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Navigating the Basel Committee proposals on counterparty credit risk

Insights, possible implications for banks

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Passing through many a storm

Global banking regulators have been on their toes steering the financial ecosystem away from repeated headwinds.

Events such as the Covid-19 pandemic-induced shutdowns, the Archegos crisis of 2021, the gilt crisis in 2022, bank failures in the US in 2023-2024 and geopolitical uncertainties have kept unleashing shock waves, which underscore the risks of a sudden shift in monetary policy and financial environment.

The prolonged low interest environment during the pandemic prompted some banks to considerably broaden their capital market offerings to riskier and less transparent counterparties in pursuit of higher yields. This resulted in complex interconnections between banks and non-banks — non-banking financial institutions (NBFIs), unregulated entities such as hedge funds and family offices — through financial instruments such as loans, securities, derivatives and funding relationships that have posed systemic risks.

Material concentration in counterparty credit risk (CCR) and the increasingly intricate and diverse linkages between banks and NBFIs, inadequate CCR risk management practices — such as insufficient monitoring of counterparty risk, failure to resolve internal limit breaches, and inadequate risk mitigation measures and risk governance framework — leading to significant failures in the past underscore the need for robust and effective CCR management.

Aspects banks can focus on to bolster their CCR management...

As the financial landscape evolved, CCR, too, has been mutating, compelling financial institutions and regulators to not just to be vigilant but flexible to mitigate emerging risks.

Some of the focus areas for banks are:

- Streamlining and simplifying credit assessment procedures
- Active due-diligence and client monitoring (during onboarding and the client lifecycle through early warning indicators and covenant and collateral monitoring)
- Developing closeout playbooks and devising realistic simulated close-out scenarios
- Careful calibration of limits
- Improving margining and stress-testing practices, particularly for high-risk clients vulnerable to tail-risk events and potential close-out risk
- Establishing robust risk governance structure with emphasis on reporting and integration into decision-making
- Developing agile and reliable risk infrastructure and systems

Banks could also revisit their strategic roadmaps to bolster CCR capabilities aligned with target business objectives, market dynamics, and regulatory expectations. This approach would help identify opportunities to further develop and enhance the existing CCR management tools and processes.

In the recent past, regulators have released multiple guidelines urging banks to adopt a risk-based and proportional approach when applying these guidelines. The approach should consider the level of CCR generated by the business lines of banks, their trading and financing activities and the complexity of such CCR exposures.

According to the US Federal Reserve (Fed), banks have been fortifying their CCR management practices, including enhancing client information disclosures, increasing adoption of risk-sensitive margin practices, and using better risk management tools. The European Central Bank (ECB) notes that the presence of several sound practices across most institutions demonstrate the sector's adaptability to evolving market conditions. However, there are some areas where only a few institutions adhere to sound practices.

…the Basel Committee's latest paper emphasises the same…

On April 30, 2024, the Basel Committee on Banking Supervision published a consultation paper on guidelines for counterparty credit risk management.

While banks globally have been under the spotlight for CCR management, the new proposals highlight increased scrutiny and underscore the significance of robust risk functions, specifically CCR management.

The Basel Committee proposes comprehensive guidelines to tackle the ongoing challenges in CCR management, suggesting focus on four key areas:

- Implementation of **comprehensive due diligence** both at initial onboarding and on an ongoing basis
- Implementation of **credit risk mitigation strategies** including advanced margining techniques, cross-collateralisation and written guarantees
- Refinement of **CCR exposure measurement and management** by employing various complementary metrics, such as potential future exposure (PFE) and stress testing, to evaluate the impact of adverse scenarios
- Establishment of a robust **CCR governance framework** with clearly defined responsibilities and procedures for CCR management, oversight mechanisms at both senior management and board levels and strong risk culture integrating CCR management into the decision-making processes

The Basel Committee is soliciting feedback on the proposals till August 28, 2024. Upon finalisation, the guidelines will replace the committee's previous guidance, titled '*Sound practices for banks — interactions with highly leveraged institutions*,' issued in January 1999.

…these have been a priority since long for banks and regulators…

CCR has been a focus area for banks and regulators for over a decade following events such as the collapse of Long-Term Capital Management in 1998. Since then, several international supervisory and regulatory reports and guidance notes have been issued on CCR management.

