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Distressed Debt:
Hitting the Sweet Spot

Since the Global Financial Crisis first appeared, distressed debt has been widely touted as an obvious potential home run for investors. Past history has proven that the distressed debt asset class can be extremely profitable after market crashes, with at times, the ability to create extraordinarily outsized returns. Hitting the sweet spot is dependant upon accurate, preferably low, entry pricing followed by efficient monetization. Low entry pricing occurs when sellers negotiating ability is impaired, usually as a function of huge amounts of supply in need of simultaneous liquidation. Successful execution is proportional to servicing competence. Highest returns are driven by proximity to the bottom of the market cycle, the likelihood of a strong sustained upturn in economic conditions, and jurisdictional arbitrage. Given the magnitude of downturn experienced so far in the west, the conditions for achieving a lucrative turnaround story should in theory all be present. However, unprecedented government intervention, political, market, sectoral and jurisdictional interconnectedness and interdependence have made identification of the entry sweet spot more complicated and challenging. This paper aims to give some perspective to this issue.

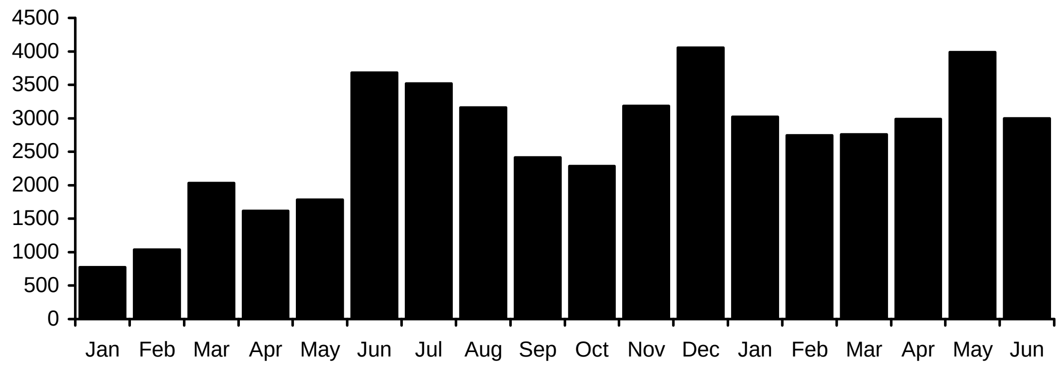
The Global Market

The term “global contagion” has been missing from political vernacular since the Great Depression. In 2009 it resurfaced, once markets appreciated that an economic crash, as well as an economic boom, could be exported. In addition to the financial system, economic contagion has been transmitted through trade relations, commodities, derivatives and currencies. The subsequent confusion and lack of understanding is still clearly evident amongst western governments and hampers their ability to initiate solutions that will sustain recovery.

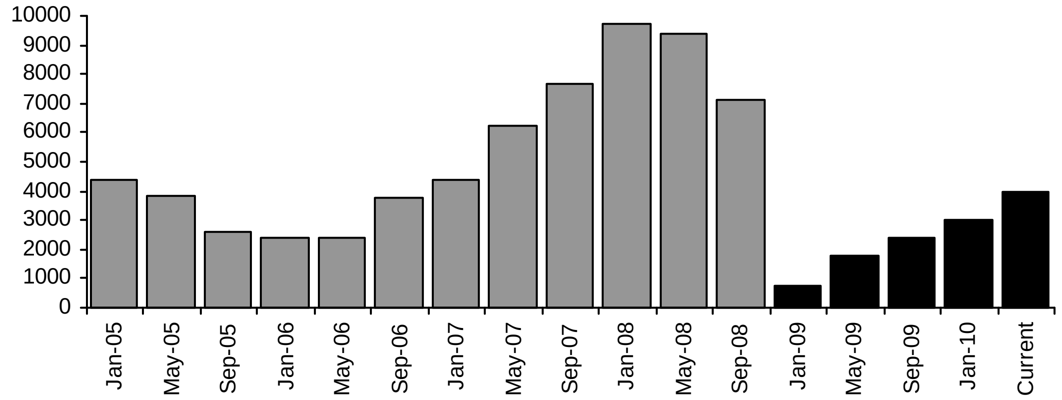
In 2010, western markets are characterized by unemployment, a transfer of massive private debt problems into a potential sovereign debt crisis and an urgent and critical need for institutions and households to deleverage. The policy forces that are driving recovery are gradually losing strength and the underlying financial forces remain weak. Confidence in western jurisdictions is plunging to a level not experienced since the Second World War. Economic and market indicators continually oscillate causing commentators to alternate between renewed optimism and despair. Most of the western world has now come to the end of an era of gradually reducing interest rates. Now there is nowhere else for rates to fall to; either they will remain flat or appreciate, which eliminates any rate-driven boost to the process of revival. As a result, prospects for recovery are still uncertain and world trade has understandably plummeted.

The Baltic Dry Index provides a daily assessment of the price of moving major raw materials and commodities around the globe by sea. Specifically, the index measures the demand for shipping capacity versus the supply of dry bulk carriers. It is independent and free of political spin or government influence and therefore cannot be massaged to serve narrow interests. The global demand for shipping varies with the amount of cargo that is being traded or moved in various markets. Given the supply of cargo ships is generally inelastic, the Index is viewed as a true measure of global trade and an empirical way of understanding what is really going on with the fundamentals of the industrial world.

The Index numbers clearly shows a sizeable rebound in world trade during 2009 and 2010, as shown on the following chart:



Putting the same series of numbers into a longer term context though puts the 2009 rebound into perspective, as shown on the following chart:



The pre-2009 Baltic Dry Index numbers are shown in grey and the 2009-2010 recovery is shown in black on the right side of the chart. This demonstrates in numbers how far global trade has plummeted since 2008. The recovery in the past 12 months is a source of optimism, but world trade is clearly still in the trough of a severe recession with a long way to go to catch up again with its previous heights.

