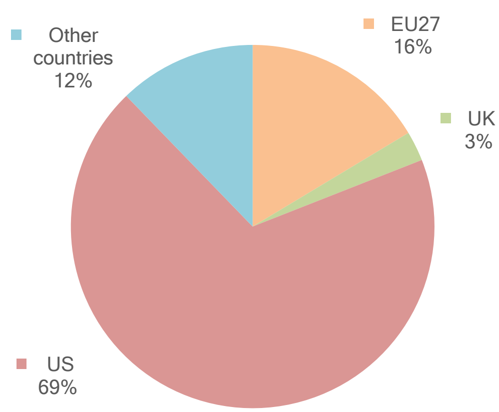
Market structure: Providers concentrated, wide product universe

High CRA market concentration



Note: CRA market share, in % of total, based on audited financial statements with reference to the annual turnover from the credit rating activities and ancillary services.
Sources: ESMA supervision (Report on CRA Market Share Calculation 2020).

Outstanding ratings: EU27, UK and US



Note: Proportions of oustanding ratings endorsed or issued in the EU, split by EU27, UK, US and other countries.
Sources: ESMA RADAR.

CRAs: Small, concentrated market

— CRAs: 32 CRAs in EU, 29 registered EU-based entities, 3 certified CRAs outside EU
— Market concentration: >90% of ratings from big-3 providers
— Coverage: Big-3 plus 5 smaller CRAs offer full range (corporate, public, structured finance), others only partial coverage

CRA ratings: Vast universe of ratings

— Ratings: >800.000 ratings globally, >130.000 by EU27 issuers
— Issuer domicile: 70% of ratings on US entities (esp US sovereigns, >300k), EU only 16%
— EU issuers: DE, IT, FR, NL, ES largest markets
— EU issuer type: Corporate bonds 84%, sovereigns 12%, structured finance 4%

EU CRA Regulation: Enhance reliability of ratings

ESMA CRA supervision

Registration, certification	• CRA submits information on business, governance, rating methodologies • ESMA assesses compliance with CRAR • If successful, CRA is registered
Perimeter regulation	• EU firms can only carry out CRA activities if registered • EU monitors perimeters and can sanction firms in breach
Supervision, investigation	• ESMA uses risk-based framework for supervision • Analyses the periodic information CRAs submit, complaints from market participants • Reviews notifications of changes to initial conditions from registration • Monitors rating data submitted to ESMA by CRAs • Investigations • Enforcement action for breaches of CRAR (fines, withdrawal of registration)
Annual market share calculation	• To increase competition among CRAs • Issuers must consider a CRA with less than 10% market share when obtaining two ratings (for structured finance, issuers must obtain at least one small CRA rating • ESMA annual report of market shares

CRAR objectives

— Common regulatory approach to CRAs

— Enhance integrity, transparency, responsibility, good governance and independence of CRAs

— Contribute to quality of credit ratings issued in EU

CRAR milestones

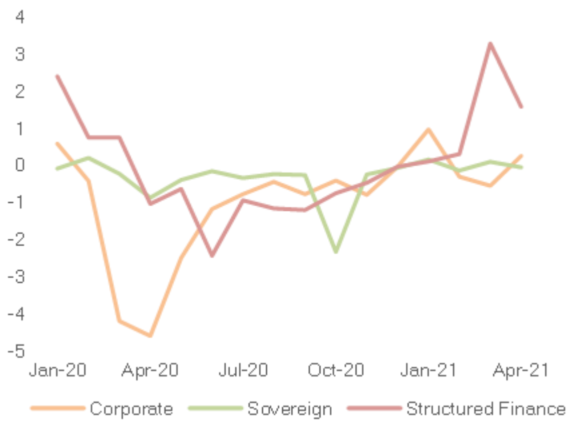
— **Regulation**: 2009 adoption of EU regulatory framework

— **Institutions**: 2011 establishment of ESMA as regulatory and supervisory authority

— **Enhancement**: 2013 CRAR amendments to reduce reliance on big-3 (Art 8 requires issuers to consider small CRAs); establishment of European Ratings Platform (CRAs submit ratings to ESMA, ESMA makes ratings accessible to investors)

