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BLOG

Counterparty Risk: A Multifaceted Risk

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Since the 2008 credit crisis, which saw the failure of large financial institutions such as Lehman Brothers, Fannie Mae, and Freddie Mac, markets have considered Counterparty Credit Risk (CCR) as the key financial risk. The global financial crisis exposed the entire industry, particularly financial institutions (FIs), to this new, complex, and dynamic risk. The complexity of transactions, collateralization, and structures such as special purpose vehicles enhances counterparty risk. In addition, counterparty risk presents a challenge because it is expressed as a blend of credit risk with other types of risks such as liquidity and market risks.

It is important to note that privately negotiated contracts, such as OTC derivatives, are exposed to counterparty risk. Depending on market movements, the contract value can move north or south, which makes CCR bilateral in nature, as either party can default. Aggravating the counterparty risk is the "wrong-way risk," which occurs when exposure to a counterparty is adversely correlated to the credit quality of the counterparty.

Following the recent financial and economic crises, FIs and regulators are working together to develop a robust suite of rules to reduce CCR. These include involving central counterparties, reconciling the daily collateral portfolio, diversifying exposure across different counterparties, trading with creditworthy counterparties, and netting and hedging FIs' exposure.

The implementation of tougher Basel III guidelines, such as the addition of a new capital charge for credit value adjustment risk and the independent review of CCR, has further signaled the need to reduce CCR. In recognition of this, banks have been improving their practices around CCR, including giving the Risk Management division more authority to manage risks.

However, one cannot say that the guidelines under Basel III and new regulations would completely set the system free of all risks. Rather than relying on regulations, banks should improve their own practices, such as using a specialized team of analysts to regularly analyze the credit of counterparties; conducting stress tests under a range of scenarios on a consolidated basis; applying strict limits on specific trades, exposures, or concentrations; leveraging the full potential of netting arrangements by squaring off positive and negative positions with the same counterparty in the event of a default; and contracting with high-quality entities (central counterparties) for clearing and settlement.

The successful implementation of these approaches should help banks limit their exposure and avoid the risk of a substantial portion of their capital turning sour, and also help monitor and manage their range of exposure.

Our credit-risk specialists help clients identify weakening credits through the use of credit assessment scorecards that assess counterparty risk. These scorecards are based on qualitative and quantitative credit risk parameters and specific industry-segment benchmarks and weightings that produce a numerical credit score, which can be mapped to the Ratings Services credit rating scale. We cover entities across FIs such as commercial banks, investment banks, brokers, and multilateral trading facilities.