Since the 2008 crisis, governments worldwide out of necessity continue to intervene with huge subsidies; in the west to prevent financial meltdown, and in the east, to bolster trade and try to combat the negative effects of slowing demand in western markets. In spite of substantial stimulus in emerging Asian markets, this is insufficient to compensate for the lost spending power of the western consumer. A robust 2009 Asian performance was driven by massive government stimulus in an increasingly divided China. In 2010, the Chinese central authorities are trying to cool their domestic market and reduce inflation risk. Depending on how enthusiastically this central directive is implemented by regional and local authorities, it remains to be seen how this will impact the rest of Asia in the second half of 2010 and into 2011.

The problems in the Eurozone that appeared in Q1 2010 are here to stay and will escalate. European solidarity is being severely tested and will be put under even further pressure over the next 18 months. The single currency experiment across such diversely different economies now seems unsustainable in its current format. Disagreement is fermenting and the risk of the European market splintering appears to be increasing. In addition to escalating volatility in the global market, the EU problems are driving investors into US treasury bills and gold as perceived 'safe havens.' This is also taking the spotlight away from the extraordinary build up of public debt in the USA which now appears to be mounting to 'Japan-style' proportions. Once problems in the EU are resolved one way or another, the focus of attention will likely return to US sovereign debt, which will lead to even greater instability and nervousness in world markets. Nobody really knows what will happen next. The chances of an immediate, strong, sustained recovery now look unlikely. More and more commentators now fix on the likelihood of a double dip or a prolonged drawn out western recovery with high deflationary risk. In the meantime, for how long will China remain as 'the last man standing' and keep churning out the good news for the benefit of the global market, and what happens if the Chinese economy sneezes?

Most of the world's traditional benchmark currencies: the Yen, Euro, US Dollar and Sterling now all look to be in varying stages of difficulty as a result of extraordinary fiscal imbalances. This problem is being exacerbated by the Chinese Yuan peg to the US Dollar and is spilling over into a number of emerging market currencies. In 2008, the dollar strengthened, in 2009, it weakened, and so far in 2010 it has strengthened again. The global market has never faced a problem of this magnitude or complexity before, so current high market volatility levels will be sustained and probably escalate. One of the side effects of currency instability is likely to be increasing global trade conflict either as jurisdictions seek advantage through currency manipulation or through tariff-based protectionism. Instead of providing a desperately needed boost to support recovery through further globalization, future policy will almost certainly achieve the opposite and slow down global growth.

Systemic Weakness Exposed

The 2007-8 crash, that western government neither understood nor thought ever likely to occur, generates its own staggering statistics. Surprisingly, many of the same generals who oversaw the crash have managed to retain their jobs and their credibility. Now they are charged with leading the recovery, which shows a worrying lack of understanding and leadership in western jurisdictions.

The initial political response to this crisis in Washington, London and other capital hubs was refutation of the existence of a problem and denial of responsibility. This stance was soon overtaken by fear and shock at the scale of the crash which resulted in a series of short-term knee jerk reactions. These were badly thought out, given that governments never really understood what was happening until it was too late and, as a result, they have continued to play catch-up ever since. This has set western economies on a track which has started out in the wrong direction and is extremely difficult to break free from. Instead of addressing the root of the problem, even partially, governments have embarked upon a series of reactionary quick-fixes and highly risky, untried, theoretical monetary experiments. High stakes indeed! The die is cast, resulting in a range of populist, one-size fits all policies that will stifle and delay the revival of market forces essential to recovery. Government's immediate aim is to maintain and hopefully boost confidence in both the markets and the population at large. So far this approach has only benefited short-term speculation whilst businesses, institutions and households continue to deleverage at the risk of deflation. These developments are bad news for western economies, but for savvy distressed investors, they continue to boost potential future opportunity.

At the heart of the intellectual conflict in the USA is the Federal Reserve and the concept of a central bank standing by and doing nothing whilst bubbles form. This is a contentious issue within academic circles, with much of the controversy stemming from the comments of Greenspan and Bernanke. They have asserted that central banks can do little to control bubbles; they can only clean up afterwards. They argue that instead of trying to contain a growing bubble by intervention with largely unpredictable consequences, they are better served by focusing on policies that mitigate the fall-out when it occurs. To most sensible business people this strategy is bizarre. Apart from moral hazard issues, and the licence to act irresponsibly that this bestows, the concept of directly fuelling a bubble through monetary policy, then standing by and watching it burst is absurd! The argument around non-intervention due to uncertainty smacks of dream-world. Every professional and most responsible individuals in the world face uncertainty when they make either everyday or big decisions. Uncertainty doesn't stop the Federal Reserve making decisions around targeting inflation. Maybe the crux of this problem is accountability: the Federal Reserve is comfortable making decisions around issues where it is more difficult to hold them responsible for the results. On subjects that have a direct influence on markets, they appear to believe that decisions should only be made when all other alternatives have evaporated, leaving no other choice. In other words, politics and fear of mistakes rules over economic results. This exposes a core deficiency: that central banks work best when independent from government, but not if they are driven by politics and fear of making errors.

Irrespective of the academic debate around intervention and decision making, how well has the Federal Reserve undertaken what they said they would do in cleaning up the bubble? The answer is discouraging, they haven't even started! This crisis was caused by a build up of extreme liquidity causing massive housing credit overcapacity, and until this is resolved the housing market cannot even begin to recover. They may claim that the scale of the crisis made strong action overly risky, but the Federal Reserve is the supreme monetary authority for the greatest nation on earth and the world should expect better! Instead of focussing on assets and markets, the Fed has bailed out banks and has sanctioned the removal of regulations that would have forced banks to value their toxic assets at something approaching real world values. Banks can now pretend their real estate assets are worth more than they really are, and now have no incentive to unload them, thereby freeing up their balance sheets for new lending. The Fed has purchased or guaranteed a mountain of toxic real estate backed securities which they intend to hold to maturity in order to avoid monetizing them with massive short to medium term losses. They have converted a now nationalized Fannie May and Freddie Mac into a mortgage asylum. This situation also prolongs the need for and cost of government support of distressed homeowners with negative equity as well as diminishing fiscal revenues and increasing public deficits. All these acts keep providing households, financial institutions and corporations with new incentives to behave in precisely the ways that contributed to the making of this crisis, and postpone the essential wreaking of creative destruction necessary to creating an autumn of falling leaves from which a new spring growth can take root. In summary, not only is the Fed's chosen policy position of cleaning up the mess afterwards contentious, but so far they have failed to implement it, all of which suggest that something is seriously wrong with their organization.

