Credit Risk

Meaning

Credit risk is the possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Traditionally, it refers to the risk that a lender may not receive the owed principal and interest, which results in an interruption of cash flows and increased costs for collection. Excess cash flows may be written to provide additional cover for credit risk. Although it's impossible to know exactly who will default on obligations, properly assessing and managing credit risk can lessen the severity of a loss. Interest payments from the borrower or issuer of a debt obligation are a lender's or investor's reward for assuming credit risk.

Losses can arise in a number of circumstances, for example:

- A consumer may fail to make a payment due on a mortgage loan, credit card, line of credit, or other loan.
- A company is unable to repay asset-secured fixed or floating charge debt.
- A business or consumer does not pay a trade invoice when due.
- A business does not pay an employee's earned wages when due.
- A business or government bond issuer does not make a payment on a coupon or principal payment when due.
- An insolvent insurance company does not pay a policy obligation.

- An insolvent bank won't return funds to a depositor.
- A government grants bankruptcy protection to an insolvent consumer or business.

Factors used to Assess Credit Risk

In order to assess the credit risk associated with any financial proposal, the project finance division of the firm first assesses a variety of risks relating to the borrower and the relevant industry.

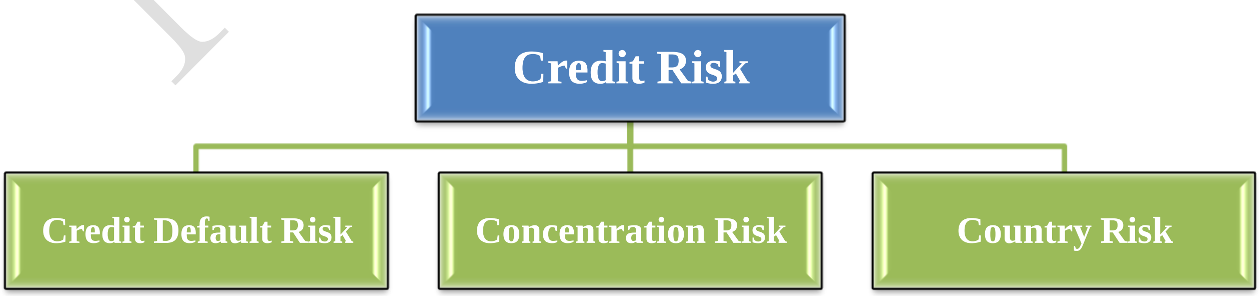
The borrower credit risk is evaluated by considering:

- The financial position of the borrower, by analyzing the quality of its financial statements, its past financial performance, its financial flexibility in terms of the ability to raise capital, and its capital adequacy
- The borrower's relative market position and operating efficiency
- The quality of management, by analyzing its track record, payment record, and financial conservatism

Industry-specific credit risk is evaluated by considering:

- Certain industry characteristics, such as the importance of the industry to the economic growth of the economy and government policies relating to the industry
- The competitiveness of the industry
- Certain industry financials, including return on capital employed, operating margins, and earnings stability

Types of Credit Risk



1. **Credit Default Risk**

The risk of loss which arises from the debtor being unlikely to repay the amount in full or when the debtor is more than 90 days past is the due date of credit payment; it gives rise to credit default risk. The Credit default risk impacts all the sensitive transactions which are based on credit like loans, derivatives or securities. Credit default risk is also checked by banks before approving any credit cards or personal loan.

2. **Concentration Risk**

This is the type of credit risk which is associated with exposure of any single or group with the potential to produce large losses to threaten the core operations of a bank. It may arise in the single form of single name concentration even industry concentration.

3. **Country Risk**

This is the risk which arises from a sovereign state when it freezes the payments for foreign currency overnight defaults or its obligation which is termed as sovereign risk. Country risk is exclusively associated with the performance of macroeconomics of a country and is also closely related to the political stability in the country. Sudden instability, which tends to happen during the elections, results in high country risk.

Mitigation of Risks

There are multiple ways to mitigate the credit risk which are as follows:

1. **Credit Risk-Based Pricing**

The lenders usually charge a higher rate of interest to borrowers who are defaulters. This practice is known as risk-based pricing. The lenders take into consideration the factors such as on purpose credit rating and loan to value ratio.

2. **Credit insurance and credit derivatives**

Bondholders hedge the risk by purchasing credit derivatives or credit insurances. These contacts ensure the transference of the risk from the gender to the server against a specific amount of payment. Credit default swap is the most common form of credit derivative used in the market.

3. **Best Covenants**

Stipulations may be written by lenders to the borrowers which are called covenants. These are usually written into loan agreements such as a periodic report about the financial condition, refrain from paying dividends or further borrowing of amount or any other specific action that affect the company’s financial position in a negative way or repayment of the full loan at the request of the gender in events such as borrower changes or changes in debt to equity ratio or change in interest coverage ratio.

4. Diversification

Lenders to a small number of borrowers (or kinds of borrower) face a high degree of unsystematic credit risk, called **concentration risk**. Lenders reduce this risk by diversifying the borrower pool.

5. Tightening

Lenders can reduce credit risk by reducing the amount of credit extended, either in total or to certain borrowers. For example, a distributor selling its products to a troubled retailer may attempt to lessen credit risk by reducing payment terms from *net 30* to *net 15*.

6. Deposit insurance

Governments may establish deposit insurance to guarantee bank deposits in the event of insolvency and to encourage consumers to hold their savings in the banking system instead of in cash.