August 23, 2024

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
4051 Basel, Switzerland

Re: Guidelines for Counterparty Credit Risk Management; Basel Committee on Banking Supervision; ISBN 978-92-9259-757-3 (April 30, 2024)

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the consultative document ("Proposal" or "guidelines")[2] cited above, issued by the Basel Committee on Banking Supervision ("Committee") of the Bank for International Settlements ("BIS"). The Proposal is being issued in response to recent counterparty credit risk ("CCR") management failings and is intended to identify key practices to address these weaknesses.

Better Markets commends the Committee for addressing this subject. There is an urgent need for action to address weaknesses in banks' management of CCR exposures. These exposures are large, opaque, and have the potential to amplify economic shocks and send the financial system into crisis, at great cost to consumers, taxpayers, and small businesses. In short, they are ticking time bombs that have been largely ignored—other than rhetorically—for far too long; meaningful, concrete, and specific action is long past due. The time to act is now.

The Proposal adds to an extant body of supervisory guidance that attempts to address many years of ongoing material weaknesses in CCR management through yet more principles-based moral suasion. The hope appears to be that the industry will finally do a better job of identifying, measuring, managing, and controlling a range of risks associated with banks' web of interconnected CCR exposures if they are urged again to do so. However, there are inherent limits on the effectiveness of supervisory guidance in achieving meaningful changes to bank practices, and the history with CCR bears this out. We recommend that the Committee go beyond previous CCR guidance documents by clearly labeling certain CCR management deficiencies as unsafe and unsound banking practices, and by identifying the role of national supervisors in requiring timely corrective action.

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance— to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Guidelines for Counterparty Credit Risk Management; Basel Committee on Banking Supervision; ISBN 978-92-9259-757-3 (Apr. 30, 2024), https://www.bis.org/bcbs/publ/d574.pdf.

A prudentially conservative CCR measurement framework—in conjunction with appropriate exposure limits implemented by regulation in national jurisdictions—would have the force and effect that prior guidance has been unable to achieve. In that respect, the Proposal itself alludes to important shortcomings in the Basel Framework for CCR. Better Markets recommends that the Committee initiate a workstream to address the Framework weaknesses the Proposal has identified. It should also tighten the quantitative single counterparty net exposure limits and introduce single counterparty gross exposure limits into the Framework.

The next section consists of a brief overview of selected observations about longstanding weaknesses in banks' risk management of CCR and the high costs to the economy, financial system, and the public of those weaknesses. After 25 years of issuing CCR guidance, supervisors continue to express concerns about CCR management weaknesses, and CCR risks remain large, opaque, and concentrated. This clear track record requires corrective action and motivates our comments on the Proposal, which are provided in more detail in a subsequent section.

BACKGROUND

CCR is the risk of loss resulting from counterparty default or deterioration in credit quality.[3] CCR exists both in traditional lending and in banks' capital markets activities such as trading, securities financing transactions, and derivatives. Measuring and modeling of CCR from such capital markets activities is complex but also critically important.

The risks associated with opaque, interconnected exposures of large financial institutions burst into the public consciousness in 1998, when Long Term Capital Management ("LTCM"), at that time the largest hedge fund in the U.S., nearly collapsed in part as a result of derivatives losses.[4] Several of the largest financial institutions in the U.S. had exposure to LTCM. Concerned about contagion from a failure of LTCM igniting a financial crisis if not calamity, the Federal Reserve Bank of New York convened 14 of LTCM's large counterparties, who agreed to a rescue package to prevent the failure.

The LTCM episode was significant in part for focusing policymakers' attention on the potential for systemic risk associated with large interconnected CCR exposures. For example, the report on the LTCM crisis by the President's Working Group on Financial Markets ("PWG") stated:

> The near collapse of [LTCM] highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system.[5]

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3 *Id.* at 2.

4 Michael Greenberger, *The Role of Derivatives in the Financial Crisis: Testimony of Michael Greenberger, University of Maryland School of Law* 7-8, Financial Crisis Inquiry Commission Hearing (June 30, 2010), https://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-Greenberger.pdf.

5 PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS; HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT viii (April 1999), https://www.cftc.gov/sites/default/files/tm/tmhedgefundreport.htm.

The significance of the LTCM crisis was not lost on large banks or their regulators. In February 1999, for example, the Federal Reserve ("Fed") published a supervisory letter containing guidance on CCR[6] which said, among other things:

> [S]ome large institutions have credit risk exposure measurement and management regimes that, while effective in traditional areas of bank credit extension, need enhancements when employed in more sophisticated or complex trading and derivatives activities.[7]

It instructed examiners and supervisory staff to:

> [C]ontinue and, where appropriate, strengthen their efforts to evaluate . . . [banks' management of CCR].[8]

The letter did not, however, make any reference to supervisors' addressing or taking corrective action in response to CCR management weaknesses.

