## Box 3

### IS CORPORATE CREDIT QUALITY IN THE EURO AREA NEARING A TURNING POINT?

The overall credit quality of the non-financial corporate sector in the euro area has been very benign for the last couple of years, following substantial efforts on the part of firms to restructure their balance sheets. This, in parallel with a notable strengthening of profits, helped improve corporate sector balance sheets. Against this background, the frequency of corporate sector defaults declined, and an overall improvement in credit quality was acknowledged through declining credit spreads and improving credit ratings. As corporate credit quality tends to be cyclical and determined by factors such as leverage and the strength of profitability of firms, the most recent cycle of improvement can eventually be expected to come to an end. With this consideration in mind, this Box examines whether corporate sector creditworthiness in the euro area is nearing a turning point.

In the aftermath of the substantial leveraging of non-financial firms in the late 1990s and 2000, which sowed the seeds of financial vulnerability, euro area firms responded to falling stock prices, tightening lending standards and widening spreads on corporate bonds by undertaking considerable efforts to repair and restructure their balance sheets. The restructuring process, together with recovery of stock prices, brought the debt-to-equity ratio – an important indicator of financial leverage – for the euro area corporate sector down from over 200% in early 2003 to around 130% by Q4 2005. Similarly, the debt-to-financial assets ratio of the sector declined by almost 10 percentage points between end-2002 and end-2005. At the same time, these restructuring efforts were complemented by a strong rebound in corporate earnings as well as by declining interest rates across the entire maturity spectrum, which markedly lowered the net interest burden of the corporate sector. This favourable confluence of factors brought about a significant improvement in credit risk assessments, which was not only reflected in ratings but also by the performance of firms' securities prices and the interest rate spreads applied by banks. By early 2005, BBB-rated long-term corporate bond spreads had reached their lowest levels since at least 1998. While it cannot be ruled out that part of the narrowing of spreads was attributable to the search for yield that pervaded global capital markets – especially credit markets – during much of this time, bank credit spreads also fell, while the standards applied by banks to loans to enterprises became less restrictive. Moreover, the frequency of corporate sector defaults declined to very low levels in 2004 and 2005. These positive developments were also reflected in an increasing ratio of credit rating upgrades to downgrades (see Chart 2.3 in the main text) and in declining expected default frequencies (EDFs) (see Chart 2.9 in the main text).

In recent quarters, some indications have emerged that non-financial corporate sector credit quality may have ceased to improve, which raises the question of whether the credit cycle in the euro area may be nearing a turning point. To some extent, this could be attributable to the fact that credit quality has already been enhanced to a great degree. Very favourable financing conditions and strong corporate earnings may have begun to reduce incentives for firms to continue with balance sheet repair, and may have encouraged them instead to start gradually re-leveraging their balance sheets. Very strong corporate loan growth in recent quarters is indicative of this, as have been a growing number of shareholder-friendly actions (such as an increase in share buybacks at the expense of creditors. Debt-to-GDP and debt-to-equity ratios also started to increase slightly in the last few quarters.

Although it is too early to be certain, there are indications that the long period of positive credit rating developments may have begun to peak in recent quarters (see Chart B3.1).[1] While low rates of default, low EDFs and tight credit spreads all underpinned a favourable credit risk assessment by early May 2006, several factors point to the potential for a deterioration in credit quality in the period ahead, of which four can be highlighted.[2] First, there have been indications

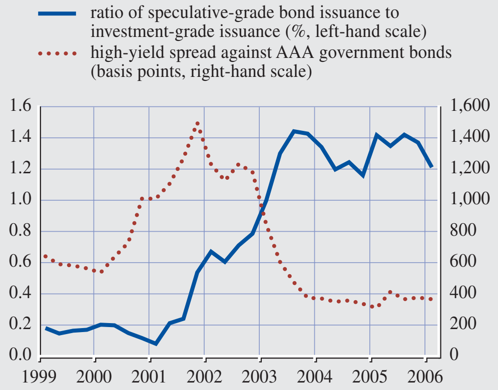
1 Despite the upward trend in the credit rating upgrades-to-downgrades ratio in recent years, the total number of western European non-financial corporate downgrades still far exceeded the number of upgrades observed from the beginning of 2001, i.e. roughly at around the time when the previous credit cycle turned. This may indicate that credit quality has remained below the levels seen in the late 1990s.

