MFA

28 August, 2024

Submitted via BIS Comments Portal

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Consultative Document on Guidelines for Counterparty Credit Risk Management

MFA[1] appreciates the opportunity to provide comments on the Basel Committee on Banking Supervision's ("**BCBS**") proposed "guidelines for counterparty credit risk management" (the "**Consultation**")[2] that would establish guidelines for counterparty credit risk ("**CCR**") management.

As end users of financial services and counterparties to banks, MFA members have a strong interest in ensuring a strong and robust banking system. In this regard, MFA strongly supports BCBS's objective to provide a robust, global baseline for counterparty credit risk management. In its current form, however, the Consultation would diminish the efficiency of capital markets and lead to increased costs for pensions, foundations and endowments without a corresponding benefit to CCR management or financial markets overall. This result would arise because the Consultation would impose overly prescriptive requirements by mandating practices that would (i) make it more expensive for financial end users such as MFA members to obtain critical financial services for the benefit of their sophisticated investors, which are typically pensions, foundations, and endowments, (ii) result in potential disclosure of sensitive proprietary information and (iii) limit contractual flexibility, in each case without a corresponding benefit to counterparty credit risk management.

We further would note that the underlying rationale for the Consultation – Archegos Capital Management ("**Archegos**") – is wholly misplaced in its applicability to private funds, given that Archegos was an unregulated family office, and its principals are currently standing criminal trial in the U.S. for fraud. That firm and the circumstances surrounding its failure is hardly an appropriate prism through which to

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[1] Managed Funds Association ("**MFA**"), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member fund managers, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] Basel Committee on Banking Supervision, Guidelines for counterparty credit risk management (30 Apr. 2024), avail. at https://www.bis.org/bcbs/publ/d574.pdf).

view CCR management for the broad, diverse spectrum of entities that constitute nonbank financial intermediaries ("**NBFIs**").

We submit these comments and recommendations to ensure that the Consultation is appropriately tailored to all segments of the asset management sector—from retail financial planners to managers serving institutional investors such as pension funds, endowments, and large foundations. Below, we first provide thematic comments on the Consultation, and then discuss specific areas of concern.

We would be pleased to meet with BCBS to provide additional background on the industry and context for our comments.

I. Executive Summary

- While MFA agrees with the overall objective of the Consultation to establish standards for managing CCR, we are concerned that, as currently drafted, the Consultation does not effectively carry forward its goals of setting out a "risk-based and proportional approach."
- Instead, we believe the Consultation sets out several prescriptive requirements that do not permit banks to customize their approach to best mitigate CCR on an individual counterparty or portfolio basis.
- A one-size fits all approach does not allow a bank to appropriately, nor effectively, account for the CCR of each fund and would result in increased costs, delays in transaction timing and an increased chance that proprietary information would be improperly obtained or disseminated. The additional costs may also simply make it uneconomic for a bank or its counterparty to pursue the relationship.
    - Banks may be forced to incur these additional costs and risks or simply choose not to do business with the fund(s) that are unwilling to satisfy the new CCR requirements and seek alternative counterparties).
    - Other requirements, like the requirements surrounding margining and exposure quantification, may simply be untenable for some fund counterparties (despite alternative transaction structures being available that would properly mitigate CCR).
- Thus, as a general matter, we recommend the BCBS adopt final guidelines that allow more flexibility for banks to deal with counterparty risks in a nuanced fashion, particularly around diligence and monitoring requirements.

