

Workshop

Counterparty Risk Management and Application of CVA

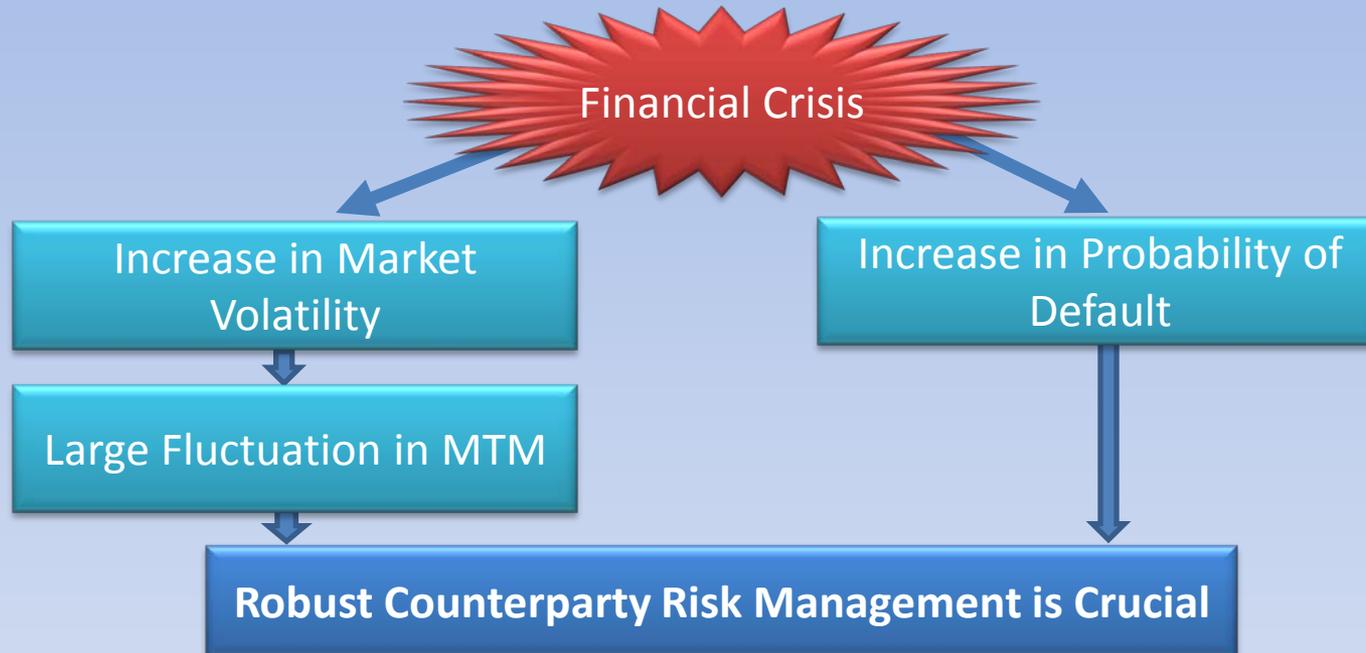
Counterparty Credit Risk Management with ISDA® Master Agreement and CSA

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Increasing Importance of Robust Counterparty Risk Management



- Is your valuation correct?
- Is close-out netting with the counterparty enforceable?
- Does your collateral efficiently work as a credit support?
- Does your internal risk management structure function well?

- ISDA Master Agreement
- Credit Support Documents
- Legal enforceability
- Enhancement of operational infrastructures
- Collaboration and coordination between front office, risk management, legal and operations.

Importance of Correct Valuation in Counterparty Risk Management

- ◆ Correct valuation of transactions and collateral is a key to sound counterparty risk management.
- ◆ It is necessary to value transactions and collateral, as well as to calculate potential future movements of current valuations.
- ◆ Valuation should be daily and correct.
- ◆ Valuations are especially important when Events of Default occur under the ISDA Master Agreement
 - Non-defaulting party to calculate the net mark-to-market value (current exposure) of all outstanding transactions under the ISDA Master Agreement on Early Termination Date
 - If collateralized: In addition to the net mark-to-market value of the transactions, non-defaulting party to calculate the sum of the current market value of collateral assets held on Early Termination Date

	Valuation	Potential future movements
Exposure	Net mark-to-market value of all transactions under the ISDA Master Agreement	The potential increase in the net mark-to-market value over a predefined period. ➡ Could be covered by initial margin (Independent Amount under the ISDA CSA)
Collateral	The sum of the market value of all collateral assets held inclusive of accrued interest and dividends	The potential decrease of the value in collateral assets held over a predefined period. ➡ Could be covered by haircuts of collateral assets (Valuation Percentage under the ISDA CSA)

ISDA Master Agreement and CSA (Components having an impact on credit risk)

◆ ISDA Master Agreement

- ◆ Legal entity of the counterparty in the ISDA Master Agreement
- ◆ Events of Default, Termination Event, valuation measures of Early Termination Amount, Letter of Guarantee, etc.
- ◆ Transactions covered under the ISDA Master Agreement
- ◆ Parties covered under the ISDA Master Agreement, e.g. Multibranch Party, etc

◆ CSA

- ◆ Threshold
- ◆ Minimum Transfer Amount
- ◆ Independent Amount
- ◆ Valuation Percentage (Haircut applied to collateral assets)
- ◆ Frequency of margin calls
- ◆ Transfer Timing of the collateral assets
- ◆ Dispute Resolution etc.

Recent Topics

- ◆ Valuation Measures under the ISDA Master Agreement
 - ◆ Market Quotation / Loss
 - ◆ Close-out Amount
- ◆ Amendment to the ISDA CSA
 - ◆ Reducing Threshold / Zero Threshold
 - ◆ Reducing Minimum Transfer Amount
 - ◆ More frequent margin calls
 - ◆ Ad-hoc calls
 - ◆ Cash Collateral
- ◆ Enhancement of collateral management process
 - ◆ One of Commitments to improve OTC Derivatives trading infrastructures

Trends in Documentations and Practices in Collateral Management in Japan

- ◆ Amendments to the ISDA CSA or changes made to collateral management practices by many firms after recent financial crisis
 - ✦ Reduction of Threshold
 - ✦ Reduction of Minimum Transfer Amount
 - ✦ Increased ad-hoc calls to counterparties
 - ✦ Increased frequency of valuations

- ◆ Not yet amended nor changes made by many firms
 - ✦ Shortening Transfer Timing
 - ✦ Increased use of electronic platforms
 - ✦ Portfolio reconciliation on regular basis

(Based on the results of “2009 Annual Survey of Collateral use in OTC derivatives in the Japanese Market”)

Efforts to Enhance Bilateral Collateralization Arrangements for Robust Risk Management (2010 Roadmap for Collateral Management)

- ◆ Best Practices for Collateral Management
- ◆ Electronic Communication of Margin Calls
- ◆ Portfolio Reconciliation Implementation Plan
- ◆ Legal Review, Analysis, and Improvements on Current Documentation
- ◆ Reducing Barriers to Use of a Third Party in Independent Amount Holding Arrangements
- ◆ Promote Efficient Collateralization with CCPs
- ◆ Recommendation for Regulators and Legislators