LECTURE 7

CHAPTER 10 & 11 – MEASURING RISK

Credit Risk Pricing Loan Portfolio (CLOs – ie. WARF, ranking)

Credit Scores assigned to each company Migration probabilities

BUSINESS RISK Vs CREDIT RISK

**Business Risk**

* Industries (fundamental/economic drivers need to be identified)
* Products & Services (Cost positioning, Diversity, Integration)

i.e. Forest Products

Cost Positioning 50% score 7/10

Diversity 30% score 8/10 6.7/10

Integration 20% score 4/10

**Financial Risk**

“Good company with a bad balance sheet”

1. Profitability
2. Balance Sheet weights based on credit ratios
3. Cash Flow
4. Financial Flexibility

**Other Risks: Management Strategy & Governance**

Defensive reasons only – used for downgrade/ not to upgrade

**RISK SPECTRUM**

success distress

Business Risk (BR) Credit Risk (CR)

Page 277 – combining BR and CR

Measuring

AAA (No Risk)

AA to B (Risk) based on 5 levels: Very Low risk, Low Risk, Moderate Risk, Gigh Risk and Very High Risk

RECOVERY CONCEPTS (Secured vs Unsecured based on Waterfall and asset strength)

Chapter 11 – Measuring Risk / Pricing Risk

* Exposure at Default (EAD)
* Probability of Default (PD)
* Probability of Recovery (LGD) LGD = (1-Recover)
* Probability of Expected Loss (EL)

**EL = EAD x PD x (1 – LGD)**

BASEL CAPITAL ACCORD of 1975 – ensure stability and consistency in assessing risk

BASEL II of 1999 – promote soundness / financial system

 Capital Adequacy – capital requirement

BASEL III – take effect 2017 – capital ratios

Other discipline measurements –

* Altman’s Z score
* Merton Model – options concepts –
	+ Equity hold a Call option
	+ Debt holders – sell a put option
* KMV – the same concept as Merton modified on a scale – EDF (Expected Default Frequency)