II. Industry Background and Counterparty Credit Risks

A. <u>Description of the Private Fund Industry</u>

The term "Private Fund" encompasses in both the E.U. and U.S. a wide range of pooled investment vehicles sponsored and managed by a single investment adviser. In the U.S., the typical private fund structure consists of both a domestic private fund organized under U.S. law and an offshore private fund

organized under the laws of another country, such as the Cayman Islands.[3] The same general investment strategy will be followed for both the domestic and offshore private fund.[4] Investors in the domestic private fund tend to be U.S. individuals and entities subject to taxation in the United States, while the offshore private fund's investors generally tend to be comprised of non-U.S. individuals and entities and tax-exempt U.S. investors, including U.S.-based pension plans, endowments, foundations and other charitable organizations.[5] It is typical for an adviser to be affiliated with private funds and to manage several affiliated private funds (referred to herein as a "**Private Fund**" or "**Private Funds**").

In the EU, many private funds are structured to qualify as alternative investment funds in order to benefit from the pan-European marketing passport in the Alternative Investment Fund Managers Directive ("**AIFMD**"). The AIFMD covers a wide range of funds that are not undertakings for collective investment in transferable securities ("**UCITS**"), including hedge funds, private equity funds and real estate funds. In order to rely on the AIFMD passport, a fund must be established in an EU Member State, its manager must be licensed in an EU Member State as an alternative investment fund manager under the AIFMD and marketing can only be directed at professional investors. In contrast, UCITS-compliant funds can be marketed to retail investors. It is also possible for interests in non-EU funds (e.g., Cayman Islands and Delaware) to be sold to professional investors in the EU on the basis of private placement regimes in individual EU Member States. It is relatively common for non-EU investment advisers to rely on national private placement regimes to market their offshore private funds to professional investors in the EU.

To be eligible to invest in Private Funds under U.S. federal securities laws, an investor generally must qualify in most cases as a "qualified purchaser," and, less frequently, an "accredited investor," depending on the Private Fund. An accredited investor is defined as individuals with a net worth of at least $1 million (not including the individual's primary residence) or annual income of at least $200,000 in the past two years, and institutions with assets in excess of $5 million.[6] A qualified purchaser is defined as individuals with at least $5 million in investments or institutions with at least $25 million in investments.[7] Almost all Private Funds have minimum subscription amounts with a common amount being $1 million (and often times more).

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[3] *See, e.g.*, SEC. AND EXCH. COMM'N DIV. INV. MGMT., PRIVATE FUNDS STATISTICS SECOND CALENDAR QUARTER 2023 13 (2024), avail. at https://www.sec.gov/files/2023q2-private-funds-stats20240109.pdf).

[4] Some registered investment advisers ("**RIAs**") for Private Funds also advise single-investor Private Funds or managed accounts for a single investor. Generally, the investment strategy employed on behalf of such single-investor vehicles mirrors the strategy followed for the RIA's larger Private Funds.

[5] *See* Sec'y Treasury, Bd. Gov. Fed. Rsrv. Sys. & Sec. and Exch. Comm'n, A Report to Congress in Accordance with § 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act) 21–22 (2002) (avail. at https://home.treasury.gov/system/files/136/archive-documents/po3721b2.pdf).

[6] *See* 17 C.F.R. 230.501(a)(5) and (6) (setting forth the requirements applicable to individual investors); 17 C.F.R. 230.501(a)(3) and (7) (setting forth the requirements applicable to institutions).

[7] *See* 15 U.S.C. § 80a-2(a)(51).

Although it is possible for retail investor in the EU to invest in a private fund in certain limited circumstances, eligibility is generally limited to investors that qualify as a professional client within the meaning of the recast Markets in Financial Instruments Directive, also known as MiFID II. A professional client is defined in MiFID II as: (i) an entity which is required to be authorized or regulated to operate in the financial markets (e.g., credit institutions, investment firms, insurance companies, etc.); (ii) a large undertaking meeting at least two of the following three requirements on a company basis: (a) a balance sheet total pursuant to the balance sheet equivalent to not less than EUR 20,000,000, (b) net turnover pursuant to the balance sheet equivalent to not less than EUR 40,000,000, and/or (c) shareholders' equity pursuant to the balance sheet equivalent to not less than EUR 2,000,000; (iii) countries, regions, national and regional authorities, public bodies that manage public debt, central banks and the European Central Bank as well as the European Investment Bank, the World Bank, the International Monetary Fund and other similar international or supranational organizations; and (iv) an institutional investor other than those listed in points (i) to (iii) whose main activity is to invest in financial instruments, including undertakings dedicated to the securitizing of assets or other financial transactions. It is possible for an investor that does not satisfy the criteria outlined above to be treated as a professional client provided that it satisfies certain quantitative and/or qualitative tests that focus on the investor's experience with, and knowledge of, financial markets.

