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CANADIAN BANKERS ASSOCIATION

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Basel Committee on Banking Supervision
Centralbahnplatz 2
4051 Basel, Switzerland

Re: CBA[1] Comments on BCBS Consultative Document – Guidelines for counterparty credit risk management

We welcome the Basel Committee on Banking Supervision's proposed improvements to counterparty credit risk (CCR) management and the opportunity to comment on the Consultative Document – *Guidelines for counterparty credit risk management* (Guidelines). CBA members support the BCBS' emphasis on a risk-based and proportional approach to the application of the Guidelines by both banks and supervisors, and value the recommendations as banks continue to reassess and evaluate market best practices for CCR management.

We understand the Guidelines are to apply to CCR broadly, however, the requirements as drafted are too specific to cover all types of counterparties. In practice, certain types of counterparties will not disclose some of the required information as outlined during the onboarding process and in ongoing reporting. CBA members believe that distinguishing between sectors (for example, between non-bank financial intermediaries (NBFIs) versus corporates) would be a practical way to achieve the objectives of the Guidelines while allowing banks to implement them in an effective manner.

CBA members suggest that the applicability of the Guidelines based on the type of counterparty would allow banks to calibrate their KYC and due diligence activities. For example, the due diligence section appears to focus more on hedge funds than on traditional corporates given the suggestions on client onboarding, reporting frequency, sample trading portfolios, and leverage.

On an ongoing basis, some counterparties might, for strategic reasons, be reluctant to share their full exposures. In addition, obtaining an understanding of the exposure with other counterparties facing the borrower might have unintended consequences (e.g., confidentiality and revealing proprietary information). Banks have risk-based processes in place to monitor

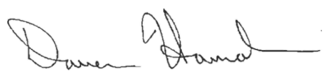
[1] The Canadian Bankers Association is the voice of more than 60 domestic and foreign banks that help drive Canada's economic growth and prosperity. The CBA advocates for public policies that contribute to a sound, thriving banking system to ensure Canadians can succeed in their financial goals. www.cba.ca

CCR and allowing some discretion in the application of the Guidelines could result in a more targeted and effective approach.

In the attached detailed comments we have provided some examples of areas where additional flexibility could result in more efficient CCR management including monitoring of wrong way risk (WWR), intraday limits, margining, potential future exposure (PFE) modeling and close-out exercises. We believe that leveraging banks' risk frameworks while allowing discretion in implementing the Guidelines in the areas discussed above, would make for a more focused and risk-based approach. It is this risk-based proportionate approach that will enable banks to take practical steps to resolving outstanding industry weaknesses in CCR management.

We would be pleased to discuss our comments further at your convenience.

Sincerely,



cc: Patrick Tobin, Office of the Superintendent of Financial Institutions

CBA Members' Comments
1 - Introduction
No comments
2 – Due diligence and monitoring

Onboarding

Paragraph 8:
Different counterparty types provide different information as part of onboarding and ongoing due diligence requirements. Typically for corporate and regulated counterparties (banks, insurance, investment funds), it would not be market standard to provide information referenced in paragraph 8, for a variety of reasons. In some cases, they may not produce detailed VAR or stress testing results for consumption by their counterparties and in other situations, counterparties may be unwilling to provide this information to a competitor (e.g., bank counterparties).

Internal risk reports, stress tests, and VaR are items that would typically be provided by large institutional hedge funds. Not all clients are sophisticated enough, or in some cases willing, to provide this information. Information requirements should be commensurate with the counterparty risk profile, and it should be clearly articulated for which counterparty types this type of information is required. To the extent that not all requirements are met, banks should be given the flexibility to address this within their borrower risk rating and with other risk mitigants (i.e., lower credit limits, increased margin requirements, stronger documentation terms, enhanced monitoring triggers / requirements).

Paragraph 10:
Reviewing trading positions or sample portfolios during the onboarding stage is reasonable for prime brokerage activity but is not market practice outside of this activity for secured financing transactions (SFTs) or OTC derivatives dealings. Sample portfolios are typically provided for new hedge fund clients or existing prime brokerage clients that may be executing a new strategy. For counterparties that trade SFTs and OTC derivatives, trading strategies are typically discussed in due diligence. However, the level of granularity provided, including internal metrics used for risk monitoring varies (similar to paragraph 8) and may not be provided by all counterparty types for the same reasons - not all counterparty types produce this for external consumption or will not provide it as they are competitors.

