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What is credit risk in bonds?

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WHAT DOES IT MEAN?

Credit risk is a critical risk component embedded in bonds. It comprises default risk and recovery risk for these bonds which usually offer investors fixed periodic interest payments and principal payback at maturity.

The default risk represents the probability that the promised interest or principal payments may not be made by the issuer. In the case of late or missing payments, the recovery risk refers to how much the investors would eventually receive from the issuer at the final settlement.

WHY IS IT IMPORTANT?

Commonly observed bonds in Singapore may include Singapore Government Securities (SGS), Singapore Savings Bonds (SSB), government agency bonds (such as bonds issued by the HDB, Central Provident Fund Board and so on) and corporate bonds. Although the credit risk is a common risk embedded in them, the exact magnitude of the risk is not apparent to investors as it is not mentioned explicitly.

The starting point to understand credit risk would be using the credit ratings provided by third-party international rating agencies such as Standard & Poor's, Moody's or Fitch.

The credit rating grades assigned by the agencies give a reasonable range of the relative level of credit risk which is mapped to different default probabilities and recovery rates computed by the agencies using historical data.

Although different agencies use different alphabet grades, they are comparable, ranging from the highest (for example, AAA or Aaa) to the lowest grade (for example, D represents "default"). Since the Singapore Government resides in the highest possible rating category (that is, AAA), the credit risk related to SGS, SSB and other government agency bonds will be at the minimum.

However, credit risk is much less transparent for corporate bonds, especially when they were not rated (that is, about half of the bonds issued in Singapore in 2016).

For international bond issuers, investors may use the credit default swap spreads to find out the level of credit risk embedded in the bonds. But such market benchmarks are not always available for local bonds.

The lack of trading activity in the secondary market makes the credit risk even less transparent for investors. Another way to assess the credit risk would be to examine the yield promised. The higher the yield compared with that from the SGS or SSB with similar maturity would indicate a higher level of credit risk.

IF YOU WANT TO USE THE TERM, JUST SAY:

"Credit risk should be carefully assessed by lenders as it is an indication of the risk that they may not receive the owed principal and interest from the borrower."

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