The current Fed policy is countercyclical and constitutes a complete break from procyclical policy patterns that have dominated western commerce, and upon which markets have operated for the past 80 years. So far in the aftermath of crisis, the Fed has saved the banking system in the wake of the Lehman bankruptcy, guaranteeing institutions, corporations and the money markets, sponsoring a rally in the equity markets, and assisting the banks left standing make a lucrative trading rebound. In its rush to prop up the financial system, it has rescued and continues to support both illiquid and insolvent institutions, and has created an artificial market for unwanted assets. In addition to providing liquidity and short-term debt they have also become the investor of last resort. In doing so, they have sent out a message to the markets, that they will do almost anything and everything to prevent the crisis spinning further out of control. The Fed should be given credit for this dramatic and unprecedented shift in central bank activity. However, nothing like this has ever been seen before, and it will undoubtedly have unintended consequences that have not yet unravelled.

In Europe, the core deficiencies of the Maastricht Treaty have been exposed by downturn, notably the lack of fiscal flexibility amongst Eurozone members to deal with economic crisis. A monetary union without fiscal union now appears to be increasingly untenable, and the fundamental underlying rules desperately need to be changed if the union is to avoid collapse. The EU has been substantially less pro-active in its efforts to mitigate the effect of crisis by comparison with the US, and has monumental problems achieving consensus and unity of action amongst its different member states.

A number of jurisdictions have blamed the USA for the global contagion in 2009 which saw world economic activity plummet at a rate not seen since the Great Depression. The USA has also tried to deflect the blame for the huge US current account deficit, by Bernanke claiming that Asians save too much. Both of these criticisms are unfair. The credit bubble that occurred in the USA that caused the current downturn also occurred in other parts of the world, most notable in Europe, and when the USA crashed, Europe followed. Regarding the savings glut hypotheses, this is tantamount to blaming Columbian drug cartels for Americans coke habits. There is a clear relationship, but the truth is a lot more complicated, with the underlying dependency emanating from the USA.

When times are good, neighbours tend to get on well whilst divisions and disputes tend to appear at times of stress. The international community follows a similar pattern. For most of the post Second World War era, the USA has done more or less what it wants without worrying too much about its neighbours. Now the USA is imploring other countries to align with them in order to avoid harmful shocks to their fragile domestic markets, and finds itself a hostage to Chinese monetary policy. Future international relations will likely be characterized by economic coercion and further chaos, exacerbated by a global market under the control of individual national governments and regulators, with different jurisdictions now scrambling over one another in the best interests of their own individual economies, oblivious as to who else they damage or whether they are working against each other.

Increasing policy conflict will continue to escalate amongst the G-20 nations. The last G-20 summit in 2009 focussed on bank regulations to prevent a reoccurrence of 2008. The current summit in Toronto has taken a step backwards, and is focussed on the need for governments to keep bailing out their economies to prevent them sliding into another recession. In a letter dated June 16th 2010 to his G-20 counterparts, President Obama urged a focus on economic growth saying order to public finances should be restored in the "medium term." In other words, the US economy is still too weak, and will continue needing bail-outs and new money printing for the foreseeable future in order to stop it plunging into a deflationary spiral. Germany, on the other hand, is openly opposed to this approach, even though it is clearly necessary for some members of the Eurozone. Their finance minister responded to the USA by saying that "nobody can dispute that excessive public debts are one of the main causes of this crisis. That's why they have to be reduced." In other words the German balance sheet is in much better condition than the USA and the rest of Europe and the German taxpayer is opposed to the idea of continuing to bail out the European basket cases as they will end up footing the bill! This clearly highlights the difficulty of finding a common solution within a formal monetary union. If this is difficult for the Eurozone, what chance is there for the G-20 group of independent nations or the rest of the world?

Opportunity in Asia

Historically, advanced economies have tended to run surpluses, whilst emerging markets like those in Asia ran deficits. The accumulated western surplus would end up being invested in emerging economies. This flow of capital increased significantly over the last quarter of the 20th Century. After the shock of 1997 though, Asia deleveraged, cleaned up its balance sheet, and radically adjusted its trade, credit, financial and fiscal policies and the spending habits of its consumers. This coincided with western consumers, institutions and corporations dramatically increasing consumption, fuelled by low interest rates and lax credit. Extreme leverage and moral hazard engulfed common sense whilst western governments either didn't notice or looked the other way. The end result is extraordinary, and back in 1997, would have seemed unimaginable. Within a decade the world has been turned upside down. The West crashed whilst Asia appears to continue booming. Capital flows have reversed, and excess Asian capital is now invested in mature markets, with the world's investment playing field suddenly and spectacularly levelling out. The traditional investment approach of finding cheap, underdeveloped investments in emerging Asian markets may now be an anachronism. Most technology has already been transferred, and absent new financial crises, the only reason for westerners investing in emerging markets in the future may be limited to demographic plays. Given the enormity and speed of change, second guessing where the world will be in the next decade will likely be more difficult than the last. It is worth remembering that 200 years ago, China and India combined accounted for the best part of 50% of world GDP, so maybe what we are witnessing now is a natural reversion towards the norm.

The concept of third party investors purchasing portfolios of distressed debt from financial institutions took off after the US Saving and Loans Crisis in the late 1980s. The technology developed from this initiative was exported through Japan in the 1990s to the rest of Asia after their 1997 Crisis, with the USA championing the critical need for Asian economies to quickly deleverage in order to stimulate recovery. For distressed debt investors this represented a huge lucrative opportunity, some of whom were extremely successful, producing outsized returns. After the last US crisis and then Asia 1997, successful distressed debt investment and post-crisis economic revival became synonymous.

