

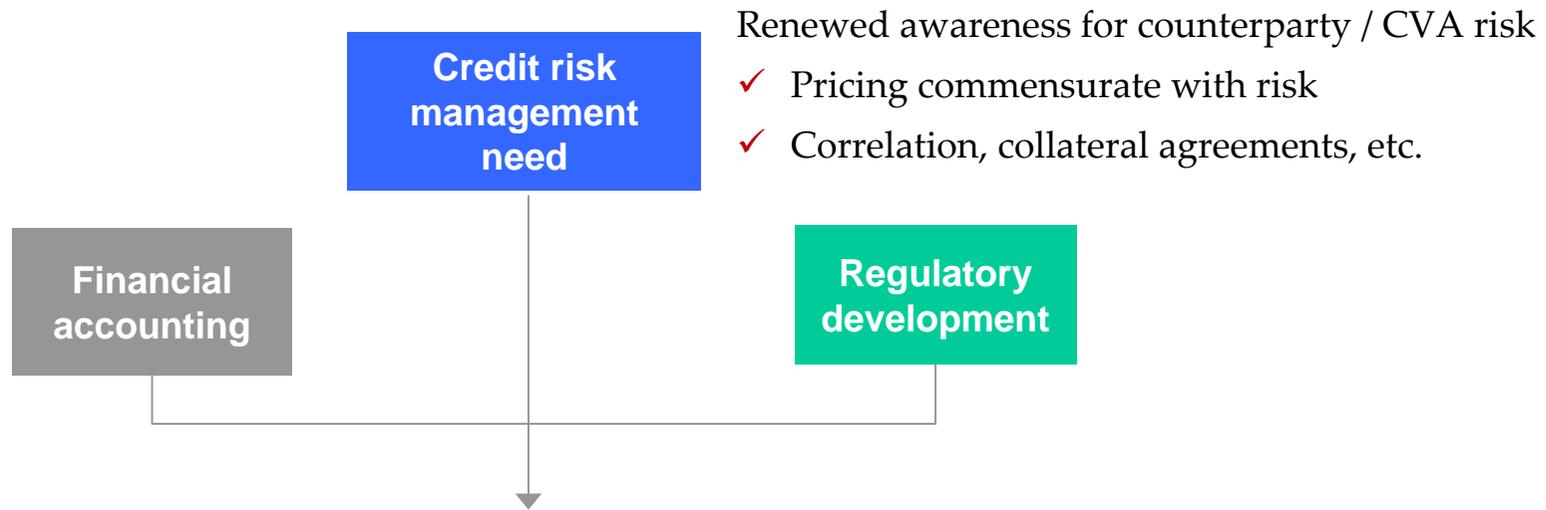
# Implementation of CVA - Far-reaching Value

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# Recent development around CVA



**More financial institutions implementing CVA at transactional level and working to manage CVA risk dynamically**

**⇒ How can you ensure that CVA gets incorporated in an institution's risk management process and fully embedded in the institution?**

**What value can you expect from the implementation of CVA?**

# Typical objectives for CVA implementation

- Measure counterparty risk size and price commensurate with the risk
  - Charge proper cost for the risk
  - Measure and understand risk-adjusted return by transaction, client, and business unit
- Enhanced counterparty risk management
  - Reduce overall credit risk, including concentration and credit migration risk
  - Reduce P&L volatility by executing hedges for both credit and market risk factors (⇔ also, address the need for financial accounting purpose)
  - Centralize counterparty risk management
  - Reduce capital required for counterparty risk
- Facilitate the growth of client business
- Optimize counterparty risk portfolio and leverage any revenue opportunity
  - Optimization of the portfolio and improvement in capital efficiency

# CVA Implementation: objectives and effects

By implementing transactional CVA into day-to-day business and its dynamic management -

*Direct, immediate effect*

- Measure counterparty risk size and price commensurate with the risk <Objective metric that allows the cost to be visualized>
  - ✓ Charge proper cost for the risk :
    - Allow the cost which has been not tangible or left ambiguous to be visualized and measured
    - Avoid business opportunities from being missed and adverse or excessive risk concentration due to 'mis-pricing'
    - Fund hedge cost
  - ✓ Obtain accurate risk-adjusted return data by transaction, client and business unit:
    - Quantification of all the costs related to counterparty risk (credit, collateral, funding, etc.) in an appropriate and comprehensive manner facilitates more concrete discussions in the decision-making process for approval and portfolio management
    - Facilitate exploring other alternatives than "Yes/No"
- Enhanced counterparty risk management <Centralized and enhanced risk management>
  - Tools and power (authority & financial resources) to ensure increased effectiveness of risk management framework
  - Clarification of the roles and responsibilities throughout origination and risk management process
  - Facilitate the expansion of client business by adding to risk management tools available and reducing existing risk / capital usage amount