The Committee also published CCR guidance in 1999.[9] It indicated that managing exposures to highly leveraged entities is difficult because of the opacity of their activities, their use of leverage, the dynamic nature of their trading activities, and in some cases their market impact.[10] It stated that it had observed at some banks an over-reliance on collateralization of mark-to-market exposures, insufficient credit analysis and insufficient measurement and management of exposures, and exceptions to credit standards made out of a desire to conduct business with certain counterparties.[11] The 1999 guidance (25 years ago) stated that the Committee "encourages supervisors to promote the application of sound practices by banks" in their interactions with highly leveraged institutions.[12] However, again, the guidance made no reference to supervisors' taking corrective action to address CCR management weaknesses.

The PWG issued its above-mentioned LTCM lessons-learned report in 1999.[13] The report recommended among other things that financial institutions publicly disclose information about their material financial exposures to significantly leveraged institutions; that they improve CCR management; that regulators make capital rules more risk-sensitive; and that Congress enact legislation to support financial contract netting.[14]

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[6] Board of Governors of the Federal Reserve System, *Supervisory Guidance Regarding Counterparty Credit Risk Management* (Feb. 1, 1999), https://www.federalreserve.gov/boarddocs/srletters/1999/sr9903.htm.

[7] *Id*.

[8] *Id*.

[9] Basel Committee on Banking Supervision, *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (Jan. 1999), https://www.bis.org/publ/bcbsc123.pdf.

[10] *Id*. at 1.

[11] *Id*.

[12] *Id*. at 2.

[13] PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 5.

[14] *Id*.

Also in 1999, the Counterparty Risk Management Policy Group ("CRMPG"), consisting of representatives of twelve of the world's largest banks, issued a report recommending banks strengthen their management of CCR.[15] The report acknowledged weaknesses in the risk management of over the counter ("OTC") swaps at CRMPG member institutions and promised risk management reforms.[16] The CRMPG subsequently issued two more reports on CCR management, one in July 2005[17] and another in July 2008.[18] Both reports expressed concerns with the management of risks in credit default swaps.[19]

With the onset of the 2008 financial crisis ("2008 Crash"), it became clear that the necessary improvements in CCR management had not materialized, and that large banks' CCR exposures would cause the collapse of the financial system absent a government bailout. For example, regarding risk management, Fed Chairman Ben Bernanke later told the Financial Crisis Inquiry Commission ("FCIC"):

> It turned out that, in many cases, large institutions were exposed to risks in very concentrated ways that they did not even appreciate, they didn't even understand.[20]

Chairman Bernanke further stated that in the September-October 2008 period,

> So out of maybe the 13 -- 13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two.[21]

In explaining how important it is for regulators to recognize the systemic risks arising from interconnections among large institutions, Chairman Bernanke said:

> [Someone might say] 'Well, four out of your five heart ventricles are fine, and the fifth one is lousy.' They're all interconnected, they all connect to each other; and, therefore, the failure of one brings the others down.[22]

In the aftermath of the 2008 Crash, further guidance on CCR management emerged. In 2009, the Financial Stability Board ("FSB") published "Senior Supervisors Group: Risk

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15 COUNTERPARTY RISK MANAGEMENT POLICY GROUP, IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICES (June 1999), https://fimmda.org/pdf/CDS/Improving-counter-party-Risk-Manangement-Practices.pdf; Greenberger, *supra* note 4 at 8.

16 Greenberger, *supra* note 4 at 8.

17 COUNTERPARTY RISK MANAGEMENT POLICY GROUP, COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (2005).

18 COUNTERPARTY RISK MANAGEMENT POLICY GROUP, CONTAINING SYSTEMIC RISK: THE ROAD TO REFORM: THE REPORT OF THE CRMPG III (Aug. 6, 2008), https://www.iasplus.com/en/binary/crunch/0808crmpg.pdf.

19 Greenberger, *supra* note 4 at 13.

20 Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Commission Closed Session with Ben Bernanke* 15 (Nov. 17, 2009), https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/FCIC%20Interview%20with%20Ben%20Bernanke,%20Federal%20Reserve.pdf.

21 *Id*. at 24.

22 *Id*. at 52-53.