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The expectation is that large institutional hedge funds may provide this information, but that it would not be market standard for corporate and regulated clients to provide this type of information. Information requirements should be commensurate with the counterparty risk profile, and it should be clearly articulated for which counterparty types this type of information is required. To the extent that not all requirements are met, banks should be given the flexibility to address this within their borrower risk rating and with other risk mitigants.
3 – Credit risk mitigation
<u>Margining</u> Paragraph 16: The Guidelines point to a margining framework that is consistent across all trading products and onboarding platforms. However, in practice, margin practices can vary across products and market sectors. For example, margin on bilateral SFTs are typically agreed with the counterparty on a per transaction basis by considering various factors such as underlying collateral, asset type, term of the transaction etc. However, for derivatives the bilaterally exchanged margins can be determined by industry-wide standard approaches (e.g., sensitivities based RMR IM framework). Banks may also make further distinctions on enforcing additional margin requirements based on the risk profile of the counterparty (e.g., stricter requirements for higher risk counterparties such as hedge funds). We suggest consistency in margining practices between products be left to a bank to determine based on appropriate review and challenge. Paragraph 20: We would appreciate more clarity relating to monitoring the effectiveness of margining frameworks and methodologies. The Guidelines indicate the need to perform back-testing on margin frameworks to ensure their effectiveness using realised historical exposures as well as stress scenarios. Clarification is needed on the particular measures that should be compared as part of the requirement for back testing. We note that banks ultimately rely on credit and stress limit frameworks to ensure sufficient margin is being charged relative to the risk appetite with a particular counterparty. Paragraph 27: The text on credit risk mitigation refers to a double benefit from collateral that should be avoided when determining probability of default and exposure. We would appreciate more clarity on the applicability of this paragraph on credit limit monitoring practices.

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4 – Exposure measurement
Exposure metrics The complexity of CCR exposure measurement requires that a flexible rather than a rigid, prescribed approach be taken to managing the risks. Alternative approaches that effectively address the substance of the Guidelines should be permitted. A risk-based approach, based on the size, nature and complexity of the CCR risk profile of the banking organization, should be leveraged to determine the appropriate exposure measurement framework. While there is wording in Section 1 (Introduction) indicating that the Guidelines should be viewed as industry best practices which banking organizations have the discretion to interpret and apply as appropriate, it would be helpful to add clarity by reiterating this within the exposure measurement context of Section 4. Paragraph 44: As written, the Guidelines require that exposure measurement conservatively reflects idiosyncratic risks and wrong way risk (WWR), which would be a challenge to model systematically. Effectively managing CCR requires the use of multiple metrics and credit exposure / potential future exposure (PFE), while a critical measure, is just one of them. Alternative approaches to monitoring these idiosyncratic risks (such as a more stringent limit policy or stress testing) could also be considered depending on the size, nature and complexity of the CCR risk profile. The Guidelines should provide flexibility to banking organizations to determine how to best monitor such risks. Potential future exposure Paragraphs 50, 51, 52, 54 & 55: The Guidelines suggest enhancements to the PFE metric and quantifying CCR exposures daily using PFE to the life of the contract. Considering some of the shortcomings of PFE raised in the Guidelines, implementing a PFE model that addresses all the shortcomings highlighted may be impractical or subject to even more complicated assumptions - leading to a false sense of security. Instead, as stated in paragraph 55, it is most important for institutions to be aware of the limitations of the metrics being used and to compensate for this in the CCR management process by assessing exposures using complementary risk metrics (such as gross notional, gross trade deltas, collateral composition, current net exposure, stress testing etc.), or by possibly leveraging different controls based on the type of CCR exposure.

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Paragraph 53: Clarification is required on whether the expectation is that PFE should account for specific wrong way risk (SWWR) or general wrong way risk (GWWR). While SWWR can be readily accounted for in the PFE metric, including GWWR in the PFE metric presents modelling challenges and introduces complex assumptions on correlations. Consistent with the paragraphs discussed immediately above, flexibility should be provided to determine the appropriate approach to account for GWWR, as other metrics such as stress testing are better suited to identify and monitor GWWR. Paragraph 56: Banks should be provided with the flexibility to determine whether real or hypothetical portfolio back-testing is used to assess model performance. Banks should be allowed to apply either choice judiciously, provided that the approach is supported by sufficient justification and subject to appropriate governance and controls. Hypothetical portfolios may be complicated to set up, and maintaining them with appropriate aging and initial conditions across all asset classes can be very computationally and operationally onerous. Additionally, hypothetical portfolio construction requires assumptions about the composition which can easily bias the results and may not be representative of actual risks in the portfolio. While there are benefits to back-testing hypothetical portfolios for new businesses / products without a real portfolio available for testing, for ongoing testing of mature portfolios it may not add significant value in most circumstances. Actual portfolios are more reflective of the risks of the bank's exposure. <u>Limits</u> Paragraph 69: We agree that recalibration of limit frameworks should be considered with reasonable frequency, however, not all market events would necessitate the need for a change in policy or limit calibration framework. Review of limits should only occur with very significant changes in market conditions. Flexibility should be given for banks to determine when limits should be reviewed and if market conditions or other changes mentioned in this paragraph necessitate a recalibration.

