

Default Risk

The risk that a borrower will be unable to make the required payments on their debt obligations.
Example: A company going bankrupt and failing to make payments to bondholders.

Downgrade Risk

The risk that a borrower's credit rating will be lowered, impacting the value of the borrower's debt securities.

Example: A credit rating agency downgrading the debt of a corporation, leading to a decline in the market value of its bonds.

TYPES OF CREDIT RISK

Concentration Risk

The risk arising from excessive investment or lending in a particular sector, region, or type of borrower.
Example: A bank having a significant portion of its loan portfolio in the real estate sector, which becomes problematic if the sector faces a downturn.

Country Risk

The risk of loss arising from a sovereign state freezing foreign currency payments (transfer/conversion risk) or when it defaults on its obligations (sovereign risk).

Example: An investor holding bonds issued by a country that defaults on its debt.

Counterparty Risk

The risk that the other party in a financial transaction will not fulfill its obligations.
Example: A counterparty in a derivatives contract failing to settle the owed amount.

Settlement Risk

The risk that one party will fail to deliver the terms of a contract with another party at the time of settlement.
Example: In foreign exchange transactions, if one party delivers the currency amount but the other party fails to deliver the corresponding amount.

Prepayment Risk

The risk that a borrower repays a loan before its maturity date, affecting the lender's expected returns.
Example: Homeowners refinancing their mortgages at lower interest rates, leading to early repayment.