Best Practices for Counterparty Risk Management

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Agenda

Disney’s Counterparty Risk Program

Counterparty Risk Best Practices

Why It Works

Next Steps
Learning Objectives

• Understand the key features of a counterparty risk policy
• Understand appropriate metrics for evaluating and monitoring counterparty risk
• Understand what to negotiate in ISDA and CSA agreements
• Understand how to put in place a collateral management program to mitigate counterparty risk
Disney’s Counterparty Risk Management Program
The Walt Disney Company

Theme Parks & Resorts
Studio Entertainment
Media Networks
Consumer Products
Interactive

Walt Disney World Resort
Disneyland
Disneyland Paris
Tokyo Disney Resort
Hong Kong Disneyland
Walt Disney Imagineering
Disney Cruise Line
Disneyland

Lucasfilm Ltd.
Marvel
Pixar Animation Studios

ESPN
The Worldwide Leader in Sports

Disney
Disney Princess
Disney Home
Disney fairies
Disney English
Disney Baby
Disney Publishing Worldwide

ABC
Family

A&E
History

Infinity
Club Penguin

AFP® Annual Conference
# Overview of Corporate Treasury

## Our Mission
- To provide innovative financial solutions to allow the Company to achieve its strategic objectives and manage its exposure to the global financial markets.

<table>
<thead>
<tr>
<th>International Treasury</th>
<th>Investment Management</th>
<th>Corporate Finance &amp; Financial Risk Management</th>
<th>Cash Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manages global currency exposure, international JV financing activities and international M&amp;A support.</td>
<td>Provides investment oversight for the pension and 401(k) plans.</td>
<td>Executes domestic financing and capital raising initiatives, domestic M&amp;A support. Manages interest rate exposure from the Company’s global debt obligations.</td>
<td>Manages the global movement of cash and all banking services for business units.</td>
</tr>
</tbody>
</table>
Disney Capital Markets Activity

• Asset classes that drive capital markets volume and counterparty risk
  – Foreign Exchange
  – Interest Rate Risk Management
  – Commodities
  – Commercial Paper
  – Long-Term Debt
  – Bank Deposits, CD’s and Money Market Investments
Treasury Capital Markets Operations

Front Office
- Exposure analysis
- Trade execution (derivatives and investments)
- Hedge accounting designation & prospective effectiveness assessment
- Intercompany loan administration

Middle Office
- Trade confirmation and settlement
- Control and Compliance Group
- Derivative Valuation
- Collateral management
- Assembles counterparty data that depicts risk across all product categories
- Manage settlements

Back Office
- General ledger and hedge accounting
- Retrospective hedge effectiveness assessment
Counterparty Risk Management Program

• The Walt Disney Company (TWDC) has a long history managing counterparty risk

• Risk mitigation practices enhanced and refined over time as financial markets evolved

• Culture within TWDC Treasury department includes a significant focus on counterparty risk management
  – Counterparty risk is taken into consideration when evaluating financial risk management strategies and executing derivative transactions
Evaluating Risk

How Disney Defines Counterparty Risk

- Mark-to-Market Risk
- Settlement Risk
- Cash & Investment Principal Risk

Capital Markets Risk
Monitoring Counterparty Risk

• Metrics reviewed each counterparty include:
  – Mark-to-Market exposure
  – Notional exposure
  – Bank deposit, CD’s and Money Market Fund balances
  – 5-Year Credit Default Swap (CDS)
  – Credit ratings: Moody’s, S&P, Fitch

• Other considerations include current events/news related to a specific bank, banks within a region (e.g. European crisis) or overall market volatility
Examples of Risk Mitigation Practices

- Establish ISDA and Credit Support Annexes (CSA) agreements with your counterparties
- CSA agreements can include provisions to exchange collateral at predefined MTM thresholds, dependent upon each parties’ credit rating
- Monitor closely concentration risk of exposures (notional and effective)
- Consider using Continuous Linked Settlement (CLS) to mitigate settlement risk for FX transactions
Best Practices for Counterparty Risk
### Evaluating Risk

#### A Comprehensive View of Counterparty Risk

<table>
<thead>
<tr>
<th>Cash in global bank accounts:</th>
<th>Investments:</th>
<th>Derivatives:</th>
<th>Credit facilities:</th>
<th>Credit facilities drawn:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Converted to common reporting currency</td>
<td>Time deposits, direct CP, money market funds</td>
<td>FX, interest rate and commodities contracts – notional and mark-to-market values (adjusted for FAS 157)</td>
<td>Unused facilities</td>
<td>Revolvers, letters of credit, etc.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash at risk</th>
<th>Potential risk</th>
</tr>
</thead>
</table>

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![Walt Disney Company logo]

![Treasury Strategies logo]

![Association for Financial Professionals logo]
Establish a Policy

- Objectives
- Definitions – what constitutes risk?
- Scope – which entities and activities are covered?
- Process overview
  - Limits
  - Monitoring
  - Mitigation
  - What to do in exception situation
- Responsibilities
- Reporting
Roles & Responsibilities

Front Office
- Set policy
- Establish counterparty risk criteria

Middle Office
- Value derivative positions
- Calculate counterparty positions
- Monitor counterparty risk and produce reports
- Manage collateral exchange and settlements

Back Office
- Account for collateral movements
Evaluating Risk

Determine Risk Tiers & Set Limits

Your policy and system should group counterparties according to stability and establish limits.