Management Lessons from the Global Banking Crisis of 2008."[23] The report identified several risk management deficiencies that contributed to or were revealed by the 2008 Crash. Among the weaknesses cited regarding CCR measurement were an inability to aggregate exposures on a timely basis, especially to institutional counterparties, and offline trades that were not captured in banks' exposure measures but were material relative to their overall CCR. The report stated that these and other weaknesses, "require further work by the firms to address,"[24] but again did not address the role of national supervisors other than to say that the findings in the report "support the ongoing efforts of supervisory agencies to define policies that enhance financial institution resilience."[25]

In 2011, the U.S. banking agencies published guidance on CCR management.[26] The document stated that implementation of sound CCR management practices had been uneven across the industry and that the 2008 Crash revealed CCR management weaknesses at many banking organizations.[27] These included weaknesses in the ability to aggregate exposures and to monitor and measure counterparty exposure limits and concentration risks.[28] With regard to the role of regulators, this guidance went slightly farther than its predecessors summarized above, by describing its recommendations as "supervisory expectations,"[29] rather than merely as sound practices. That said, the reference to supervisory expectations was limited to a single sentence. ***No discussion was included of how supervisors would ensure banks met these expectations, nor of the consequences for banks that do not meet the expectations.***

In 2013, the Committee published guidance on risk data aggregation and reporting, a subject that is integrally related to CCR management.[30] This guidance stated that ***many banks lacked the ability to aggregate risk exposures and identify concentrations quickly and accurately, and that this had severe consequences to the banks themselves and the financial system***.[31] After stating, in the form of 11 principles, the risk management capabilities banks should have to remedy these and other deficiencies, the guidance went on to say that:

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23 FINANCIAL STABILITY BOARD, SENIOR SUPERVISORS GROUP: RISK MANAGEMENT LESSONS FROM THE GLOBAL BANKING CRISIS OF 2008 (Oct. 21, 2009), https://www.fsb.org/wp-content/uploads/r_0910a.pdf.

24 *Id.* at transmittal letter.

25 *Id*.

26 *Interagency Supervisory Guidance on Counterparty Credit Risk Management* 2; Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, and Office of Thrift Supervision (June 29, 2011), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20110705a1.pdf.

27 *Id*. at 2.

28 *Id*.

29 *Id*.

30 Basel Committee on Banking Supervision, *Principles for Effective Risk Data Aggregation and Risk Reporting* (Jan. 2013), https://www.bis.org/publ/bcbs239.pdf.

31 *Id*. at Paragraph 1.

> Supervisors should periodically review and evaluate a bank's compliance with the eleven Principles above (Principle 12), and
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> Supervisors should have and use the appropriate tools and resources to require effective and timely remedial action by a bank to address deficiencies in its risk data aggregation capabilities and risk reporting practices (Principle 13).[32]

This 2013 guidance thus went further than any of the predecessors indirectly pointing to the role of national supervisors.

With the catastrophic experience of the 2008 Crash[33] and the wealth of CCR guidance that governmental and private groups have published over the last 25 years, it might be expected that adherence to sound practices for CCR management would now be widespread, at least among large, sophisticated banks. In this respect, however, consideration of the 2023 collapse of Credit Suisse ("CS") and a careful reading of CCR guidance published shortly thereafter by the European Central Bank ("ECB") suggests that ***CCR risks remain material and in urgent need of addressing***.

The acquisition of CS by UBS, "with the aid of extraordinary state support measures,"[34] was announced on March 19, 2023, a few days after CS informed the Swiss National Bank that its ongoing attempts to secure funding were unlikely to be successful.[35] In a lessons-learned report, the Swiss prudential regulator FINMA described how "repeated scandals and losses severely damaged CS's reputation and undermined confidence in the bank."[36] Ratings agency downgrades of CS in May 2022, citing risk management deficiencies, and an October 1, 2022, tweet citing concerns about an unknown investment bank, were followed by substantial withdrawals of client assets in late 2022.[37] FINMA described how the ongoing bad news led professional counterparties to demand higher collateral and reduce or end their business with CS, exacerbating CS's situation.[38]

A development that highlighted CS's risk management weaknesses was its roughly $5.5 billion dollar loss following the March 2021 default of Archegos Capital Management.[39] A report

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32 *Id*. at Principle 12-13.

33 *See* Better Markets Report, The Cost of the Crisis: $20 Trillion and Counting (July 2015), https://bettermarkets.org/wp-content/uploads/2021/07/Better-Markets-Cost-of-the-Crisis_1.pdf.

34 FINMA REPORT: LESSONS LEARNED FROM THE CS CRISIS 39, SWISS FINANCIAL MARKET SUPERVISORY AUTHORITY (Dec. 19, 2023), https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/cs-bericht/20231219-finma-bericht-cs.pdf.

35 *Id*. at 37.

36 *Id*. at 52.

37 *Id*. at 32-34.

38 *Id*. at 37.