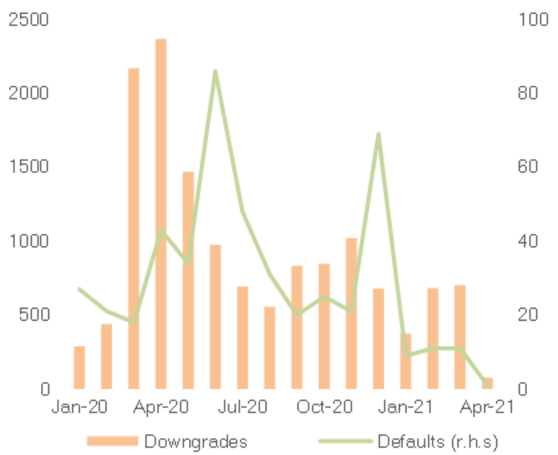
Ratings during market stress: Largely as expected

Rating drift in corporates



Note: Ratings drift in percent over 2020 for corporate, sovereign and structured finance ratings. Ratings include EU27 and rest of world in RADAR..
Sources: ESMA, RADAR.

Non-financial issuer downgrades, defaults



Note: Corporate non-financial defaults by unique issuer per month.
Sources: ESMA, RADAR.

Corporate non-financials most affected

- Non-financials: Spike in downgrades and in defaults, correlated with C19 waves, esp energy, cyclicals, industrials
- Financials, insurance: Less affected
- Regions: Impact seen globally (US, EU, UK)

Sovereigns with limited impact

- National vs regional: Downgrades of national issuers more early on, other public ratings (eg regional) affected later

Public policy background: Massive support

- Fiscal, monetary actions: Unprecedented
- Debt: Public, private debt levels as concern

Structured finance: Less affected than in GFC

CLO senior tranches largely unaffected

	AAA	AA	A	BBB	BB	B	CCC	CC	D
AAA	100								
AA	0.9	99.0		0.1					
A		0.7	98.6	0.8					
BBB			0.4	92.0	7.3	0.3			
BB				0.1	78.4	19.6	1.9		
B						79.6	20.2	0.3	
CCC							69.2	30.8	
C									100

Note: Percent of Big5 CLO ratings starting in left column rating on 31/1/2020 finish with rating in top row on 31/10/2020. CLOs identified using a term search on issuer names.
Source: ESMA. RADAR.

CMBS greater impacts, junior tranches most

	AAA	AA	A	BBB	BB	B	CCC	CC	C	D
AAA	99.4	0.4	0.2							
AA	0.5	96.6	2.3	0.4	0.1		0.0			
A	0.1	0.7	93.6	4.0	1.2	0.4	0.1			
BBB	0.1		0.2	91.3	4.3	3.6	0.5		0.1	
BB	0.1			0.1	79.5	15.2	4.7		0.2	0.3
B				0.1	0.5	77.7	20.4	0.2	0.3	0.7
CCC						1.2	77.6	5.2	6.8	9.2
CC						1.2	1.2	76.2	8.3	13.1
C				0.2					94.6	5.2

Note: Percent of Big5 CLO ratings starting in left column rating on 31/1/2020 finish with rating in top row on 31/10/2020. CLOs identified using a term search on issuer names.
Source: ESMA. RADAR.

CLOs: Senior tranches face little impact

— **Overall:** Severe downgrades in summer 2020, subsequent partial recovery; pre-C19 concerns (high leverage), but proved more resilient than CDOs were in GFC

— **Senior tranches:** Essentially unaffected, AAA and AA with minimal downgrades

— **Mezzanine tranches:** Some downgrades, mainly one step down

— **Junior tranches:** Biggest effect on HY rated, but typically by one rating category

CMBS: Stronger C19 effect

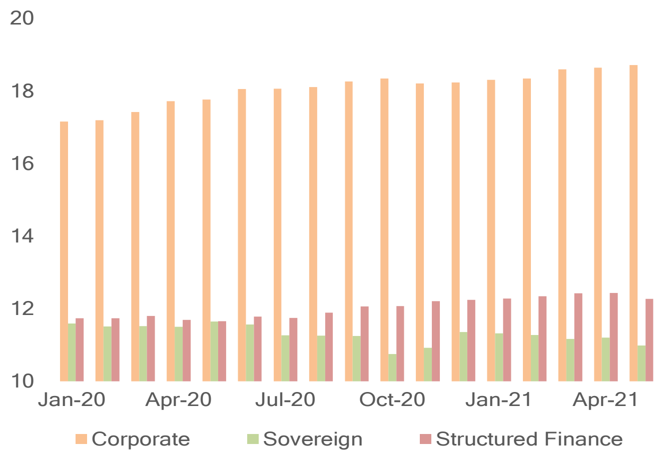
— **Overall:** All ratings saw downgrades, (mainly US, esp exposed sectors eg hospitality, retail outlets)

