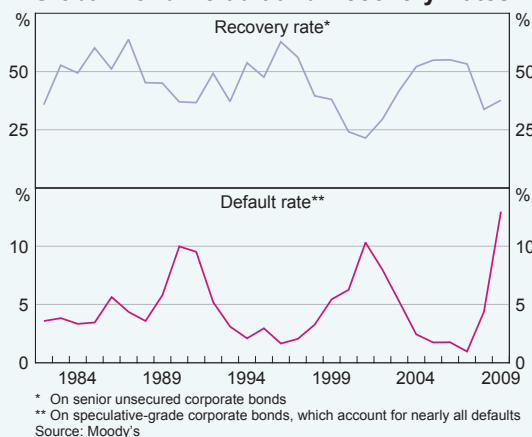


## Box A

# Global Recovery Rates on Corporate Defaults

Recovery rates on defaulted bonds are naturally cyclical. When defaults are at their highest, recovery rates tend to be lower, because the market for the bankrupt firms' assets is typically relatively weak at such times, and potential purchasers may themselves have limited financial resources or be unable to access capital (Graph A1). In the most recent global cycle, when the average default rate for lower-rated firms reached 13 per cent in 2009, the average recovery rate on senior unsecured bonds fell to 38 per cent. This is relatively low by historical standards, but not as low as the recovery rates seen in the early 2000s.

**Graph A1**  
**Global Bond Default and Recovery Rates**



In the recent period, many of the corporates that ran into difficulty had greatly increased their leverage in the lead-up to the crisis; this had often been facilitated by a significant loosening of lending standards. In particular, loan covenants, such as interest-coverage ratios, were often relaxed, delaying

creditor intervention in failing firms, and reducing remaining asset values once defaults occurred. Many of the highly leveraged companies were associated with private equity investors, where higher gearing is typically part of the investment strategy. According to Standard & Poor's, for defaults in 2008 and 2009, recovery rates on bonds associated with leveraged buy-outs were 13 percentage points lower than for bonds without this association.

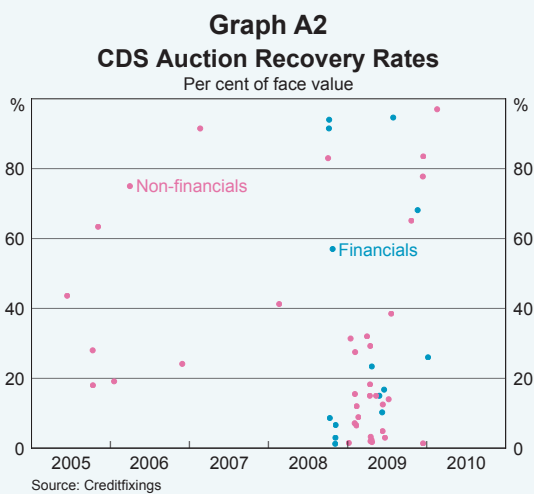
While lending standards had been eased in the boom, they have subsequently been tightened. As a result, many distressed firms have been unable to source finance, even from lenders that traditionally service this market segment. In the United States, debtor-in-possession loans – first-ranking loans provided to firms in Chapter 11 (reorganisation) bankruptcy – are reportedly more difficult to obtain than in previous recessions. A lack of access to finance also affects potential purchasers of distressed assets and can make it harder to recover value from a defaulted company.

More timely and disaggregated data on recovery rates can be obtained for the subset of defaulting corporations that have credit default swaps (CDS) written on their bonds. In 2009, the average recovery rate on senior unsecured bonds implied from 32 CDS auction results was around 24 cents in the dollar, below the long-term average of the universe of senior unsecured bonds (Graph A2). In some cases, recovery rates were close to zero. To date in 2010, there have been relatively few auctions.

The fall in recovery rates has been particularly severe for creditors of some defaulting banks and financial institutions. For example, recovery rates on senior

bonds issued by the three Icelandic banks were between 1 and 7 cents in the dollar, while Lehman Brothers' senior bondholders recovered less than 9 cents in the dollar. One reason why the recovery rates for some financial institutions have been low is the structural subordination of bondholders. In the case of Lehman Brothers, a significant amount of its assets was pledged as collateral and therefore liquidated at distressed prices by counterparties at the time of default. As a result, many of these counterparties joined the pool of unsecured creditors with their balance of unpaid claims. In addition, many Lehman assets were held in subsidiary entities, with creditors of those subsidiaries paid in full before funds were available for the parent bondholders. A few financial institutions, namely Fannie Mae, Freddie Mac and Bradford & Bingley, had recovery rates close to 100 per cent after receiving government guarantees on their senior unsecured bonds. The terms of the government rescues meant that 'credit events' were deemed to have occurred, triggering CDS auctions.

While a number of factors have served to lower recent recovery rates, the increase in distressed debt exchanges over the past two years has helped to support recovery rates. Distressed debt exchanges are essentially an out-of-court bankruptcy



arrangement, where borrowers and creditors agree to materially change the features of outstanding debt. Since 2008, around one third of bankruptcies have been distressed debt exchanges, compared to an historical average of around 10 per cent. The agreements appear to result in a quicker emergence from bankruptcy and higher recovery rates for debt holders. Moody's calculates that when distressed exchange defaults are excluded, the average recovery rate on senior unsecured bonds in 2009 falls from 38 per cent to 27 per cent. ❖

