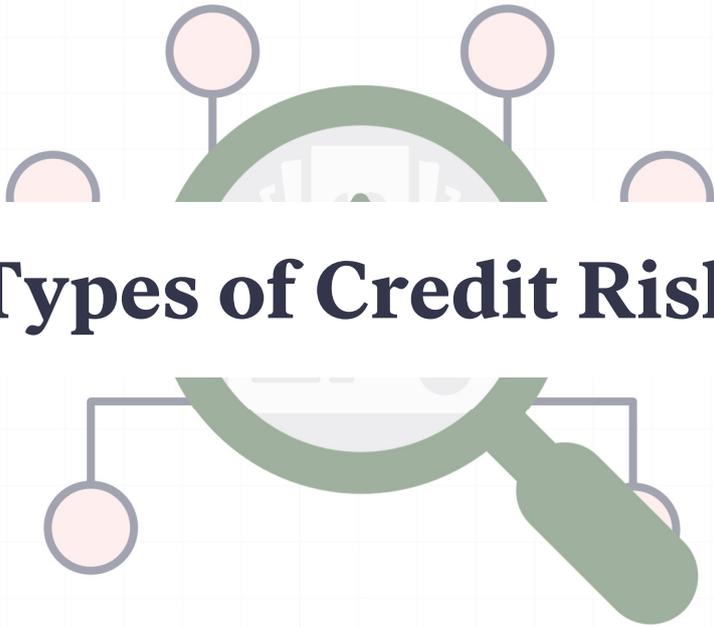
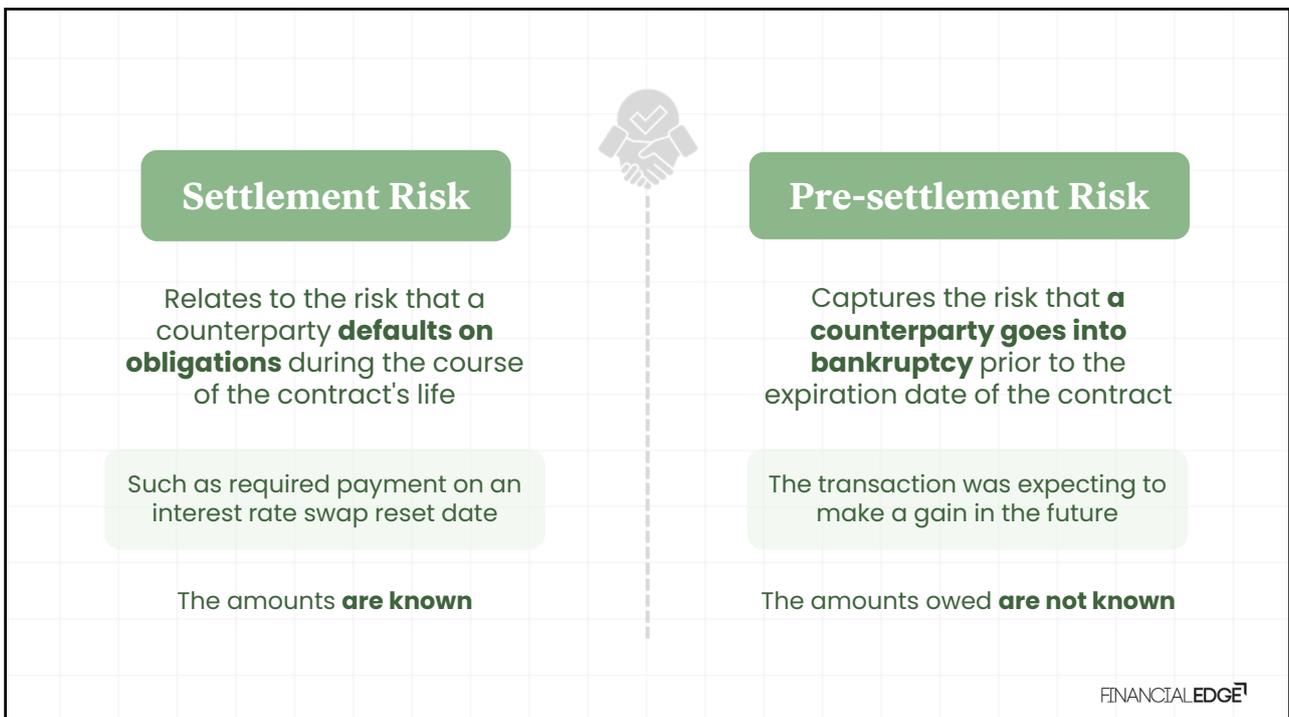
