

A credit risk assessment framework is a structured approach used by financial institutions and lenders to evaluate the creditworthiness of borrowers and manage credit risk effectively. It typically involves a series of steps and considerations to analyse various aspects of a borrower's financial condition, business operations, and other relevant factors.

The main components involved in credit risk assessment process are:

1. **Borrower's Credit History:** The borrower's credit history is a crucial component of credit risk assessment and involves evaluating the borrower's past behaviour in managing credit obligations. Key aspects of the borrower's credit history include:

- a) **Credit Report:** Obtaining the borrower's credit report from credit bureaus such as Experian, Equifax, TransUnion which provides detailed information about their credit accounts, payment history, outstanding debts, credit inquiries, and public records such as bankruptcies or liens
- b) **Credit Score:** Assessing the borrower's credit score, which is a numerical representation of their creditworthiness based on factors such as payment history, credit utilization, length of credit history, types of credit used, and new credit inquiries. Credit scores range from poor to excellent and provide an overall indication of the borrower's credit risk
- c) **Payment History:** Reviewing the borrower's payment history on past and existing credit accounts, including whether payments were made on time, missed, or late. Consistent, timely payments reflect responsible credit behaviour, while delinquencies or defaults indicate higher credit risk.
- d) **Credit Utilization:** Analysing the borrower's credit utilization ratio, which is the percentage of available credit being used. High credit utilization may indicate financial strain or overextension, while low utilization suggests responsible credit management.
- e) **Length of Credit History:** Considering the length of time the borrower has had credit accounts open and active. A longer credit history demonstrates stability and responsible credit management, while a shorter history may pose higher credit risk.
- f) **Types of Credit:** Assessing the variety of credit accounts held by the borrower, including credit cards, loans, mortgages, and other types of credit. A diverse credit mix can indicate responsible credit management, while a limited mix may suggest higher risk.
- h) **Recent Credit Inquiries:** Reviewing recent credit inquiries made by the borrower, as multiple inquiries within a short period may indicate financial distress or attempts to obtain new credit, potentially increasing credit risk.

2) **Borrower's Financial Stability:**

Assessing a borrower's financial stability is a critical component of credit risk assessment, as it helps lenders evaluate the borrower's ability to repay debt obligations. Several factors can be considered when assessing a borrower's financial stability:

- a) **Financial Statement Analysis**
- b) **Revenue and Profitability Trends**
- c) **Cash Flow Analysis**
- d) **Debt Management**

3) **Market Conditions:** Assessing market conditions is essential in evaluating credit risk for borrowers as it helps lenders understand the external factors that could impact a borrower's ability to meet financial obligations. Here are some key market conditions to consider:

- a) **Economic Environment,** such as GDP Growth, inflation rates, unemployment levels and interest rates
- b) **Industry Trends:** Assess trends and developments within the borrower's industry, including market demand, competition, regulatory changes, and technological advancements. Strong industry fundamentals and growth prospects can mitigate credit risk, while challenges such as market saturation, regulatory uncertainty, or disruptive technologies may increase risk.

c) Market Volatility: Consider market volatility and fluctuations in asset prices, including equity markets, commodity prices, and currency exchange rates. Volatile markets can impact borrower financial performance, asset valuations, and access to capital, affecting credit risk.

### **Credit Scoring Model:**

One common credit scoring model widely used by lenders is the FICO (Fair Isaac Corporation) Score.

#### **Calculation of FICO Score:**

- The FICO Score is calculated based on information from credit reports provided by three major credit bureaus: Equifax, Experian, and TransUnion.
- FICO Scores range from 300 to 850, with higher scores indicating lower credit risk and better creditworthiness.
- The FICO scoring model considers various factors, each weighted differently, to calculate a borrower's credit score. The factors and their respective weights are as follows:
  - Payment History (35%): This factor assesses the borrower's payment history, including on-time payments, late payments, and any derogatory marks such as bankruptcies or foreclosures.
  - Amounts Owed (30%): This factor considers the borrower's total debt levels, credit utilization ratio (credit card balances relative to credit limits), and balances on different types of accounts.
  - Length of Credit History (15%): This factor evaluates the length of time the borrower has held credit accounts and the average age of their accounts.
  - New Credit (10%): This factor assesses the borrower's recent credit inquiries and new credit accounts opened, as multiple inquiries or new accounts within a short period may indicate higher credit risk.
  - Credit Mix (10%): This factor considers the variety of credit accounts held by the borrower, including credit cards, instalment loans, mortgages, and retail accounts.

#### **Interpretation of FICO Score:**

- Excellent (800-850): Borrowers with scores in this range typically qualify for the best interest rates and terms, as they demonstrate excellent credit management and low credit risk.
- Very Good (740-799): Borrowers with scores in this range are considered low credit risk and may still qualify for competitive interest rates and terms.
- Good (670-739): Borrowers with scores in this range are generally considered to have good credit, although they may not qualify for the lowest interest rates.
- Fair (580-669): Borrowers with scores in this range may encounter difficulty obtaining credit or may be offered higher interest rates due to moderate credit risk.
- Poor (300-579): Borrowers with scores in this range may have significant credit issues, including past defaults or delinquencies, and may struggle to qualify for credit or loans.

#### **Use of FICO Score by Lenders:**

- Lenders use FICO scores as a key factor in determining creditworthiness and making lending decisions, including mortgage loans, auto loans, credit cards, and personal loans.
- FICO scores help lenders assess the likelihood of repayment and set appropriate interest rates, credit limits, and loan terms based on the borrower's credit risk profile.
- Lenders may also use FICO scores to screen applicants, manage credit risk, and determine eligibility for promotional offers or credit products.