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ABOUT

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Managing the 7.5%

Anticipating Credit Rating Downgrades to Preserve CLO Resilience

Collateralised Loan Obligations (CLOs) remain a critical source of demand within the leveraged loan market. However, heightened macroeconomic uncertainty has renewed focus on a long-standing structural risk: rating migration of underlying assets into the "Caa" category. With credit conditions tightening, driven by recessionary signals, geopolitical trade tensions, and rising funding costs, expectations of increased downgrade activity are gaining traction. While most CLOs currently operate within their Caa limits, the buffer is narrowing.

The implications of a breach are well understood. CLO structures typically cap Caa exposure at 7.5% of portfolio assets. Exceeding this threshold can trigger overcollateralisation tests, diverting cash flows away from junior tranches – including equity – until the structure is brought back into compliance. Although these mechanisms are designed to protect senior noteholders, they also place pressure on managers to reduce exposure to weaker names ahead of formal ratings downgrades. In practice, this can result in forced selling under adverse market conditions, crystallising losses and diminishing portfolio income.

In this context, the ability to anticipate ratings pressure becomes increasingly important. Moody's Deterioration Probability (DP) metric provides a forward-looking, probabilistic estimate of credit rating downgrade risk for rated companies and shadow-downgrade events for unrated companies. Grounded in a logistic regression framework, the model incorporates both market-based and fundamental drivers, including point-in-time default risk, sector-adjusted benchmarks, recent credit rating momentum, macro exposure, and idiosyncratic risk factors. The output is a statistically robust signal, enabling early identification of credits statistically likely to fall below investment thresholds, often

before formal rating agency action is taken. Although derived at the issuer level, the measure aligns closely with how managers evaluate credit quality and supports more proactive portfolio oversight.¹

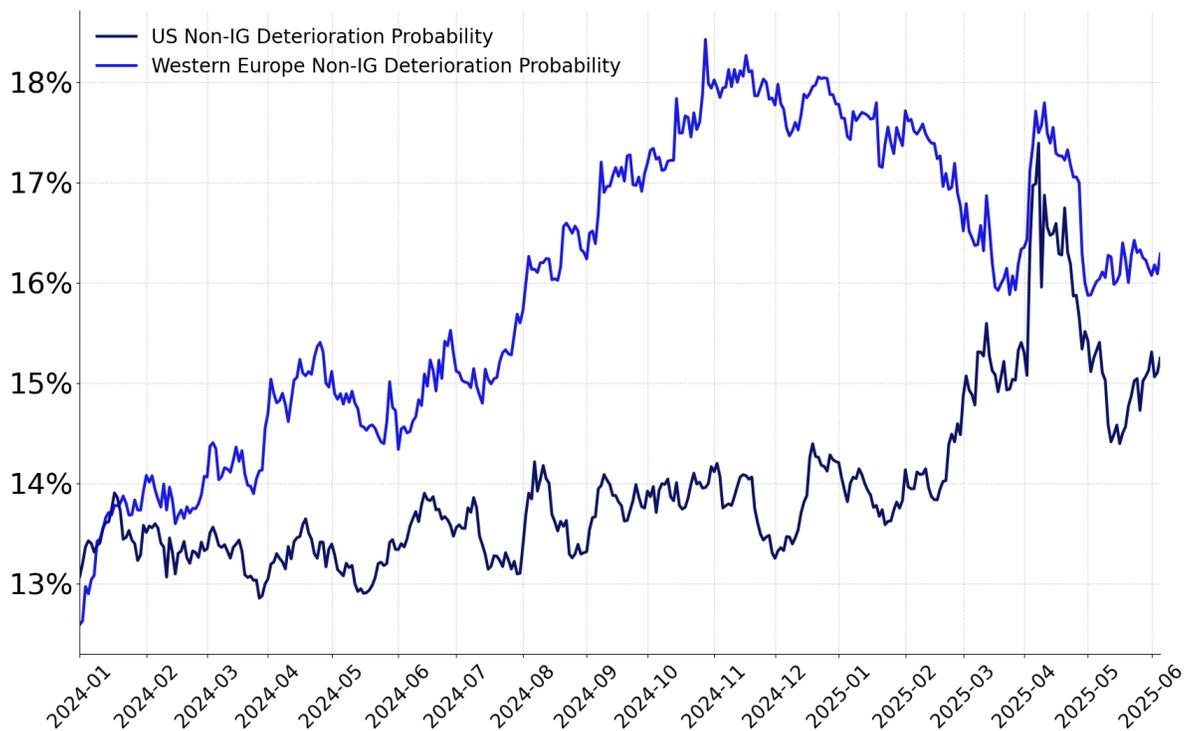
Earlier identification of ratings downgrade risk can materially reduce the likelihood of breaching Caa constraints. By enabling targeted rebalancing ahead of structural triggers, DP contributes to the preservation of cash flow to junior tranches and enhances overall portfolio resilience. In an environment where downgrades may cluster (in time, in certain sectors) and accelerate, forward-looking credit risk metrics play an increasingly important role in maintaining CLO structural integrity.