The response to the 1997 Asian Crisis is now especially pertinent to the current western downturn, as it provides an opportunity to compare the relative recovery performance of different jurisdictions according to how quickly and comprehensively they deleveraged. Generally in Asia, there was a persistent resistance to undertake fundamental legal and regulatory reform which only served to delay recovery. It was also apparent that waiting for banks to fix themselves using market forces alone would be far too slow. Government intervention in theses areas was critical, and the jurisdictions in which this occurred quickly, recovered first and rebounded strongest. Markets within jurisdictions that postponed deleveraging and recycling of real estate assets effectively went into hibernation until assets were monetized and were the last to rebound. Western jurisdictions should take heed now!

Since 1997 Asian banks have grown accustomed to, and realized the benefits of selling non-performing loans, and there has been a steady flow of transactions throughout the last decade. The technology transfer that occurred after 1997 has also seen the establishment of domestic loan servicing operations. A secondary trading market for distressed debt has been slow to develop outside the main commercial hubs.

In the wake of the post-1997 distressed debt investors, new waves of western inbound cash flooded into Asia at all levels of the capital structure until 2007. Since 2008, investment has increasingly been restricted to short-term 'hot money' and carry trade forays into the more liquid speculative markets. Investors have been particularly attracted to Asian ex-Japan jurisdictions as a result of current account surpluses, low public debt, high reserves, robust manufacturing sectors, low unemployment and healthy financial sectors.

Asia now currently separates into two clear economic divisions: Japan, which is following similar troubled trends to western markets, whilst the remainder of the region has so far largely avoided major problems in their economies.

Opportunity in Asia: Japan

Japan has been in recession for most of the last twenty years, with according to western leaders “a unique set of problems in the world.” The difficulties of the 1990s, insolvent banks and corporations kept alive as zombies as a result of regulators looking the other way, and use of creative accounting techniques is remarkably similar to the USA today. Japan has only survived without a major fiscal crisis as a result of printing extraordinarily high amounts of public debt, financed cheaply by its owns citizens savings which has created an artificiality low bond yield spread. Public debt has increased steadily each year since 1991 and in 2010 it surpassed the 200% GDP mark. The negative effects of high public debt have been counteracted to some extent by a positive trade balance with current account surplus.

The amount of distressed debt held by Japanese banks markedly declined after 2002, rising again in 2008 due to the financial crisis. Debt-deflation reappeared in 2009 and the risk of continuing deflation for the foreseeable future is high. Persistent deflation, high public deficits and weak growth are discouraging for investors. Under such circumstances distressed debt will lose value which limits the venture appeal of the Japanese distressed sector and the likelihood of purchasing debt portfolios at realistic levels, with upside potential.

Opportunity in Asia: China

China was one of the few major economies not to fall into a major recession in 2009. Growth was maintained at a plus 8% trajectory through a USD 600 billion stimulus programme, which not only boosted Chinese productivity, but most of its Asia Pacific supply markets too. In a manner reminiscent of a giant Ponzi scheme, government-owned banks were ordered to provide huge amounts of credit to state-owned enterprises in order to encourage them to hire more workers, produce more goods, stockpile more commodities and increase capacity, even though a glut already existed in many of these areas. Other credit flooding through China is going towards other unproductive uses such as speculation in commodities, equities and property. The Chinese economy still has a long way to go to transfer from the existing export-driven model to a new badly needed domestic demand-driven model, and it remains to be seen how well current growth levels can be maintained whilst this transition progresses.

In line with international practice Chinese banks are encouraged to offload bad loans from their loan books. However, banks are generally required to only sell impaired loans to a number of state-owned Asset Management Companies (AMCs) who effectively act as wholesalers. Commercially, this system fails because AMCs purchase loans at unjustifiably high prices, which makes it difficult to then sell them on to investors at realistic pricing levels.

In addition to this difficulty, distressed debt law in China is unclear and heavily favours the debtor, particularly if it is a state-owned enterprise. There are also unresolved issues and uncertainties around guarantor laws that need to be determined. Even though China has great promise as one of the largest distressed loan markets in Asia, it is increasingly difficult for foreign investors to operate there profitably, and few see the point of considering it further as long as the system is so heavily slanted against them. Given the prevailing influence of government owned AMCs, there is also limited opportunity for foreign entities in loan servicing.

Opportunity in the rest of Asia

Since the millennium, sale of non-performing loans (NPLs) has become commonplace throughout the region. New markets such as India have also opened up during this time. Given the strong growth of Asia, distressed debt sales have tended to be more strategic, frequently occurring as a result of consolidation or takeover in the banking sector. Asian banks are generally in much better condition than western institutions, so sales have been conducted on an orderly liquidation process with higher seller expectations. In parallel with the emergence of domestic servicing operations, NPL purchases have increasingly been dominated by local players, who have lower risk return requirements than their international counterparts, and will generally outbid them.

Logically, given the 2008 crisis, there should be more new non-performing loans (NPLs) appearing for sale, but so far this has not yet materialized. At the same time, potential buyers have become choosier and more risk averse, leading to an increasing valuation and price gap between sellers expectations and buyers targets. Where transactions have been consummated more recently, these have tended to be undertaken on softer terms with structured payment schemes or profit-sharing agreements.

Unless there is another financial crisis or major event, this situation looks likely to prevail for the foreseeable future. Some investors have been anticipating an increase in product availability as the full effects of the implementation of Basel II come into play. However, it remains to be seen how this will play out internationally now, given the attention that the regulatory area is now receiving in the light of western recession, and the current illiquidity of many western financial institutions.