Investor monies are pooled together and become assets of the Private Fund, which is usually organized as a limited partnership or limited liability company. In return, an investor acquires an ownership interest (e.g., a limited partnership interest) in the Private Fund in proportion to its contribution. Investors participate in the gains and losses of the Private Fund through their respective ownership interests.

The Private Fund's administrator is an independent third party that provides valuation, administrative and other services to the Private Fund and its investors, such as, for example, calculating the management and performance fee; maintaining books and records; acting as the registrar and transfer agent for shares held by investors; and handling the receipt of subscriptions and the payment of redemptions (i.e., collecting funds from, and disbursing funds to, investors).

Private Funds employ a myriad of strategies, each creating a distinct profile reflecting the strategy and the Private Fund itself and its manager. From the perspective of the lending bank, a Private Fund employing a fundamental-based long-only strategy will have a very different risk profile than a quant fund or a long-short fund or a Private Fund focusing on emerging markets. The lending bank will require different levels of capital for a loan to each such Private Fund, and of critical importance is the Private Fund itself and the collateral used to secure the underlying loan. The risk profile of a Private Fund, in addition, will be very different than the risk profile of a specialty finance company or a nonbank provider of residential mortgages or auto loans. Application of any know-your-borrower requirements for the lending bank also will be very different depending on the size and nature of the borrower.

III. General Recommendations

A guiding principle for the Consultation is broad applicability, whereby "[b]anks and supervisors are encouraged to take a risk-based and proportional approach in the application of the guidelines, taking into account the degree of CCR generated by banks' lines of business, and their trading and financing activities,

as well as the complexity of such CCR exposure."[8] MFA recognizes the need for a common baseline for CCR management; however, bank risk management should not be evaluated based on the "lowest common denominator" or encourage a "race to the bottom." On the other hand, risk management guidelines should not encourage banks to avoid risk altogether, but rather to prudently manage risk. The Guidelines thus must balance the benefits of standardization against the flexibility of "a risk-based and proportional approach" that considers the full range of counterparties to which a bank may have credit exposure. In this regard, the Consultation's rigid prescriptions are not universally appropriate for Private Funds, whose varied strategies and structures demand complementary nuanced approaches from counterparty banks.

Ultimately, Private Funds have many options in financing their activities, but often prefer regulated banks to appropriately safeguard investor assets. In this regard, robust CCR management is important to Private Funds. Bank failures in recent years have directly impacted Private Funds' ability to access critical services, as well has indirectly impacted market liquidity and pricing more broadly. A prescriptive, heavy-handed approach to risk management would only compound these difficulties by making it more difficult for even the most well-managed banks to continue to provide critical capital markets services. Given the critical role that banking organizations play as financial intermediaries, it is imperative that the BCBS consider the economic impact on counterparties with which banks transact and markets in which banks operate.

Importantly, banks are best positioned to identify the credit risk of a given nonbank counterparty and it is critical that they be afforded the flexibility to tailor margin and collateral requirements to reflect the attendant risk that they have identified with a given counterparty. Bank-counterparties similarly must be afforded the flexibility to manage the risks that they have identified and the Consultation should recognize the considerable operational, compliance, and corporate governance requirements around managing such risks. These risk frameworks have developed over time, often with heavy input and evolution as directed by prudential regulators to the bank-counterparties.