2 This deterioration has, to a somewhat lesser extent, also been reflected in euro area corporate bond spread patterns: spreads on long-term BBB-rated bonds and high-yield bonds widened by 25 and 70 basis points respectively between end-2004 and end-January 2006. Some of this widening was, however, related to a number of major firm-specific credit events that occurred in 2005; see Box 9 in ECB (2005), *Financial Stability Review,* December.

**Chart B3.1 Credit rating drift and issuers placed under rating review**


Sources: Moody's and ECB calculations.
Note: These figures also include non-euro area western European countries. The "rating drift" is defined as the difference between the number of credit rating upgrades to credit rating downgrades over the total number of rated issuers (trailing 12-month). "Rating reviews" indicates the number of issuers put on review for upgrades and downgrades respectively (12-month moving sum). A high negative figure indicates that more firms are being put on review for downgrading than for upgrading.

**Chart B3.2 Ratio of speculative-grade to investment-grade gross bond issuance and the high-yield corporate bond spread in the euro area**




Source: Thomson Financial Datastream.
Note: The ratio of speculative-grade (BBB-rated and below) bond gross issuance to investment-grade (A-rated and above) is calculated as a four-quarter moving average. The coverage of the data on gross issuance of corporate bonds is somewhat limited and hence the data only provides a partial assessment of corporate bond issuance in the euro area. The high-yield corporate bond spread is the spread between euro area high-yield bond yields to AAA-rated government bond yields.

that firms have changed their business strategies from cost-cutting and earnings accumulation to exploiting M&A opportunities and undertaking fixed capital investment, both of which should imply higher leverage ratios in the period ahead.[3] Second, as reported in Section 2.2 of the December 2005 FSR, the interest rate sensitivity of the non-financial corporate sector may have increased somewhat in recent years owing to firms' increasing recourse to floating rate debt. Thus, while the net interest burden of non-financial corporations was historically low in the first months of 2006, it was also more sensitive to changes in interest rates than in previous periods. Third, the combination of a rise in shareholder-friendly actions (such as share buybacks and dividend payouts) and a surge in LBOs, predominantly by private equity firms, is also likely to lead to an overall increase in corporate sector leverage.[4] Fourth, focusing on the corporate bond market, one notable development observed in recent years is that the issuance of lower than average quality corporate bonds picked up significantly (see Chart B3.2). After early 2003, the gross issuance of speculative-grade bonds exceeded that of investment-grade bonds: this may have been induced by investors' demand for yield in credit markets, but could have also reflected supply factors, as higher quality firms attempted to reduce their debts. The result of such high levels of issuance of lower quality credit may be that the credit quality of the overall stock of corporate bonds issued by euro area firms has been declining, which implies that default rates are likely to rise in the coming years (see Box 5).[5]

3 As mentioned in Section 2.2 in the main text, euro area M&A activity in 2005 reached its highest level since 2000. In addition, as noted in Box 10 of this FSR, in the April 2006 Bank Lending Survey, banks reported that the recent strength of firms' loan demand was, to a large extent, driven by their need to finance fixed investment, inventories and working capital, as well as M&A activity.
4 According to Thomson Financial, the amount of European leveraged buyouts reached a record high in 2005. Concerning the growth in share buybacks in the US, see Box 1 in ECB (2005), *Financial Stability Review*, December. Share buybacks in the euro area amounted to around €27 billion in 2005, compared with an average of €18 billion in the period 2001-2005 (data from Thomson Financial Datastream).
5 Indeed, a lagged positive relationship between speculative-grade issuance and default rates can be expected; see for instance Moody's (2005), "Default and recovery rates of European corporate bond issuers: 1985-2004", Special Comment.

All in all, the substantial efforts made by firms to repair their balance sheets in recent years seem to have markedly improved their financial condition. These efforts have been acknowledged in several indicators of corporate sector credit risk. Although the outlook still remains favourable, there are some indications that a turn in the credit quality cycle may be approaching. Unless this is carefully taken into account by banks and other financial investors, it may pose some financial stability concerns to the extent that banks and investors in corporate bond markets may face higher credit risk in the medium term.