



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

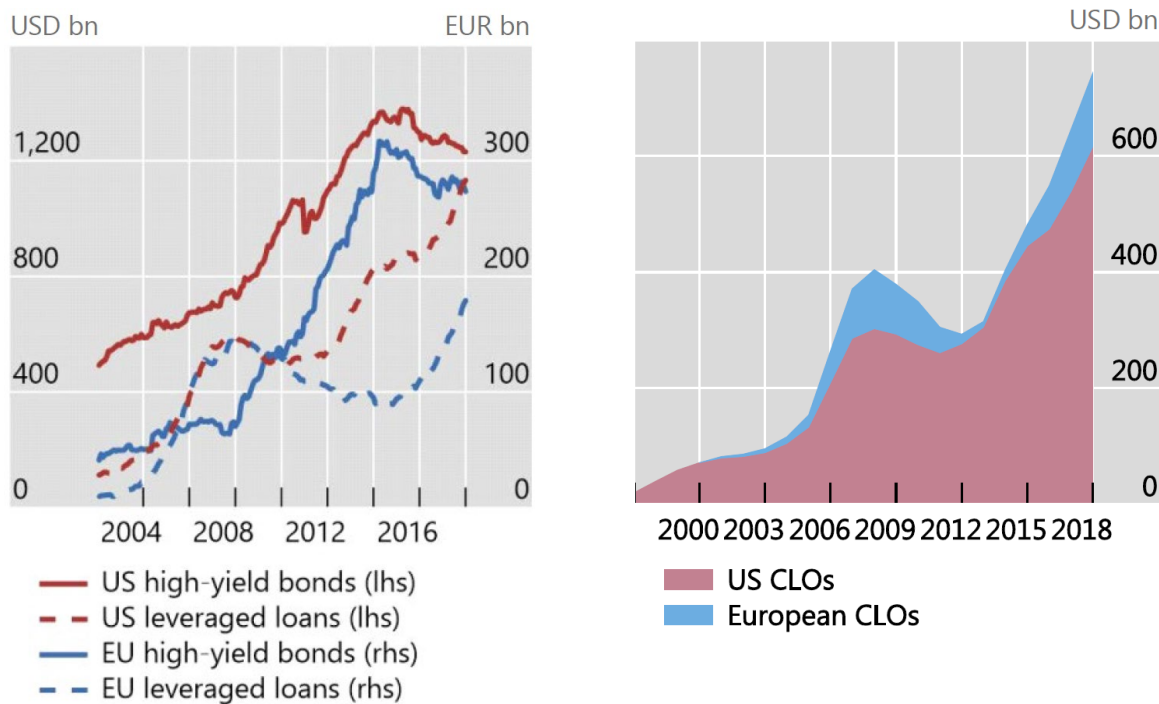
European debt market by ratings and collateralization

- 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"

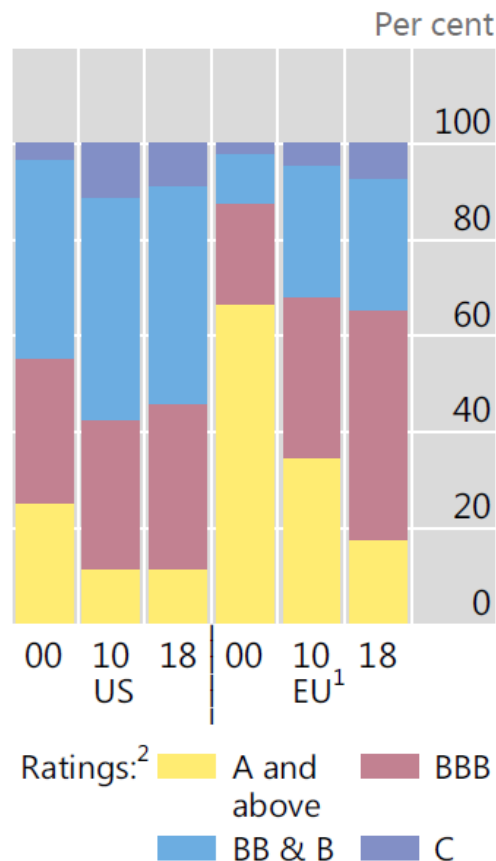
Bond mutual funds and liquidity transformation (1/2)

- 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)

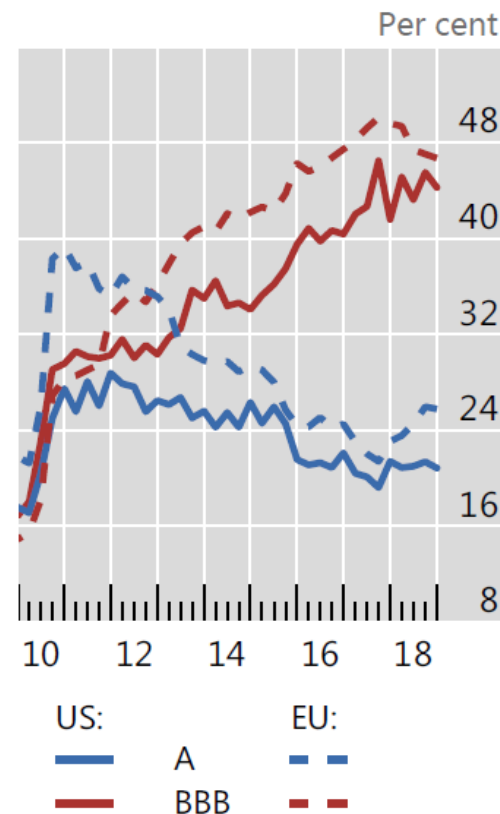
Data: European Commission

Bond mutual funds and liquidity transformation (2/2)

Share of BBB issuers increased



Mutual funds focused on IG held more BBB bonds



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

Charts: Aramonte & Eren, "Investment mandates and fire sales: the case of mutual funds and BBB bonds", *BIS Quarterly Review*, March 2019

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