Deviating from Absolute Priority
Panel IV: Macro-economic repercussions: Benefits and costs

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Roadmap

- Financial stability perspective
  - How can certain market/product features amplify the effect of expected losses and/or loss uncertainty?
- Focus on characteristics of two investment vehicles
- Mutual funds
  - Liquidity transformation
- Collateralised loan obligations (CLOs)
  - Asset securitisation adds complexity
  - CLOs in light of wholesale funding issues due to CDOs in 2008
  - Holders of CLOs
European debt market by ratings and collateralization

- European corporate debt market
  - Investment grade
    - 95% bonds (69% senior unsecured; 16% senior secured)
    - 3% loans
  - High-yield
    - 61% bonds (33% senior unsecured; 16% senior secured)
    - 33% loans

- In terms of ratings:
  - 14% AAA; 8% AA; **32% A; 32% BBB**
  - 9% BB; 5% B

Data: S&P Global
A closer look at high-yield debt markets

- Leveraged loan markets have expanded rapidly, offsetting the decline of high-yield bonds
- CLO market rise is a key post-crisis development

Charts: FSB, “Vulnerabilities associated with leveraged loans and collateralised loan obligations”
Bond mutual funds and liquidity transformation (1/2)

- Euro-Area non-MMF investment funds held a little more than 10% of corporate bonds outstanding

- General policy concern: “run” on funds can generate temporary price dislocations

- In principle, funds can suspend redemptions
  - In practice too, even if it affects reputation (eg, Third Avenue)

Data: European Commission
Bond mutual funds and liquidity transformation (2/2)

- Low liquidity (as sequential service constraint) could interact with other market features

Loss uncertainty and CLOs

- Relative to bonds, securitisations like CLOs introduce an element of complexity
  - During the financial crisis, uncertainty about the loss waterfall of CDOs contributed to wholesale funding problems
- CLOs have similar structure as CDOs, with important differences
  - Uncertainty about underlying payoff is magnified by tranching
    - Especially if uncertainty is about correlations
  - Not as complex, less securitisation and synthetics (so far)
  - They are not used as repo collateral

Reference: Aramonte & Avalos, “Structured finance then and now: a comparison of CDOs and CLOs”, BIS Quarterly Review, September 2019
Holders of CLOs

- Two-thirds are held by non-banks. Mainly:
  - Insurance companies, pension funds, and investment funds (EUR 37 bn in UCITS and 17 bn in AIF)
  - EU Securitisation Regulation imposes reporting covering CLOs

- Top 20 UCITS account for 40% of CLO (and CDO/CMO) exposure

- Pension funds and insurance companies are long-term investors
  - By and large, limited liquidity transformation

Data: ESMA