

CREDIT RISK: A GENERAL SCHEME IN A BANKING PERSPECTIVE

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Contents

Overview

1. Risk as a function of operation
 2. Risk as a function of bank commitment
 3. Risk as a function of guarantees
 4. Conclusions
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Overview

What are the issues banks consider and evaluate for assessing credit risk? The decision whether to grant a loan or other banking facilities for industrial or financial investment (as well as for consumption or other aims) depends mainly on the perceived risk of the credit, i.e. the probability that the borrower might not respect the contract with the bank. The borrower could not be able or not be willing to pay back the money, in full or in part, thus leading to a bank loss.

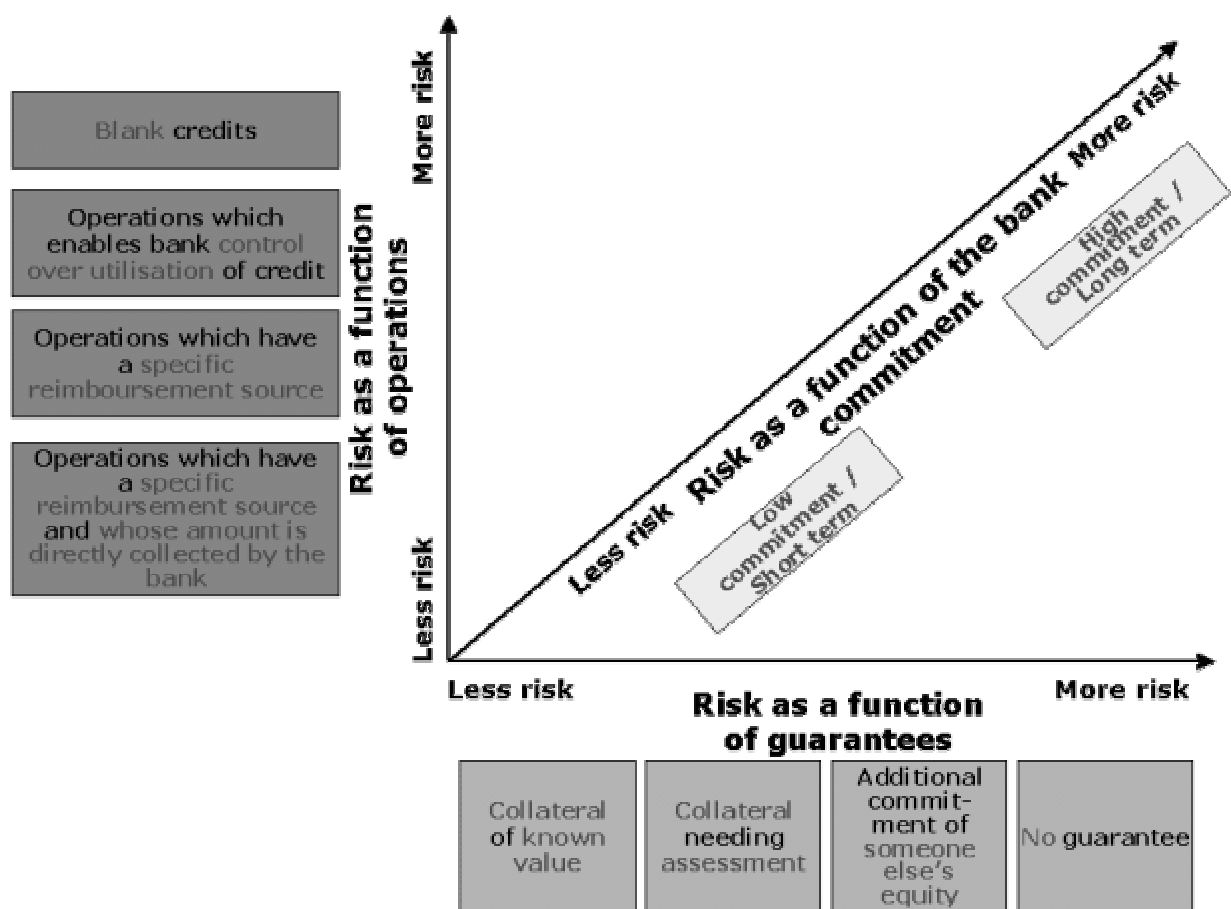
First of all, the banks consider the personal and institutional **creditworthiness** of borrower, which is the main issue. Secondly, they will examine the characteristics of the proposed **operation**, and they will probably fine-tune them in order to meet bank desired risk level for that borrower.