The collapse of Archegos in March 2021 and the gilt liquidity crisis of 2022 highlighted the urgent need for enhancing the guidelines. These events exposed pervasive weaknesses in areas related to due diligence, risk measurement and management, and governance with concerns magnified for high-risk counterparties, including entities with substantial concentrations, opaque operations, limited transparency, or high leverage.

Supervisory directives pertaining to CCR management have been issued by regulatory bodies in key areas, including the Fed, the ECB and the Prudential Regulation Authority (PRA) of the UK, particularly targeting banks with substantial trading book operations and derivatives exposure and designating CCR as the primary focus of banking supervision.

The Fed issued targeted guidance pertaining to CCR in the past, including SR21-19 (December 2021 – to be read in conjunction with SR11-10: Interagency Counterparty Credit Risk Management Guidance in July 2011), which reiterated its supervisory expectations for CCR management by banks after the Archegos default.

The significance of CCR management was underscored by Michael S Barr, the Vice Chair for Supervision of the Board of Governors of the Fed, at the Basel Committee's CCR conference in February 2024, where he recapped the need for comprehensive due-diligence practices and the importance of implementing appropriate risk measurement tools (primarily margining) and establishing effective limits.

Further, as part of its 2024 Comprehensive Capital Analysis and Review, the Fed introduced a 'Hyper-Archegos Test' to assess the potential impact on globally systemically important banks (G-SIBs) of simultaneous defaults of their five largest hedge fund counterparties.

Likewise, in the aftermath of the Archegos downfall, the ECB conducted a targeted analysis of the risk governance and management frameworks of a sample of banks heavily active in providing prime brokerage services, a specific capital markets activity associated with high CCR exposure. In August 2022, the ECB published its supervisory expectations for prime brokerage services, emphasising the importance of effective risk management, governance and culture in addressing CCR risks stemming from prime brokerage.

Later, in October 2023, following public consultation, the ECB released a report, titled '*Sound practices in counterparty credit risk governance and management*' identifying sound practices, grouped into four categories: (i) CCR governance; (ii) risk control, management and measurement; (iii) stress testing and wrong-way risk; and (iv) the watchlist and default management process. The importance of sound CCR management practices was reiterated by Elizabeth McCaul, Member of the Supervisory Board of the ECB, at the Basel Committee's CCR conference this February.

The PRA has also stepped-up scrutiny. In its recent release in October 2023, it shared insights from its thematic review of fixed-income financing at banks, identifying several shortcomings in CCR management and margining arrangements. Several of these CCR management themes closely mirrored earlier findings related to cash prime brokerage and synthetic equity financing subsequent to the Archegos default (outlined in the PRA's '*Dear CEO*' letter of December 2021 and in subsequent supervisory communications with the firms).

…especially due to material concentration of NBFI exposure

The interlinkages between banks and NBFIs have rapidly expanded over the years with material concentration in a few large banks. There have been instances where banks exposed to NBFIs have struggled to avoid large counterparty concentrations, leaving them vulnerable to the risk of spillover effects.

According to the ECB[1], the asset as well as the liability side exposures to NBFIs are concentrated among fewer than 20 large and complex European Union banks[2], which exposes them to contagion risks.

The top five of these banks account for ~half of total loans and securities exposure to NBFIs, and the top 13 for over 80%. On the liabilities side, 13 large banks account for ~80% of total repo borrowing from NBFIs with ~88% of such repo funding provided by top 10% of lenders[3] by size, highlighting elevated concentration risk.

In terms of derivatives transactions, 80% of the outstanding notional for derivatives traded by NBFIs in the euro area is intermediated by 10 banks, mostly domiciled in France or Germany, or subsidiaries of non-euro area banks. The concentration is even higher in commodity and credit derivatives trading, where the three largest banks account for over 75% of all trades with NBFIs.

