

**Risk Transfer Credit Risk Hedging
Final Audit Report
Report Nr.09/09
September 29, 2009**

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Introduction

In accordance with our FY2009 Audit Plan, EDC Internal Audit (IA) performed an audit of the Risk Transfer credit risk hedging process. EDC's loan portfolio assumes higher credit concentrations and lower credit quality than comparable financial institutions by virtue of its mandate. Accordingly, Risk Transfer launched a credit risk hedging program in 2009 to help mitigate the credit exposures in EDC's loan portfolio. The program to buy credit protection through the purchase of single name Credit Default Swaps (CDS) was approved by EDC's Board of Directors. A minimal number of CDS's have been purchased to date under the program.

Audit Objectives & Scope

The objective of this audit was to evaluate the design effectiveness of the controls surrounding the credit risk hedging processes. In evaluating design effectiveness, consideration was given to the appropriateness of the controls to mitigate risks pertaining to governance, issuer and counterparty, market value, compliance, transaction processing, and system. Definitions of these risks are provided in Appendix A. The scope of this audit covered all key aspects of CDS transactions including transaction initiation and approval, trade capture and transaction reporting, trade confirmation and settlement, and CDS valuations. Audit fieldwork was performed from March 2009 through August 2009.

Internal Audit Opinion

In our opinion, the design effectiveness of the Risk Transfer Credit Risk Hedging program is **Well Controlled**¹. The audit was performed concurrent with the launch of the program. A strong commitment was made by management to address control issues as they were identified. As a result, no major² audit findings exist. We found that the controls were effectively designed to mitigate the following ERM risk elements as they pertain to the credit risk hedging process: governance, issuer and counterparty, market value, compliance, transaction processing and system. The findings and associated recommendations are discussed in the following section.

¹ Our standard audit opinions are as follows:

- **Strong Controls:** Key controls are effectively designed and operating as intended. Best in class internal controls exist. Objectives of the audited process are most likely to be achieved.
- **Well Controlled:** Key controls are effectively designed and operating as intended. Objectives of the audited process are likely to be achieved.
- **Opportunities Exist to Improve Controls:** One or more key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process may not be achieved. The financial and/or reputation impact to the audited process is more than inconsequential. Timely action is required.
- **Not Controlled:** Multiple key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process are unlikely to be achieved. The financial and/or reputation impact to the audited process is material. Action must follow immediately.

² Our audit findings are ranked as follows:

- Major** - a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk is more than inconsequential. The process objective to which the control relates is unlikely to be achieved. Corrective action is needed to ensure controls are cost effective and/or process objectives are achieved.
- Moderate** - a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk to the process is more than inconsequential. However, a compensating control exists. Corrective action is needed to avoid sole reliance on compensating controls and/or ensure controls are cost effective.
- Minor** - a weakness in the design and/or operation of a non-key process control. Ability to achieve process objectives is unlikely to be impacted. Corrective action is suggested to ensure controls are cost effective.

Audit Findings & Recommendations

1. Controls to address MNPI.

CDS are security based swap agreements. Regulations restrict the trading of CDS on the basis of Material Non Public Information (MNPI). By virtue of EDC's ongoing contact with portfolio companies, individuals at EDC may come into possession of MNPI. Appropriate controls have been designed at the operational level to prevent CDS purchases in the event that EDC is in possession of MNPI. Entity level controls in the form of a policy, training and communication are needed to ensure the effectiveness of these operational controls. Accordingly, we have recommended that a MNPI policy be developed and that the implementation and communication of this policy be supported by training for targeted employees.

Rating of Audit Finding - Moderate

Action Owners - Risk Transfer in collaboration with Legal

Due Dates - Q2 2010

2. Counterparty Risk Monitoring and Reporting

Processes are in place to authorize, monitor, mitigate and report on counterparty risk initiated through EDC's Treasury activities. Risk Transfer CDS activities also generate counterparty risk but have not yet been formally integrated into the policies and processes applied to Treasury transactions. Accordingly, we have recommended that the scope of the Treasury Credit Risk Policy be expanded to include CDS exposures. One overall credit limit should be assigned to a counterparty, and there should be a single DOA process to authorize these counterparty credit limits. The Risk Transfer DOA (C4) should be expanded to include authorization of counterparty credit limits, which should mirror the existing Treasury DOA in Appendix G-1 of GEN 002 in this regard. Daily monitoring reports of counterparty credit exposures should also be enhanced to include the Risk Transfer portfolio.

Rating of Audit Finding - Moderate

Action Owner - Risk Transfer and MRM

Due Date - Q2 2010

3. CDS Valuation Methods and Responsibilities

EDC should be able to value all new Credit Default Swap (CDS) transactions internally. Recently, the Standard North American Corporate (SNAC) CDS contract convention was adopted to facilitate the clearing of corporate CDS contracts. This SNAC convention features a standardized coupon rate, rather than individually negotiated coupon payments that were previously the norm. This change necessitates adjustments to CDS valuation models. The existing model has not yet been adjusted for the new CDS convention. As a result, an interim process is in place to obtain CDS valuations from Bloomberg. However, this involves significant manual intervention creating operational risk. We recommend that the Numerix model be updated to accommodate the new SNAC CDS convention to allow for accurate valuation and automated transaction processing in the Treasury system. Once the Numerix model is updated, Loans Accounting should rely on the CDS valuations in the Treasury system at period end.

Rating of Audit Finding - Moderate

Action Owners - MRM/ Loans Accounting in collaboration with Treasury

Due Dates - Q2 2010

4. Controls to Ensure Counterparty Confirmations Are Obtained Prior to Issuing Payments.

Corporate Banking has established a control to verify the legitimacy and accuracy of CDS transaction payment details with the counterparty (CP) before payment is sent. The report that Corporate Banking uses to execute this control (DIM Report) does not currently highlight CDS transactions that have not yet been confirmed with the counterparty. As a result, significant manual effort is needed to identify these transactions. We recommend that the DIM Report be re-designed to sort payments by transaction status, highlighting any payments that have not been confirmed with the counterparty. This would allow Corporate Banking personnel to more easily and reliably monitor for unconfirmed payments to ensure that all such items are investigated and confirmed with the counterparty before payment is sent.

Rating of Audit Finding - Moderate
Action Owners - Corporate Banking
Due Dates - Q4 2009

Conclusion

The audit findings and recommendations have been communicated to and agreed by Management, who have developed action plans that are scheduled for implementation no later than Q3 2010. We would like to thank Management for their support throughout the audit.

Appendix A: Risk Definitions

| Risk Element | Definition |
|-----------------------------|--|
| Governance Risk | The risk that current governance and decision-making models, policies and practices are not effective in proactively and effectively managing the business. |
| Issuer & Counterparty Risk | The risk that the issuer of a marketable bond or a swap counterparty defaults. |
| Market Value Risk | The risk of both financial and opportunity loss due to incorrectly estimating the market's appetite for a borrower's name, country or industry sector; to mispricing; or to incorrectly structuring a transaction. |
| Compliance Risk | Risk due to non-compliance with a regulatory body or set of standards. |
| Transaction Processing Risk | The risk due to human or system error within a certain process or transaction. |
| System Risk | The risk due to information, communication or computer system (software & hardware) failure, computer virus, inappropriate access and data integrity issues. |