39 CREDIT SUISSE GROUP SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS REPORT ON ARCHEGOS CAPITAL MANAGEMENT 1, CREDIT SUISSE (July 29, 2021), https://www.credit-suisse.com/about-us/en/reports-research/archegos-info-kit.html; *see also* FINMA, *supra* note 34 at 29.

by a special committee of the CS Board described CS's risk management in scathing terms, including that relevant CS business lines had:

> [A] lackadaisical attitude towards risk and risk discipline; a lack of accountability for risk failures; risk systems that identified acute risks, which were systematically ignored by business and risk personnel; and a cultural unwillingness to engage in challenging discussions or to escalate matters posing grave economic and reputational risk.[40]

Shortly after the collapse of CS, the ECB issued guidance on CCR management which included the results of a survey of 23 large banks.[41] The survey identified areas in which CCR risk control, management, and measurement did not fully demonstrate "convergence with observed sound practices."[42] For example:

- For the sound practice of "Adequate identification and monitoring of illiquid and concentrated positions," 6 of the 23 banks reviewed by the ECB were described as being in significant need of improvement and 14 were in moderate need of improvement.[43]
- For the sound practice of "Appropriate economic measure for costs of CCR portfolio wind-down," 11 of the 23 were described as being in significant need of improvement and 8 of the 23 were in moderate need of improvement.[44]

These two sound practices directly relate to a bank's ability to measure and control the losses it will incur during a period of severe market stress. Weaknesses in these and other practices identified in the ECB guidance increase the potential for economic or market shocks to have greater effects on banks than they had anticipated, with adverse effects on counterparties and financial stability.

The ECB survey of the state of CCR management practices should concern supervisors as it suggests that ***weaknesses in managing CCR at large banks are not only "longstanding" as stated by the Proposal, but they also remain widespread***.

Meanwhile, there is no indication from publicly available data that the quantitative magnitude of CRR exposures is receding. For example, the BIS reported that aggregate notional

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40 CREDIT SUISSE, *supra* note 39 at 2.

41 EUROPEAN CENTRAL BANK, SOUND PRACTICES IN COUNTERPARTY CREDIT RISK GOVERNANCE AND MANAGEMENT (Oct. 2023), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisory_guides202310_ccrgovernancemanagement.en.pdf.

42 *Id*. at 26.

43 *Id*.

44 *Id*.

OTC derivatives exposure reported by the BIS stood at $667 trillion at year end 2023, after 8 percent annual growth in 2023, the fastest growth rate since 2017.[45]

Gross notional volumes are, of course, uninformative about the types of risks banks are taking. It is likely, however, that as the Proposal suggests, management of CCR exposures to nonbank financial institutions ("nonbanks") is of particular importance. For example, referring to the first quarter of 2024, the BIS reported that:

> Much of the rise in global cross-border credit during Q1 was driven by lending to non-bank borrowers [and that within the nonbank sector] credit to non-bank financial institutions (NBFIs) rose the most.[46]

The report stated that year-over-year credit growth to nonbanks increased to 10 percent during the first quarter, led by growth in credit to entities in the Cayman Islands.[47] That the world leader in the growth of banks' cross-border claims is a secrecy jurisdiction such as the Cayman Islands is a telling indicator of the opacity of risks being taken by large banks.[48]

Moreover, banks' complex CCR exposures remain highly concentrated: for example, according to the Committee's most recent annual publication of global systemically important bank ("G-SIB") indicator values, 25 G-SIBs held about 78 percent of global gross notional OTC derivates at yearend 2022.[49] There is, in short, no indication that the interconnectedness discussed by former Fed Chairman Bernanke is his 2009 FCIC interview would be less of a concern today in the event of a severe economic or financial shock.

In short, based on the track record of supervisory guidance regarding CCR risk management over the past 25 years, toothless encouragement of sound practices is an ineffective approach to changing bank behavior to protect society or the financial system. The only appropriate conclusion is that CCR remains an unseen ticking time bomb that regulators and supervisors continue to largely ignore, other than rhetorically. This conclusion motivates our comments on the Proposal, which are discussed below.

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[45] Bank for International Settlements, *OTC Derivatives Statistics at End-December 2023*, at 1 (May 16, 2024), https://www.bis.org/publ/otc_hy2405.pdf.

[46] Bank for International Settlements, *Statistical Release: BIS International Banking Statistics and Global Liquidity Indicators at End-March 2024,* at 3 (July 31, 2024), https://www.bis.org/statistics/rppb2407.pdf.

[47] *Id*.

[48] INTERNATIONAL ANTI-CORRUPTION RESOURCE CENTER, GUIDE TO COMBATING CORRUPTION & FRAUD IN DEVELOPMENT PROJECTS: SECRECY JURISDICTIONS, https://guide.iacrc.org/secrecy-jurisdictions/ (last visited Aug. 16, 2024).

[49] For the individual bank gross notional values (in Euros) of OTC derivatives at yearend 2022, see the spreadsheet available at https://www.bis.org/bcbs/gsib/gsib_assessment_samples.htm. For the 1.0704 Euro per dollar exchange rate at end 2022, see https://www.poundsterlinglive.com/history/EUR-USD-2022. For yearend global OTC derivatives gross notionals of $618 trillion, see Bank for International Settlements, *OTC Derivatives Statistics at End-December 2022*, at 2 (May 17, 2023), https://www.bis.org/publ/otc_hy2305.pdf.