[1] *Key linkages between banks and the non-bank financial sector (published as part of the Financial Stability Review, May 2023)*
[2] *Top banks include the 13 EU large banks that are among the ten banks most exposed to NBFI entities and includes eight EU G-SIBs*
[3] *Refers to the largest bank funding providers within a given NBFI sector*

Chart 1: Concentration of exposure of large EU banks to NBFIs

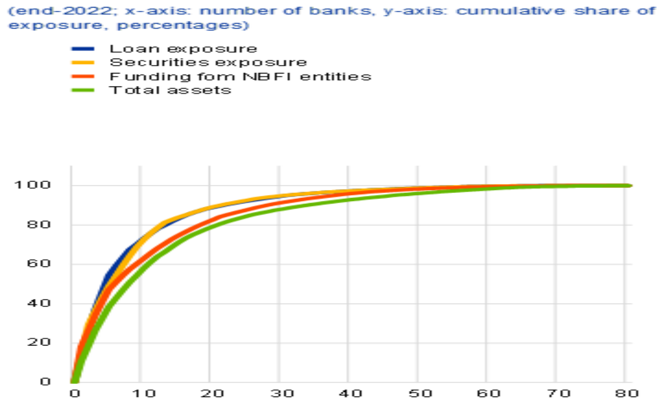
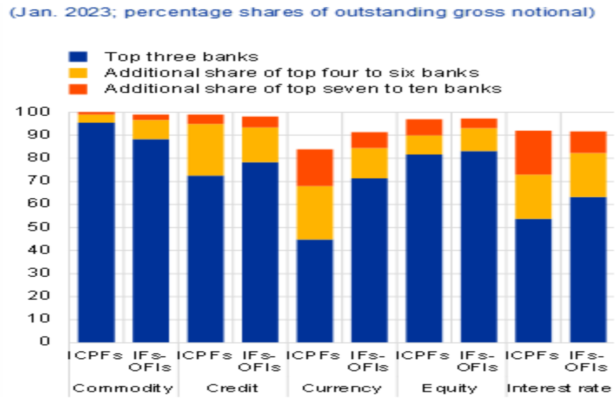


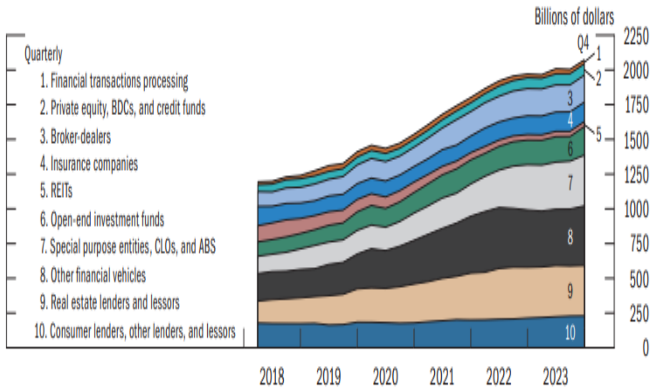
Chart 2: Concentration of EU banks derivatives' exposure to NBFIs



Source: ECB

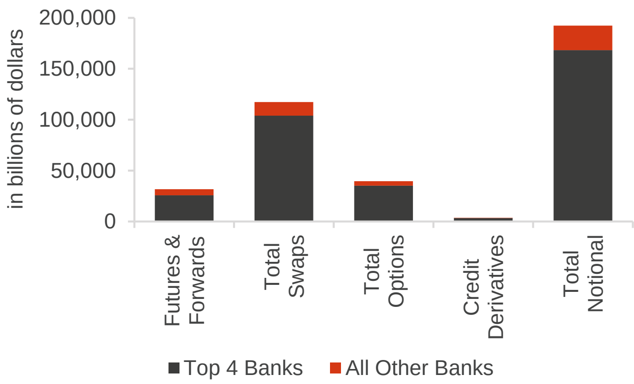
Similarly, the exposure of US banks to NBFIs has grown over the years, as reflected in significant expansion in committed amounts on credit lines and term loans extended. Derivatives exposure is also highly concentrated in US banks, with four large commercial banks accounting for 87.4% of total banking industry notional amount of derivatives, whereas the largest 25 accounted for nearly 100% of all contracts (as of 4Q23; *Source: Quarterly Report on Bank Trading and Derivatives Activities* published by the Office of the Comptroller of the Currency).