Since the Consultation expressly references Archegos as an impetus for the Consultation, it is worth noting that Credit Suisse, for example, had extensive controls that would have prevented at least some of its losses to Archegos, but it failed to properly implement those controls.[9] As the Credit Suisse Group Special Committee of the Board of Directors Report on Archegos noted, "this is not a situation where the business and risk personnel engaged in fraudulent or illegal conduct or acted with ill intent."[10] Moreover, "*[n]or is it one where the architecture of risk controls and processes was lacking or the existing risk systems failed to operate sufficiently to identify critical risks and related concerns*" (emphasis added).[11] Rather, the lack of activity resulting in the failure of Credit Suisse was due to a "persistent failure of the business and risk

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8 Consultation at 2.

9 *See* Credit Suisse Group, "Credit Suisse Group Special Committee of the Board of Directors Report on Archegos Capital Management" at 2 (July 29, 2021), avail. at https://www.credit-suisse.com/media/assets/corporate/docs/about-us/investor-relations/financial-disclosures/results/csg-special-committee-bod-report-archegos.pdf.

10 *See id.*

11 *See id.*

to manage and remediate the risks, and pervasive issues of business competence and resourcing adequacy, described in detail in this Report, require CS's urgent attention."[12] We note that other bank-counterparties that conducted business with Archegos and enforced their risk controls and processes and remain in business today. In short, the conduct that resulted in Credit Suisse's failure was not the result of poor processes or controls, but rather an inability to follow and enforce them.

Overly prescriptive and inflexible initial and ongoing due diligence requirements moreover are at odds with dynamic, flexible, and rigorous CCR management. For example, the Consultation prescribes a number of due diligence, monitoring and contractual requirements, but does not consider the potential impact these guidelines will have on banks and their counterparties. The guidelines' manifold requirements regarding margining and exposure notification undermine the commercial impact it will have on banks in terms of the decrease in business volume and revenue. Moreover, the guidelines would also undermine the bank-counterparties' ability to engage in arms' length negotiations by effectively giving banks the unilateral right to dictate contractual terms. It is also impractical, or at least creating operational challenges and risks, for the bank to document and operationalise the detailed margining terms that would seemingly be required under the Consultation, especially at the outset of a relationship.

Pushback by the non-bank counterparty will create additional operational, personnel, and corporate governance burdens for the banks as they must escalate internally in a never-ending series of exception requests and corporate governance committee reviews in an attempt to bring the contractual terms back to a place that more appropriately reflects the CCR identified by the bank – the very party that is best positioned to "know its counterparty." It would be far preferable for the bank for the trading agreements to *begin* with an accurate reflection of counterparty credit risk than end there after much consternation, negotiation, and expense – both internally within the bank and externally with the nonbank.

Many non-bank counterparties also may find it uneconomic to accept a bank retaining such broad authority over the terms of the agreement. As described below, overly broad disclosures requiring banks to review "proposed trading positions or sample portfolios" could cause the leaking confidential proprietary trading strategies, which could be particularly damaging in situations where banks also compete with Private Funds through other business lines.

To reiterate, MFA supports the BCBS's overarching goals, but strongly recommends that requirements be better calibrated to balance risk mitigation measures with a fulsome view of the measures' costs. We would therefore recommend that the BCBS adopt final guidelines that allow more flexibility for banks to deal with CCR in a more nuanced fashion, particularly around diligence and monitoring requirements.

[12] *See id.*

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IV. Specific Recommendations

Below, MFA offers specific comments on the Consultation.

A. Comprehensive collection and review of financial and non-financial information must be calibrated to the counterparty

The Consultation states that a bank's "credit approval process should begin with comprehensive collection and review of financial and non-financial information – including legal, regulatory, reputational and operational risks, as well as other relevant risks."[13] It goes on to state that ongoing monitoring requires "updated information about material developments such as changes in trading activities and leverage taken, profit and loss developments, as well as significant changes to how the counterparty measures and manages their risks."[14] While we certainly understand why this level of diligence and monitoring may be appropriate in some instances, the Consultation's approach to apply this broadly to all counterparties imposes rigid standards that will exact unnecessary costs on banks and further protract the due diligence process, leading to delays for both counterparties that may limit or delay the banks' abilities to offset its own risks against counterparty exposures.

