

## A Haunting Tale: The Changing Face of European Distress Market

I had been meaning to write these observations for some time, but I was waiting for the evolution of certain credit outcomes to provide clearer evidence.

One might ask whether this represents the European stressed or distressed market that opportunistic and long-term investors were either anticipating or hoping to circumvent. In practice, however, market dynamics have rarely conformed to initial expectations.

The first group - “the stressed players” - entered this cycle with hopes of active trading opportunities; the second group expected a more traditional distressed cycle, with organized restructurings and orderly secondary-market activity. Yet what we’re seeing today is a very different landscape — one that bears little resemblance to the “Distress Land” of the Global Financial Crisis (GFC).

Since 2008, the architecture of the European credit market has evolved dramatically. Weak covenant protections in the post-GFC era and the growing strain of higher rates in the post-COVID world have fundamentally reshaped how financial distress is managed. Persistently elevated interest rates are eroding corporates cash flows forcing over-levered borrowers to confront unsustainable balance sheets much sooner than in past cycles. Several familiar names to the HY investors have been flashing distress signals for quarters and for years — a slow-motion unraveling rather than a sudden break. While some market participants were able to detect these early warning signals, others remained inactive, failing to respond to the gradual accumulation of credit and liquidity risks.

The four points outlined below often operate in conjunction, collectively highlighting the transformed landscape of the European market. This framework, I hope, clarifies why comparisons of current default levels with historical data, or of distressed percentages- OAS spreads above 10%- against previous numbers, volatility gaps and moving averages, are largely uninformative.

## **What Has Changed, in My Opinion**

### **1. Distressed exchanges (DEs) and liability management exercises (LMEs) now dominate stressed credit situations and defaults**

Since 2022, distressed exchanges (DEs) and liability management exercises (LMEs) have accounted for the majority of European corporate defaults, representing a structural shift in how high-yield companies manage financial distress. Yet in most cases, these transactions have fallen short of providing the long-term viability they were hoping for. Many corporates have been forced back to the negotiation table for additional debt reductions, as the “liquidity runway or the creative solutions” provided by such deals and restructurings has often been insufficient to restore revenue streams or improve cash-flow generation.

In practice, and drawing on actual examples, the liability exercises are typically structured to minimize immediate and dip losses for creditors (particularly the CLO-dominated par investor base) rather than to deliver sustainable business solutions. The result is under our eyes: a default cycle that, while muted in magnitude on the surface, is entrenched and drawn-out, in stark contrast to historical distressed periods, which tended to feature sharp volatility peaks resolved within a few quarters (the Great Financial Crisis-GFC- remains anyway unique for its characteristics and intensity).

LMEs themselves are not a new phenomenon — “coercive exit consents”, for example, have long been part of the restructuring toolkit and widely used during the GFC — but they have evolved in both complexity and structure, assuming a central role in today's financial playbook. The distinctions between seniority levels and debt classes have become increasingly nuanced and difficult to untangle, reflecting the increasingly layered and heterogeneous composition of corporate balance sheets. The rising prevalence of DEs and LMEs is therefore having significant macroeconomic implications for market-wide default statistics and recovery rates—widely studied but probably useless—, while also producing tangible value shifts across capital structures at micro-level. Crucially, the final outcome of any given DE or LME remains highly case-specific. Success or failure depends on the particular structure of the transaction, the underlying business fundamentals, the credit sector, and, more importantly, the relative positions and incentives of creditors, making these exercises far less predictable than traditional distressed restructurings.

### **2. The erosion of creditors protection (a self-inflicted damage)**

In recent years, credit documentation standards and covenant protections have steadily eroded, giving rise to a legal framework increasingly

characterized by gaps, inconsistencies, and weakened investor safeguards. Existing financing docs have become a patchwork legal framework that allows different creditor groups -or single investors- to act autonomously, exploit technical loopholes, and prioritize their own recoveries. This fragmentation has made restructurings more complex, coordination more fragile, and outcomes less foreseeable. In essence, creditor rights have been diluted, and traditional investors now operate in a far more intricate and contentious environment.

Litigation surrounding aggressive liability management exercises (LMEs) has become a recurring feature of the restructuring landscape, as creditors frequently find themselves contesting not only the strategies of shareholders and private equity sponsors seeking to retain control over underperforming companies, but also the tactics of other creditor classes and opportunistic distressed investors. “Uptiering” transactions — where select lenders are granted seniority at the expense of others — are now being challenged across courts in Europe and the United Kingdom, underscoring how legal disputes rarely benefit the underlying companies or lead to constructive resolutions. In this environment, traditional “white lists” of pre-approved creditors have lost much of their relevance, as current market dynamics often defy standardized contractual frameworks. Moreover, cooperation agreements — once seen as mechanisms to safeguard minority investors — are not always equitable in practice; in several cases, they have been structured to favor specific groups of creditors, undermining the recovery prospects of dissenters. The long-held assumption that such agreements inherently protect minority rights must therefore be reconsidered in light of the increasingly fragmented and adversarial nature of today’s credit markets.

