Box 5

CORPORATE DEFAULTS: A LIKELY SOURCE OF FURTHER FINANCIAL SYSTEM STRESS

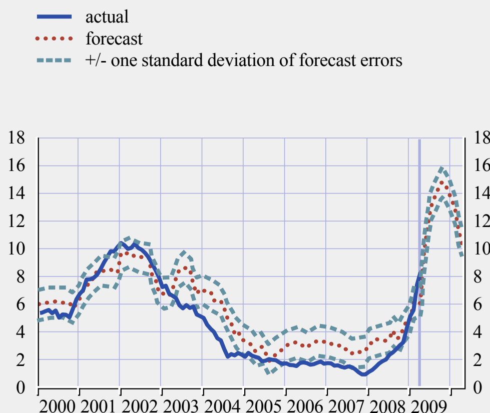
Throughout the ongoing financial turmoil, much emphasis has been placed on the size and significance of write-downs by financial institutions on their asset-backed securities and derivatives holdings. Increasingly, however, attention is focusing on corporate debt and the likely loan losses that may materialise as the turmoil continues and the real economy endures a significant slowdown. This box explores this issue in the context of speculative-grade corporate debt and finds evidence of a sharp increase in losses on corporate bond holdings since the end of 2008. These have arisen from an increase in corporate default rates, combined with a decline in the remaining value of defaulting firms. This may have an impact on the ability and willingness of the financial system to provide further financing to the non-financial sector.

Global speculative-grade corporate default rates had declined to extraordinarily low levels from the peaks of 2002 (see Chart A). While default rates had been expected to increase as from 2005, actual default rates only started picking up in the course of 2008 and intensified during the first months of 2009. Recent default rate patterns in Europe have been very similar. Moody's latest model-based forecasts, however, predict that 12-month trailing-sum default rates in Europe will be close to 20% by late 2009 (see Chart S53), somewhat higher than the global rate (see Chart A); default rates in all regions are expected to moderate in 2010.[1] At the same time, the recovery rates for defaulting global firms declined in 2008 (see Chart B). Given the high level of firms'

1 Data for forecasts of European default rates are only available from 2008. As it is important to be able to make a comparison with the previous downturn, this box focuses on global data. In Europe, Moody's expects the sector of *durable consumer goods* to experience the highest default rate over the next 12 months. This differs from the United States where, among various industries, Moody's expects the *consumer transportation* sector to be the most troubled. Figures should be read with caution since the high level of uncertainty surrounding the potential length and severity of the current global economic downturn implies similarly high uncertainty for model-based forecasts of default rates.

Chart A Actual and forecast default rates of global speculative-grade corporations

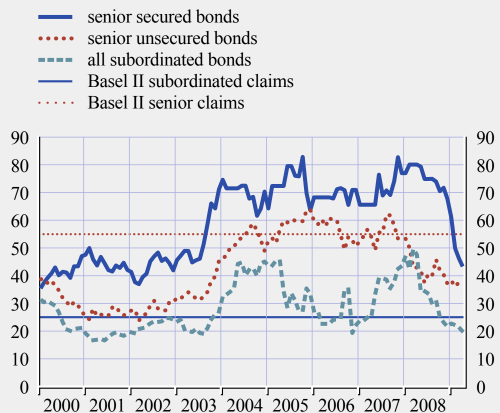
(Jan. 2000 – Apr. 2010; percentage; 12-month trailing sum)



Sources: Moody's and ECB calculations.
Notes: Dashed lines represent one standard deviation of forecast errors. Forecast refers to the 12-months-ahead forecast default rate.

Chart B Defaulted bond recovery rates of global speculative-grade corporations

(Jan. 2000 – Apr. 2009; per USD 100; 12-month trailing sum)



Source: Moody's.
Note: Measured by bond prices taken one month after default.

indebtedness and expectations for weak corporate earnings, recovery rates are expected to be relatively low. Indeed, recovery rates are now (significantly) below the values assumed in the foundation approach for the internal rating-based (IRB) method for assessing credit risk in the Capital Requirements Directive (Basel II).[2] The combination of the forecast increase in default rates with the decline in recovery rates suggests significant potential for further losses on these bonds, particularly if they have not been marked to market by their holders.

Given the extreme nature of recent developments in financial markets, it might be reasonable to expect that the performance of models forecasting default rates may be adversely affected in the present environment and that the degree of uncertainty surrounding the forecast rates is considerably higher than normal. It is, therefore, possible that current forecasts may prove to be unduly pessimistic, despite the sharp decline in economic activity. Furthermore, the low recovery rates in Chart B may be biased downwards as they are based on bond prices one month after default in markets that are, arguably, less liquid than in previous years.

The shock-absorption capacity of the financial system has been tested significantly since mid-2007, and there is greater uncertainty about the extent to which the system's ability to absorb losses has been diminished. That said, the possibility of global and European speculative-grade corporate default rates reaching close to 15% and 20% respectively, with recovery rates falling, presents a significant risk to the financial system.

2 According to anecdotal evidence, about 50% of the typically larger banks that apply the IRB approach use the foundation method. The remaining 50% rely on the advanced IRB approach, whereby banks may – after supervisory approval and subject to meeting minimum standards – use their internal estimates of loss given default, which is equal to one minus the recovery rate.