October 8, 2020

Market Concepts

INTRO TO CREDIT RISK

"Credit risk refers to the possibility of a counterparty defaulting or not being able to meet its contractual obligations, resulting in losses to the company."

By:
Dina Sayed - Analyst

Evaluating credit risk is an essential step most companies or banks take before executing a transaction. Credit risk refers to the possibility of a counterparty defaulting or not being able to meet its contractual obligations, resulting in losses to the company.

Credit risk is governed by what is popularly referred to as "The Five C's of Credit". They are as follows:

1. Character: an opinion on the counterparty's trustworthiness and credibility. Character is assessed using credit history and reputation.

2. Capacity/Cash flow: the counterparty's ability to meet their contractual obligation. Capacity is assessed using financial metrics and benchmarks (debt and liquidity ratios, cash flow statements), credit score, and credit history.

3. Capital: the amount of money a counterparty has. More capital suggests a lower chance of default. Capital is usually assessed by analyzing the counterparty's cash flow statements.

4. Conditions: the conditions of the agreement/contract between the two counterparties. This refers to the specifics of the deal and its corresponding risk. Common notable factors of conditions are interest rates, payment structure, or macroeconomic events such as pending legislative changes.

5. Collateral: assets used to guarantee a loan/contract. If a counterparty defaults on its contract, their collateral will be seized by the other counterparty to mitigate losses. Collateral usually consists of "hard assets" such as cash, real estate, or equipment.