The impact of ratings on structured products

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In the intricate landscape of financial instruments, structured products have gained significant prominence as versatile investment options that combine various underlying assets to offer tailored risk-return profiles. These products have witnessed a surge in popularity due to their potential for delivering enhanced yield and diversification. However, one crucial factor that plays a pivotal role in shaping investors' perceptions and decisions regarding structured products is the assigned credit rating. With the recent downgrade of US government rating, this white paper delves into the profound impact of ratings on structured products, exploring how ratings influence investor behaviour, market dynamics, and regulatory considerations.

Understanding Credit Ratings: Different Agencies and Rating Notes

Credit ratings represent the independent assessment of the creditworthiness of a financial instrument or issuer. They are assigned by specialized credit rating agencies, which evaluate various factors such as underlying assets, collateral quality, issuer's financial health, and prevailing market conditions. Ratings help investors gauge the level of risk associated with a structured product, influencing their investment decisions. The following section provides an in-depth exploration of various credit rating agencies and the rating notes they assign.

Several reputable credit rating agencies operate globally, each offering independent assessments of credit risk. These agencies are trusted sources of information for investors, helping them navigate the complex landscape of financial products. Some of the most well-known credit rating agencies include:

1. **Standard & Poor's (S&P):** S&P is one of the oldest and most recognized credit rating agencies. It assigns ratings based on a combination of financial data, qualitative analysis, and economic indicators. Ratings range from 'AAA' (highest credit quality) to 'D' (default).
2. **Moody's Investors Service:** Moody's is another prominent rating agency that evaluates credit risk. It uses a similar rating scale to S&P, ranging from 'AAA' (highest) to 'C' (default).
3. **Fitch Ratings:** Fitch assigns credit ratings to issuers and financial instruments based on quantitative and qualitative analysis. Its rating scale is similar to those of S&P and Moody's, ranging from 'AAA' to 'D'.
4. **DBRS Morningstar:** This agency specializes in rating structured finance products and is known for its comprehensive analysis of underlying assets and collateral quality. Its rating scale includes 'AAA' to 'D', similar to other agencies.

Credit rating agencies assign specific rating notes to structured products and issuers, providing investors with a standardized assessment of credit risk. The most common rating notes are as follows:

1. **Investment Grade Ratings:** These are ratings assigned to structured products and issuers that are deemed to have a relatively low risk of default. Ratings in this category include 'AAA', 'AA', 'A', and 'BBB'.
2. **Speculative Grade Ratings (High Yield):** These ratings indicate a higher level of credit risk and are associated with the potential for higher returns. Ratings in this category include 'BB', 'B', 'CCC', and 'CC'.
3. **Default and Near Default Ratings:** Ratings in this range, such as 'D' or 'RD' (restricted default), indicate that the issuer is in default or has missed payments. These ratings highlight severe credit risk.

Investors rely on these rating notes to quickly assess the risk level associated with structured products. Investment mandates, risk tolerance, and overall portfolio strategies often guide investors' preferences for products within a certain rating category.

The Influence on Investor Behavior: Impact of Ratings on Investor Decisions

Ratings play a significant role in shaping investor behavior, guiding their decisions and perceptions of structured products. The impact of ratings on investor behavior encompasses various scenarios, including downgrades and the perceived benefits of lower-rated manufacturers.

Downgrades, or the lowering of a structured product's credit rating, can have notable implications for investor behavior. Typically, downgrades that maintain a rating above A- might not significantly affect investors' perceptions. As long as the rating remains within the investment-grade category, investors might continue to view the product as viable, albeit with increased caution.

However, when a structured product's rating falls below A-, a distinct shift in investor behavior is observed. Investors often respond by unwinding their trades involving the downgraded product and seeking alternatives from other issuers. The drop into the non-investment-grade or speculative grade territory raises concerns about heightened credit risk and potential default, prompting risk-averse investors to take protective measures.

Interestingly, investors can benefit from considering structured products offered by lower-rated manufacturers, provided those manufacturers still maintain an investment-grade rating. This benefit emerges when the funding terms offered by these manufacturers are more favorable compared to those offered by higher-rated counterparts.

