

Counterparty Default Risks

Credit risk by definition comprises of default, spread and settlement risks. Default risk refers to losses arising from occurred defaults of contractual counterparties (counterparty risk) or debtors (issuer risk).

In the case of counterparty risk, the final loss depends on the positive mark-to-market value of derivatives or reinsurance recoverables at the time of default and on the recovery rate which is affected by collaterals.

In the case of issuer risk the final loss depends on the investor’s holding of the security or deposit at the time of default, mitigated by the recovery rate.

Spread risk refers to losses resulting from changes in the credit spreads of debt instruments and credit derivatives. Credit spreads are affected when the

market’s perception of probabilities of defaults is changing. In essence, credit spread is the market price of default risk which is priced into the market value of the debt instrument. Hence the debt instrument’s value should lower before the event of default occurs. Because of these features, spread risk, including also the default risk of debt instruments, is categorized in Sampo Group under investment portfolio market risks.

Settlement risk realizes when one party fails to deliver the terms of a contract with another party at the time of settlement. Settlement risk can be the loss associated with default at settlement and any timing differences in settlement between the two parties. Settlement risks are effectively mitigated by using centralized settlement and clearing systems by Sampo Group companies.

Counterparty Default Risk

External drivers

Economic, social and financial market conditions, laws, taxation & regulations, technical development and innovations, natural disasters and other catastrophic events

- Changes in counterparty creditworthiness
- Terms of the instruments and collateral mechanisms
- Volatility of underlying instruments and collateral markets

Default risk of derivate counterparty

Credit losses resulting from:

- Rapid increase in value of net exposure
- Derivative counterparty is not able to post collateral or pay settlement amounts when they fall due
- Value of collateral differs from expected.

- Changes in counterparty creditworthiness
- Terms of the agreement

Default risk of reinsurance counterparty

Credit losses resulting from:

- Increase in reinsurance recoverables
- Reinsurer is not able to pay reinsurance recoverables when they fall due.

Negative impact on financial results