SUMMARY OF THE PROPOSAL

The Proposal provides a conceptual taxonomy of the types of activities that banks should use to manage CCR. It encourages banks and supervisors to take a risk-based and proportional approach to its application, commensurate with the nature and complexity of the banks' CCR exposures. The risk management taxonomy described by the guidelines is as follows:

> *Due diligence and monitoring*. The guidelines describe the importance of banks fully understanding the risks to which they may become exposed when entering into a counterparty credit relationship. This includes both risk analysis at the initial onboarding of the relationship and the ongoing monitoring of risk through time.
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> *Credit risk mitigation*. The guidelines identify margining as the primary risk mitigant for most CCR exposures and emphasize the importance of banks' tailoring their margining requirements to the risks posed by the counterparty, and that these risks need to be monitored regularly and margin adjusted accordingly. The guidelines also detail the importance of contractual provisions governing CCR exposure issues that arise when relying on written or unwritten guarantees as risk mitigants.
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> *Exposure measurement*. The guidelines emphasize that CCRs are complex and driven by tail events and that consequently, banks should use a holistic exposure measurement approach that includes multiple measures of exposure. Using the Archegos experience as an example, the guidelines acknowledge that CCR exposures computed using important components of the Basel Framework can greatly understate true exposure. The guidelines state that banks calculating exposure using the Framework's measure of potential future exposure (PFE) need to understand the limitations of this measure and compensate for those limitations in their risk management practices.
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> *Governance*. The guidelines state that effective governance of CCR relies on three pillars. The first is having a strong risk culture in the organization. The second is a written strategy for managing CCR, approved by the bank's board of directors and consistent with the bank's appetite for risk. The third is management reporting and its integration into decision making, with the goal of being able to make swift CCR decisions in any market scenario.
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> *Infrastructure, data, and risk systems*. The guidelines emphasize that the quality of data, systems, and the ability to aggregate exposure data are fundamental to all aspects of CCR management. More specifically, "Banks with sound practices maintain capabilities to aggregate and measure risk exposures seamlessly across products, businesses, geographies, and risk factors to support concentration monitoring at both counterparty and portfolio levels."[50]
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> *Closeout practices*. The guidelines emphasize the importance of being able to close out a counterparty quickly when necessary and indicate that experienced professionals including the legal department need to be involved. The guidelines note that liquidation of trades can be

[50] Guidelines for Counterparty Credit Risk Management, *supra* note 2 at 21.

expected to generate mark-to-market losses and more generally that the costs of closeout are material and should be understood by the bank.

SUMMARY OF COMMENTS

Better Markets agrees that it is important for banks and supervisors to address weaknesses in CCR management. Experience shows these exposures can precipitate a financial crisis and pose large costs to taxpayers, consumers, and small businesses. Better Markets commends the Committee for providing much thoughtful and useful discussion of CCR management in the proposed guidelines, including its candid discussion of the limitations of certain exposure measures, such as the calculation in the Basel Framework of potential future exposure (PFE).

However, the experience of the past 25 years of supervisory guidance regarding bank management of CCR, demonstrates that the extant guidance has not been effective in constraining banks' CCR practices. This observation motivates our comments, presented below in summary form, and discussed in more detail in the next section. Some of these comments relate to the Basel Framework, in light of issues with the Framework identified in the Proposal, and others relate to the Proposal itself.

- The Committee should initiate a workstream to improve and strengthen the CCR measurement methodology contained in the Basel Framework to correct the deficiencies in the Framework's PFE calculations that the Committee itself identified in the Proposal.

- The Committee should tighten the Framework's quantitative single counterparty net exposure limits and should add single counterparty gross exposure limits to the Framework.

- The guidelines should unambiguously state that operating a bank without the ability to timely measure gross and net CCR exposures to each large counterparty, fully aggregated across business lines, product types, and operational units, is an unsafe and unsound banking practice.

- The guidelines should unambiguously state that banks should have internal aggregate risk limits on gross exposures to a single counterparty[51] and its affiliates that will be sufficient to protect the bank's solvency and liquidity in the event of the counterparty's failure, and that not having these limits is an unsafe and unsound banking practice.

- The guidelines should discuss challenges to the performance of net settlement under conditions of severe market stress or default of a large counterparty, including how valuation disputes can result in significant delays in net settlement and make the ultimate net amount highly uncertain.

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[51] With an allowable exception for the bank's own sovereign.

- The guidelines should state that national supervisors should use the authorities available to them under the laws of their respective jurisdictions to take timely action—including while risks are building and not merely after a blow-up has occurred—to require banks to correct deficiencies in CCR, including ensuring that banks measure and control their CCR exposures within safe and sound limits.

COMMENTS

I. THE COMMITTEE SHOULD INITIATE A WORKSTREAM TO IMPROVE AND STRENGTHEN THE CCR MEASUREMENT METHODOLOGY CONTAINED IN THE BASEL FRAMEWORK TO CORRECT THE DEFICIENCIES IN THE FRAMEWORK'S PFE CALCULATIONS THAT THE COMMITTEE ITSELF IDENTIFIED IN THE PROPOSAL.

