Guidelines on counterparty credit risk management – Executive Summary

Counterparty credit risk (CCR) is the risk that a counterparty defaults before final settlement of a transaction's cash flows. It depends on exposure size and counterparty credit quality, and their interaction, including with wrong-way risk (WWR) arising from the dependency between a counterparty's solvency and its underlying exposure, so that exposure grows when the counterparty's ability to pay declines.

Prompted by the collapse of Long-Term Capital Management, in 1999, the Basel Committee on Banking Supervision (BCBS) published *Sound practices for banks' interactions with highly leveraged institutions*. Subsequent episodes, such as the March 2021 Archegos Capital Management default, showed that CCR practices remained short of supervisory expectations, driven by the rapid evolution of CCR management techniques and the complexity of derivatives and securities financing transaction products.

In 2024, the BCBS issued *Guidelines for counterparty credit risk management* to supplement the 1999 sound practices. The guidelines cover exposures to all counterparty types, with supervisory expectations for non-banks whose activities could pose financial stability risks. While aimed at internationally active banks, the guidelines are broadly applicable based on proportional implementation.

Due diligence and monitoring

Due diligence involves collecting and assessing information on a counterparty to reach credit decisions. Banks should be wary of managing material counterparties on a portfolio basis without regard to the individual names or entities involved. Credit standards should set expectations by counterparty type, and banks should establish risk-based disclosures that feed into internal ratings, margin and limits: the greater the exposure and risk, the more visibility a bank should demand, and inadequate disclosure should lead to more conservative treatment, rejection or offboarding. Financial statements alone are insufficient, and hedge funds and other complex counterparties should supply their own loss estimates or stress test results.

Sound management of CCR requires both a strong initial assessment and an ongoing understanding of the counterparty's risk profile in both business as usual and stress conditions. At onboarding, banks should take a group-wide view regardless of platform, business line or legal entity. Reputation and profitability should not solely drive credit decisions, and non-financial risks, such as legal, reputational, geopolitical and country risk, should be assessed and escalated, since they can crystallise into CCR over time. Monitoring should continue after onboarding: tracking trading direction, net asset value, leverage and key personnel, with material change prompting reassessment of applicable credit standards.

Credit risk mitigation

Mitigants include terms, cross-collateralisation and guarantees, with margin being the most important: its adequacy depends on counterparty creditworthiness, disclosure reliability and the riskiness of its positions relative to market and liquidity risk. Margining frameworks should be transparent, consistent across products and sensitive to changes in risk profile and to market volatility and liquidity. Banks should

exchange variation margin daily with material counterparties and set initial margin by reference to portfolio risk;[1] where margin is not risk-sensitive, banks should rely on limits and contractual terms instead.

Banks should assess margin sufficiency across all products, forming a view when acting as agents for derivatives transactions. Concentration and WWR deserve attention, as they erode collateral value when most needed. Other mitigants, such as collateral haircuts, netting, early termination rights and guarantees, should be defined and tested for legal enforceability. Implied parental support is not equal to a guarantee, and capped guarantees require monitoring, as exposures can outgrow the cap under stress.

Exposure measurement

CCR losses are often driven by tail events and involve multidimensional risks across numerous counterparties and various underlying assets in concentrated, diversified, hedged and directional positions. Banks should use non-equivalent metrics that provide a complementary and comprehensive view of risk across the full exposure distribution (average, high quantiles, residual tail risk) under normal and stressed conditions. Metrics should be calibrated conservatively for model risk; embedded in pricing, risk monitoring and capital assessment; and independently validated.

Banks should compute CCR exposures daily, using potential future exposure (PFE) or alternative metrics.[2] PFE and other standard metrics generally produce little actionable signal for over-collateralised, highly leveraged counterparties, since they typically ignore WWR and the possibility of margin-driven default. Such metrics should be complemented by measures that better capture residual risk.

Banks should develop CCR stress tests, with stressed exposures integrated into risk management and monitored against limits. Scenarios should span historical, hypothetical and reverse stress tests, shock trades and collateral simultaneously, and test where mitigants fail. Limits should span current and stressed metrics at counterparty and portfolio level, capture all exposures and reflect risk appetite: neither permitting excessive build-up nor setting thresholds too low to reflect the bank's risk tolerance.

Governance

CCR governance rests on competent people and risk culture, a clear strategy with sound processes and limits, and reporting integrated into decision-making. As CCR straddles market and credit risk, CCR functions are essential, with managers senior enough to engage trading businesses and board committees.

The board should approve a CCR strategy defining risk appetite, supported by policies not overridden by competitive pressure. Risk committees should oversee limits, permitted products, hedging, collateral eligibility and methodologies; draw senior representation from trading, risk, compliance, finance, legal and operations; and report to the board. Limits should be set independently of the business, and with all breaches – technical, passive or active – subject to similar scrutiny. Exposures should be monitored at least daily, with a de-risking strategy executable in volatile, illiquid conditions. Reporting should cover key metrics, exposure evolution, top exposures, limits and breaches, in stressed and normal conditions.

Infrastructure and closeout practices

Timely, accurate data and risk systems underpin sound CCR management, affecting due diligence, digitisation of contractual terms, exposure metrics and reporting. Systems should match the size and

[1] Variation margin is collateral exchanged to reflect changes in a portfolio's current daily market value. Initial margin is collateral held against the further change in value that could occur between the last margin exchange and the closeout of a defaulted counterparty.

[2] PFE quantifies, over a defined future horizon and at a specified confidence level, how sizeable the CCR exposure of a given counterparty's portfolio may become given the applicable contractual terms and credit risk mitigants.

complexity of exposures and support stress measurement. Banks should minimise aggregation frictions, reduce the number of systems, align data definitions organisation-wide, and maintain controls to prevent, detect and correct issues. Risk reporting and oversight should provide key stakeholders – including credit risk officers and front office traders – sufficient information to assess the effectiveness of counterparty risk data aggregation and measurement. Fragmented reporting environments should be redesigned promptly.

Sound CCR management requires prompt action to close out a counterparty, with full knowledge of the steps required, including collateral liquidation and replacement trades. Banks should ensure that experienced staff, with legal support, can initiate closeouts, maintain watch lists overseen by independent credit officers and keep playbooks current through mock exercises and post-mortems.

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