# CVA Implementation: objectives and effects

By implementing transactional CVA into day-to-day business and its dynamic management -  
*Longer-term, ultimate impacts*

- Performance evaluation and resource allocation
  - Achieve fair performance evaluation through accurate cost measurement
  - Provide inputs to develop a business strategy, including allocation of management resources
  - Facilitate a business strategy through enhanced risk management and increased alternatives available
- Increased transparency and consistency in the decision-making process
  - Increased accountability by introducing and establishing an objective metric
  - Promote a risk/return perspective further <Influencing a way of thinking>
- Enhance risk awareness and provide incentive <Incentivatizing the right behavior for an institution: Influencing a behavior>
  - Automatic, institutionalized mechanism to prompt and ensure appropriate risk judgment/selection (not on a ad-hoc basis)
  - Being able to offer a transparent standard to recognize risk-reducing efforts and incentive for such efforts
  - Lead to enhanced risk culture for an institution as a whole, such as risk awareness shared across, including front office, and risk-reduction measures proactively explored

# Examples

- Prices quoted with always taking into account CVA; Know Walkaway price exactly
  - Trade unwind/putting on an offsetting trade, assignment
  - Prompt you to better understand the composition and sensitivities of each client portfolio
- Work on CSA negotiations more proactively
  - CVA refund commensurate with the magnitude of risk reduction; reflected in performance evaluation
  - Pay attention to details such as margin call frequency and eligible collateral type
- Consult voluntarily with Risk Department/CVA desk as appropriate for trades where you perceive higher risk exists
  - Wrong-way risk
  - Transactions where legal enforceability of collateral agreement, etc. is questionable
  - Concentration risk
  - Collateral for which liquidity and ease of marking to market may pose a concern
- Adjust a business strategy in light of more accurate or complete measurement of risk size and cost

**It is necessary that relevant risk factors are reflected properly in the calculation of risk size and CVA, and that methodology are transparent and understood well**

# Ultimate goal – true value

- Incentivatize the right thought process and behavior
    - Visualize the cost associated with counterparty risk
    - Increase the use of a risk/return perspective through quantitative and objective measurement of risk-adjusted return
    - ‘Automatic, institutionalized’ risk selection mechanism through proper pricing
    - Alignment of risk appetite
  
  - Strengthen risk culture
    - Risk management should not end up with isolated efforts; Share risk awareness across departments
      - Establish common evaluation metric and ‘language’ → Nurture and enhance organization-wide risk culture
      - Relationship with and contribution to business plan / strategy:
        - Input for its development
        - Alignment with risk management framework
        - Contribution to its successful accomplishment
- ⇔ Critical for sustainable success

*Adoption of transparent common language to promote risk culture to spread across and penetrate your organization*

# Ultimate goal – true value

Business strategy

Business objectives need to be accomplished

- ✓ in a sustainable manner

Risk management

Enhancement of risk management framework/capabilities + risk culture

- ✓ Authority, setup and financial resources to allow actions to be taken as needed
- ✓ Clarification of the role and accountability of each dep't/staff and risk awareness shared by everyone
- ✓ Ongoing efforts (not one-time)

CVA is one of the tools to achieve the above

- ❖ Provide transparent metrics for risk and corresponding return to promote objective, tangible discussions
- ❖ While heightening awareness for risk and its cost, promote risk/return based decision-making (in credit approval, resource allocation)
- ❖ Function as incentive to encourage desired actions from the perspective of *an organization as a whole*
- ❖ Get risk culture spread *across the organization*, including front office

