How safe is your loan security? That question is going to be asked more often as weakening economy makes defaults more common

Secured private credit is more protected than other debt classes, especially should recovery rates fall as defaults rise

With the world economy facing both rising inflation and slowing growth, default rates are expected to rise after being at historic lows the past few years.

As a result, lenders are now going to have to pay more attention to the quality of the securities offered up by borrowers, after many years when these matters weren't much of a concern.

Moody's[1] sees default rates for European speculative grade borrowers rising to 4.3% by late 2023, up from 2.3% a year earlier. In their worst-case scenario, defaults could rise to 12.5%. In France, after steadily declining since 2014, defaults have started picking up since the start of 2022. While central banks for the U.S and the Eurozone would like to avoid deep recessions, they have made it clear they are willing to inflict pain to get inflation under control.

Lenders anticipate higher defaults, as evidenced by high yield bond spreads widening to around 200 basis points since early 2022. But it's not just the top-line default rate that matters. As default rates rise, recovery levels could fall too because a rush of defaults would set off fire sales and increase supply of distressed assets, therefore reducing their price. Between 1985 and 2020, average recovery rates on defaulting unsecured loans were around 50%, but this rate dropped to 30% at the depths of the financial crisis in 2008[2]. Many academics documented how recovery rates decrease when defaults rise[3], and this phenomenon is likely to heighten as cov-light structures spread on private debt markets over the past few years In these cases, poorly protected debt investors lose twice, once on the default and again on the recovery. Secured loans' recoveries appear to be way more resilient than that of unsecured, dropping to 63% in 2008 compared to a long-term average of 68%[2].

So, what constitutes solid security? What makes a good collateral? Those are the questions that investors have to consider as everything they had come to take for granted this past decade gets turned upside down with today's risks of stubborn inflation and slowing growth.

Collateral for a secured loan can include physical assets like real estate, land, inventory, equipment and machinery, or intangible assets such as intellectual property. Or it can be equity in the borrower. The best collateral is comprised of assets with low volatility, low value correlation with the company's activity, and adequate liquidity. Highly cautious lenders anticipate a potential decrease of their collateral value and set significant haircuts, therefore setting the collateral significantly larger than the underlying loan.

While unsecured lenders are always subordinate to other creditors such as tax authorities, suppliers and employees, secured lenders sit at the top of the food chain, as their collateral is well targeted and identified. That s a belt and braces approach for turbulence ahead of us.

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[1] 2023 Outlook – Risks are rising across the credit spectrum as conditions turn adverse, Moody's (2 November 2022)
[2] Default and recovery rates of European corporate issuers, 1985-2020, Moody's (1 April 2021)
[3] See Default Recoery Rates and LGD in Credit Risk Modeling and Practice, Altman (2011)