First, counterparty risk varies depending, in part, on complexity, counterparty size and exposure size. Due diligence and monitoring requirements should be tailored to the risk that a counterparty poses. For example, a small credit fund that obtains financing from a bank for its portfolio of loans would not ordinarily implicate reputational or operational risks, and a bank should have the flexibility to determine that the expected risk, based on the exposure to and characteristics of the Private Fund, do not necessitate an in-depth due diligence process. Imposing such a risk- and capital-intensive yoke on the banks as contemplated under the Consultation will drive up the banks' costs in trading with that counterparty, resulting in higher margin and collateral requirements and increased risks *for the bank* that are outsized given the modest risk posed by the nonbank counterparty. It also could result in the inability of smaller Private funds to find bank counterparties if banks determine that the opportunity cost and attendant risks of taking them on as a counterparty is too high.

Second, even in cases where a counterparty would ordinarily be subject to heightened due diligence, a counterparty may be unable to provide sensitive trading information or may be subject to privacy restrictions (e.g., pursuant to an agreement with the Private Fund's investors). It should not follow that a nonbank counterparty should be faced with the Hobson's choice of breaching its fiduciary obligations in providing sensitive trade secrets to the bank (trade secrets that rightly exist for the benefit of the fund) or incurring legal risk by breaching the privacy restrictions of its investor contracts. While the bank could simply choose not to pursue the relationship, a far better approach, and the approach currently taken, is for the bank to work with the counterparty to arrive at a risk-based, flexible solution to appropriately mitigate the bank's risk. Common concessions may include higher interest rates on financing, more favorable default remedies for the bank, or alternative monitoring provisions.

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[13] Consultation at 3.

[14] *Id.*

Thus, while we endorse the objective to establish minimum standards for due diligence and monitoring, we strongly recommend that any final standards avoid over-prescription that could impede banks' flexibility to pursue more risk-based contractual arrangements in response to the varied needs of its counterparties.

B. The final guidelines should permit reasonable reliance on verbal information

The Consultation would require banks to adopt practices that "ensure that credit risk decisions are not made based on unverified or verbal information," seemingly restricting banks from relying on verbal information. We understand that written information is often more reliable than verbal information, in large part because it provides a permanent record of the information to which the provider must be held accountable. However, the guidelines fail to recognize that both market practice and a concern for confidentiality necessitate that some information is often better conveyed verbally, and that such information can be more valuable and more timely than written information. For example, official net asset value ("**NAV**") for Private Funds is typically calculated and formally reported monthly, but in a dynamic marketplace or in times of stress, such information may be valuable from time to time during the month. Verbal communication thus helps to address the occasional need for "off-cycle" information.

As another example, due diligence may involve disclosing sensitive information, which bank and nonbank counterparties alike may be unwilling to convey in writing. Restricting reliance on verbal communications could expose counterparties to confidentiality risks or incentivize them to refrain from disclosure altogether to avoid having to commit such sensitive information to writing.

We therefore recommend that the guidelines encourage written verification where appropriate but should not wholly preclude reliance on verbal information.

C. The final guidelines should not mandate use of third-party information verification services

The Consultation states that "banks may benefit from engaging third-party information verification services" in confirming the accuracy of information under the onboarding due diligence guidelines.[15] The recommendation to use third-party verifications services should be qualified to note that such verification is not required and that some scenarios may call for other forms of verification. Banks should be given the option to use third-parties to verify information, as they reasonably deem appropriate to satisfy their due diligence obligations (e.g., when onboarding a new counterparty or when a counterparty raises red flags), but a mandate to do so would impose inessential costs and delays for the bank. Significantly, the use of third-party verification services also increases the risk that a counterparty's proprietary information passes into the wrong hands. Banks must be given flexibility in their approach.