Chart 3: Rising bank credit commitments to NBFIs



Source: Federal Reserve's Financial Stability Report, April 2024

Chart 4: Four US banks dominate the derivatives* segment



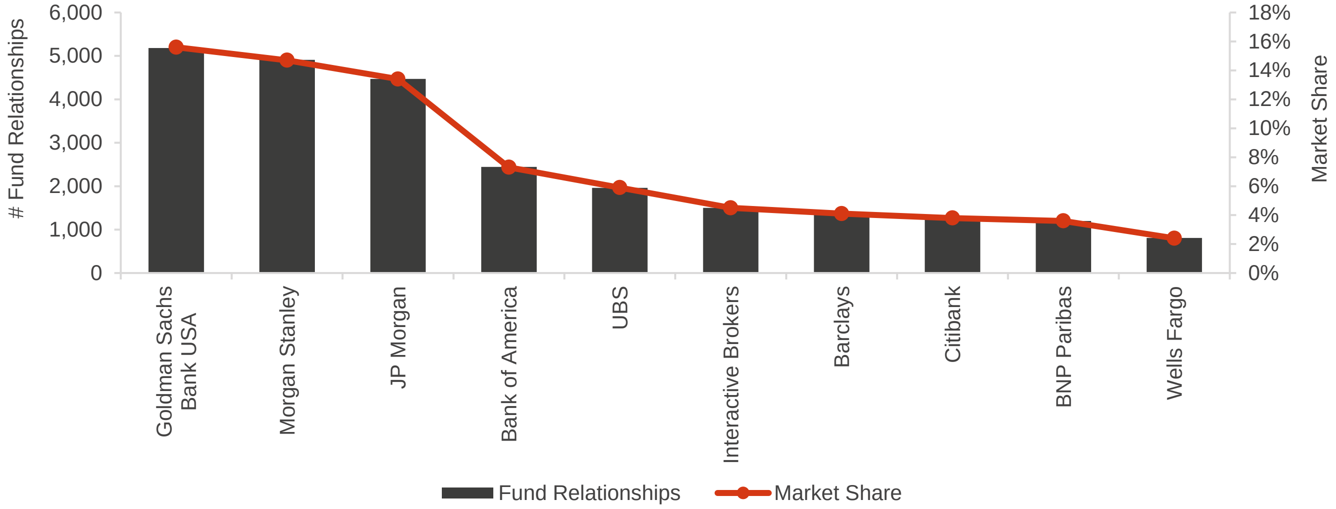
**Notional amount of total: futures, exchange-traded options, over-the-counter options, forwards, and swaps; Source: OCC's Quarterly Report on Bank Trading and Derivatives Activities (March 2024)*

Regulators have time and again insisted that banks need to have a clear line of sight on their exposure to different counterparties, enabling them to gauge possible risks.

In its March 2024 quarterly review, the Bank for International Settlements highlighted concerns about the material concentration in the prime brokerage business, with hedge funds heavily relying on only a few prime brokers, most of which are G-SIBs, each serving over 1,000 funds.

Furthermore, 10 financial institutions (of which nine are G-SIBs) accounted for about three-quarters of the total global fund relationships as of October 2023 (*Source: Prime Broker League Table* for Oct 2022-Oct 2023 released by Convergence Inc).

Chart 5: Global prime brokerage industry dominated by G-SIBs



Source: Fund Prime Broker League Table for Oct 2022-Oct 2023 released by Convergence Inc.

Closing thoughts

In response to potential CCR shocks and regulatory initiatives, banks have been in the process of implementing remediation programs and enhancing their management practices.

Key areas of improvement for banks have been credit risk assessment and continuous monitoring of counterparty creditworthiness, limit and exposure management and measurement, improving margining processes, as well as strengthening CCR governance and oversight.

We note that many banks have refined their quantitative risk rating methodologies and have focused on enhancing exposure metrics for potential future exposures and stress measures. Improvements have also been made to limit-setting, with increased granularity, and to escalation and breach management processes.

While regulators acknowledge the progress made by banks in reinforcing their CCR management capabilities, they highlight the need for continued efforts to enhance CCR governance and management approaches industry-wide, particularly given the high concentrations in the NBFI space, along with intensifying complexity of these exposures.

Supervisors should also be tasked with ensuring compliance and encouraging a proactive approach towards CCR management in the banking sector.

This collaborative approach will not only mitigate risks of future financial disruptions but will also safeguard against potential losses stemming from counterparty failures.

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