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Counterparty Credit Risk

What Have We Learnt After Lehman and AIG?

Scope and Objectives

- **Lehman Brothers' bankruptcy and AIG's bailout brought the concept of counterparty risk to light** across a variety of products. Market participants who were aware of master, collateral and netting agreements (such as ISDA, CSA, etc.) in principle had to quickly understand and apply them.
- Post Lehman and AIG, and given continuing concerns about counterparty risk, it is **important for those involved in** both the execution and operations of **transactions to understand how they work if their counterparty defaults**.
- Even more important is to understand the risk to, and collateral agreements in place with, a counterparty and **how to hedge or manage those risks in order to put preventative measures in place before a default is even a concern**.
- In this course participants will:
  - Review how the cash and derivative markets work and why banks manage so much counterparty credit risk
  - Analyze the risk profile of counterparty credit risk, breaking it down into market risk, credit risk and liquidity risk
  - Analyze the process of liquidating derivative trades post a counterparty default, including the general sequence of events laid out in master agreements, and how collateral and cross margining work
  - Use various derivative examples as case studies to illustrate the concepts of counterparty risk and liquidation
  - Discuss the current focus and trends in the market

Target audience

This course has been designed for audiences from front office through to operations, who are already familiar with cash and derivative products but need a better understanding of derivative markets and how they generate counterparty credit risk. The purpose is to give them a high level overview of the key issues and concerns around counterparty credit risk.

Topics not included

- Pricing and modelling derivatives

The objective of this course is to provide a high level overview of counterparty credit risk and the process in the event a derivative counterparty defaults. A discussion of pricing and modelling derivatives is beyond the scope of this course, but could be discussed in a follow-up course.

Training methodology

The course will focus on the practical realities of the market, rather than taking an excessively mathematical or academic approach. The course will blend discussion with case studies allowing the participants to think through the concepts and thus gain a more intuitive understanding of them.

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Course Agenda

Introduction

- What recent events have put counterparty risk in the spotlight
- Why counterparty credit risk is mostly about derivative counterparty risk
  - Counterparty credit risk in funded trades vs. derivatives

This section will discuss the concept of counterparty risk at large and why derivative counterparty risk is the key focus, and will help the trainer gauge the knowledge level of participants.

How derivative markets work

- How and why banks intermediate
  - Tailored vs. standardized trades
- Banks key counterparties vs. the universe of counterparties
  - Clients vs. interbank counterparties
- Review of the derivative products with the largest risk profiles
  - Key interest rate products
  - Key cross currency interest rate products
  - Key credit default swap products

Case study: Trading IRS, FX, and CDS

This section will review the dynamics of the derivative markets and how and why counterparty risk is generated.

Identifying counterparty credit risk

- What is "exposure"
  - Current vs. potential future exposure
  - Credit vs. market risk
  - The behaviour profile of different derivative types
- Managing the exposure
  - CVA
  - Regulatory capital
  - Credit Limits
  - Hedging strategies

Case study: Identifying Counterparty Credit Risk

Case study: Hedging Counterparty Credit Risk

This section will detail the types of risks that banks manage and describe the different ways the risk is managed.

The legal framework

- The master agreements (ISDA plus a few other standards)
  - The key tenets of ISDA and how they impact the risk
- How do collateral agreements work (CSAs in particular)?
  - Independent Amounts, Thresholds, Margin Calls

- Does cross margining apply?
  - How does it work?
  - Legal docs vs. practice
- What are the master agreement procedures when a counterparty defaults?

Case study: Netting Exposures

Case study: Calculating collateral haircuts

Case study: When do losses happen

Case study: Contesting withholding payments

This section will detail the legal and documentational framework used to trade derivatives and what it means in practice.

Current markets

- Current state of markets and calls for greater regulation
- Central clearing for CDS
- Central counterparties for all swaps

Case study: Current regulation proposal ramifications

This section will discuss where we are in current markets with respect to derivatives, and will review the recent initiatives to reduce counterparty risk and increase market transparency and the pros and cons of those initiatives.