D. The final guidelines should recognize the cumulative effects of general loss absorption together with risk management measures (such as margin requirements)

The Consultation characterizes credit mitigants as the primary way in which banks manage CCR, with a particular focus on margin requirements. Specifically, the Consultation requires that banks manage margin both at the counterparty and portfolio level, taking into account the individual "name and risk factor

[15] Consultation at 5.

level."[16] Although margining, exposure measurement, and stress testing all can be important measures that a bank uses to address counterparty credit risk, such measures must be consistent and considered together with, overall bank loss absorption measures such as capital adequacy requirements.

When engaging with a counterparty, banks should be expected to try and mitigate their losses, but the bank cannot entirely foreclose loss in every transaction. For every potential measure a bank may take, the bank must balance the reduction in risk with the (often) corresponding increase in cost. In this case, highly dynamic margin requirements protect the bank but (i) increase the bank's monitoring costs and (ii) correspondingly increase the counterparty's costs in complying with the agreement. If the bank is required to implement dynamic margin requirements without regard to counterparty, then the overall increase in costs will often outweigh the corresponding reduction in risk. Dynamic margining also increases the bank's risk for error or settlement failures. In these cases, a bank would be better served by refraining from implementing dynamic margining measures and using the cost savings to absorb against potential losses. Once again, the bank is best positioned to determine the approaches necessary to mitigate its risk of loss based on the risks it has identified with a particular counterparty and the trading and exposures used by that counterparty.

The Consultation also recommends varying margin based on information that Private Funds currently do not provide and that may be considered confidential and proprietary. For example, for hedge funds, the Consultation recommends varying margins based on "new trading strategies, as well as changes in portfolio directionality, concentration or leverage."[17] The risks posed by a particular counterparty to a particular bank should be based on the derivatives or other trading *that* counterparty is engaging *that* bank to facilitate. The trading that a particular counterparty engages with a prime broker related to its investment strategy do not directly implicate the bank. It would be tremendously burdensome for the bank to have to monitor not only the trading the counterparty does with the bank but also to consider the trading the counterparty does elsewhere. In addition to the increased costs to the bank in monitoring a counterparty's strategies, its inability to do so or adjust on a timely basis would subject the bank to considerable regulatory and legal risk. While such information can be valuable depending on the exposure, a better approach would be to consider other risk mitigants, such as higher fees or other concessions rather than seek to monitor information that the nonbank counterparty would likely consider proprietary and, as noted above, may be legally unable to provide.

We recommend that any final guidelines instead take a more holistic view of margining that balances the value of margin against other loss absorbency measures. In other areas of regulation, most prominently the BCBS's capital framework, the BCBS acknowledges that banks can deal with increased risk through credit mitigation, such as entering guarantees or holding high-quality collateral, but also permits cushioning the impact of the risk by holding more or safer capital. Capital adequacy can be accomplished by reducing risk or by simply increasing capital to sustain adequate capital if risks actualize. Margining and other credit-risk mitigants might introduce more costs than benefits, particularly with less complex counterparties and transaction, and banks can better offset the costs by holding further capital or engaging

[16] Consultation at 7.

[17] Consultation at 7.

in other loss absorption strategies, including charging higher fees. The final guidelines should encourage banks to consider these trade-offs. This approach would give banks and counterparties more flexibility in designing a transaction to maximize value between them rather than engaging in value-reducing mitigation provisions that could be more easily dealt with through loss absorption. The BCBS should especially avoid requirements that go beyond current BCBS standards, such as the proposal to adjust margin period of risk ("**MPOR**") to account for "excessive risks from concentration, liquidity, idiosyncratic risks" when BCBS's capital framework generally requires an MPOR to be of at least 10 days. Expanding the time horizons would (i) add unnecessary complexity given the prescribed measures in the capital rules and (ii) reduce the effectiveness of potential future exposure ("**PFE**") by requiring the bank to make more assumptions in its modeling (e.g., determining future market liquidity,).

