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## ***Credit Enhancement Techniques***

### **OVERVIEW OF CREDIT RISKS AND THEIR EFFECTS**

\* Evaluating three key issues:

- pricing of credit losses
- managing credit lines
- calculating credit risks and capital charges

\* Assessing the three components of credit risks:

- exposure to single counterparty
- default probability
- recovery rates

\* Credit risk vs market risk

### **CREDIT RISK OF VARIOUS FINANCIAL PRODUCTS**

- \* Credit risk of OTC options
- \* Credit risk of zero cost collars
- \* The evolution of credit risk of interest rate swaps through time
- \* Credit risk of exotic options
- \* Credit risk of equity swaps vs interest rate swaps

### **EVALUATING THE PURPOSE OF CREDIT ENHANCEMENT**

#### **TECHNIQUES**

- \* Control credit exposure and minimise risk
- \* Improving return on capital
- \* Solving problems created by credit risk of derivatives

### **TECHNIQUES FOR REDUCING COUNTERPARTY CREDIT RISK:**

#### **COLLATERALISATION**

- \* What is collateralisation?
- \* Assessing collateralisation as a credit risk mitigator and as a business driver
- \* Determining the need: cost versus benefits of implementing collateralisation
- \* Identifying constituents for effective collateralisation
  - liquidity
  - security interests
- \* Using collateral to reduce risk based capital requirements
- \* Trends in collateralisation

## **IMPLEMENTING COLLATERALISATION OF DERIVATIVES TO REDUCE CREDIT RISK**

- \* How to effectively select and value collateral:
  - how to accurately measure the exposure to be collateralised
  - determining what is acceptable collateral
  - how to effectively value collateral
- \* Identifying types of collateral which are effective for giving a complete offset
- \* Deciding when to use bilateral collateral agreements or one way collateral agreements
- \* Collateralisation as a tool in portfolio management: legal, security and liquidity issues that enhance the credit rating and quality of a portfolio

## **SPECIAL PURPOSE VEHICLES**

- \* History:
  - who created these and why
  - reaction to SPV's by the clients
  - how to isolate the SPV from the parent

## **CREDIT ENHANCEMENT IN ASSET BACKED SECURITIES**

- \* Internal vs. External credit enhancement techniques
- \* The role of Monoline insurance companies
- \* Examining several deals and observing the credit enhancement

## **NETTING AS A SUCCESSFUL TECHNIQUE FOR REDUCING CREDIT EXPOSURE**

- \* What are the principal forms of netting
- \* Identifying the risks and how netting can mitigate these risks
- \* Cross-border netting/cross product netting
- \* Assessing the impact of netting on a counterparty's potential credit exposure
- \* Understanding the role of the regulators and their interest in netting systems
- \* The G30 proposals
- \* How documentation can strengthen your netting position
- \* The legal perspective: when can you net and which countries would let you do it?

## **ALTERNATIVE FORMS OF CREDIT ENHANCEMENT**

*For each of the following alternative forms of credit enhancement, delegates will look at the mechanics, advantages and disadvantages, suitability guidelines and documentation requirements:*

- \* Credit enhancement for single transaction: single swap resets:
- \* Defaults modifiers:
  - credit guarantees
  - credit triggers
- \* Combining potential exposure reduction and default probability reduction:
  - mutual termination option contracts or time put
- \* Third party credit support
- \* Elective termination rights
- \* Credit insurance
- \* Enforceability issues:

- domestic
- international

**Case Study:** Choosing appropriate credit enhancement arrangements for given credit enhancement situations

### **APPLYING CREDIT DERIVATIVES TO EFFECTIVELY REDUCE AND DIVERSIFY CREDIT RISK**

- \* Analysing the special role of credit derivatives, the risks they offset and the risks they create
- \* Examining the different structures and their applications
- \* Structuring credit derivatives for optimum credit risk management
- \* Coping with the pricing complexities of implementing credit derivatives
- \* Overcoming the legal and documentation constraints
- \* Evaluating the potential of the recent regulatory proposals of credit risk and credit derivatives
- \* Integrating back and front office techniques to calculate risk on a bank portfolio containing credit derivatives

**Case Study:** Working in small teams, delegates will be presented with term sheets of various deals using credit derivatives and will analyse each deal.

### **THE WHOLE PICTURE: CREDIT PORTFOLIO MANAGEMENT**

- \* Defining credit portfolio management
- \* Advantages of adopting a credit portfolio management procedure
- \* CreditMetrics - the benchmark for understanding credit risk
- \* Exploitation of portfolio effects

### **TECHNIQUES FOR REDUCING CREDIT RISK IN EMERGING MARKETS**

- \* How to assess the credit risk of the issuer given the low standard of documentation and lack of historical data
- \* What is the appropriate probability of default
- \* What is a reasonable recovery value
- \* In case of default, how to deal with foreign legal systems & how to ensure agreements and judgements will be enforced