The Committee rightly identifies severe shortcomings in the Basel Framework's calculation of exposure to CCR. While the guidelines state that banks should use PFE to measure future exposure to counterparties conditional upon default, they also state that PFE for overcollateralized counterparties are often computed ignoring the possibility of margin-driven defaults.[52] The case of Archegos is a prime example, as ***forecasted PFE was less than a tenth of the realized closeout losses*** (about $500 million forecast vs. over $5 billion actual) incurred by Credit Suisse.[53] The Committee goes on to explain that the calculated PFE to collateralized counterparties may often be zero, or negligible amounts, because the calculation methodologies do not account for the material possibility of margin driven defaults caused by abrupt large price moves in relevant asset classes.[54] The Committee concludes (with respect to PFE) that banks relying on PFE to measure CCR should understand its limitations, and should use their own risk management methodologies to compensate for these shortcomings.[55] Such compensating methodologies could include, for example, gross exposure measures.[56]

Better Markets is recommending the Committee establish a workstream to strengthen its CCR and large exposure limit frameworks because the historical record described in the Proposal demonstrates that supervisory CCR guidance has been ineffective in achieving its objectives. A prudentially conservative CCR measurement framework in conjunction with appropriate exposure limits, implemented by regulation in national jurisdictions, would have the force and effect that supervisory jawboning has been unable to achieve.

There are several reasons to expect supervisory guidance to be of limited effectiveness. First, as stated in the 2008 report of the CRMPG:

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[52] Guidelines for Counterparty Credit Risk Management, *supra* note 2 at 11-12.

[53] Guidelines for Counterparty Credit Risk Management, *supra* note 2 at 13.

[54] *Id*.

[55] Guidelines for Counterparty Credit Risk Management, *supra* note 2 at 14.

[56] *Id*.

> [I]n a highly competitive marketplace it is very difficult for one or a few institutions to hold the line on best practices or to stand on the sidelines in the face of booming markets.[57]

Put differently, banks are in a money-making business and are unlikely to constrain their own activities based solely on the encouragement of "sound practices."

Moreover, some national supervisors may be under real or self-imposed limits on their legal authority to enforce changes in bank behavior if they cannot cite to a specific violation of law or regulation. The FINMA report on the CS collapse is a notable illustration. The report describes at length the many formal actions taken over a period of years by FINMA to obtain correction of CS's risk management deficiencies, that it exhausted the remedies available to it, and that these efforts were unsuccessful.[58] As another example, the U.S. banking agencies have taken the view that guidance is not legally enforceable.[59]

While the authority available to national supervisors is jurisdiction-specific, many supervisors may be less prescriptive than their statutory authorities allow them to be in regard to forcing changes in bank behavior. As a result, they may wait to take decisive action until they have the factual evidence of an unraveling bank. At this point, however, supervisors' actions are too late and often society is left to pay for the bank and supervisors' failures to act.

Whatever the reasons for the ineffectiveness of CCR guidance, the record shows it is a settled fact. An effective regulatory framework is needed to address this important risk. In its Proposal, the Committee has identified serious deficiencies with its CCR framework, and it should institute a workstream to correct them.

II. THE COMMITTEE SHOULD TIGHTEN THE FRAMEWORK'S QUANTITATIVE SINGLE COUNTERPARTY NET EXPOSURE LIMITS[60] AND SHOULD ADD SINGLE COUNTERPARTY GROSS EXPOSURE LIMITS TO THE FRAMEWORK.

The Basel Framework[61] states that the sum of all a bank's exposures to a single counterparty or group of connected counterparties must not exceed 25 percent of the bank's tier 1

[57] COUNTERPARTY RISK MANAGEMENT POLICY GROUP, *supra* note 18 at iv.

[58] FINMA, *supra* note 34 at 52.

[59] *See, e.g.*, Press Release, Board of Governors of the Federal Reserve System, *Federal Reserve Board Adopts Final Rule Outlining and Confirming the Use of Supervisory Guidance for Regulated Institutions* (Mar. 31, 2021), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210331a.htm; Better Markets Comment Letter, *Role of Supervisory Guidance, Notice of Proposed Rulemaking* (Jan. 4, 2021), https://bettermarkets.org/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20Notice%20of%20Proposed%20Rulemaking%20-%20Role%20of%20Supervisory%20Guidance.pdf.

[60] With an allowable exception for the bank's own sovereign.