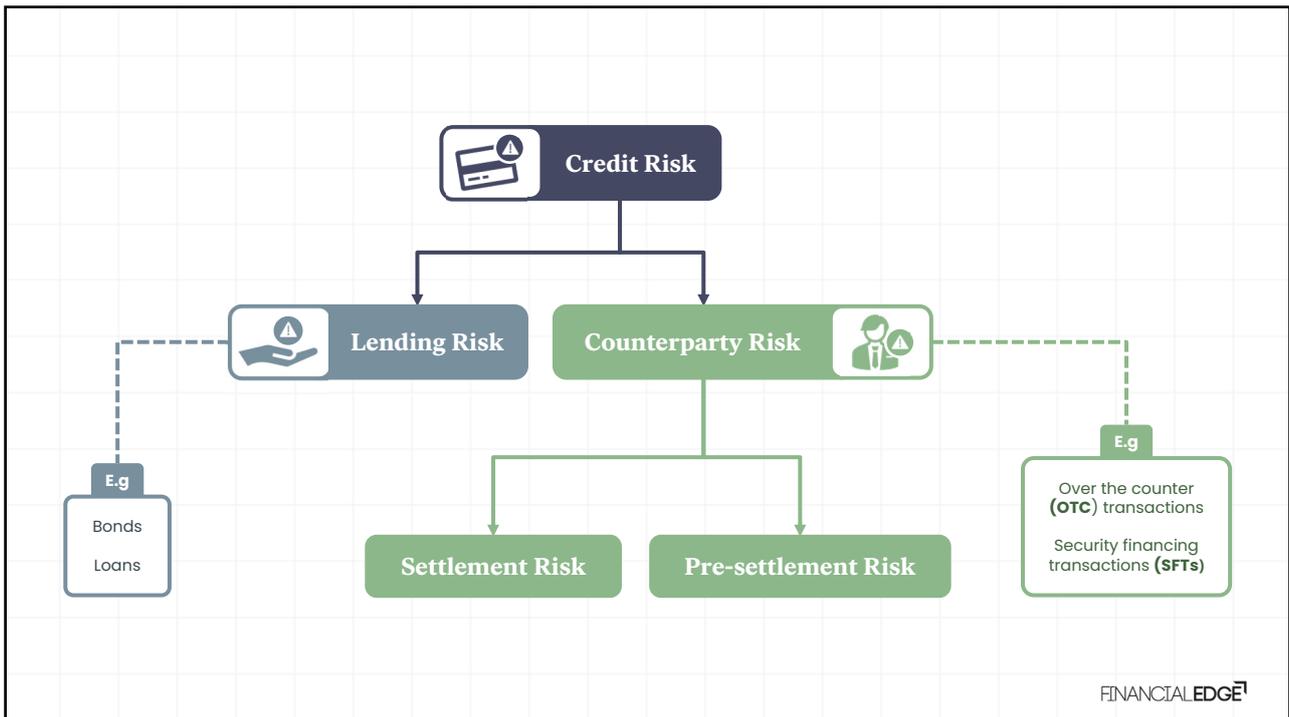