<table>
<thead>
<tr>
<th>Tier</th>
<th>Risk Ratings</th>
<th>Limits</th>
<th>Collateral Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>AAA-rated, CDS below X, etc.</td>
<td>• MTM limit</td>
<td>Set higher threshold limit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Notional outstanding limit</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Settlement limit</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>AA-rated, CDS below X, etc.</td>
<td>• MTM limit</td>
<td>Set lower threshold limit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Notional outstanding limit</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Settlement limit</td>
<td></td>
</tr>
</tbody>
</table>
Monitoring Risk

Independently Value Portfolio

Technology should be in place to produce mark-to-market valuations on derivative positions, independent of bank valuations.
Monitoring Risk

Establish Criteria

It is best to have a combination of dynamic and static measures to monitor risk.

<table>
<thead>
<tr>
<th>Dynamic Measures</th>
<th>Static Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Default Swap Prices</td>
<td>Credit Ratings</td>
</tr>
<tr>
<td>Market Cap</td>
<td>Capital Adequacy Ratios</td>
</tr>
<tr>
<td>Stock Prices</td>
<td>Loan Loss Reserves</td>
</tr>
<tr>
<td></td>
<td>Basel III Ratios</td>
</tr>
</tbody>
</table>
Monitoring Risk

Set Criteria – Credit Default Swap Prices

• Credit Default Swap Prices
  – 5 year CDS
    • Why 5 year versus 90 day?
  – Always look at CDS rate of change relative to rest of universe
Monitoring Risk

Set Criteria – Stock Prices

• Stock Prices and Market Capitalization
  – Volatile indicator
  – Can evaluate relative to 52-week high
  – Indicator of future revenue outlook
  – Decline of more than 5% in market capitalization could be flagged
Monitoring Risk

Set Criteria – Capital Adequacy Ratios

• Capital Ratio (Total Capital / Risk-Adjusted Assets)
  – Seeking Capital Ratios equal to /greater than 12.0
  – Capital Ratios less than 8.0 trigger review

• Tier II Capital Ratio (Tier II Capital/Risk-Adjusted Assets)
  – Seek Tier II Capital Ratios equal to /greater than 8.0
Monitoring Risk

Basel III Liquidity Measures

• Liquidity Coverage Ratio
  – Seek LCR greater than 1
  – High-quality, highly-liquid assets available must exceed the net cash outflows of the next 30 days

• Net Stable Funding Ratio
  – Seek NSFR greater than 1
  – Won’t be implemented until 2018, but global banks are reporting and measuring now
Monitoring Risk

Report Frequently

• Standardize and automate reporting across global entities
• Make it more frequent than quarterly – if volume warrants, should be daily
Mitigating Risk

Documentation

- Should use ISDAs for all derivative trading
- Ensure Credit Support Annexes exist for all ISDAs
- Negotiate reasonable bilateral thresholds
  - Threshold will vary based on creditworthiness of counterparty
ISDA Framework

Credit support documents
- Offers each party security against the other party's credit risk.

Master agreement
- Framework agreement between the parties.
- Covers non-commercial terms, including events of default, termination events, set-off, covenants and so on.

Schedule
- Master agreement may be amended by schedule.

Confirmations
- Set out the economic terms of each individual transaction.
- Incorporate the ISDA definitions for the relevant transaction.

ISDA definitions
- Depends on the type of derivatives.
Mitigating Risk

Diversify Counterparties

- Cash Concentration
- Investment Counterparties
- Other Dealing Counterparties
Mitigating Risk

Start Collateralizing Positions

Based on CSA thresholds, more and more clients are setting up collateral management programs to support derivative activity

- Allow for cash or US Treasuries
- Automate calculation of collateral positions in a system
- Can outsource this activity to a variety of providers
Mitigating Risk

Shorten Tenors and Net Settle Contracts

• Limit tenor of contracts depending on rating of counterparty

• If high volume of derivative contracts, consider net settling through third party

• Continuous Linked Settlements (CLS) service reduces settlement risk by operating as the counterparty and running a net settlement service in 17 currencies
What About Exceptions?

• Report to senior management immediately
• Move assets if possible
  – If you include cash in your counterparty risk reporting, that’s the most feasible to move
• Talk to counterparty about options
Why It Works
Benefits

- Reduces risk of loss due to counterparty default
- Instills culture that focuses on counterparty risk
- Better prepared for regulatory changes around clearing and collateral
Next Steps

• Put policy in place
• Assign responsibilities for process
• Update ISDA documentation
• Establish risk criteria that are meaningful
• Get ready for collateral management
• Keep updated on Dodd-Frank
Questions?

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