To reiterate, we would not support abandoning the margining or credit mitigation measures the Consultation recommends, as we recognize that these are important in accounting for CCR. However, we do recommend that the final guidelines (i) provide more flexibility to banks through less prescriptive margining requirements, (ii) discuss loss absorption and (iii) provide that a bank should balance risk mitigation and loss absorption strategies to maximize value.

E. The final guidelines should allow banks to use standard transaction terms

As noted above, the Consultation appears to require that banks customize contracts based on individual counterparties and transactions. While ideally every transaction could be customized to the unique idiosyncrasies of each counterparty, we believe the guidelines must acknowledge that this is often impractical and costly compared to developing standard transaction terms for simpler or less material counterparties and transactions. For example, the bank-counterparties, through International Swaps and Derivatives Association ("**ISDA**"), have developed industry standard trading documentation for a variety of derivatives products, and over the course of decades the market has gravitated towards a standard menu of contractual variations, particularly for "plain vanilla" products. This standardization improves efficiency by minimizing transaction costs and providing certainty to both parties of the circumstances giving rise to a default and the prompt and efficient close-out and resolution of a default. Parties cannot be expected to negotiate each contract from a blank slate. Instead, banks should be permitted to evaluate a counterparty and determine if specialized terms are necessary, or whether standard terms are more appropriate.

ISDA documentation has evolved and adapted with each market cycle to better protect bank counterparties in the event of a nonbank counterparty default. Specific terms such as the events of default and how damages are measured are regularly reviewed and revised by bank counterparties through various ISDA committees. ISDA has developed a series of protocols in response to particular developments, such as a resolution protocol to better protect banks if a resolution authority has been imposed, the imposition of a "deemed ISDA" if banks elect to trade with a counterparty on undocumented basis, or in response to specific market events such as the cessation of LIBOR.

Consistent with our previous recommendation, the bank can compensate for the CCR by investing cost savings in capital to use as loss absorption or by sharing in a counterparty's risk-savings through different margin requirements or other mitigation techniques.

F. <u>The final guidelines should provide banks more flexibility in the methodology they can use to calculate CCR and not prescribe specific measures</u>

The Consultation states "CCR exposure metrics should be comprehensive in covering banks' material risks at portfolio, counterparty and a more granular risk factor level."[18] The Consultation also prescribes specific risk measures, requiring banks to implement a Wrong-Way Risk ("**WWR**") modelling framework and to use PFE to quantify CCR.[19] We would recommend that the final guidelines take a more measured posture, regarding each of these exposure metrics as a tool banks should consider using but not requiring them to do so, especially if new measures have proven more effective. While we appreciate that each of the exposure metrics the Consultation discusses has utility, we believe it is inappropriate to prescribe these measures without regard to specific counterparties and transactions.

First, with regard to comprehensive risk metrics, as we have discussed throughout this letter, a bank must be permitted to exercise its judgment in determining its risk tolerance based on the given transaction so that the costs of the measures do not outweigh the corresponding reduction in risk, which would be the case for many transactions if banks are required to always use granular CCR exposure metrics. For example, a transaction with a traditional credit fund, where the risk involved is unlikely to be idiosyncratic, does not merit the same degree of diligence as a complex equity fund.