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5 – Governance
<u>Risk framework</u> Paragraphs 77 & 81: These paragraphs indicate that approvals are required from relevant oversight committees for important policy changes, with risk committee review authority for approved limit exceptions. While there are various risk committees in banks, not all the approval and risk decisions are made by risk committees. In practice, risk executives and risk officers with relevant delegated authority can approve policy changes and limit exceptions. In addition, having all decisions made by committees may result in less clear individual accountability. Additionally, we suggest that banks be provided with the flexibility to determine policy review frequency based on materiality and complexity, subject to appropriate internal governance. Paragraph 82: We recommend that banks be allowed flexibility to determine the appropriate extent of participation by different groups based on the specific purpose and mandate of a risk committee, as the alternative is inefficient and can be challenging to implement in practice. The stricter requirements could be limited to higher level committees (e.g., banks' board risk committee). <u>Limit, governance and exception management</u> Paragraph 98: It will be challenging for banks to set up intraday limit monitoring for all business lines. The Guidelines state "*banks are encouraged to establish ad hoc intraday exposure monitoring, which should be adequate for assessing impacts of large intraday market moves on risk limits*". Does intraday capability here refer to market or position data, as intraday usually refers to position data? Is it the BCBS' expectation to be able to create the capability to recalculate all counterparties with updated market data intraday? Streaming market data in real time to calculate CCR exposure in the event of large market moves would be both complex and expensive, and would provide little value added. For example, leveraging the stress testing framework could be a more efficient tool to assess the possible impact of large changes in market data on a portfolio. We note that not all business lines have intraday risk monitoring capability.

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Specifically, updating market data intraday into PFE or stress testing systems will be challenging and will go beyond existing infrastructure for most institutions. Thus, monitoring all counterparties and all metrics intraday will be difficult and we propose that this is an area where flexibility should be permitted. Ad hoc systems to monitor intraday moves could be difficult to set up for all counterparties, and instead limiting monitoring to large intraday moves would be more informative for counterparties that trade frequently or which have been shown to be most sensitive to large market moves.
6 – Infrastructure, data and risk systems
Paragraph 104: The number and complexity of systems used by each bank will be commensurate with its overall business and product mix. The number of systems required to manage exposure and requiring "seamless" aggregation of exposure is subject to interpretation and is a very difficult hurdle to meet from a cost and technology development perspective. Banks should be given the flexibility to manage their technology resources provided that they are able to effectively aggregate and measure exposures as required.
7 – Closeout practices
Paragraph 114: We believe the BCBS could provide further clarity on the last two sentences in this paragraph. We note that liquidation of trades does not "*invariably lead to realisation of MTM losses*" (for instance where the closeout amount is due to the defaulting party). In the sentence: "*The costs of carrying out a closeout are material and should be known*" is BCBS referring to items beyond the closeout value? Some examples provided by the BCBS would be helpful. We note that the future potential cost cannot be known with certainty. Paragraph 116: We believe it is unrealistic in practice to run a large, complex counterparty default exercise without advance notice to participants, although it is possible that certain portions of the exercise (e.g., exposure aggregation) could be done in that way. It is unlikely that optimal testing / learning results could be achieved for a complex exercise involving a large group of people (some at a very senior level) if no advance warning was given to participants. We suggest changing the wording to "*where feasible, the bank should minimize*

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advance notice to participants regarding the date of such an exercise". In addition, the requirement that the counterparty "*vary from year to year*" implies that BCBS is looking for annual frequency for close-out exercises. We believe the Guidelines should suggest "*at least annually, but no later than every two years"* to include some flexibility. Paragraph 118: System and vendor back-up plans could be wide-ranging and complex involving many internal bank platforms, systems and clearing platforms. Not all crucial vendors and third-party relationships have secondary 'replacement' providers. In these cases, the appropriate fallback would be robust contingency processes. The details of a realistic scenario underlying a jurisdiction-level, close-out exercise due to sanctions would be extremely hard to determine and the exercise itself would potentially be very large for some banks. While there could be benefits to such an exercise, we believe a jurisdictional level scenario exercise will need additional resources and time for banks to implement, and this should be noted in the paragraph along with the need for guidance from national authorities. In addition, sanctions may not result in contractual closeout triggers across all counterparties within a jurisdiction, but rather may be targeted at specified institutions.