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Credit Risk Modelling Under Recessionary and Financially Distressed Conditions

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Credit Risk Modelling Under Recessionary and Financially Distressed Conditions

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Abstract

This paper provides clear cut evidence that economic recession and distressed financial conditions, as well as political instability constitute the key factors for mortgage default. Banning foreclosure procedures, often adopted by governments to mitigate the effects of the above conditions on loan defaulting, are found to positively influence the loan default probability, and thus they make efforts of banks to restructure (or refinance) mortgage loans a difficult task. Our results add support to the view that foreclosure moratorium may raise moral hazard incentives that borrowers will not maintain their payments in long run. The empirical analysis of the paper is based on an extension of the discrete-time survival analysis model which allows for a structural break in its baseline hazard function and a unique set of individual loan accounts. We also consider alternative specifications of the binary link function between default events and covariates. Asymmetric link functions are found to be more appropriate under financial distressed conditions.

JEL classification: G12, E21, E27, E43

Keywords: mortgage loans, survival analysis, structural breaks, financial distressed conditions, probability of default.

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