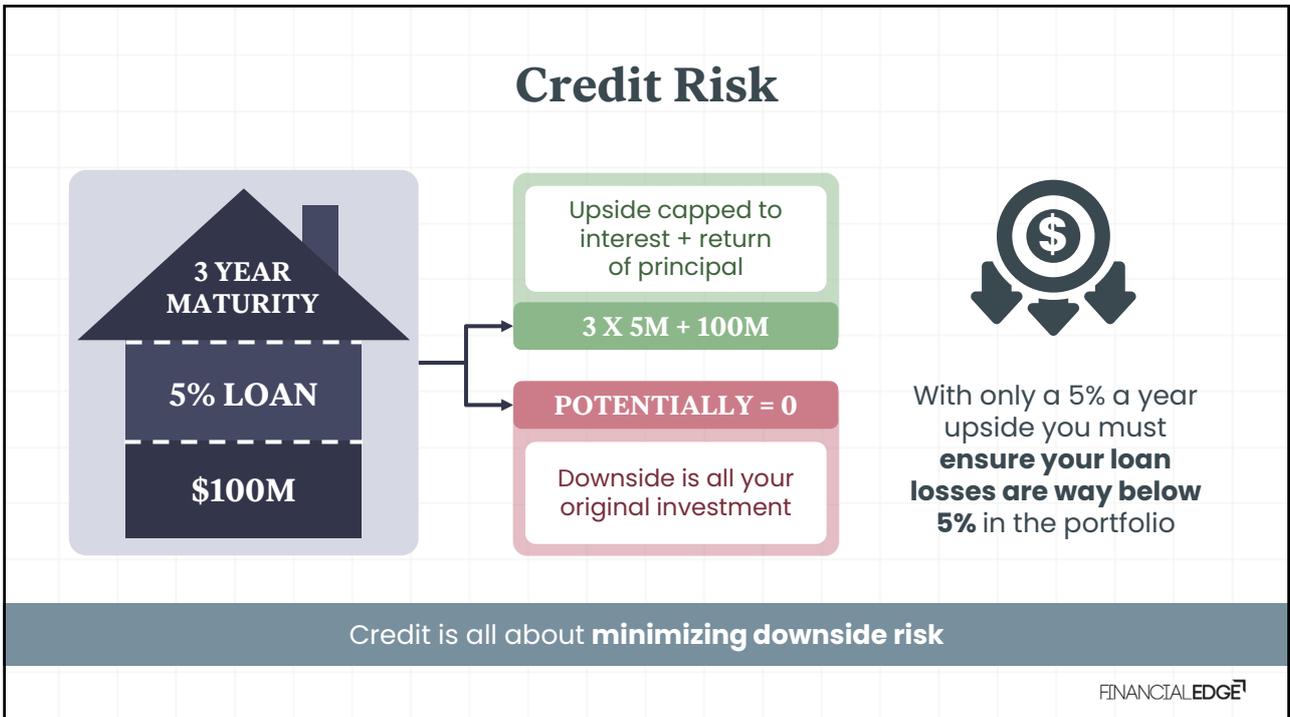


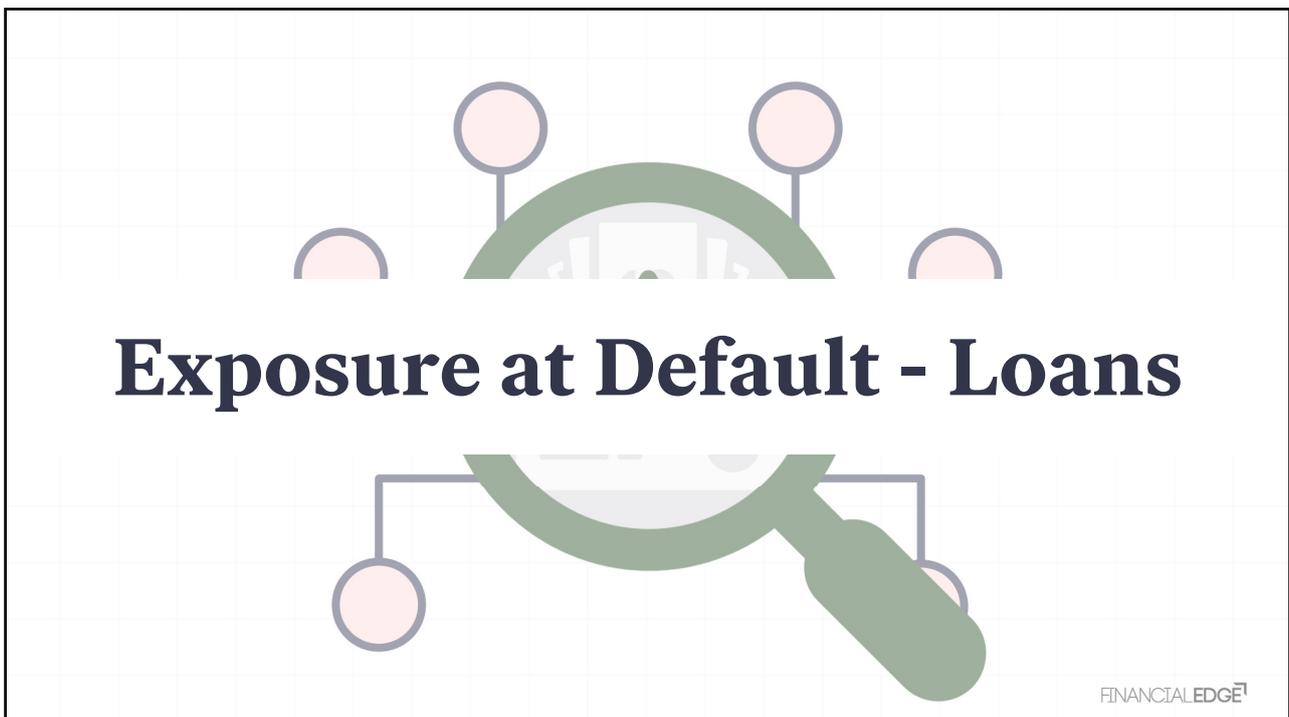
Credit Risk Fundamentals



Types of Credit Risk







Loans

The client could **draw on the RCF at any stage** up to the pre-agreed facility limit

If the company were to get into **financial difficulties**, they would use of the financing tools at their disposal

Equal amortizing loans are **least risky**

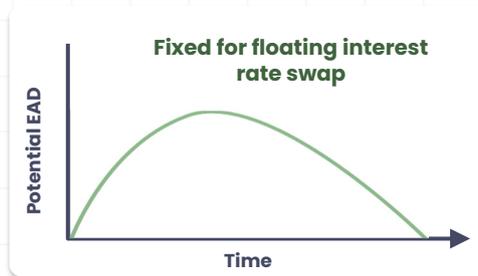
A bullet loan is the riskiest, the principal is repaid in its entirety at the maturity

