KPMG

Counterpart Credit Risk

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Measurement of Counterpart Credit Risk

Approaches to Measurement

Notional Amount

- Suitable for corporations with limited counterparts
- Not suitable when mixing investments and derivatives
- Good for monitoring extent of relationship, provides limited information on actual exposure

Mark to Market

- Provides information on the current exposure
- Can also be adjusted for netting agreements
- Provides no feel for future exposure
- Addresses all financial market exposures similarly

Mark to Market + Projected Exposure

- Provides a forward view however it can be challenging to calculate
  - ✓ Can use 'Rule of Thumb' – provides an assessment based on instrument and tenor
  - ✓ Can use an 'at risk' calculation
  - ✓ Needed if two way collateralisation/margining is to be used

Match the level of sophistication with the level of hedging activity, risk acceptance and range of counterparts

Measurement of Counterpart Credit Risk

Market Value

In assessing the credit risk ⇨ the key is determining the amount which a position can be replaced.

Dirty or clean valuation ⇨ need to be dirty

Should a CVA/DVA valuation be used?

- This is an assessment of the credit risk using just the value at the current market rates, does not represent what the future value will be.
- While banks still transact typically on a non CVA/DVA basis, then the replace cost test means that this valuation approach should not be used.

Collateral

- The credit risk measure approach is the same, the difference is that collateral will be required or can be collected at different valuation levels.

Margining

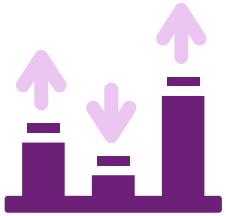
- Not applicable for local corporations – as hedges are not being cleared through an exchange – this is something which is applicable in the US.

Methodology for setting limits

Methodology for setting limits

Linked back to:

- The manner in which the credit risk is calculated
- Support the management of treasury risks and not inhibit
- How credit risk is to be managed
- Be straight forward, so risk is clear



Also relates to the manner in which hedging is being taken;

- ✓ Only one or two counterparts available, then no need for setting limit.
- ✓ Can be grouped at a rating level
- ✓ Can be a set amount or based on diversification

The setting of the limits will also need to be considerate of any netting and collateral arrangements.

Just because there may not be a defined limit does not absolve from reporting, all credit exposures need to be reported

Management of Counterpart Credit Risk

Strategies for Management of Counterpart Credit Risk

- **Most corporations do not actively manage CCR**

- **Although more corporations are considering using collateralisation**
  - ✓ mostly seeking to improve pricing, this is happening more in US or Europe
  - ✓ The advantage in pricing needs to be assessed versus the cost of providing collateral
  - ✓ Corporations with multiple risks gain more of an advantage in contrast to single risk corporations, as the different risks could offset each other.

- **Collateralisation is commonly used now between financial institutions**

- **Cross Currency Interest Rate Swaps are causing the most challenges**
  - ✓ Offshore debt issuance when the A$ was high is now creating significant in the money valuations.

Corporate Case Study

The Challenge

- **Currency movements was causing credit limits to be breached from CCIRS**

- **Need to go to Board to get limit increase**
  - ✓ this has happened more than once

- **There was not a clear measurement approach set for establishing limits**
  - ✓ the approach was linked to rating and the existing limits in place.

- **Was looking for an approach that would adjust with changes in the business's treasury needs and risk appetite.**

Corporate Case Study

The Solution

- Linked the credit risk acceptance to the organisation's overall risk framework and level of acceptance, which for treasury activities was ranked low. In the organisation risk matrix the frequency of the risk was set as a function of the maturity profile of the hedges not the likelihood of default (i.e. 5 years) combined with a medium consequence, which was a loss of up to $10 million, as ranked low in the risk matrix.
- $10 million is the set amount of credit risk allowed. A matrix is then developed which sets limits per counterpart based on their rating then uses the ratings likelihood of default and recovery rate to determine an 'at risk' amount – this is totalled across all counterparts and cannot exceed $10 million (this is the 'Board limit'). This approach is applicable as it is based on the premise that the hedging is to be done regardless so the credit risk will be there.
- The objective was having a diversified approach favouring more highly rated counterparts, hence a ratio for the limits was set between different level of ratings.
- Treasury was given authority to decrease the credit limit on an individual organisation.

Corporate Case Study

The Solution

- The outcome was credit risks being increased (providing sufficient coverage for the current business).
- The limits are supported by a framework which is linked to the organisation's risk framework.
- The limits can be adjusted at a counterpart level to facilitate different treasury needs.
- The limits will be adjusted as there are changes in the business in line with adjustments to the organisation's risk management framework – for instance if the risk acceptance level is increased, the credit limits can be adjusted up and vice versa.

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Thank you

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