

KDB Asia Limited

Table CCRA: Qualitative disclosures related to counterparty credit risk (including those arising from clearing through CCPs)
31 December 2017

Counterparty risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations; it is otherwise known as default risk. Counterparty risk relates closely to performance risk, which arises whenever one entity depends on another to honor the terms of a contract. The Company has adopted the Current Exposure Method for regulatory capital calculation of its counterparty credit risk ("CCR") arising from securities financing transactions and derivative contracts booked in the banking book. The Company has in place a set of policies and a comprehensive framework to effectively manage such counterparty credit risk. From a risk management perspective, the Company monitors the risk exposure due to fluctuations in the market by using the current exposure and the potential exposure value of the transactions.

The key objective is to ensure the adequacy and effectiveness of the Company's CCR control and management on the level and trend of the CCR exposure.

CCR may stem from credit exposures to counterparties in both the banking book and the trading book of the Company, irrespective of the types of counterparty concerned. The types of transactions that normally incur CCR include OTC derivatives, Securities Financing Transactions ("SFTs") and long settlement transactions which the Company may enter into in the course of conducting trading or capital market transactions.

The risk exposure should be measured as the sum of outstanding payments or deliveries as expected under the contract. There are two components for CCR; they are pre-settlement risk and settlement risk.

Pre-settlement Risk- Pre-settlement risk is the risk that a counterparty will default prior to the derivative instrument contract or agreement finally settlement at expiration. The default of the counterparty will lead to a replacement risk exposure equal to counterparty's net obligation on that contract, that is the cost of replacing ("Replacement Cost") the original transaction at current market prices.

Replacement Cost - Replacement cost is a basic metric of credit exposure due to pre-settlement risk. It is the cost that the Company would incur if counterparty completely defaults on its obligations.

Current replacement cost ("mark-to-market exposure") is the replacement cost of a portfolio of contracts with a counterparty based upon those contracts' current market values.

Settlement Risk- Settlement risk is the risk arises at final settlement if there is timing differences between when each party performs on its obligation under the derivative instrument contract or agreement. Failure to perform at the settlement date can arise from a number of reasons including counterparty default, operational problems and market liquidity constraints.

Wrong-way risk occurs when counterparty's risk exposures are adversely correlated with its credit quality. It is further classified into specific wrong-way risk and general wrong-way risk. The Company has set out a process for identification of wrong-way risk for individual counterparties. To monitor and control wrong-way risk, any wrong-way risk will be identified and evaluated at the time of credit application, in which the analysis and mitigation measures are documented in the credit proposal for approver's consideration. The wrong-way risk will be monitored during the tenor of relevant transaction, and cases with wrong-way risk are reported.