FINANCIALEDGE¹

Exposure at Default – Counterparty Risk

FINANCIALEDGE¹

Counterparty Risk



The **more interest rates deviate** from what was expected at the inception of the swap



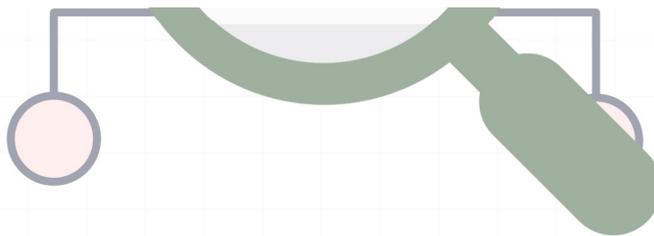
The EAD is the **present value of the future expected payments** on the swap



Beyond a certain point, **potential EAD reduces** as number of remaining periods declines

FINANCIALEDGE¹

Loss Given Default & Probability of Default

FINANCIALEDGE¹

Loss given default (LGD) is the **amount of money the bank loses** when an obligor defaults. Expressed as a percentage of total exposure

e.g.

If the total exposure at default is 100,000

The LGD is 60%

The bank would lose 60,000 in the event of a default

LGD is mitigated through the use of:



Guarantees



Collateral



Hedging



Guarantees

These are a promise by one party (the guarantor) to **assume the debt obligation of a borrower** if that borrower defaults.

For example, this could be the parent company of a subsidiary that has taken the loan



Collateral



Hedging



Collateral

This is where an asset of value is pledged to the bank so that they can use that **asset to recoup their losses in the event of default.**

This is equivalent to the house acting as collateral in a residential mortgage loan



Guarantees



Hedging



Hedging

Exposure can be hedged by either:

Using financial market instruments, such as credit default swaps

Ensuring that a bank's loan portfolio is sufficient well diversified and not concentrated in one area or product type