While lower-rated manufacturers might come with higher perceived risk, they often compensate investors with more attractive terms, such as higher yields. This situation is particularly advantageous for investors with higher risk tolerance who are seeking greater returns. As long as the manufacturer's creditworthiness remains within the investment-grade threshold, these products can offer a strategic advantage for yield-seeking investors.

Market Dynamics and Liquidity

The impact of ratings extends to the broader market dynamics. Highly rated structured products tend to enjoy higher demand and increased liquidity due to the perception of lower risk. This liquidity can lead to tighter bid-ask spreads and a smoother secondary market trading experience.

In contrast, lower-rated structured products may face limited liquidity, as investors become wary of their riskier nature. This lack of liquidity can amplify market volatility, potentially leading to pricing disparities and increased trading costs. The interaction between ratings and liquidity creates a complex feedback loop that affects both individual products and the overall market stability.

Empirical results in the US market

In this study, we delve into empirical evidence illuminating the profound effects of rating adjustments on structured products within the US market. Our analysis is centered specifically around five notable rating alterations that transpired over the last two years. Notably, these changes encompass three instances of upgrades involving Morgan Stanley, Bank of America, and Credit Suisse, alongside two instances of downgrades concerning UBS and RBC.

Our investigation unravels two distinct dimensions of impact stemming from these rating shifts – firstly, their influence on existing live products, and secondly, their effect on the cumulative outstanding amount linked to the issuers in question.

Turning to the performance of existing live products, we discern a noteworthy trend. On average, rating upgrades appear to yield a positive repercussion on the fair value of products, exhibiting an enhancement of approximately 20 basis points. Conversely, instances of downgrade manifest a contrasting outcome, as the fair value of products registers a decline of 35 basis points. While these alterations may seem modest in scale, it is important to acknowledge that establishing a definitive positive correlation proves elusive. This complexity arises from the observation that the valuation of products is substantially influenced by the payout structure of the product itself, introducing an additional layer of intricate dynamics.

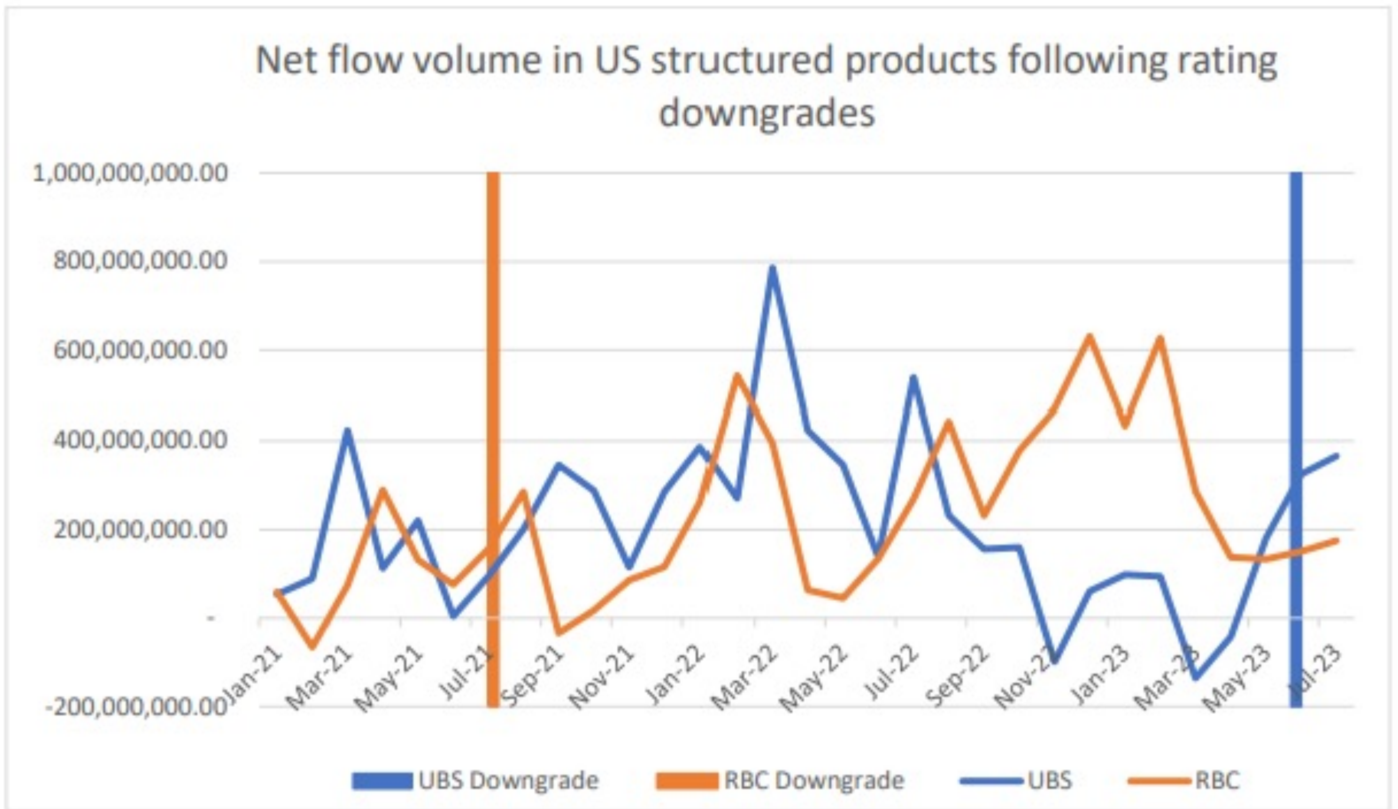
Performance above market average on the day after announcement	
Upgrades	0.19%
Downgrades	-0.35%