— **HY:** Most affected, with downgrades down more than one rating category

— **RMBS, ABS:** Less affected

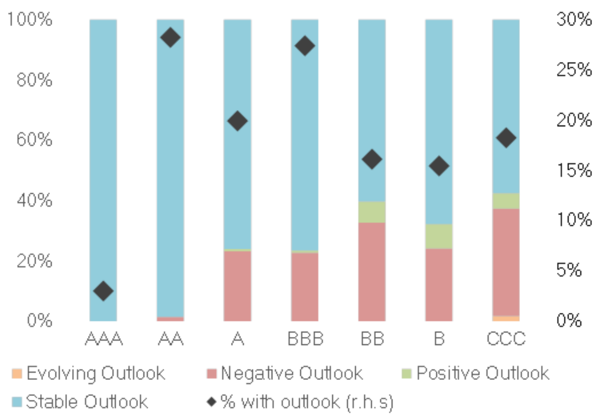
Reliance on ratings: Fallen angels as case study

Share of BBB-rated ratings grew



Note: Share of Big 5 CRA ratings rated BBB, by rating type.
Sources: ESMA, RADAR

Rating outlook improved



Note: Distribution of outlooks for corporate non financial instruments (ISINs) with outlook rated by the Big 5 (Fitch, Moody's, S&P, Scope and DBRS) by category value over the total ratings per category value. Cutoff date 30/9/2021.
Sources: RADAR, ESMA.

Fallen angels and investment mandates

— **Investment mandates:** Widely assume IG status; portfolio rebalancing in case of downgrade to HY; potential cliff effect

— **Potential C19 risk:** Concerns of a sharp growth in fallen angels, and wider impact from sales from investment mandates

Despite fears, fallen angels were limited

— **C19 impact:** 0.5 % of EU IG corporate ratings downgraded to HY in 1H20, esp non-financials

— **Recovery:** By 1H21, share of fallen angels reduced significantly, to 0.1 % for corporates overall, and to 0.3 % for non-financials

— **Cliff effect:** IG-to-HY transition very limited, but share of BBB-ratings grew, so vulnerability to fallen angels increased

— **Outlook:** Currently, BBB corporate bonds still skewed to negative, but improved in recent months; potential fading-out of public support measures may reveal zombie firms

CRA market: Concentration continues

Market shares for registered CRAs

Year	Market share: Small CRAs	Market share: Large CRAs	Number of small CRAs	Number of large CRAs
2015	8%	92%	24	3
2016	7%	93%	24	3
2017	7%	93%	24	3
2018	7%	93%	25	3
2019	8%	92%	25	3
2020	9%	91%	24	3

Note: The table displays the market share for each registered CRA, as calculated by ESMA in accordance with Article 8d(3) of the CRAR, using the annual turnover generated from credit rating activities and ancillary services at group level in the EU for that CRA or group of CRAs. The number of registered CRAs reflects all CRAs registered with ESMA as presented in its annual market share calculation report. When calculating the number of CRAs, different registered CRAs within the same group are classed as one CRA. INC Rating was de-registered on 26 November 2020—if this is taken into account, the number of small CRAs in 2020 is 23 rather than 24. See https://www.esma.europa.eu/supervision/credit-rating-agencies/risk
Source: ESMA

Status: High concentration unchanged

— Concentration ratio: Big-3 CRAs still hold >90% market share, largely unchanged over last 5Y

— Regulation: Where issuers intend to use 2 or more CRAs, appointing 1 CRA with less than 10% market share needs to be considered (CRAR Article 8)

— 10% threshold: 90% of CRAs below 10% market share, 87% below 1%

— Issuers: Concentration similar across issuer categories, esp high for financials