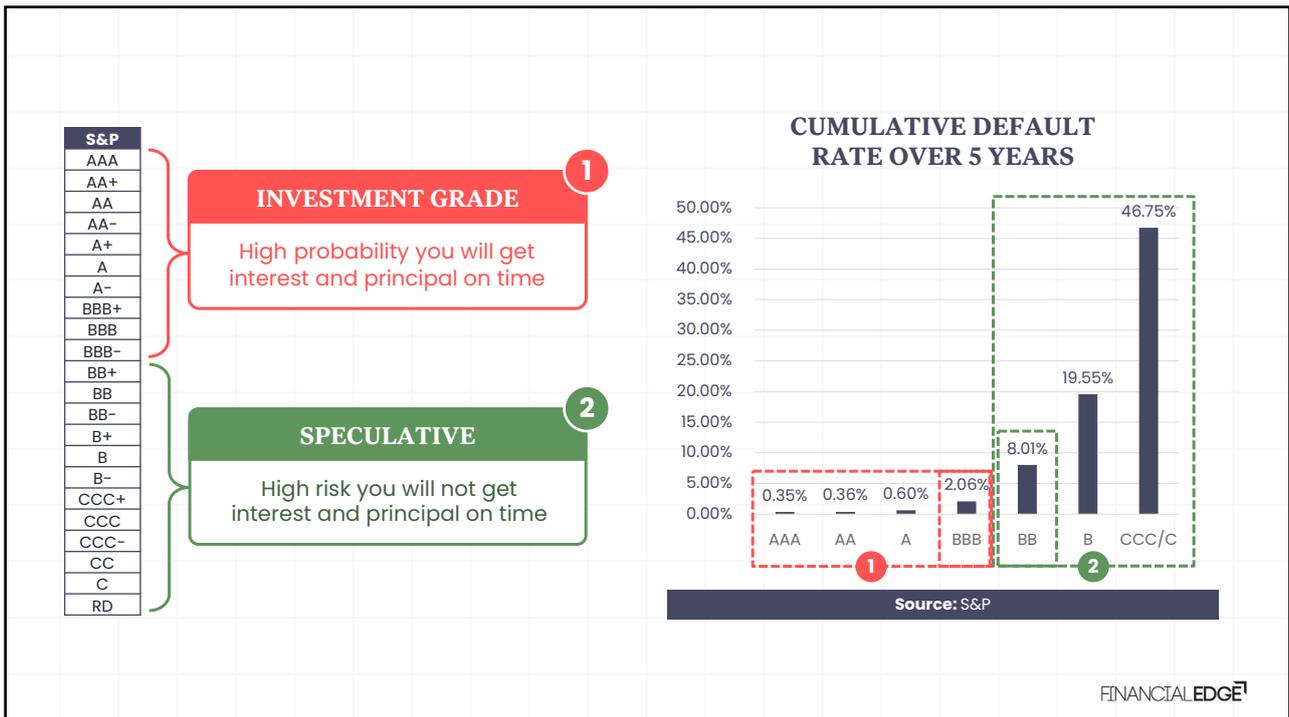
Guarantees



Collateral

Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Extremely strong capacity to meet commitments
Aa1		AA+		AA+		Very strong capacity to meet financial commitments
Aa2		AA		AA		F1
Aa3		AA-	AA-			
A1		P-2	A+	A-1	A+	F2
A2	A		A			
A3	A-		A-2	A-	F3	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions
Baa1	BBB+			BBB+		
Baa2	BBB			BBB		
Baa3	Not Prime	BBB-	A-3	BBB-	B	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments
Ba1		BB+		BB+		