Opportunity in North America

The lessons of the US Saving and Loans Crisis and the 1997 Asian Crisis are clear. In order for real estate markets to be arrested from free-fall, deleveraging and monetization of bad assets has to occur. This creates renewed market confidence and a new firm foundation for growth from which recovery can begin. Given the extraordinary scale of this downturn in the USA, the process of liquidating distressed assets should by now be creating a huge abundance of opportunity as a precursor to recovery, but this has not yet occurred.

Elsewhere in North America, Canada has neither experienced a real estate nor banking crisis whilst property values have reverted to growth again in the past year. The major risk facing Canadian real estate is continuing falling prices south of the border ultimately reaching such disparity that it causes a future correction in Canada.

Steps so far taken by the US government are extreme and unprecedented. In addition to more traditional remedies like stimulus plans, tax cuts, state and infrastructure spending, the government has bailed out banks, businesses and changed state guarantee regulations. They have purchased securities, bonds and equities. They have undertaken stress tests on banks, marking their impaired balance sheets to cost rather than current real world value, in spite of history showing many times that protecting a bad bank prevents the establishment of a future good bank. So far, they have not yet properly addressed the most critical area, the real estate markets. Action taken in the property sector has concentrated on subsidy and relaxing regulations in order to manage a soft landing, with the likely outcome a situation with large sections of real estate backed debt suspended in cryogenic animation for the foreseeable future. This is bad for the property market, the US economy and alters opportunity dynamics for distressed debt investment.

The critical decisions that have set the US economy on its current track were made during October and November 2008, when the government abandoned their original plan to invest in bad debts. Instead, they chose to invest in banks in order to shore up their balance sheets. From their actions, it appears that the administration understood the critical importance of monetizing bad assets and wanted to undertake the necessary clean-up. However, as they investigated it further, they realized that the scale of the crisis was staggering. Politically, the extent of the problem was indefensible, and as a result, short-term political expediency took precedent over critical, bold, socially unpopular steps essential to engineering the earliest possible recovery.

Attempts at creating a cohesive policy to spearhead recovery have been slowed down by infighting, not only between political parties but amongst different branches of US government and their advisors. This problem is most clearly exemplified in President Obama's Georgetown 'bang for your buck' speech of April 2009. With reference to the Troubled Assets Relief Programme (TARP), he says "history has shown repeatedly that when nations do not take early and aggressive action to get credit flowing again, they have crises that last years and years instead of months and months: years of low growth, years of low job creation, years of low investment, all of which cost these nations far more than a course of bold, upfront action." He continues to say "there are a lot of Americans who understandably think that government money would be better spent going directly to families and businesses instead of to banks. But the truth is that a dollar of capital in a bank can actually result in eight or ten dollars of loans to families and businesses. So that's a multiplier effect that can ultimately lead to a faster pace of economic growth. That's why we have to fix the banks." The President's statements were counteracted by the Federal Reserve in July 2009 when they reported that the goal of the cash injection into the banks was not to encourage new lending, but to mitigate the effects of disruption in the interbank market. By lending banks more money and also paying them interest on the reserves they held, the Fed believes it will be able to control inflation through the money multiplier effect. The Fed's aim was to increase confidence through liquidity whilst ensuring the excess liquidity remained trapped in the banks, which is diametrically opposed to what the President believed to be the case. Unsurprisingly, Obama's dream of a credit-driven return to economic growth shows little sign of materializing.

The time for sharp, short, harsh action that would cause a seismic shock to the system and short-term hardship leading to early recovery, is long past. The US government seems to be backing one horse only in its efforts to recover from the current crisis and restore the economy to growth. Returning again to the Georgetown speech, Obama said "Governments should practice the same principle as doctors: First, do no harm. So rest assured, we will do whatever is necessary to get credit flowing again, but we will do so in ways that minimize risks to taxpayers and to the broader economy." In other words, there will be no painful, short-term fixes. This crisis will take a long time to repair which will necessitate years of soft, quantative easing and money printing. As a result, public debt has reached extraordinary levels, to the extent that if the USA were an emerging market it would have experienced a collapse of confidence in its debt and currency a long time ago. Now, there are only two realistic ways of reducing the debt: either through default or by the academics in the Fed using monetary policy to turn on the inflation taps. Then as long as the rate of inflation is higher than the 30-year bond rate, the debt will be inflated away.

The Federal Deposit Insurance Corporation (FDIC) is currently the principal seller of assets of failed financial institutions in the USA. Given current economic conditions, the process of bad asset monetization will likely escalate in the foreseeable future. It is estimated that in excess of USD 1.4 trillion of commercial mortgages will mature in the next few years, a significant proportion of which are under-collateralized. According to official numbers, bank NPLs are somewhere between 5% and 6% of their loan books. This is after the Financial Accounting Standards Board (FASB) changing its mark-to-market accounting standards in April 2009, so the real percentage of distressed loans on bank books is probably much higher. At some time in the foreseeable future, it seems inevitable that a large supply of distressed debt will have to be sold.

So far, monetization of distressed assets held in securitization vehicles such as Commercial Mortgage-backed Securities (CMBS) and Residential Mortgage-backed Securities (RMBS) has been muted. Fund Managers, through their fee structure, are not incentivized to pursue foreclosure as default levels and redemptions trigger substantial fee reductions. Fund Managers have preferred to adopt delaying tactics through an 'amend and extend' approach, which has been facilitated by continuing low interest rates. Where special servicers have been appointed to deal with distressed assets, they are, on the other hand, incentivized through their fee structures to accelerate foreclosures. Their 'slash and burn' approach has in cases resulted in achieving some exceptionally low fire sale prices, which has tended to further reinforce the adoption of 'amend and extend' strategies by Fund Managers and banks.

According to the Wall Street Journal, sales of distressed debt have been falling since 2007 as banks try to avoid losses from write-offs that wipe out their earnings or erode capital. In 2007, USD 557 Billion of commercial real estate transactions occurred compared with USD 181 billion in 2008, and USD 54 billion in 2009. Banks seem particularly concerned about selling into a declining market that will further erode the value of their balance sheet, and are currently disincentivized from taking losses on their loan books. Interested investors now quote pricing as the biggest obstacle to executing new transactions.

