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Response to the call for comment on the consultation on guidelines for counterparty credit risk management.

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I am interested in the banking industry, particularly in risk and its sociological connections. I want to bring sociological concepts within the banking industry based on empirical evidence. My dissertation thesis for my Master and Business Administration MBA was about the efficiency of commercial banks.

My comment on the consultation on guidelines for counterparty credit risk management focuses on the dynamic capabilities of banks and sociological aspects that present a different perspective on risk guidelines.

Written Comment:

The Counterparty Credit Risk (CCR) should establish a credit due diligence checklist for banks' standard operational procedures. This checklist will help banks in creating a list of important data elements. The importance of these data elements varies from bank to bank and from one environment to another. Once banks have established their list of crucial indicators, they should share it with supervisors to minimize surprises and for effective supervision.

Effective management of Counterparty Credit Risk (CCR) involves analyzing economic risk factors: business conditions and complacency embedded in organizational behavior. Complacency is a long-term danger that may not have immediate effects but can lead to severe crises for banks individually and spread to the entire financial environment over time. Therefore, CCR guidelines must address the risk of complacency. While banks generally prefer to adopt a trust management approach with their counterparties, this approach allows counterparties more freedom with less control over their actions. The CCR guidelines should emphasize a shift towards thorough control as the key driver in building trust relationships with banks, rather than an obstacle to it. The current perception of information disclosure tends to lean towards the banks' leadership as the relationship with the counterparties evolves. Over time, bank leaders may adopt a laissez-faire leadership style, which can be detrimental to financial and organizational health.

The relevance of information on credit standards should address aspects of validity and reliability. The validity of credit standards information should meet quality standards and have a positive impact on banks' long-term growth and performance. Banks’ short-term performance often relies on quick fixes that address day-to-day operational issues without addressing their root causes. Therefore, deploying resources and capabilities for problem-solving in the banking and financial environment can affect long-term management. The risk of recurrence and severity are costly to banks and a threat to the overall environment.

The phenomenon of herd behavior in financial and banking markets can spread inefficiencies. The CCR guidelines should differentiate between clinical and statistical significance regarding banks' credit standards management and performance. Clinical relevance would address banks' operational and reputational risks and their immediate responses. Statistical significance would question the overall impact of CCR on banks' performance and its effects on the banking environment. The CCR should encourage collaboration between banks and supervisors based on a credit risk severity matrix for efficient decision-making.

Banks' information should be timely, relevant, and statistically consistent. The effectiveness and efficiency of banks’ decisions include time as a key element. The relevance of information for banks is time-bound, and the time of exchange value is critical for credit performance. The CCR guidelines should propose a code of conduct for employing time efficiently as a resource. The guidelines should emphasize the importance of planning for anticipatory rather than immediate responses to enable effective and long-term management.

During their onboarding process, banks should educate and familiarize potential and existing clients with best practices and compliance with banks’ requirements. This client induction process should be part of their routine and practices. The CCR guidelines should consider the presence and the role of asymmetric information and its impact within a legal context, which may hinder banks' due diligence investigation. The CCR should encourage supervisors to create a culture and system of information accessibility for potential clients.

The CCR guidelines should discourage embezzlement in the relationship between banks and counterparties. For instance, a credit contracted from a bank for a defined activity by a counterparty must diligently be recovered in the account where the loan is posted. Therefore, the CCR guidelines should engage the commitment of supervisors to create a loyal and safe banking environment.

The CCR guidelines should consider states' policies regarding financial inclusion confining banks to a certain type of clientele. As a result, banks are exposed to systematic risks in corporate loans. However, the current CCR guidelines do not address the exposure to systematic risk in corporate loans.

The CCR guidelines should discourage embezzlement in the relationship between banks and their counterparties. For example, when a counterparty borrows credit from a bank for a specific activity, the loan should be diligently repaid from the account where the loan was posted. Therefore, the CCR guidelines should involve supervisors in creating a trustworthy and secure banking environment.

The CCR guidelines should encourage banks to be mindful of their environment and take responsible actions regarding financial literacy. Small and medium-sized enterprises (SMEs) are the backbone of most economies, and banks are deeply connected to these economies. In today's environment, banks must take social responsibility for promoting financial literacy in their communities to mitigate associated risks.

The CCR guidelines should prompt banks to recognize the importance of research and development in creating better plans and reducing impulsive decisions, particularly in product development and changes in business models. However, decision-making in a fast-paced environment can sometimes be more intuitive than well-thought-out, and changes in business models driven by trends in the environment can expose banks to high risk and potentially lead to the collapse of the entire banking system.

Ongoing credit assessment

The CCR guidelines should encourage banks to adopt a situational awareness strategy for ongoing credit assessment. The banking environment is inherently risky, so bank leadership should continuously assess potential risks. A situational awareness strategy provides banks with a systematic cognitive approach to address the high-risk financial environment. It encompasses perception, comprehension, and prediction of surrounding events. Banks' information assessment should include a sociological and humanistic dimension to achieve a comprehensive understanding.

The CCR guidelines should warn banks about impulsive behaviors and reactions. The CCR guideline should encourage banks to adopt management strategies based on anticipated emotions to make appropriate decisions. Malpractices in the financial environment are the main causes of crises and system collapses. Banks should adopt preventive vigilance and security measures during ongoing monitoring while establishing metrics for key indicators such as performance, volatility, liquidity, management quality, and concentration.

