

## Box 5

## GLOBAL AND EURO AREA CORPORATE DEFAULT RATES

The overall credit quality of the corporate sector improved considerably over recent years. An important reflection of this was a significant decline in corporate sector default rates in the euro area as well as around the world. The global speculative-grade default rate of issuers rated by Moody's, fell for the fourth consecutive year to 1.7% in March 2006, reaching the lowest level observed since 1997. In the euro area the default situation was even more benign: the default rate was 0% from June 2004 onwards. However, against the background of some evidence suggesting that corporate creditworthiness in the euro area could turn in the period ahead (see Box 3), this Box examines recent patterns in speculative-grade default rates, both in a global and a euro area context. Furthermore, the short-term outlook for euro area default rates is briefly discussed in light of the 12-month global speculative-grade forecast provided by Moody's.

In terms of long-term corporate debt, the bulk of outstanding issues is concentrated in the investment-grade segment, where the issuing firms have very low probabilities of default. The vast majority of all corporate defaults take place in the lower-rated speculative-grade segment, which accounted for 31% of Moody's global rating coverage in March 2006 (see Table B5.1). Within the speculative-grade segment, default rates differ widely depending on a firm's rating. For example, firms rated Caa or lower (constituting 14% of all speculative-grade-rated firms globally) experienced a default rate of 7.7% in March 2006, compared with 0.5% for firms rated B. The US dominates the speculative-grade market, representing 70% of global issues, compared with just 8% in the euro area.<sup>1</sup> For this reason there is a tight correspondence between global and US speculative-grade default rates (see Chart B5.1). Default rates in the euro area by contrast follow global developments less closely, indicating differences in corporate credit conditions between regions.<sup>2</sup>

Table B5.1 Global, US and euro area corporate bond market rating structure

(March 2006, % of total number of ratings)

	global		US		euro area	
	weight (%)	default rate (% 12-month trailing)	weight (%)	% of global	weight (%)	% of global
investment-grade	69	0.03	61	48	83	17
speculative-grade	31	1.65	39	70	17	8
of which:						
Ba	35	0.00	29	58	38	8
B	51	0.48	54	74	53	8
Caa-C	14	7.71	17	84	11	6

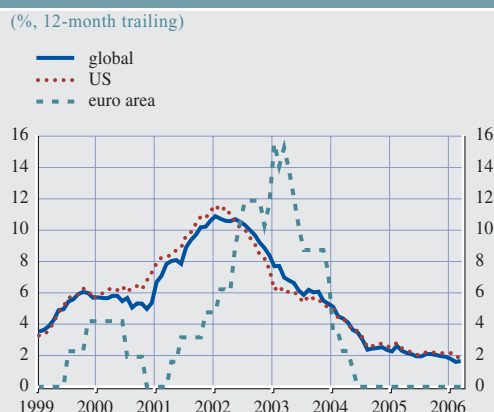
Sources: Moody's and ECB calculations.

Moody's provides monthly forecasts for the global speculative-grade default rate, which is a widely monitored indicator of corporate credit quality. The forecast model incorporates the

1 The US speculative-grade segment is also more important within its domestic market, representing a weight of 41% of the total US market, whereas the corresponding weight for the euro area accounted for only 17%. Since the late 1990s, when a market for corporate debt started to develop in the euro area (spurred by the introduction of the euro), market-based lending has continued to grow. In terms of size, however, the euro area corporate bond market is still small in a global context, with total bond accounting for less than 8% of total GDP in 2001, compared with roughly 30% in the US. See for instance L. Baele, A. Ferrando, P. Hördahl, E. Krylova and C. Monnet (2004), "Measuring financial integration in the euro area", *ECB Occasional Paper Series*, No 14.

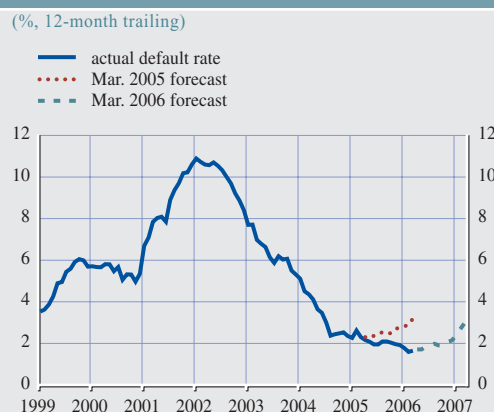
2 This difference might, at least to some extent, be explained by the limited number of speculative-grade issuers in the euro area.