In this essay we won't talk about the first point (how banks assess the creditworthiness of borrower), since there is plenty of literature about it. We just remember that banks consider, among other factors, the current and

prospect patrimonialisation and profitability, the borrower's history, as well as its industrial sector and how the borrower is positioned in it. Instead, we will propose a general synoptic scheme about the other issues to be considered in the perspective of the bank.

We can distinguish three "risk drivers" (from the less to the most important):

1. [Risk as a function of operations;](#)
2. [Risk as a function of the bank commitment;](#)
3. [Risk as a function of guarantees;](#)



These drivers apply to both *cash credits* and *non-cash credits* (e.g. commercial and financial bonds, issued by a bank on client's request).

We will now describe the content of the three drivers.

1. Risk as a function of operation

We can classify the range of the lending operations according to which control banks have over the amount granted and to their "auto-cashing" attitude.

Now, we proceed from the most to the less risky operation.

Class	Examples	Description	Risk degree
Blank credits	<i>Overdraft credit</i>	Banks have no control over the sum borrowed and the client uses the money for operations which – as far as banks know – don't have a specific reimbursement source	Extremely high
Operations which enables bank control over utilisation of credit	<i>Letter of credit, import facility, performance and advance payment bond</i>	By the <i>import facility</i> , for example, banks grant a loan to pay a foreign provider and, at the same time, they transfer money to him (so they control the utilisation of the granted amount). When a bank issues a <i>performance bond</i> on behalf of one of its clients, it knows exactly what the underling operation is and how the bond will be used.	High
Operations that have a specific reimbursement source	<i>Accounts receivable financing; bid bond</i>	<i>Accounts receivable financing</i> is an "auto-cashing" operation: when its client's debtor will pay him, the client, in its turn, will reimburse the bank.	Rather High
Operations which have a specific reimbursement source and whose amount is directly collected by the bank	<i>Accounts receivable financing with collection by the bank</i>	As the former, but, in this case, the bank, by itself, should collect the amount directly by its client's debtor.	Medium

Needless to say, other elements can balance the degree of risk as function of operation but one should remember that usually banks will require higher margins on more risky operations.

2. Risk as a function of bank commitment

In the ordinary credit facilities, bank commitment is very low. It means that a bank can call its money back at a moment's notice (usually at two days notice). The credit facilities described in the former paragraph are usually granted as "day-to-day loan".

However, large companies are sometimes granted by **"committed" facilities**: the technical structure of the operations is usually very similar, but the bank commits itself, for a defined period, to keep the amounts at the disposal of the client without the possibility of calling back the credit line. This "service" is rewarded by a *commitment fee*, paid on the amount granted and not drawn at the date.

In long-term loans and mortgage loans the bank is highly committed: it can call its money back only when the borrower doesn't pay at least two or more installments. For this reason, banks usually ask collateral (real-estate mortgage).

Finally, we should remember that bank commitment and duration has an effect not only on risk, but also on costs. Banks should fulfil some ratios provided by Central Banks. And long - term (as well as risky) facilities *absorb more capital*, which is the "limited resource" for banks.

3. Risk as a function of guarantees

What happens when a company can't pay back its facilities and interests?

The bank should consider the so-called *second barrier* (the first barrier is the long-term profit and cash flow): guarantees and collaterals.

According to their effect to risk, how can we classify them? We will now explain the four groups of guarantees and collaterals, from the most to the least risky.

Class	Examples	Description
No guarantee		In this case, the bank has decided not to have a "second barrier": the creditworthiness of borrower is so strong, the competition among banks is so high, that the bank doesn't ask for any guarantee or collateral.

Class	Examples	Description
Additional commitment of someone else's equity	<i>Guarantee issued by another company or another bank; committed patronage letter</i>	When granting loans to a "local" company, for example, banks usually ask the "mother" company to sign a committed patronage letter: if the local company is insolvent, the mother company should reimburse the bank on behalf of it.
Collateral needing assessment	<i>Real-estate mortgage, listed securities, pledges</i>	The borrower, one of its shareholder or another company of the same group, provides the bank with a guarantee on a "real" asset.
Collateral of known value	<i>Government securities, money, bonds issued by the lending bank</i>	As the former, but, in this case, due to the kind of securities, the value of the collateral doesn't need to be assessed. The extreme case is a money collateral.

4. Conclusions

In this essay, we shortly illustrated a general scheme about the way banks tackle with credit risk. The purpose was not to exhaust the issue, but to provide a comprehensive scheme that considers together all the "risk drivers". By order of importance, we remember that banks usually evaluate first of all the **creditworthiness** of borrower, then, if necessary, **guarantees and collaterals**, then the type of **commitment** and, finally, the requested **operations**.

JEL Classification of this essay: G21, G31, D81, D92

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