[61] BANK FOR INTERNATIONAL SETTLEMENTS, BASEL FRAMEWORK, https://www.bis.org/basel_framework/ (last visited Aug. 16, 2024).

capital (or 15 percent in the case of G-SIB to G-SIB exposures).[62] Better Markets thinks these limits are imprudently high, especially since the measured exposure for purposes of the limits is not on a gross basis, but is reduced to reflect adjustments for netting arrangements, collateral, and eligible credit derivatives and guarantees.[63]

Better Markets recommends that net single counterparty exposures be limited to 10 percent of a bank's tier 1 capital and that the Committee should include gross single counterparty exposure limits in the framework. Regarding numerical exposure limits, Better Markets notes that, as discussed above in connection with the CS collapse, material losses resulting from risk management failures can lead to ratings downgrades and cause counterparties to pull back from a bank, and associated adverse social media can lead to precipitous withdrawal of funding. Consequently, prudence is warranted in the setting of regulatory exposure limits.

Better Markets' proposed 10 percent limit has a basis in existing standards: the Basel Framework states that all net single counterparty exposures exceeding 10 percent of a bank's tier 1 capital should be reported to supervisors, and that separately, all gross single counterparty exposures exceeding 10 percent of a bank's tier 1 capital should be reported to supervisors.[64]

Regarding net versus gross exposures, introducing single counterparty gross exposure limits would appropriately recognize that the effectiveness of these arrangements can be severely compromised in times of market stress or default of a large counterparty. The 2008 rescue of AIG illustrates the systemic risk that may arise from significant reliance on credit derivatives as a form of guarantee.[65] The Lehman bankruptcy provides an example of practical obstacles to netting effectiveness during times of severe market stress. Reports describe how the day before the Lehman bankruptcy, its largest counterparties met to try to reduce their exposures to each other through netting, but, they note, "the netting effort largely failed as there was little trading during the session."[66] For netting to take place, the counterparties must agree on amounts owed, and with the stressed and illiquid markets prevailing at the time, agreeing on valuations proved difficult. The final settlement of Lehman's OTC derivatives took years.[67] Regarding collateral, the 2008 Crisis again provides examples of how assumed risk mitigation benefits may not materialize as anticipated. For example, researchers found that rapidly increasing collateral haircuts fueled by

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62 BANK FOR INTERNATIONAL SETTLEMENTS, BASEL FRAMEWORK LARGE EXPOSURES REQUIREMENTS (LEX 20.1), https://www.bis.org/basel_framework/chapter/LEX/20.htm (last visited Aug. 16, 2024).

63 BANK FOR INTERNATIONAL SETTLEMENTS, BASEL FRAMEWORK LARGE EXPOSURES REQUIREMENTS (LEX 20.2 and 20.3), https://www.bis.org/basel_framework/chapter/LEX/20.htm (last visited Aug. 16, 2024).

64 BANK FOR INTERNATIONAL SETTLEMENTS, BASEL FRAMEWORK LARGE EXPOSURES REQUIREMENTS (LEX 20.4), https://www.bis.org/basel_framework/chapter/LEX/20.htm (last visited Aug. 16, 2024).

65 Financial Crisis Inquiry Commission, *supra* note 20 at 26.

66 Michael J. Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers* 185, FEDERAL RESERVE BANK OF NEW YORK ECONOMIC POLICY REVIEW (Dec. 2014), https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf.

67 *Id*. at 184.

fears about collateral quality, and by counterparties' fears about the solvency of banks, contributed to a run on repo that was tantamount to a massive withdrawal of funding from banks.[68]

Given that the mitigants used to reduce calculated exposure can be severely compromised when they are most needed, and these failings may give rise to liquidity risk as well as credit risk, a prudent approach to limit-setting must include gross exposure limits.

III. THE GUIDELINES SHOULD UNAMBIGUOUSLY STATE THAT OPERATING A BANK WITHOUT THE ABILITY TO TIMELY MEASURE GROSS AND NET CCR EXPOSURES TO EACH LARGE COUNTERPARTY, FULLY AGGREGATED ACROSS BUSINESS LINES, PRODUCT TYPES AND OPERATIONAL UNITS, IS AN UNSAFE AND UNSOUND BANKING PRACTICE.

The Proposal provides much useful food for thought and an ambitious agenda for the range of risks that banks need to measure. In practice, it is likely to be difficult for banks, and supervisors, to fully understand, measure and model the range of risks arising from CCR exposures. That reality supports the need for simple and strong exposure limits in the Framework. It also supports the need for revisions to the guidelines that clearly designate risk management practices that are unacceptable.

As noted above, extant supervisory guidance has for years emphasized that banks need to be able to timely aggregate their CCR exposures across business lines and other dimensions. Not being able to do this while engaged in complex trading, securities financing, and derivatives activities amounts to irresponsible and unsafe banking; the guidelines should communicate this unambiguously. The guidelines should state that operating a bank without the ability to timely measure gross and net CCR exposures to each large counterparty, fully aggregated across business lines, product types, and operational units, is an unsafe and unsound banking practice.