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		
B2	B	B	C	C	Currently vulnerable and dependent on favourable business, financial and economic conditions to meet financial commitments	
B3	B-	B-				
Caa1	CCC+	CCC+				
Caa2	CCC	CCC	C	C	Currently highly vulnerable	
Caa3	CCC-	CCC-				
Ca	C	C	C	C	Bankruptcy petition is filed but payments continue	
C		RD	D	DDD	D	Payment default on financial commitments





How Do Rating Agencies Come Up With Them?



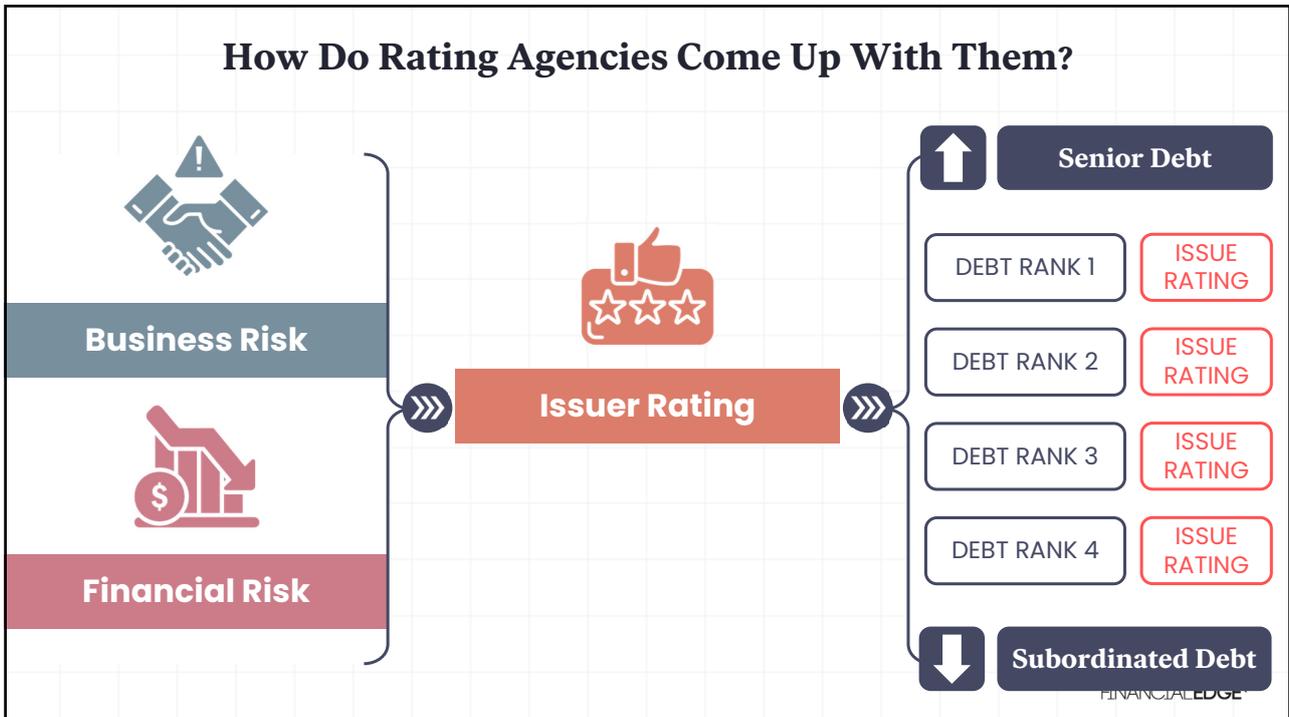
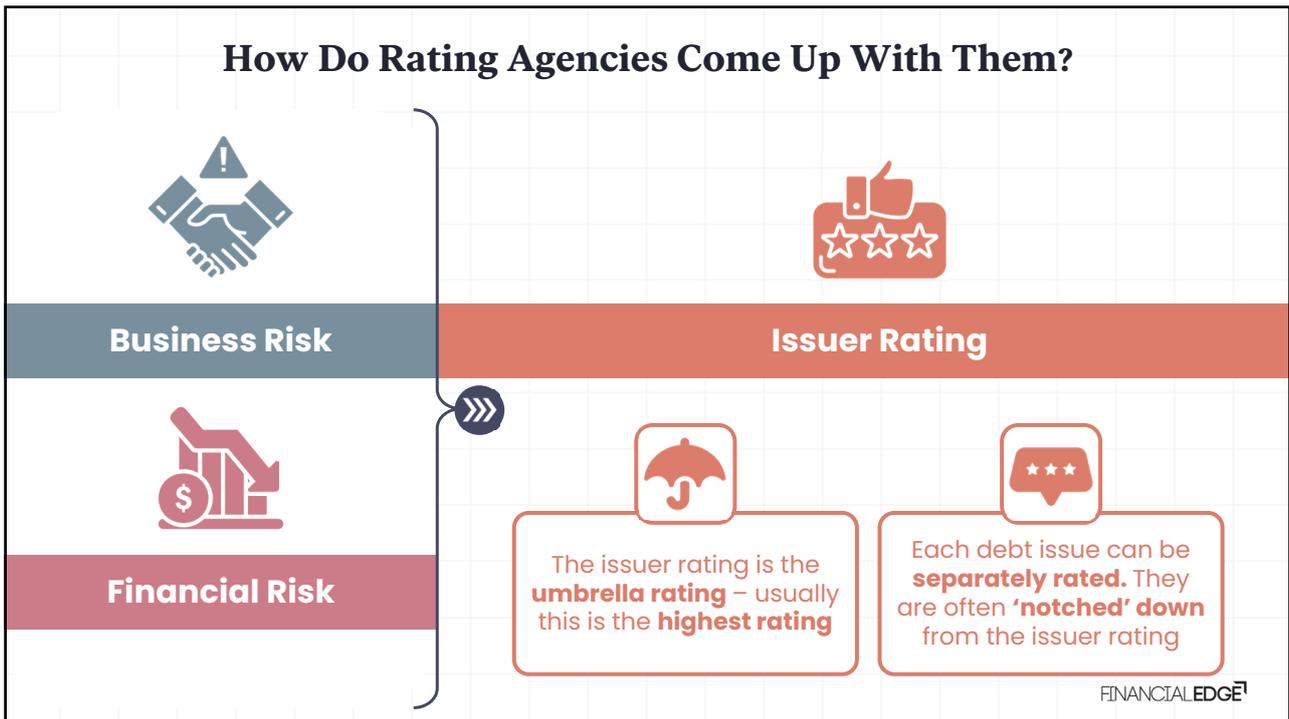
Business Risk

