Default (finance)

In finance, **default** is failure to meet the legal obligations (or conditions) of a loan,[1] for example when a home buyer fails to make a mortgage payment, or when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

Distinction from insolvency and bankruptcy

The term default should be distinguished from the terms insolvency and bankruptcy.

- "Default" essentially means a debtor has not paid a debt which he or she is required to have paid.
- "Insolvency" is a legal term meaning that a debtor is unable to pay his or her debts.
- "Bankruptcy" is a legal finding that imposes court supervision over the financial affairs of those who are insolvent or in default.

Types of default

Default can be of two types: debt services default and technical default. Debt service default occurs when the borrower has not made a scheduled payment of interest or principal. Technical default occurs when an affirmative or a negative covenant is violated.

Affirmative covenants are clauses in debt contracts that require firms to maintain certain levels of capital or financial ratios. The most commonly violated restrictions in affirmative covenants are tangible net worth, working capital/short term liquidity, and debt service coverage.

Negative covenants are clauses in debt contracts that limit or prohibit corporate actions (e.g. sale of assets, payment of dividends) that could impair the position of creditors. Negative covenants may be continuous or incurrence-based. Violations of negative covenants are rare compared to violations of affirmative covenants.

With most debt (including corporate debt, mortgages and bank loans) a covenant is included in the debt contract which states that the total amount owed becomes immediately payable on the first instance of a default of payment. Generally, if the debtor defaults on any debt to the lender, a cross default covenant in the debt contract states that that particular debt is also in default.

In corporate finance, upon an uncured default, the holders of the debt will usually initiate proceedings (file a petition of involuntary bankruptcy) to foreclose on any collateral securing the debt. Even if the debt is not secured by collateral, debt holders may still sue for bankruptcy, to ensure that the corporation's assets are used to repay the debt.

There are several financial models for analyzing default risk, such as the Jarrow-Turnbull model, Edward Altman's Z-score model, or the structural model of default by Robert C. Merton (Merton Model).

Sovereign defaults

Sovereign borrowers such as nation-states generally are not subject to bankruptcy courts in their own jurisdiction, and thus may be able to default without legal consequences. One example is with North Korea, which in 1987 defaulted on some of its loans. In such cases, the defaulting country and the creditor are more likely to renegotiate the interest rate, length of the loan, or the principal payments.[2] In the 1998 Russian financial crisis, Russia defaulted on its internal debt (GKOs), but did not default on its external Eurobonds. As part of the Argentine economic crisis in 2002, Argentina defaulted on $1 billion of debt owed to the World Bank.[3]

Orderly defaults

In times of acute insolvency crises, it can be advisable for regulators and lenders to preemptively engineer the methodic restructuring of a nation's public debt- also called "orderly default" or "controlled default".[4][5] Experts who favor this approach to solve a national debt crisis typically argue that a delay in organising an orderly default would wind up hurting lenders and neighboring countries even more.[6]

Strategic default

When a debtor *chooses* to default on a loan, despite being able to service it (make payments), this is said to be a strategic default. This is most commonly done for non-recourse loans, where the creditor cannot make other claims on the debtor; a common example is a situation of negative equity on a mortgage loan in common law jurisdictions such as the United States, which is in general non-recourse. In this latter case, default is colloquially called "jingle mail" – the debtor stops making payments and mails the keys to the creditor, generally a bank.

Sovereign strategic default

As with Strategic default when a debtor *chooses* to default on a loan sovereign borrowers such as nation-states also can choose to default on a loan. Ecuador's president Rafael Correa in 2008 had given the order not to approve a debt interest payment.[7] See also Odious debt.

Consumer default

Consumer default frequently concern arrears in rent or mortgage payments, consumer credit, or utility payments. A European Union wide analysis identified certain risk groups, such as single households, being unemployed – even after correcting for the (significant) impact of having a low income -, being young (especially being younger than around 50 years old, with somewhat different results for the New Member States, where the elderly more often at risk as well), being unable to rely on social networks, etc. Even internet illiteracy has been associated with increased default, potentially caused by these households being less likely to find their way to the social benefits they are often entitled to. While effective non-legal debt counseling is usually the preferred -more economic and less disruptive- option, consumer default can end-up in legal debt settlement or consumer bankruptcy procedures, the last ranging from 1-year procedures in the UK to 6-year procedures in Germany.[8]

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