The traditional monetary theory that low interest rates and a steeper yield curve triggers demand for loan growth has been proven to be a fallacy by this recession. The Fed's own statistics clearly show that demand for credit is contracting as deleveraging continues. Traditional monetary theory does not work in a balance sheet recession. The main beneficiaries of the current artificially steep yield curve are the banks. They are able to pay next to nothing for deposits whilst investing that capital at vastly higher rates in the bond market. This provides banks with substantial profits without having to take credit risk and assists them prioritize the rebuilding of their depleted balance sheets.

Despite all the infusions of cash or creation of government guarantees, US banks continue to perform badly in 2010. According to FDIC data mid-sized banks are suffering most, whilst big banks continue to grow bigger and take a larger market share. From the data, the TARP money seems to have had no effect upon bank capital or bank lending activity. Lending and earnings overall continue to decline, with most of the earnings gains from larger banks coming from trading activities. Overall, it seems only a matter of time before the US government is forced to resurrect a modern day equivalent of the Resolution Trust Company, and the distressed debt clean up opportunity can then begin in earnest.

A recent Ernst & Young survey of US investments funds, private equity, institutional investors and developers showed that during 2009, 60% of distressed debt investors surveyed had bid on portfolios with only 17% consummating transactions. This suggests that there are a lot of potential investors in the market, but bid-ask spreads may still be an impediment. The survey also identified investors return requirements between 16% and 25% with leverage ratio at between 50% and 60% of purchase price. The ideal transaction size for the majority of investors is between USD50 million and USD500 million.

Performing Loan Servicing and Special Servicing expertise developed out of the US Saving and Loans Crisis and subsequently grew exponentially, driven by rapidly improving technology. Whist not leveraged at the corporate level, servicers tend to have a high natural gearing to markets and can be affected disproportionally in a downturn. Since the 2007-8 Crisis, a combination of sharply falling markets and redemptions has produced an average 30% to 50% decline in business volume. For some servicers, fees for special events, sub-standard loans or modifications have lessened the impact of falling income. For servicers tied to financial institutions, those that are under financial pressure may see divestment of their asset management entity as a means of raising additional cash. For those tied to healthy institutions with strong balance sheets, cash flow, and access to debt, the downturn may open doors to increased market share.

Generally, the loan servicing industry has shown itself to be more robust than financial institutions over the past two years. It now remains to be seen what influence regulatory reform will have upon the servicing industry, but given servicers are not principal investors, this will likely be muted. It is possible that even though they do not have assets on their balance sheets, they may be subject to new capital requirements. Servicers will likely find greater call for more detailed information, risk and transparency, and there may be a flight to quality, based on the servicer's ability to enhance risk management and/or returns through increased efficiency and better understanding of investor strategies. Increases in taxes will probably reduce investor returns which may further squeeze servicer operating margins.

Overall, government's cryogenic policies towards distressed real estate backed loans and new initiatives, such as Home Affordable Modification programmes (HAMP), benefit the loan servicing industry by sustaining fee volumes for the foreseeable future. Servicers also benefit from priority in payment waterfalls. Given the pace of new distressed opportunity in the USA is likely to progress slowly, distressed investors might be better off in the short term investing in servicing entities that provide a better insight into the market and open up opportunities for future direct investment in assets.

Opportunity in Europe

Europe is in danger of falling apart at the seams. Things may not look so good in the USA, but the Eurozone seems a lot worse. The European monetary union is still in its infancy, or experimental stage. The concept of a currency union without fiscal and political union is a new concept that creates ambiguities and has no successful precedent. What is more, the original treaty parameters were not designed with a downturn of the current scale in mind.

The primary monetary authority is the European Central Bank (ECB), whose culture is modelled on the German Bundesbank, an institution with a strong track record in combating inflation. The monetary policy of the union is managed by the ECB and the European System of Central Banks (ESCB) which comprises the central banks of the EU states that have joined the Eurozone. Since inception, the credibility and legitimacy of the ECB has been put into question by the lack of an EU level fiscal authority counterpart. The primary means for fiscal coordination lies in the Broad Economic Policy Guidelines which are written for every member state, but with particular reference to the members of the Eurozone. In order to assure the stability of the Euro members have to respect the Stability and Growth Pact (SGP), which identifies agreed limits on national debt and budget deficits, currently set at 3% of GDP. The original theory was for member states to undertake structural reforms, and align themselves with other countries on economic performance, productivity and labour costs in order to remain properly balanced with universal interest and currency rates fixed by the ECB.

Implementation of this fundamental economic alignment issue has been wretched. Interest rates for the Euro were initially set artificially low in line with the Deutschemark, which meant that rates fell sharply for most new members. Instead of taking the necessary steps to implement economic reform, a number of states have used their membership of the union to borrow more at cheap rates and consume more than they otherwise would have been able to do. Instead of improving their competitiveness they have allowed wages to rise and failed to invest further in increased productivity. As long as these imbalances were prolonged, universal interest and currency rates stoked up the disparity further, leading to spiralling overcapacity and inequality. Germany and a few other countries have spent a decade reducing their fiscal imbalances and improving competitiveness through corporate restructuring. In Portugal, Italy, Greece and Spain (PIGS), the opposite has happened where fiscal imbalances increased, and labour costs rose above productivity growth. The dramatic appreciation of the Euro in 2008-9 increased their loss of competitive edge, leaving them ever more vulnerable to default which is now clearly evident in widening sovereign debt yield spreads.

The scale of the current debacle that the Eurozone now finds itself in was in part caused by the negative impact of the IT bubble on the German economy in 2003. Germany had fallen into a classic balance sheet recession after the IT bubble as business and households aggressively deleveraged. The ECB was obliged to intervene given that Germany is the largest member of the union, and weakness in the largest member would have undermined confidence in the union as a whole. The best way of offsetting the German recession would have been through additional public spending, in order to offset the negative effect of private savings being withdrawn from the money supply. Unfortunately Germany was prevented from doing this by the SGP cap of 3% of GDP. As an alternative, the ECB chose to lower interest rates, which further lowered credit costs for the PIGS, sharply increasing spending power for their governments, business and the population at large, which fostered overcapacity and even greater asset bubbles. German exports then became the major beneficiary of increased money supply in other EU states and the resultant boom in exports lifted Germany out of recession.

