IMFSURVEY

Interview with Manmohan Singh

Dealing in distress? Understanding the market for distressed debt

Capitalism without default would be like religion without sin. Countries and corporations have erred a lot in recent years, judging by the huge supply of defaulted or distressed assets. Surprisingly, there is also a healthy demand for these assets. Is this demand an attempt to feed off the distress of countries and corporations or does it offer them a chance of redemption? Manmohan Singh, an economist in the IMF's International Capital Markets Department, talks to Prakash Loungani of the IMF Survey *about how the market for distressed assets works.*

IMF Survey: What is a distressed asset?

Singh: It means that the asset holder or lender is not getting the income stream he was supposed to get. Either the corporation or the country has defaulted outright or some payment is being made, but below the agreed rate—that's called a subperforming asset.

IMF Survey: It seems odd that there's a healthy market in distressed assets.

Singh: Not really. Think of what happens when, let's say, people don't pay a hospital bill. After a few reminders, the hospital may turn it over to a collection agency. The hospital doesn't have the time or resources or the professional expertise to figure out why you haven't paid. But the collection agency specializes in this task. Or think of the market for junk cars. Some people buy junk cars and specialize in repairing them and selling them for a higher price than the often ridiculously low price for which they bought them. So where you and I may see a wreck, these specialists might see some recovery value.

IMF Survey: OK, so let's think of it as a market. Who are the sellers in the market for distressed assets?

Singh: Often the sellers are pension funds and insurance companies. They are required by law to classify an asset as nonperforming when the original terms are not being honored by the borrower. Moreover, these companies then have to allocate some extra capital to shield themselves against the possible losses from such nonperforming assets. That makes it expensive to hold on to distressed assets. So they tend to sell them off. And that's the time when sometimes these assets are sold below their intrinsic value because it's being done under regulatory pressure. Sometimes the holders of these assets do not have the expertise to assess their quality. So the fact that payments have been missed is enough to make them want to sell, particularly if they see that others in the market are also selling.

IMF Survey: Who are the buyers of these assets?

Singh: There are many different types of buyers, but one important class is "high net worth individuals"—also known as "very rich people." It is tempting to portray them as vultures feeding off other people's distress, and indeed there are times when some of them do behave that way. But remember that these buyers also provide a floor for the price of the distressed asset; their demand keeps the price from sinking to zero. Distressed-debt traders have played this role in recent years in Ukraine, Moldova, Brazil, and Uruguay, as well as in some of the Asian crisis countries.

IMF Survey: Aren't these individuals subject to the same regulations as the pension funds or insurance companies?

Singh: No, because they are risking their own money, not other people's. In fact, that's how the market started. In the aftermath of the debt crisis of the 1980s, there was a lot of distressed sovereign debt floating around but U.S. banks were constrained by regulations on how much of it they could hold. So some high net worth individuals purchased this debt on the cheap.

The behavior of pension funds and mutual funds is also constrained because they often have to generate returns that track some broad market index. But

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—Manmohan Singh

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
October 25	2.06	2.06	3.17
November 1	2.09	2.09	3.22

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website *(www.imf.org/cgi-shl/bur.pl?2004)*.

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investors in distressed assets are not bound by these rules. They have patience. They have deep pockets. And you need both because often these cases can be tied up in litigation for years.

IMF Survey: **So do investors in distressed assets end up making any money?**
Singh: In the market for distressed *sovereign* debt they often do, particularly if they resort to litigation. While the number of cases is admittedly small, I've found that the returns to investors in emerging market distressed debt cases have been over 50 percent a year and sometimes as high as 300 percent a year. Remember that investors buy some of this debt at only 5 or 10 percent of the face value of the asset. Then they use the courts to press for full recovery of the asset value. So the returns can be very high.

IMF Survey: **Does this explain why we sometimes see the prices of sovereign bonds rise on the announcement of a default?**
Singh: A default does immediately attract these kinds of investors, and their demand can sometimes drive up the price. Often these investors increase their leverage with the country by picking up what are called "orphan bonds," illiquid bonds that have few other investors. Cheapest-to-deliver bonds that are associated with credit default swaps also rise in value following a credit event, as was seen in the case of Argentina and Uruguay.

Singh: "What Japan's recent experience, and that of Korea after the Asian crisis, shows is that genuine restructuring creates value."

IMF Survey: **You've also studied the market for distressed *corporate* assets. How is that different from the market for distressed *sovereign* assets?**
Singh: With the sovereign you have less leverage. One of your options is to go through the courts and assert your creditor rights or simply negotiate for better terms. But it is a protracted process with many lawsuits taking as many as 10 years to settle. So even though it can be very rewarding if successful, not everybody will have the patience and the deep pockets to follow that route. Another option is to press the country to work with the IMF and hope better economic policies at the national level will bring about recovery in asset values and the country's ability to pay.

With corporations there are many more strategies that can be followed, particularly many more options for successful restructuring that can yield value for everyone—the distressed corporation, the investor, and the country too.

IMF Survey: **What's a good example of such a turnaround?**
Singh: Perhaps the most cited is the acquisition in March 2000 of Long-Term Credit Bank of Japan by a New York-based private-equity firm called Ripplewood Holdings. They really cleaned up the bank's balance sheets, upgraded its information and technology systems, and devised a new retail strategy. Today the bank, which is now called Shinsei Bank, is considered one of the best in Japan and has seen its share price rise from the depths of four years ago. And Ripplewood has exited the scene with handsome profits.

IMF Survey: **What are the implications of such cases for Japan and the rest of Asia?**
Singh: I think such cases can fight the perception that all distressed-debt investors are just vultures. More investors, foreign and local, will start to take an interest in this market if they feel there will be less prejudice against them. But there is a more important demonstration effect of these cases. Often countries tend to just move the nonperforming loans of their corporations to an asset management company—which is sort of a hospital for sick loans—and just let them sit there instead of trying to restructure them. What Japan's recent experience, and that of Korea after the Asian crisis, shows is that genuine restructuring creates value. Policymakers in China and other countries in Asia facing a nonperforming loan problem understand that they would do well to heed that message. ■

Copies of IMF Working Paper No. 04/86, "Japan's Distressed-Debt Market," by Kazunari Ohashi and Manmohan Singh, IMF Working Paper No. 03/161, "Recovery Rates from Distressed Debt," and No. 03/242, "Are Credit Default Swap Spreads High in Emerging Markets," by Manmohan Singh are available for $15.00 each from IMF Publication Services. See page 323 for ordering information. The full text of the three papers is also available on the IMF's website (*www.imf.org*).

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