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Comisión Nacional del Mercado de Valores

Corporate bond market trends, emerging risks and monetary policy. International Bulletin, November 2020.

The OECD has published a report on the strengths and weaknesses of corporate bonds in financing the productive fabric as well as on emerging risks and the influence of monetary policy on this type of activity. This report asserts that this type of financing is directly conditioned by the evolution of the economy with its various expansionary or restrictive phases and that this in turn conditions the nature, content and characteristics of these types of issues.

Expansionary monetary policy, with a quantitative policy accelerated by the various Central Banks and a special incidence in 2019, encouraged non-financial companies to take on borrowing on a global scale amounting to US$2.1 trillion in the form of corporate bonds, which represents a substantial increase compared with previous years.

Faced with such unexpected increases, regulators need to reflect on the content and characteristics of future and new corporate bond issues as they could be faced with issues of lower credit quality, higher payback requirements, longer maturities and inferior performance guarantees.

The existence of low interest rates has generally allowed companies to increase their borrowing levels while still maintaining a BBB rating (historically considered a weak rating), representing more than 52% of new investment grade bond issues in the last three years.

Among others, the most significant aspects that should be analysed are the following:

a) The issue of corporate bonds increased substantially and without interruption between 2008 and 2018, reaching an average of annual global issuance of corporate bonds of US$1.8 trillion. The rise in interest rates led to a significant decrease in these types of issues during the second half of 2018. The subsequent announcement by Central Banks that they would expand rather than freeze the quantitative monetary policy, including the direct purchase of corporate bonds, drove the issue and purchase of this type of financing back up to pre-2019 levels.

b) The decrease in the credit quality of corporate bonds. From 2010 to 2018, 20% of corporate bonds were non-investment grade. However, in 2019 this percentage increased to nearly 25%.

By the end of 2019, the global outstanding amount of non-financial corporate bonds reached US$13.5 trillion. Most of the issues are either rated BBB, are non-investment grade (below BBB) or come from companies in emerging countries.

In 2019, only 30% of the global outstanding amount of non-financial corporate bonds were rated A or above and issued by companies from advanced economies.

c) Maturities have lengthened considerably. Over the past five years, the average maturity at issue has been 12.4 years, compared with 9.4 years in the early 2000s. In 2019, the average maturity was around 13 years.

d) The combination of longer maturities and worse credit conditions creates greater risk and potential vulnerability for monetary policy. The risk of default is increasing, with the destabilising effects that this entails.

e) These types of issues are placed mainly with major bondholders such as pension funds, insurance companies and investment funds whose allocations are directly influenced by the credit rating agencies. The regulations in many jurisdictions determine the quantitative limits for investing in these types of financial instruments based on the ratings assigned by these agencies.

f) The significant increase in BBB ratings among the corporate bonds assessed seems to reflect the credit rating agencies' awareness of the fact that a lower rating would limit the investment of the financial intermediaries mentioned above.

g) The content of the institutional investors' portfolios is determined by regulations and by the credit ratings assigned to the various financial instruments. The excessive BBB rating places many issues on the borderline between what they can and cannot invest in, creating considerable stress on existing live issues.

One of the most controversial issues concerns the credit rating assignment process, which begins with a request by the issuer or is initiated ex officio by the corresponding credit rating agency. Some economists have criticised these agencies for relaxing their standards in times of boom and economic growth, arguing that lower default risks have a deleterious effect on the interpretation and rigidity of control filters.

Credit rating agencies' analyses unquestionably rely on statistical methods above all. It is important to emphasise that leverage and coverage are the most critical factors in the process of assigning a credit rating. In fact, these two factors constitute 35% of the weight of the final scorecard that determines the credit rating assigned to a financial instrument.

Monetary policy and trends in corporate bonds issued by non-financial companies

As previously mentioned, corporate bond issues have increased considerably. Investment funds have increased their holdings in corporate bond issues, especially in Japan and the United Kingdom, with increases of 2.4 and 3.7 percentage points respectively in the last ten years.

In the US, investment funds increased their percentage holding from 9.9% in 2008 to 27.7% in 2018. In the euro area investment funds hold more than a quarter of the outstanding amount of corporate bonds and are the biggest holders of this type of financial instrument. In Japan, investment funds hold 3.8% of the outstanding amount of corporate bonds issued by domestic issuers.

As regards US mutual funds, their holdings of corporate bonds increased from US$720 billion in 2008 to over US$2 trillion in 2018.

Exchange Traded Funds (ETFs) also increased their holdings of corporate bonds, from US$32 billion in 2008 to US$420 billion in 2018.

The underlying explanation for this notable buoyancy of ETFs as holders of corporate bonds is the prevalence of passive investment strategies. In times of low interest rates, such as the periods following financial crises, the increase in passive management is significant, since in periods of normality the collective feeling that passive strategies are more profitable than active portfolio management strategies has taken root.

As regards legislative policy, the increase in corporate bonds as the final home for investments in the portfolios of the major institutional investors, especially investment funds, could generate potential destabilising effects, especially in times of economic recession and market illiquidity.

The Financial Stability Board has issued specific recommendations to address hypothetical structural

vulnerabilities deriving from portfolio management activities (FSB 2017).

Supervisory authorities such as the UK's FCA, the French AMF and Hong Kong's SFC have updated their regulations on institutional investors' risk management systems. The IOSCO Assessment Committee is currently preparing peer reviews to analyse this problem in each of the jurisdictions concerned.

A final reflection of the report identifies a move of the trading of corporate bonds from the over-the-counter market through dealers towards electronic trading platforms. The new requirements for dealers to identify and manage existing risks derive from regulations such as Basel III and the Volcker Rule.

CONCLUSIONS

Corporate bonds are an important investment class, especially for institutional investors. During expansive periods, more permissive supervisory and credit rating practices have been detected with the issue and placement of these types of financial instruments.

Regulatory policy must seek to avoid bouts of instability and turbulence in relation to the systemic risk that this type of activity could generate. Liquidity and due assumption of risks by investors should be accompanied by appropriate supervision and credit rating. This is necessary in the interests of investor protection and financial stability.

The OECD notes that the leverage ratios of companies rated BBB or above (investment grade) are much higher than those of a decade ago. This situation can lead to a significant downgrade of their ratings in the event of an increase in interest rates or an economic downturn leading to lower profits.

Link of interest:

OECD report on corporate bond market trends, emerging risks and monetary policy