The German balance sheet depression also had other consequences that are now coming home to roost. After the IT bubble burst, demand for loans in the domestic market disintegrated, so German banks looked abroad, with the most natural markets being union partners. As a result, German banks ended up making extensive loans to the PIGS, to Eastern Europe and also purchased huge amounts of toxic securities from the USA. The net result for the PIGS, was to drive a number of them into a new balance sheet recession of their own. In addition to this, the PIGS now find themselves heavily indebted to banks in Germany, which further compounds the ability of the union to unwind the consequences of financial crisis. The constraints of the Maastricht treaty have ended up forcing Germany into financing the PIGs and simultaneously increasing exports to them, which has interesting parallels with China supplying the USA with the monetary rope it used to hang itself with. Unforeseen episodes like these raise the question of the extent to which the world is really prepared and able to cope with globalization in the IT age?

In addition to showing up the inadequacies of SGP, this episode also demonstrates that when fiscal policy is left in the hands of individual countries, it limits the degree to which one nation can help another. The critical problem the union is facing now is what to do next now the SGP is blown out of the water, given it doesn't work in current economic conditions, and as a result of its inadequacy, we effectively now have two Europes instead of one. European states are now so financially depleted, that some are now even reneging on third world poverty commitments. In the meantime, the ECB can continue to afford to bail out smaller jurisdictions like Greece or Ireland, but a larger jurisdiction like Spain going into similar distress would likely be too much for the system to carry.

The Eurozone now looks hopelessly divided between the 'fiscally responsible' German camp, and on the other hand, the so-called Club-Med 'basket cases.' Germany is, perhaps unfairly, now demanding that all members of the Eurozone reduce their public debt and budget deficits with austerity measures that will likely push the PIGS and others further into a deflationary spiral. In the absence of monetary and exchange rate flexibility, bringing all members of the union into fiscal line looks virtually impossible. Germany is in a no-win situation given that much of the PIGS debt is held by German banks with the German taxpayer on the hook for a disproportional amount of the PIGS bill. On top of this, 65% of German exports go to other countries in Europe so austerity measures will ultimately damage their balance of payments too. On June 23rd 2010, George Soros said "Unless Germany changes policy, its withdrawal from the currency union would be helpful for the rest of Europe. At the moment Germany is pushing its neighbours into debt-deflation: this threatens a long phase of stagnation, leading to nationalism, social unrest, and xenophobia. It endangers democracy."

A number of commentators have suggested that countries like Greece might be forced to leave the Eurozone as its current debt burden is now unsustainable, and it has been caught seeking to manipulate its numbers in order to hide problems from EU partners. Departure will not happen easily though as there is no legal mechanism to eject any member. Any exodus would have to be voluntary and would require enormous preparation in order to convert back from the Euro. For a country like Greece to leave the Eurozone of its own volition makes no sense, given the ECB continues to bail it out, and it can still borrow money at cheaper rates. If Greece were ever to leave the Euro and return to its old currency the drachma would likely collapse to a fraction of the Euro and its borrowing costs would explode. Given Greece's public debt is denominated in Euros, devaluation back to the Drachma would instantly increase the scale of public debt many-fold to unimaginable proportions that would be immediately defaulted on.

A more logical scenario is Germany voluntarily leaving the Eurozone and returning to the Deutschemark, which would probably immediately take over from and trade at similar current levels to the Euro. The value of the Euro would then probably collapse to a fraction of its current value against the Deutschemark and other world currencies. This would immediately reduce the cost of both public and private debt in those countries remaining in the Euro to manageable proportions, as well as making them significantly more competitive in world trade. In this scenario, a splintered Eurozone might well see Europe move out of recession and recover first.

European countries outside the Eurozone, such as the UK or the Scandinavian countries, have the advantage of being able to adjust their own currency and interest rates in response to downturn against the Euro and other world currencies. History has shown that competitive devaluation is the most effective way of escaping from recession and returning to growth. Given the current impasse in the Eurozone, and the fact that the US dollar is still largely pegged to the Chinese Yuan, countries like the UK should in theory be able to commence recovery earliest, provided their new government can manage monetary tightening and timing competently.

During the credit boom, European banks were equally reckless as their US counterparts in fuelling a debt bubble. By June 2008 the leverage ratios at European banks had peaked. Credit Suisse was leveraged at 33:1, ING at 49:1, Deutsche 53:1 and Barclays at 61:1. European banks had joined the feeding frenzy of financing loans and securitizing them, leaving them in possession of huge amounts of toxic securities when the sub-prime crisis hit the USA. Assets within these securities were spread all over Europe. In addition, European banks were heavily invested in Eastern Europe, particularly Latvia, Hungary, Ukraine and Bulgaria. The formula in Europe was identical to the USA: high leverage, reckless enthusiasm for high-risk assets and financial innovation.

The deleveraging process in most of Europe is now occurring at similar slow pace to that in the USA. So far the EU has committed USD4 trillion in the shape of guarantee umbrellas, risk shields and recapitalization measures for the financial sector. One of the features that differentiates the EU from jurisdictions like the USA is the need to ensure that impaired assets are valued fairly by different jurisdictions and no-one ‘cheats.’ The EU subsidy is distributed through individual states and can take the shape of either a guarantee scheme or a ‘bad bank’ AMC type structure. A huge problem in the making is the artificially high prices that AMCs appear to be paying to banks for the assets. Given that real estate markets will continue to slide, this will make it almost impossible for AMCs to cut deals at economic levels. Once the penny drops, the AMCs will become protective and negative, and probably procrastinate further as a means of delaying the inevitable and accepting blame for mistakes. Overall, assets already transferred or guaranteed under existing EU subsidies, may possibly be held in cryogenic suspension for a number of years.