Issuer group by market share 2023ytd	Current credit rating*	Date of change	Previous credit rating*	Upgrade/Downgrade
JPMorgan	AA-	21-Jun-2018	A+	Upgrade
Citigroup	A	15-Dec-2011	A+	Downgrade
Goldman Sachs	A+	19-May-2015	A	Upgrade
Morgan Stanley	A+	04-Nov-2022	A	Upgrade
Barclays	A	15-Dec-2011	AA-	Downgrade
Bank of America	AA-	07-Jun-2021	A+	Upgrade
UBS	A	12-Jun-2023	A+	Downgrade
Royal Bank of Canada	AA-	15-Jul-2021	AA	Downgrade
Toronto-Dominion Bank	AA-	28-Jun-2002	AA	Downgrade
Bank of Nova Scotia	AA-	01-Mar-1990	AA	Downgrade
CIBC	AA-	01-Mar-1993	AA	Downgrade
HSBC	A+	05-Dec-2019	AA-	Downgrade
Bank of Montreal	AA-	12-Apr-1988		
BNP Paribas	A+	15-Dec-2011	AA-	Downgrade
Societe Generale	A-	28-May-2020	A	Downgrade
Credit Agricole	A+	23-May-2017	A	Upgrade
Wells Fargo	A+	03-Oct-2017	AA-	Downgrade
Credit Suisse	A	12-Jun-2023	BBB	Upgrade
BBVA	BBB+	22-Jun-2020	A-	Downgrade
Jefferies	BBB	13-Feb-2018	BBB-	Upgrade
National Bank of Canada	A+	01-Aug-1992	AA-	Downgrade