- Country risk
- Industry dynamics
- Company position
- Profitability / peer group analysis



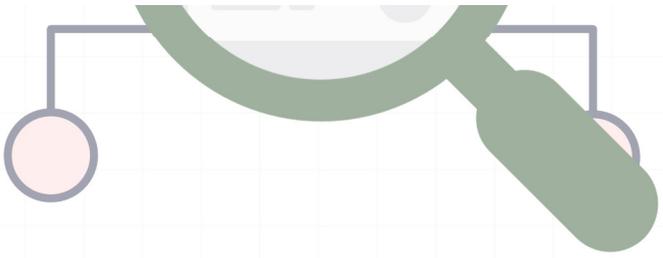
Financial Risk

- Accounting
- Financial policy and governance
- Cash flow adequacy
- Capital structure
- Liquidity





Indicative Ratios


FINANCIALEDGE¹

Indicative Ratios

	AAA	AA	A	BBB	BB	B
EBITDA / Interest	17.5	10.8	6.8	3.9	2.3	1.0
FFO / Total debt %	55	25	16	7	2	(4.5)
Total debt / Capital %	27	36	40	47	61	75
Total debt / EBITDA	1.0	2.0	2.5	3.5	4.5	5.5

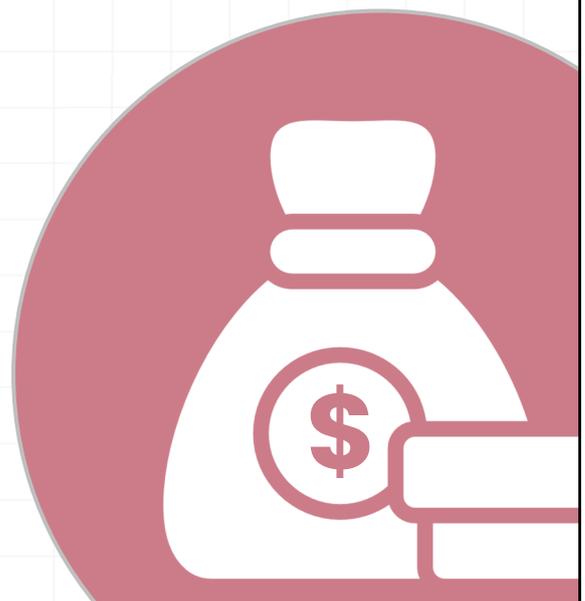
FINANCIALEDGE¹

Assessing the Credit Quality of a Counterparty

C**A****M****E****L**FINANCIALEDGE⁷

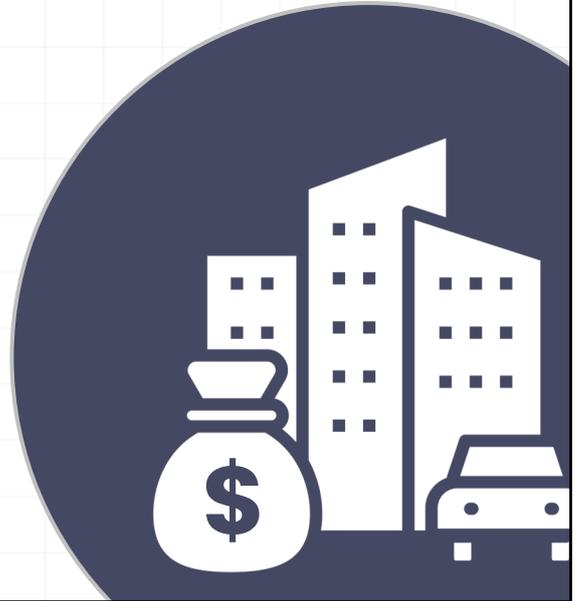
Capital

Banks want to ensure their counterparties are **adequately capitalized**, and the better the quality of the capital the lower the probability of default.



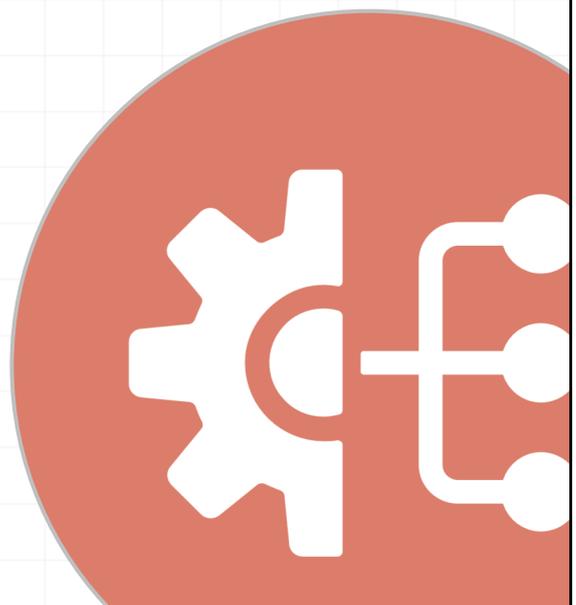
Assets

Banks want to ensure their counterparties have **quality assets on its balance sheet** and avoid concentration risk.



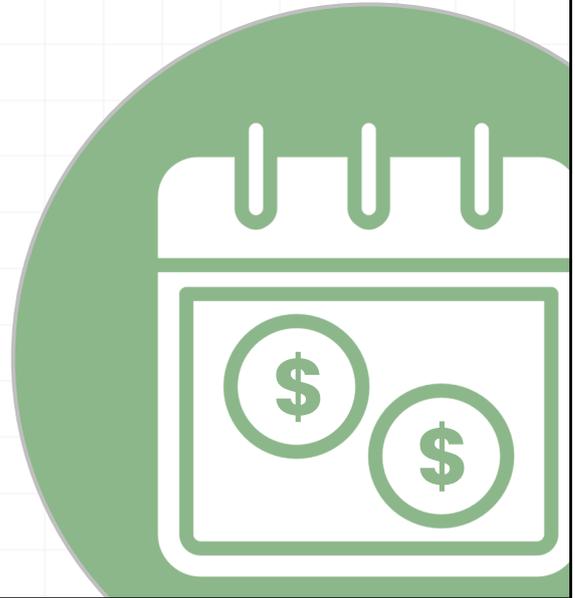
Management

Banks want to ensure the management teams of their counterparties have the **requisite level of experience to make sound judgements**, especially in times of stress.