So far, only the largest blocks of assets or biggest borrowers have been processed through the EU subsidy umbrella, equivalent to between 10% and 20% of bank NPLs. It is estimated in Brussels that a further USD16 trillion of bad loans still remains on bank balance sheets. Similar to the situation in the USA, EU banks are concerned about selling into a declining market that will further erode the value of their balance sheet, which for now is making it difficult for interested investors to execute new transactions at realistic levels.

The UK has largely followed the USA in terms of the development of the distressed debt industry. Mainland Europe started attracting significant investor interest in 2003, when German banks started to clean up their balance sheets through asset disposals. From Germany, the distressed debt industry gained footholds in jurisdictions including Italy, Poland, Czech Republic, Turkey, Austria, Spain and Portugal. Given the late development of the distressed sector in mainland Europe, servicing expertise is a long way behind the US model and is a continuing challenge to new investors. This shortage is reflected by the necessity of assets already transferred under EU state subsidy or guarantee plans continuing to be serviced by the originating institution. Looking forwards, with the new waves of distressed debt in need of monetization in the foreseeable future, there is likely to be a shortage of servicing expertise and resources.

The Sweet Spot

Whist originally dubbed a ‘global financial crisis’, it is apparent so far that regions of the world have been affected differently, both in terms of scale of downturn and their relative position within market cycles. Ultimately, the ripple effect will reach every corner of the globe at different times and often in unseen ways. In Asia, the Japanese population appears to have accepted an era of entrenched long-term deflation. With extraordinary levels of public debt and an ageing population, it is questionable whether the political will exists to painfully engineer desperately needed inflation within this generation.

The Chinese juggernaut continues to steam relentlessly forwards as an increasingly large engine of consumption. At some time it will need to correct, but how this manifests itself remains to be seen. The rest of Asia believes it has escaped the worst of the global financial crisis, and will likely continue to trundle on as long as China avoids correction. The USA is now in the eye of the storm. It needs to keep walking the tightrope of additional stimulus versus fiscal tightening for longer than previously imagined, and ultimately turn its monetary theories into hard economic results and recovery. It is not yet clear how Europe can pull itself together cohesively and find mutually acceptable solutions for disparate jurisdictions to bring them all out of recession. At the present moment, this looks extremely unlikely with the risk of the monetary union breaking up still high. If the EU was to splinter or China was to correct, then the world could easily slip into another recession, with many governments having already used up their ammunition the first time round.

In summary, the world is still in recession, but the worst now seems to be behind us. An immediate recovery is unlikely, as is another cataclysmic double dip. Most likely is that the markets will trundle along for the next twelve months with alternating good and bad news, whilst some of the macro-plays described above unravel, and public debt continues to build up. Looking beyond twelve months is difficult. In the meantime, uncertainty and volatility will dominate speculative markets. Some commentators argue over the likelihood of a "Japan-style' deflationary scenario for western markets, though in the event this did occur, it is likely that the response of western governments would be more proactive than the Japanese during its 'lost decade.'

The current weak economic environment will give rise to exceptional returns in distressed assets, with ongoing volatility and uncertainty potentially adding to valuation and pricing arbitrage opportunities. The greatest challenge appears to be timing in a market where asset values appear to be continuing to decline, whilst waiting for sellers to release larger amounts of product into the market. These issues are interconnected, as the release of a large supply of assets at discounted prices will likely arrest price declines and create market confidence for a new growth cycle. Given these uncertainties, there are advantages in being both an asset investor and an asset manager at this immediate time.

Returning to the theme of the conditions for hitting the sweet spot for distressed debt investment:

- **Low, entry pricing as a result of large amounts of supply in need of liquidation**
- **Successful execution proportional to servicing competence**
- **Proximity to the bottom of the market cycle**
- **A strong sustained upturn in economic conditions**
- **Jurisdictional Arbitrage – transparency, legal effectiveness, etc.**

Using this formula, assessing relative opportunity in different parts of the world tables as follows:

Global Region	Supply of NPLs & assets	Servicers ability	Position in Market Cycle	Economic Rebound	Jurisdictional Arbitrage
Asia- Japan	Increasing	Competent	Neutral	Limited	Low
Asia- China	Increasing	Poor	Promising	Limited	Very high
Rest of Asia	Limited	Average	Negative	Limited	High
North America	Increasing	V competent	Promising	Good potential	Low
Europe	Increasing	Limited supply	Promising	Best potential	Low

Note: Cells shaded green indicate best prospects, cells shaded yellow have medium prospects, and cells shaded pink have the weakest prospects.

Using the above formula, the regions with the greatest potential for high distressed sector returns are North America and Europe.

North America (USA)

- **Huge supply of distressed assets held by government, institutions and individuals**
- **A robust, competent, experienced servicing industry. Continuing downturn may create opportunities to purchase servicing entities which could increase market insight for investors and might open up additional buying opportunities**
- **Real estate markets continue to decline and are now close to the bottom of the cycle**
- **Good potential for economic rebound. Key indicators are unemployment rates and new bank lending**
- **Fully transparent, well organized distressed debt market, with competent professionals**

Europe

- **Big supply of distressed assets held by government, institutions and individuals. Assets may well hit the market earlier than the USA due to disagreement within the EU and monetary policy issues in the Eurozone**
- **A limited servicing industry. Opportunities exists to import new servicing entities into the region in order to take over asset management of debt covered by the existing EU state managed subsidy umbrella. Servicing entities with access to capital would be particularly interesting**
- **Real estate markets continue to decline and are now close to the bottom of the cycle**
- **Potential for earlier economic rebound in the event the Eurozone splinters with additional valuation and pricing arbitrage in different jurisdictions**
- **Transparency, organization and professionalism varies in different jurisdictions**

Distressed Debt investors should be gearing up and preparing themselves for this opportunity now!

Distressed Debt: Hitting the Sweet Spot

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