Credit risk mitigation

The CCR guidelines should promote banks' adoption of practical steps to mitigate risks and decisions among the four risk mitigation strategies: avoidance, reduction, transference, and acceptance. These mitigation strategies should be applied within the following practical steps:

1- Identification of potential risks before elaborating any plans: Banks should consult with stakeholders to share their previous experience and views on specific investment areas. This step allows banks to include critical information in their decision-making process, reducing the risk of poor record management and insufficient documentation regarding counterparties.

2- Assessment of potential default risks: Banks should grade the identified default risks according to severity level (low, medium, or high) and then apply strategic decisions for credit risk mitigation.

3- Establishment of a credit risk register: Banks should record identified default risks, their severity class, and the preventive strategy in a register available to all stakeholders to prevent chaos and confusion in case of risks.

4- Banks should consistently monitor all credit investment projects and activities they are involved in. They should monitor counterparties, including the physical surroundings (geographical and institutional location), the social surroundings (interpersonal interactions of counterparties with other players), the temporal perspectives (past and future events regarding the credit investment), the task definition (analysis of counterparties' intentions or behaviors regarding information requirements), and the antecedent states (observing counterparties' immediate search for rewards).

5- Banks should regularly report on the credit situation to all stakeholders. Information is crucial in avoiding uncertainty and stressful conditions. The staff involved in any activity regarding borrower or counterparty credit risk should have access to timely and relevant information. Thus they can conduct the activity according to the highest standards and in compliance with the bank's policies and procedures. Banks should encourage their leadership to disclose information regarding counterparty credit risk from the top down.

The sharing of information among counterparties tends to follow a systematic pattern, with counterparties willing to provide information within the limits of the law. As a result, banks in certain regions tend to adopt a protective strategy by applying higher margins on credit, regardless of the clients. However, this can lead to a concentration of banks on a specific market segment, resulting in increased risk concentration. Banks should consider disclosure of information from counterparties as a warning sign. Banks, applying higher margins may not be an effective way to ensure credit performance.

Banks should use sensitivity analyses, "what if" scenarios, and scenario analyses to forecast a margining framework. Sensitivity analysis allows banks to assess the impact of individual variables on a given situation, focusing their attention on specific cases. This kind of analysis is limited to independent and dependent variables and provides a contextual understanding. In an ever-changing financial environment, banks must create different scenarios to ensure preparedness and control in the face of ongoing innovation.

Banks should have a comprehensive view of default risk, considering the terms and conditions of financial agreements and counterparties' plans, priorities, and objectives in the five years following an investment request. Banks should categorize default risks based on their complexity, predictability, and continuous knowledge gap. To mitigate these risks, banks should become learning organizations.

Understanding the complexity of financial products and their organizational features is essential for banks to assess their needs and priorities and compare them with those of their counterparties. Banks should consider higher counterparties' compliance levels, as lower risk.

Banks should consult and engage among themselves to understand unique challenges and experiences concerning counterparty credit and risk. Additionally, banks should use metrics to assess the quality of counterparties in their relationship with credit and risk and broader categories of hazards, including environmental risks.

Furthermore, banks should develop metrics for measuring physical climate dangers and invest in resilience capabilities. It's crucial for banks to have a flexible or stringent strategy based on their CCR resilience capacity, and to adopt coordination strategies that involve different perspectives and experiences concerning CCR for decision-making purposes. This should include vertical, horizontal, and cross-functional directions to synchronize banks' efforts.

Exposure Measurement

Banks need to understand the role and impact of artificial intelligence (AI) on financial decision-making when considering CCR measurements. According to a conversation between Prof. Harari and Cecilia Skingsley, head of BIS Innovation Hub, "AI can autonomously make decisions and generate novel ideas. Similar to how steam engines wouldn't decide how to use themselves, we decide how to utilize them."

Banks should document shared experiences concerning CCR. For confident decision-making, banks should integrate the perspectives of other counterparties.

The Framework for Global Climate Resilience encourages banks to build metrics for measuring physical climate dangers and resilience capabilities, including absorption, adaptation, and transformation.

Banks should measure their CCR resilience capacity to assess their ability to handle shocks or stresses. It is crucial to evaluate the timeframe and availability of banks' capacities to absorb, adapt, and transform in the context of CCR.

Banks should adopt CCR coordination strategies from vertical, horizontal, and cross-functional directions to synchronize their internal efforts.

Potential Future Exposure (PFE)

Potential Future Exposure (PFE) is a critical metric for banks' survival, as predicting default risks challenges them as creditors. PFE, as a historical approach, should be able to identify regularities, similarities, and particularities. Banks are exposed to substantial macroeconomic risks as well as risks at the organizational level. Monte Carlo Simulations forecast and provide information on specific financial scenarios where individual or micro-group factors or variables lead banks to experience credit defaults. However, Monte Carlo Simulations do not account for external factors such as economic behaviors. They provide information on the process or course of financial events, but not their nature or origin. It is recommended that banks adopt a holistic approach to analyze Counterparty Credit Risk (CCR) through PFE. Stationary data, fat tails, and clustered volatility of financial returns in time series indicate risks in traditional approaches to analyzing PFE. Banks should consider adopting Stylized Facts, as empirical models that produce reliable forecasts of credit events.

Banks should be aware of the negative correlation between conservatism in treating and modeling excess collateral received from counterparties and inflation. Banks can overestimate or underestimate collateral due to inflation prediction and perception.