Current Risk Landscape: Deterioration Probability Across Major Equity Indices

To gauge where downgrade risk may be building across liquid credit-exposed names, we apply the Deterioration Probability (DP) framework² to non-investment grade issuers in the US and Western Europe. While these are not CLO portfolios, they serve as meaningful proxies for assessing how deterioration risk is evolving across geographies and sectors, particularly among corporates that are frequent borrowers in leveraged loan and high-yield bond markets.

FIGURE 1 The Closing Gap: Credit Risk Realignment Between the US and Europe

After a year of divergence, non-investment-grade deterioration signals suggest fiscal momentum and investment shifts may be levelling the field. This graph illustrates average DP for US and Western European non-investment grade rated issuers.



¹ As a practical matter, a high DP signalling heightened risk of a ratings downgrade for an asset in a CLO would indicate credit quality concerns for the issuer, but likely be most relevant in terms of its impact on junior tranches.

² Moody's Deterioration Probability (DP) metric is part of the EDF-X solution's suite of forward-looking risk signals. The Deterioration Probability is not a part of Moody's Ratings credit review process, like a ratings outlook or watchlisting, but is a metric produced by a quantitative model from Moody's Analytics. The Deterioration Probability is not used by the Moody's Ratings to determine ratings actions.

Credit stress among non-investment grade issuers has become increasingly regionalised. Over the past 18 months, speculative-grade companies in Western Europe have exhibited consistently higher risk of deterioration compared to their US peers, reflecting diverging macroeconomic conditions and structural pressures on European credit markets.

From early 2024 through late Q1 2025, Western Europe's deterioration probability (DP) remained elevated, hovering between 16–18%. This prolonged stress points to more entrenched refinancing hurdles, weaker earnings momentum, and sectoral headwinds - particularly in manufacturing, construction, and energy-intensive segments.

The US cohort, by contrast, maintained a more stable risk profile for most of the period. A short-lived spike in early 2025 brought US DPs temporarily in line with Europe, likely driven by a tightening in macroeconomic conditions and nearing maturity walls in high-yield segments. However, the US has since seen a reversion to lower levels, suggesting a more accommodative monetary backdrop and greater access to refinancing channels.

What's notable is not just the level, but the trajectory of risk. In Europe, deterioration signals have plateaued at high levels. In the US, they've reverted downward, implying that recent stress may have been absorbed rather than embedded.

We could note that the narrowing gap in deterioration signals may reflect early signs of structural convergence, as Europe begins to ramp up fiscal spending and private investment – potentially signalling a shift away from the longstanding productivity and capital formation gaps that previously drove regional divergence.

Lead Time Between Signal and Rating Downgrade

The practical value of any forward-looking credit risk tool lies not only in its predictive accuracy, but in its timeliness. The value of a predictive risk metric comes not just from its statistical accuracy, but from its ability to warn an asset manager that certain exposures require deeper attention. For asset managers operating within the structural limits of CLOs, early identification of credit deterioration can be the difference between optional rebalancing and forced de-risking under pressure. The Deterioration Probability (DP) metric is designed precisely with this anticipatory function in mind, providing a statistically grounded signal before formal rating agency action takes place.³

Validation results confirm that DP consistently exhibits predictive power. Across multiple historical cohorts and credit cycles, entities with elevated DP values - typically corresponding to scores above 10-15% - demonstrate a materially higher likelihood of downgrade within the subsequent six to twelve months. In particular, the model's ability to flag "shadow downgrades" (credit weakening in unrated names that later align with a public downgrade or market repricing) provides added utility for portfolios exposed to both rated and unrated borrowers.⁴

Timing matters. On average, entities flagged with high DP cross the downgrade threshold three to six months before a corresponding rating change is enacted. In many cases, this lead time is sufficient for CLO managers to act: selectively rotate out of weakening credits, maintain compliance with Caa limits, and avoid the cash flow disruption associated with overcollateralisation test breaches. This early signal is not just useful — it is actionable.