IV. THE GUIDELINES SHOULD UNAMBIGUOUSLY STATE THAT BANKS SHOULD HAVE INTERNAL AGGREGATE RISK LIMITS ON GROSS EXPOSURES TO A SINGLE COUNTERPARTY AND ITS AFFILIATES THAT WILL BE SUFFICIENT TO PROTECT THE BANK'S SOLVENCY AND LIQUIDITY IN THE EVENT OF THE COUNTERPARTY'S FAILURE, AND THAT NOT HAVING THESE LIMITS IS AN UNSAFE AND UNSOUND BANKING PRACTICE.

Banks' risk management practices should, among other things, be designed to protect their solvency and liquidity. The risks arising from gross exposures to a single large counterparty are directly related to solvency and liquidity. The guidelines gently acknowledge this by stating that

[68] Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run On Repo* 23, NBER Working Paper 15223 (Aug. 2009), https://www.nber.org/system/files/working_papers/w15223/w15223.pdf.

banks should include simple, non-modeled exposures among their other exposure measures,[69] and that an example of a sound practice measure is gross exposures.[70] The Framework itself, in fact, has already implicitly acknowledged the importance of gross exposures by requiring banks to report gross exposures exceeding 10 percent of tier 1 capital to supervisors.[71]

Operating a large, complex bank without limits on the gross exposure to single counterparties represents an irresponsible banking practice. Rather than merely referencing sound practices, the guidelines should clearly lay out an expectation in this area. The guidelines should state that banks should have internal aggregate risk limits on gross exposures to a single counterparty and its affiliates that will be sufficient to protect the bank's solvency and liquidity in the event of the counterparty's failure, and that not having these limits is an unsafe and unsound banking practice.

Given that the mitigants used to reduce calculated exposure can be severely compromised when they are most needed, and these failings may give rise to liquidity risk as well as credit risk, a prudent approach to limit-setting must include gross exposure limits.

V. THE GUIDELINES SHOULD DISCUSS CHALLENGES TO THE PERFORMANCE OF NET SETTLEMENT UNDER CONDITIONS OF SEVERE MARKET STRESS OR DEFAULT OF A LARGE COUNTERPARTY, INCLUDING HOW VALUATION DISPUTES CAN RESULT IN SIGNIFICANT DELAYS IN NET SETTLEMENT AND MAKE THE ULTIMATE NET AMOUNT HIGHLY UNCERTAIN.

While the guidelines provide a thoughtful discussion of many risk management and measurement issues associated with CCR, a discussion of the obstacles to timely and effective net settlement in a stressed market environment is not included, other than to note in Paragraph 62 that netting must be legally enforceable. Episodes of severe market stress or default of a large counterparty can pose substantial obstacles to timely and effective netting of positions, as noted above in connection with the Lehman bankruptcy. Given that the Basel Framework allows netting to reduce measured CCR exposure, and that an important theme of the guidelines is that banks should look beyond regulatory measures of exposure and fully consider potential outcomes under stress, the omission of risks to netting arrangements is unacceptable and should be added before finalization.

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[69] Guidelines for Counterparty Credit Risk Management, *supra* note 2 at 11.

[70] *Id*. at 11-12.

[71] BANK FOR INTERNATIONAL SETTLEMENTS, *supra* note 64.

VI. THE GUIDELINES SHOULD STATE THAT NATIONAL SUPERVISORS SHOULD USE THE AUTHORITIES AVAILABLE TO THEM UNDER THE LAWS OF THEIR RESPECTIVE JURISDICTIONS TO TAKE TIMELY ACTION—INCLUDING WHILE RISKS ARE BUILDING AND NOT MERELY AFTER A BLOW-UP HAS OCCURRED—TO REQUIRE BANKS TO CORRECT DEFICIENCIES IN CCR, INCLUDING ENSURING THAT BANKS MEASURE AND CONTROL THEIR CCR EXPOSURES WITHIN SAFE AND SOUND LIMITS.

These guidelines are notably—and inappropriately—silent about the role of national supervisors. Whereas the Committee's 2013 guidance on data risk aggregation—integrally connected to management of CCR risk—stated as noted above that supervisors should "have and use" authorities to require remediation of deficiencies, these guidelines say nothing about supervision. While there are references to the importance of adherence to the bank's own risk appetite,[72] nowhere do the guidelines mention that supervisors may determine that a bank's risk appetite is excessive.

The lack of a clear statement on the role of supervisors is an omission that must be remedied. ***At a minimum, the guidelines should state that national supervisors should use the authorities available to them under the laws of their respective jurisdictions to take timely action—including while risks are building and not merely after a blow-up has occurred—to require banks to correct deficiencies in CCR, including ensuring that banks measure and control their CCR exposures within safe and sound limits.***

CONCLUSION

We hope these comments are helpful for the development of CCR guidelines.

Sincerely,

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72 Guidelines for Counterparty Credit Risk Management, *supra* note 2 at 3, 17, 19.