European Securities and Markets Authority

13 May 2020
ESMA17-99-1327

PRESS RELEASE

ESMA highlights challenges for rating Collateralised Loan Obligations

The European Securities and Markets Authority (ESMA), the EU's securities markets regulator, has today 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.

The report also highlights the impact that COVID-19 may have on CLO methodologies. ESMA expects CRAs to continue to perform regular stress-testing simulations and to provide market participants with granular information on the sensitivity of CLO credit ratings to key economic variables affected by the pandemic.

Steven Maijoor, Chair, said:

> "ESMA's assessment of CLO credit rating practices highlight a number of supervisory concerns and risks associated with rating this asset class and we expect CRAs to monitor these risks and address them as appropriate.
>
> "The COVID-19 pandemic poses significant risks for CLO instruments, which will test the rigorousness of CRAs rating methodologies to respond to changing circumstances.
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> "ESMA will closely monitor CRAs response to COVID-19 and continue to assess the potential risks posed by CLOs, their ratings and associated rating processes to investors, markets and financial stability."

ESMA's main supervisory concerns

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. 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** - it is key that CRAs continue to monitor market trends and to perform a thorough analysis of all relevant developments in CLO contractual arrangements.

COVID-19

The report is based on information collected up until March 2020. It is too early to assess the aggregated consequences of the COVID-19 outbreak as it will depend on the length of the health crisis and on the effects of the associated government interventions. In light of this, ESMA expects CRAs to continue to perform regular stress-testing simulations and to provide market participants with granular information on the sensitivity of CLO credit ratings to key economic variables.

Notes for editors

1. ESMA80-189-6982 EU CLO credit ratings – an overview of Credit Rating Agencies practices and challenges

2. In May 2019, ESMA launched a thematic review of the arrangements that credit rating agencies (CRAs) have adopted in order to assign and monitor credit ratings on CLO instruments that are issued and rated in the EU. The report focused on the rating process and rating methodologies of Fitch Ratings, Moody's Investors Service, and S&P Global Ratings, who are the largest providers of ratings on these products.

3. ESMA is the supervisor of CRAs in the EU and currently supervises 27 CRAs registered in the EU and 4 certified CRAs. It publishes a supervisory work programme annually.

4. ESMA is the European Union's securities markets regulator. Its mission is to enhance investor protection and promote stable and orderly financial markets.

   It achieves these objectives through four activities:

   i. assessing risks to investors, markets and financial stability;

   ii. completing a single rulebook for EU financial markets;

   iii. promoting supervisory convergence; and

   iv. directly supervising specific financial entities.

5. ESMA achieves its mission within the European System of Financial Supervision (ESFS) through active cooperation with the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Systemic Risk Board, and with national authorities with competencies in securities markets (NCAs).

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