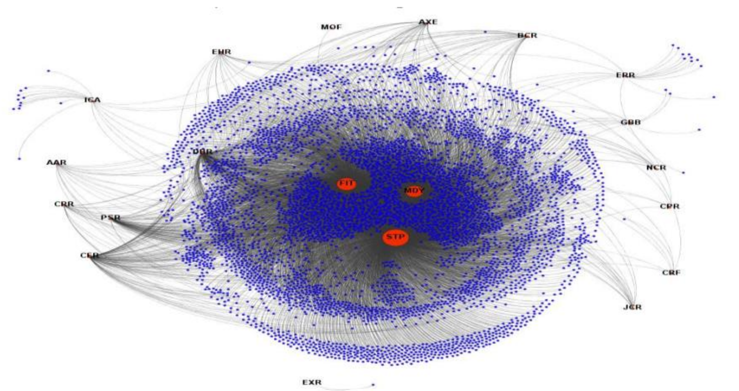
Coverage: Uneven offering

— Full coverage: Big-3 plus 5 smaller CRAs offer full range across corporates (NFC, financial, insurance), public and structured finance

— Specialisation: 5 CRAs highly specialised to cover only 1 market segment

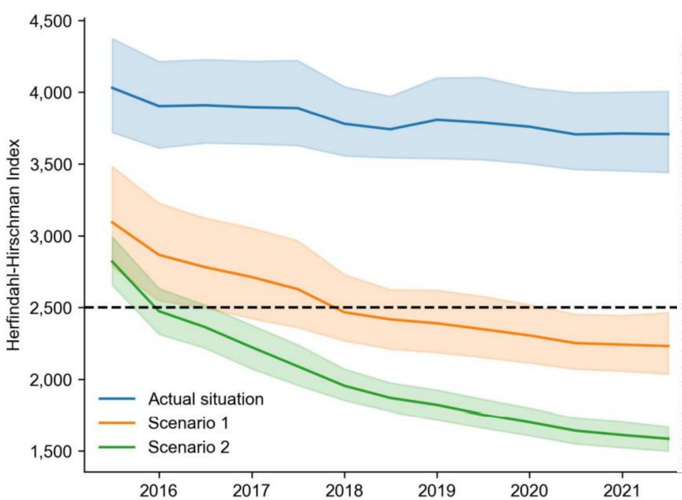
CRA market network: Structures promoting competition limited

CRA network with centre-periphery structure



Note: The chart displays the connections between issuers (blue dots) and EU-registered credit rating agencies (CRAs; red bubbles) using the set of outstanding EU ratings as at end-2020 for ESMA-registered CRAs. The number of CRA ratings on issuers' instruments are aggregated for each issuer; the size of each CRA circle reflects the relative number of ratings they provide. CRA names have been shortened to facilitate display.
Sources: ERP, FIRDS, GLEIF, Refinitiv, ESMA.

Scenarios show scope for de-concentration



Network analysis: Shows factors limiting competition

- **Big-3:** Large CRAs dominate larger multi-rating and cross-border markets
- **Small CRAs:** Mainly used locally, for single-rating markets
- **Competition:** Analysis suggests de-facto market segmentation; smaller CRAs exert little competitive pressure on larger CRAs

Scenario analysis: De-concentration possible

- **Simulation:** Current “if 2 ratings, 1 small CRA to consider” vs Scenario 1 “if 2 ratings, 1 CRA must be small” vs Scenario 2 “always 2 ratings, with 1 small CRA”
- **Outcome:** Current HHI of 3,700 (ie >2,500 mark for high concentration), could be reduced to 2,200 (S1) or 1,600 (S2)

Outlook

CRA market

— Extensive market, covers wide range of instruments, provides key information on credit worthiness
— CRAR provides comprehensive regulatory and supervisory framework aimed at ensuring soundness of ratings

Rating soundness

— C19 exerted significant stress on issuers and ratings
— Positively, ratings did not show unexpected directions and magnitudes or dramatic falls of the order of those seen in GFC, and no sign of correction in ratings
— C19 impact limited by external nature, massive public support

Automatic reliance on ratings

— Fallen angels as ongoing concern given potential of triggering sell-offs among mandated investors
— C19 has raised concerns, no significant materialisation so far, but vulnerabilities grew; potential fading-out of public measures may unveil zombie firms

Competition

— CRAR aims to increase competition, but evidence suggests that progress is extremely gradual

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