Second, regarding WWR, the Consultation requires a WWR framework, but fails to acknowledge that WWR is a context-specific measure and may not be appropriate in every transaction. Further, in some cases, the difficulties in calculating WWR may outweigh the benefits. The BCBS has acknowledged in the past that "[w]rong-way risk is sometimes difficult to identify," that "[u]nderstanding the counterparties' risk factor sensitivities can be challenging, especially for counterparties (such as some hedge funds) that tend to be opaque" and that "[e]ven when wrong-way risk can be identified directionally, it is often difficult to quantify its magnitude in an economic capital model."[20] WWR is also difficult to precisely define, as evidenced not least by the Consultation's references to WWR in the context of Archegos, which is not typically considered an example of WWR.[21] Discussion of a WWR framework is appropriate but prescription of such framework ignores its flaws and a bank's ability to effectively evaluate where its use is apt.

Third, similarly with regards to PFE, the Consultation would require banks to quantify CCR exposure using PFE despite acknowledging its "inherent limitations."[22] PFE is a useful conservative measure, but it is not always appropriate. As acknowledged in a speech by Elizabeth McCaul, a member of the supervisory board of the European Central Bank (at a conference organized in part by the BCBS), "[m]etrics need to be enhanced to address methodological shortcomings, as deficiencies can lead to risk being

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[18] Consultation at 10.

[19] Consultation at 12.

[20] BCBS, "Range of practices and issues in economic capital frameworks" at 48 (Mar. 2009), *available at* https://citeseerx.ist.psu.edu/document?repid=rep1&type=pdf&doi=85ce9161e9bbd9b728dc4beae1b3803cd5ba9eb3.

[21] Consultation at 26-27.

[22] Consultation at 14.

underestimated…These metrics need to be developed, since industry standard metrics, such as potential future exposure, are not always an adequate measure of risk for certain complex products like total return swaps."[23] Further, the recommendation that PFE "account for WWR" exacerbates the prescriptiveness of the Consultation and would be computationally challenging,

Counterparties benefit when banks can use the exposure metrics the bank has determined are appropriate for transactions with that counterparty without having to consider measures solely for a "check-the-box" exercise. This will often include WWR, PFE and idiosyncratic considerations, but lack of prescription leaves room for the use of new measures, where appropriate, and avoids superfluous costs.

G. The final guidelines should provide banks more flexibility in the design and frequency of stress-tests and testing of risk limits

The Consultation includes in-depth stress testing provisions, such as requiring granular tailoring "at the counterparty and portfolio levels" and testing for situations where "risk mitigation measures do not work as intended."[24] It also requires frequent testing of counterparty exposures against risk limits, including "ad hoc intraday exposure monitoring."[25] While these requirements will largely affect banks, we are concerned that some of the measures prescribed will pass on compliance costs to counterparties and would subject counterparties to further disclosure requirements to provide data for the banks to input into the tests. In particular, the requirement to stress test individual counterparties, without seeming regard to size or complexity, does not seem appropriately calibrated and might impose needless costs on certain counterparties, particularly considering that much of the information that a bank would require for a stress test is information that the bank would already have in the ordinary course of trading with a given nonbank counterparty.

We recommend the final guidelines provide banks with a greater ability to decide the scope and frequency of stress tests and risk limit testing.

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MFA reiterates its strong support BCBS's goals to ensure banks properly account for and mitigate CCR and has long supported BCBS's efforts related to bank safety. As discussed above, however, recommend modification to the Consultation to preserve the flexibility necessary for banks to appropriately manage their counterparty relationships.

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[23] *See* Elizabeth McCaul, "Supervising counterparty credit risk – a European perspective" (Feb. 28, 2024), *available at* https://www.bankingsupervision.europa.eu/press/speeches/date/2024/html/ssm.sp240228~a9397948a8.en.html.

[24] Consultation at 14 and 15.

[25] Consultation at 19.

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We appreciate the opportunity to provide these comments to BCBS in response to the Consultation. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Jeff Himstreet (jhimstreet@mfaalts.org) or the undersigned (jflores@mfaalts.org).

Respectfully submitted,

/s/ Jillien Flores

Jillien Flores
Executive Vice President &
Head of Global Governmental Affairs