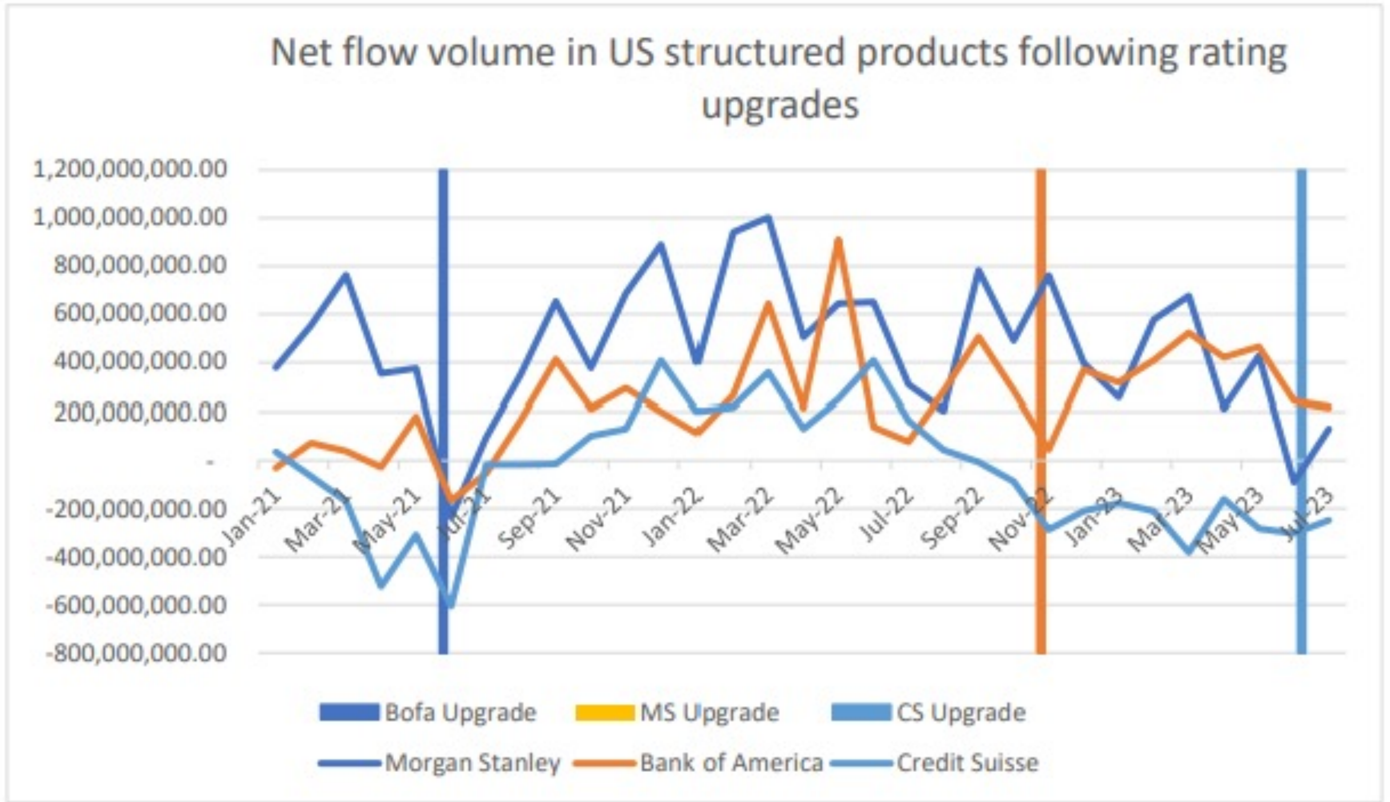
*Fitch

Examining a pair of instances involving rating downgrades, though our scope is confined, we can discern intriguing patterns. Notably, the downgrade of RBC in July 2021 displayed an initial adverse effect on RBC's new flow for the initial three months, which subsequently rebounded, showing amplified net inflows. A slightly divergent scenario unfolded in the case of UBS. Following the merger between UBS and Credit Suisse, a discernibly positive trend emerged, characterized by an influx of cash flow into UBS structured notes.

Both scenarios underscore a notable trend: medium-term positive outcomes following rating downgrades, particularly when the funding levels of the banks experience an increase. In the context of UBS, it becomes apparent that investors factored in the implications of the revised rating – specifically, the impact of the merger with Credit Suisse – prior to the formal assessment by the rating agency. This lends credence to the hypothesis that these medium-term positive effects are closely intertwined with the evolving financial landscape and investor foresight.



Regarding rating upgrades, our analysis focuses on two instances, omitting Credit Suisse due to its absence from recent issuances. Notably, a pattern emerges in the short term, characterized by an outflow of structured products. This phenomenon appears to stem from reduced funding within the treasury department. Although seemingly counterintuitive, it becomes evident that downgrades within the investment grade spectrum contribute positively to the structured product business. Conversely, while upgrades wield an indirect adverse influence, the dynamics are nuanced. Specifically, higher ratings correspond to diminished funding levels of banks in the medium term, accentuating the intricate interplay between rating adjustments and funding dynamics.



The undeniable influence of credit ratings on structured products is profound, yet the strength of correlation appears less pronounced. Contrary to intuition, downgrades appear to elicit a higher net volume of structured products, while the converse holds true for rating upgrades. Although a more extensive sample warrants examination, it becomes evident that an alternate factor holds sway. This factor pertains to the funding level of banks. The underlying rationale suggests that clients are drawn by the enticing headline rates presented by banks, with funding standing as the determining factor, particularly when investment grades are maintained.

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