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Course Directors

Terri Duhon

London

Terri Duhon is a market professional with almost 17 years of experience in financial markets with an expertise in risk management of derivatives and structured products. She graduated from MIT in Maths in 1994 and immediately joined JPMorgan as an interest rate derivatives trader in New York. In 1998, she moved to Credit Derivatives and Structured Products at JPMorgan and was instrumental in developing the credit derivative market as well as building the BISTRO business: a cutting edge securitization technique pioneered by JPMorgan. In that role she was responsible for setting up the first trading, operations and risk management of structured credit products. Later she moved to London and helped to build the European Structured Finance Business. In that role she was also the global risk manager for the counterparty credit risk book for all derivatives at JPMorgan in securitizations. In 2002, she joined ABN AMRO for 2 years as the Global Head of Structured Credit, focusing on the origination and risk management of structured credit products. Terri left in May 2004 to found B&B Structured Finance Ltd. where she has led expert witness teams for securitization litigation in both NY and London, assisted fund managers in assessing the risks of new asset classes as well as managed over 900 days of training globally for financial institutions in derivatives and structured products with a focus on the risk management of those products.

Anu Munshi

London

Anu Munshi has 14 years experience in financial markets starting with 8 years in structured credit at JPMorgan in the US, Asia and Europe. She started her career in New York structuring emerging market derivative products, following which she focused on credit derivatives within emerging markets. She then moved to Singapore as product manager for credit derivatives, CDOs and ABS for JPMorgan in Asia. She developed a market for these products, educating clients and distributing structured credit to Asian investors where there had been little knowledge or activity before. Anu moved to London in 2003 to set up the SPV notes business for JPMorgan in Europe, structuring and marketing credit-linked, asset-backed and hybrid notes. She was instrumental in developing the new generation of credit derivative products at JPMorgan including constant maturity CDS and options on CDS and synthetic tranches of CDOs. Anu joined B&B in summer 2005 and has since undertaken a variety of derivatives- and securitization-focused consulting projects, provided an expert opinion in several derivatives litigation cases, and conducted numerous training assignments in Europe, North America and Asia. Anu graduated with a BA in Economics and Mathematics from Franklin & Marshall College, Pennsylvania.

Betsy Mettler

New York

Betsy has 14 years of financial markets experience starting in investment banking at JPMorgan, with 7 years focused on developing the Credit Derivative market. Betsy began her career at JPMorgan in equity and fixed income syndicate coordination role and then moved to Debt Capital Markets. In 2000, she joined the innovative structured credit products team to manage the execution of their repackaging and structured securitization products. Moving into a marketing role, Betsy continued the growth of participants in the credit derivative market by working on the development and distribution of new products including the credit derivative indices. She moved to London in 2004 to lead JPMorgan's European Credit Derivatives Marketing effort and was instrumental in the establishment of a traded tranched index market. In 2005 and 2006, Betsy sold credit and derivatives products to UK Hedge Funds. Betsy joined B&B in summer 2006 and has since undertaken several derivatives and securitization consultancy projects as well as numerous training assignments in Europe and North America. Betsy received a Bachelors of Arts degree in Economics from the University of Virginia.

B&B STRUCTURED FINANCE

Who are B&B?

- B&B was founded in 2004 and is a partnership of experienced and respected financial market professionals who uniquely have recent, relevant market experience.

- B&B partners and consultants are experts across asset classes (equity, fixed income, credit, commodities and alternatives) with a focus on derivatives and structured products.

- B&B educates clients from basic through to advanced financial products and spanning:
  - Trading, structuring, sales and marketing, and management
  - Over 9,000 course participants and 900 training days since 2004

- We provide independent expert opinions in derivative litigations, specializing in:
  - Structured notes
  - Credit derivatives and securitization
  - Counterparty risk

- We also provide strategic consultancy services, tailored to suit client's individual requirements and specializing in:
  - Structured products across asset classes
  - Credit derivatives and securitization
  - High yield, leveraged and distressed loans
  - Hedge funds and private equity
  - Risk management (credit, market, liquidity)
  - Commodities and commodity derivatives

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