I would rather not discuss the merits or decisions of some steering committees or ad hoc investor groups, as that would make this analysis more contentious. I often advise investors to challenge the plans when they are unfair or poorly thought out because they conceal ulterior motives.

### **3.The role of private credit**

Liquidity remains a scarce and valuable resource in any difficult financial environment. Private credit has emerged as a significant and increasingly institutionalized asset class, effectively stepping into the lending role once dominated by banks. This shift has been driven largely by heightened regulatory constraints and tighter risk management frameworks that have limited traditional banks’ capacity and willingness to extend credit. Private credit funds have experienced substantial growth in both scale and influence. Restrictive monetary policy and tighter financial conditions have constrained access to public capital markets for many leveraged borrowers. In this context, private credit has provided an alternative and reliable source of financing,

particularly valued for its speed, flexibility, and certainty of execution. These features have proven especially important during periods of heightened market volatility and reduced liquidity. The abundance of deployable capital within private credit markets has, at least in theory, mitigated some of the financial distress typically observed in the broadly syndicated loan (BSL) market. By complementing public credit markets (and competing with them for market share), private credit has expanded the spectrum of funding options available to corporate borrowers seeking to optimize their balance sheets and maintain financial flexibility. Companies of all sizes, particularly those in the tail cohorts with limited liquidity and mounting cash-flow stress, have turned to alternative financing avenues to withstand the macroeconomic headwinds and their own financial issues.

The absence of comprehensive and standardized data presents challenges in assessing the true performance of the private credit asset class (I cannot know about the existence of cockroaches in the coal mine and I do not speculate). Official statistics are limited, and disclosure requirements remain minimal compared to public markets. Consequently, performance assessments rely heavily on proprietary data and market estimates. For the purpose of this analysis, it is reasonable to assume that private credit portfolios currently exhibit performance metrics and default rates broadly in line with those observed in the public leveraged loan and bond markets, with no evidence to suggest materially higher default risk.

Of particular significance is the migration of lower-rated and higher-risk companies into the private debt market, which has demonstrably accommodated this demand, providing capital and tailor made solutions (the public leveraged loan market, which I frequently flag as mispriced, receives the same interest and flow from low quality corporates but structures the financings differently due to obvious technical factors).

#### **4.The CDS market (yes, it impacts the broader market)**

The credit derivatives market is experiencing a period of profound structural and functional erosion, drifting away from its foundational role as an instrument for risk transfer, hedging, and efficient price discovery. Historically, credit default swaps enabled investors to hedge or assume credit exposure in an almost transparent, standardized, and measurable way. Today, however, these instruments have become increasingly detached from the economic realities of the underlying assets they are meant to reference. Several forces have contributed to this decline: the proliferation of liability management exercises and distressed exchanges, which have blurred traditional credit event definitions and disrupted the payout mechanics of CDS contracts; the



rising complexity of corporate balance sheets coupled with intricate organizational structures that can take weeks to fully analyze and understand; and the persistence of opaque and highly opportunistic market maneuvers by few dominant participants, which have undermined both price transparency and market confidence.

Once regarded as a reliable barometer of credit risk and a crucial tool for price discovery, the CDS market has, in many instances, lost its correlation with actual default probabilities, recovery values, and asset valuations. This dislocation has reduced investor participation and diminished the market's informational value. Recent regulatory discussions highlight the growing tension between financial innovation and systemic integrity, as authorities and market bodies seek to restore accountability and transparency. Ultimately, CDS instruments have drifted far from their intended purpose within financial intermediation: their declining transparency, limited usefulness for genuine hedging, and weak alignment with underlying credit dynamics now call for renewed scrutiny and possibly a structural overhaul. The market faces a pivotal juncture — either to reform and reestablish credibility, or to acknowledge what some already consider the effective end of credit derivatives as a meaningful component of modern finance.

What I have just put in evidence is what we are seeing in Europe at the end of 2025, independently of investors attitude, risk-on or risk-off phases, capital inflows or outflows, and the mechanics of portfolio formation. In other words, this outcome emerges not as a reflection of temporary sentiment or positioning, but as the natural consequence of deeper legal, structural and technical forces already in motion and that have been shaping the market over time.

Given everything discussed, it's almost laughable that some credit managers still trade and invest as if it's the 1990s when Bloomberg terminals dominated desks as clunky, square boxes.

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