³ Moody's Deterioration Probability (DP) is part of Moody's EDF-X risk solution, and is not in any way part of the process by which Moody's Ratings assigns or changes its credit ratings. The quantitative risk measures discussed in this paper are not inputs into Moody's Ratings credit ratings methodologies, and Moody's Ratings maintains its own, separate processes for monitoring credit risk and managing changes in its credit ratings.

⁴ Moody's Analytics. (2020). *The Deterioration Probability Methodology*. Internal document. Available upon request from Moody's Analytics.

In addition, Moody's DP model benefits from a regime-based structure, allowing it to adapt across macroeconomic conditions and credit cycles. This flexibility helps maintain predictive consistency even during periods of heightened volatility, when downgrades tend to cluster and velocity increases.

The implication is clear: credit deterioration risk can be quantified — and Moody's empirical studies show that it often shows up in the model before it appears in the rating.⁵ Managers who monitor DP across their portfolios are better positioned to stay within structural tolerances and protect the economics of the equity tranche. These predictive qualities are not theoretical; they translate directly into tangible economic value for CLO structures, particularly in how managers respond to Caa risk. The next section examines this in a stylised portfolio context.

The Case for Proactive Rebalancing

While the usefulness of Moody's DP for anticipating ratings downgrades is clear, its true value lies in the economic outcomes it enables. For CLO managers, these outcomes are most acutely felt at the equity tranche level, where distributions are highly sensitive to rating migration, structural triggers, and the timing of cash flows.

To illustrate this, consider a stylised CLO portfolio with £500 million in total assets and 6.5% of the portfolio already rated Caa. An additional 2% of exposures are currently rated B3 but exhibit elevated DPs, signalling a high probability of near-term downgrade. If no action is taken, and just 1% of these exposures are downgraded, the portfolio would exceed the typical 7.5% Caa limit; triggering overcollateralisation (OC) tests and causing residual cash flows to be diverted away from the equity tranche.

In this scenario, equity investors expecting £4 million per quarter could forgo two quarters of payments — resulting in £8 million of lost cash flow, or a reduction of 200–400 basis points in IRR, depending on the capital structure and reinvestment period. These impairments, once realised, are rarely reversible within the CLO's reinvestment period.