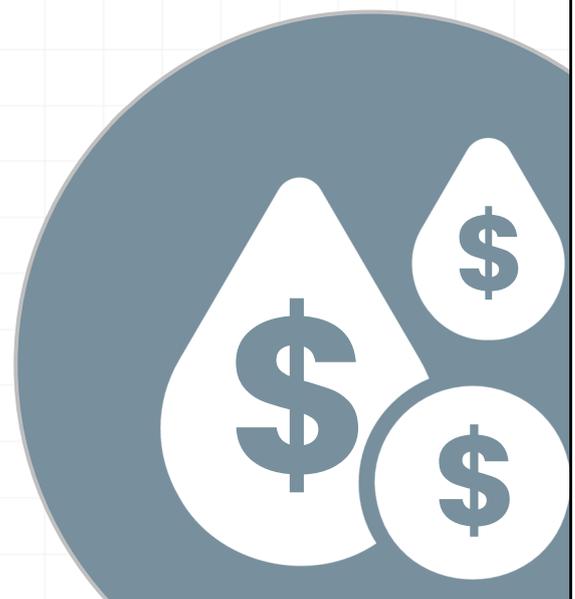
Earnings

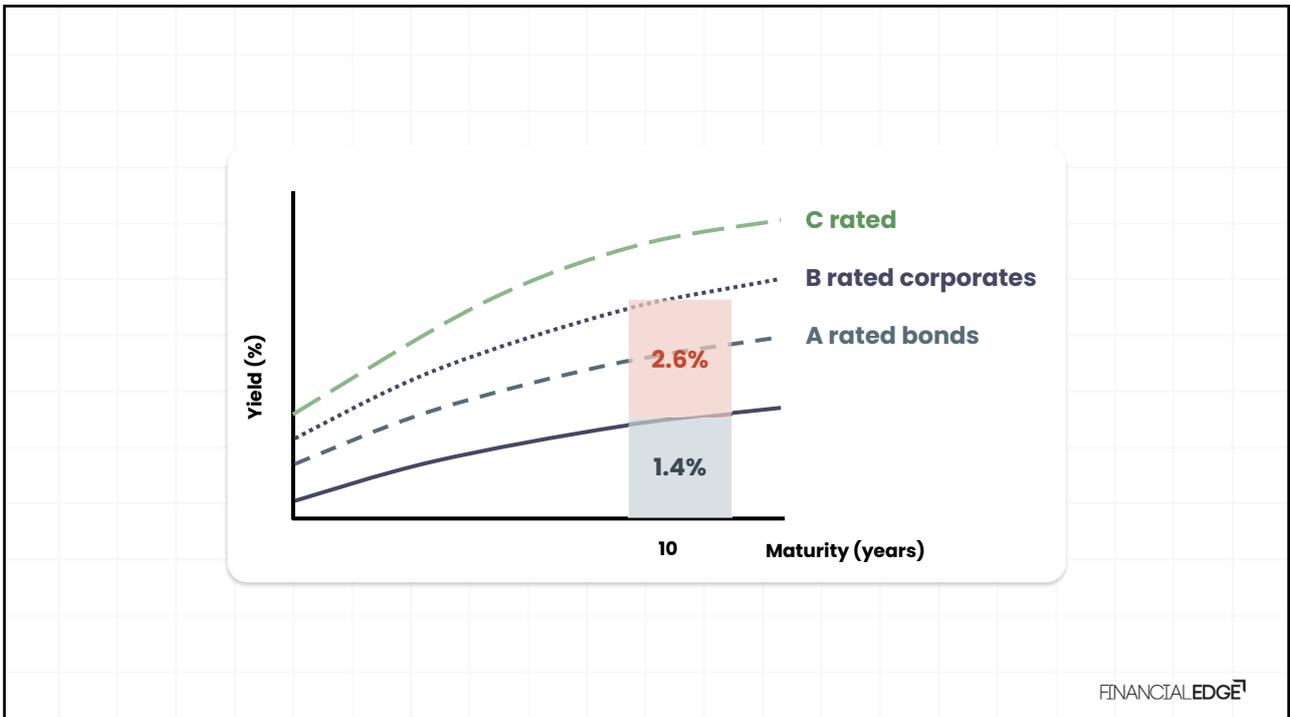
It's critical that a lender considers how a counterparty likely to be able to afford to make future interest payments, and one of the **keys ways companies can do this is through the profits they make.**



Liquidity

A bank should only want to do business with counterparties that have sufficient cash, and **assets that can be easily converted in cash**, in order to be able to meet their short term obligations.







A Credit Default Swap (CDS) is *like* an insurance policy which pays out if a particular entity defaults on its debts

Terminology



Reference entity

The 'name' which borrows



Reference asset / obligation

Normally senior unsecured bond or loan



Credit event

Default, for example; triggers payment



Notional value

Total par value insured



Premium

Price paid to insure par value

Premium

Price paid to insure par value

Acts as **compensation** for the counterparty

✔ If we use the CDS they have to pay us
 ✘ If we don't use the CDS they keep the premium

We can use the premium as **a measure of risk**

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