# Remember – to extract maximum values

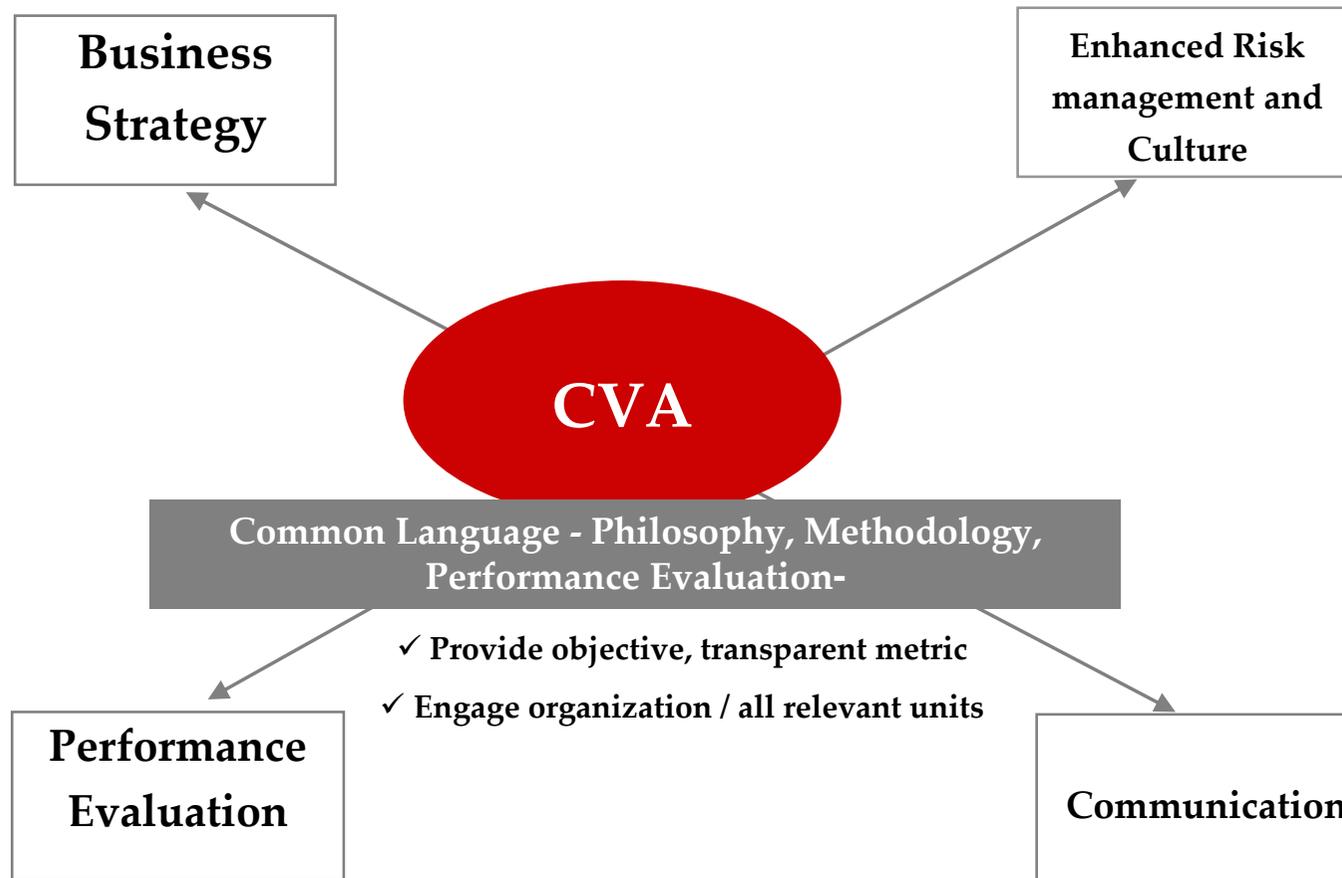
- Role as **Change Agent**

*CVA can influence an institution's thought process and behavior and as such, it's important to get it understood well and used properly*

- Importance of communication

- CVA cannot be recognized merely as one of 'taxes' in order to leverage its implementation to the maximum
- Friction with existing philosophy, practices, etc., conflicts with other departments:
  - Introducing a new perspective and risk management technique: possibility of conflicts with current way of thinking, practices, etc.
  - In case that CVA desk is given a mandate to seek revenue opportunities aggressively, possibility of conflict of interests with existing other desks in terms of business opportunities and resources including credit lines
- Potential P&L impacts (increased volatility)  
↓
- 'Enlightenment' efforts and sending out information proactively – both at the management and on the ground
  - Value of CVA implementation
  - Training on concepts, methodology and pricing tools (ensure transparency and objectivity)
  - Information on accomplishments/successes from CVA implementation, portfolio data
- Two-way, constant communication

# CVA as a tool to prompt change





# THANK YOU

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