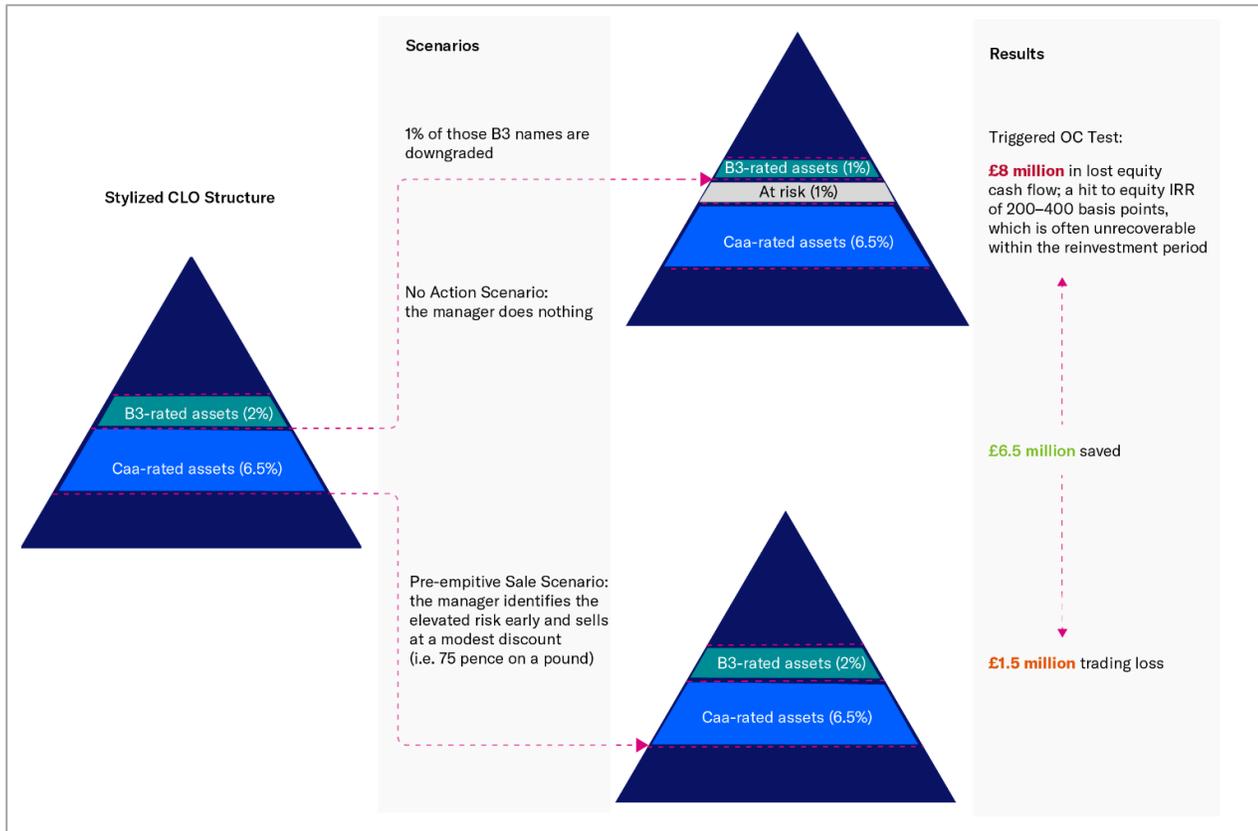
By contrast, a manager acting on the DP signal might choose to sell the high-risk names in advance at a modest discount — for example at 97 pence on the pound — crystallising a £1.5 million trading loss. However, the Caa bucket remains within compliance, OC tests are maintained, and cash flows to equity continue uninterrupted. In economic terms, a small and manageable upfront loss preserves long-term value, potentially preventing a multi-million pound hit to total equity return.

This type of pre-emptive rebalancing is difficult to justify using conventional credit risk signals, but with DP's forward-looking early warnings, managers gain the conviction to act decisively, reducing the risk of structural breach and enhancing return stability in the tranche most exposed to market dislocation.

“Deterioration Probability measure's forward-looking early warnings may help collateral managers identify exposures most at risk of a rating downgrade, enhancing return stability.”

⁵ There is a substantial literature investigating this topic, including Hull, J., Predescu, M. and A. White (2004), "The Relationship Between Credit Default Swap Spreads, Bond Yields, and Credit Rating Announcements", *Journal of Banking and Finance*, Vol. 28, Issue X, pages 278-89-2811 and Hamilton, D. and R. Cantor (2004), "Rating Transition and Default Rates Conditioned on Outlooks", *Journal of Fixed Income*, September 2004. See those papers for additional references. See also "Enhancing Returns, Mitigating Risk: Leveraging Moody's Alpha Factor and Deterioration Probability in Bond Portfolio Management," Suneil Parimoo, Zhong Zhuang, and Victor Luo, Moody's, forthcoming.

FIGURE 2 One Percent Too Far: How a Small Downgrade Triggers Big Equity Losses



From Signal to Action

As credit markets transition through a more volatile phase of the cycle, structural features within CLOs are once again being tested. The prospect of elevated downgrade activity, whether triggered by macro shocks, sector-specific pressures, or a delayed ratings cycle, places renewed importance on the ability to act early. For managers of CLO portfolios, this is not a theoretical exercise; the timing and quality of credit surveillance directly impact structural integrity and tranche-level economics.

Moody’s Deterioration Probability metric offers a practical, evidence-based solution to this challenge. By providing a statistically robust signal of emerging credit stress, often months before it is reflected in official credit ratings, it enables managers to monitor deterioration risk proactively and potentially reallocate exposures well before structural triggers are breached.

More importantly, DP does not attempt to replace traditional credit assessments. Rather, it complements existing frameworks by adding a layer of forward-looking intelligence that is both data-driven and empirically validated. In a market defined by increasing downgrade velocity and tighter tolerances, such tools are no longer a luxury — they are a necessary part of the risk management toolkit. Managers who embed DP into their portfolio oversight alongside traditional ratings will be better positioned to preserve structural integrity and optimise long-term tranche returns.

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