**Chart B5.1 Global, US and euro area speculative-grade default rates**



Source: Moody's.

**Chart B5.2 Actual and forecasted global speculative-grade default rates**



Source: Moody's.

effect on default rates of changes in the pool of rated issuers (e.g. taking the age distribution of the debt outstanding into account), and of macroeconomic conditions (as measured by growth in GDP and interest rate variables).<sup>3</sup> Besides constituting a benchmark in the overall assessment of global credit quality, this indicator complements other forward-looking indicators of corporate credit risk, such as the ratio of credit rating upgrades to downgrades and EDFs.

Since its introduction in 1999, Moody's 12-month ahead default rate forecast has performed rather well.<sup>4</sup> Despite several macroeconomic developments that might have been expected to have had a negative influence on global corporate credit quality during the past year, e.g. the flattening of the US yield curve and other downside risks to growth in both the US and Europe, actual default rates continued to fall. As such, the forecast model tended to over-predict increasing rates of default after the beginning of 2005. The forecast prepared in March 2006 indicated a pick-up in the global default rate over the course of the year, to a level of around 3% by the beginning of 2007 (see Chart B5.2).

There are two good reasons why credit conditions for euro area speculative-grade debt might be stronger than at the global level in the short term, and why default rates might remain lower for somewhat longer. First, in contrast to the US, the growth outlook for the euro area has continued to be revised upwards since the December 2005 FSR was finalised, supporting corporate credit quality. Second, while the amount of new issuance in the most vulnerable segment of the stock of speculative-grade firms (rated Caa to C) increased sharply in the US in 2004, it has only picked up more recently in the euro area. This suggests that the so-called ageing effect will push default rates upwards somewhat later in the euro area, provided that the risk of credit default peaks about three years after first issuance.<sup>5</sup>

3 See Moody's (1999), "Predicting default rates: A forecasting model for Moody's issuer-based default rates", Special Comment, August.

4 See for instance Moody's (2006), "Default and recovery rates of corporate bond issuers, 1920-2005", Special Comment, January.

5 A large part of the euro area speculative-grade market defaulted between 2001 and mid-2004 (especially in volume terms). This probably left the speculative-grade segment in the euro area with a relatively higher share of higher-rated issuers compared to the US market. Only 11% of the speculative-grade issuers in the euro area are rated in the lowest Caa-C segments, whereas the corresponding figure for the US is 17%. Historically, a third of total Caa-rated issuance has defaulted after two years and 44% after three years. See for instance Deutsche Bank (2006), "What credit spread is required to compensate for historic default probabilities?", March.

The outlook for speculative-grade corporate defaults suggested by Moody's forecast, indicates a near turn in the global credit cycle. In line with global credit conditions, there is also some evidence suggesting that the credit cycle may be about to turn in the euro area as well (see Box 3). Nevertheless, the speculative-grade default rate might be expected to stay low for somewhat longer in the euro area, given the slightly improved growth outlook compared to the US (i.e. increasingly less divergent), together with more favourable interest rate conditions and a slightly higher-rated issuer composition. Although the fundamental conditions for speculative-grade corporate credit differ to a large extent between the euro area and the rest of the global (largely the US) market, there has been strong convergence in high-yield corporate bond spreads in recent years (see Charts S21 and S50). Overall, the conditions underlying euro area speculative-grade default rates examined in this Box therefore indicate that prospects for the euro area are slightly better in the short term in comparison with global financing conditions.<sup>6</sup>

<sup>6</sup> The corporate bond spread, defined as the difference between the yield on a corporate bond and the yield on a risk-free instrument with comparable maturity, should in theory price in the expectation of corporate default over the full maturity of the bond (i.e. it should lead the actual default rate). Even though their cyclical patterns are not exactly contemporaneous, the global high-yield corporate bond spread and the global default rate tend to move in tandem over time. For a discussion of this topic, see Box 9 in ECB (2005), *Financial Stability Review*, June.