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Counterparty credit risk management

Reflecting on the ECB's targeted review

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CRISIL GR&RS analytical contacts

Sunay Jain
Director, Markets & Business Transformation
sunay.jain@crisil.com

Sivakumar Veluchamy
Associate Director, Risk SME
siva.veluchamy@crisil.com

Sivaprakasam Paramanandam
Lead Analyst, Risk SME
sivaprakasam.paramanandam@crisil.com

Kranthi Yeldi
Lead Analyst, Risk SME
kranthi.yeldi@crisil.com

Playing catch-up

Counterparty credit risk (CCR) management frameworks of leading banks have failed to keep pace with evolving regulatory requirements and enhanced scrutiny.

Amid the banking sector's quest to adapt to technological advances, several key links in the risk management framework remain vulnerable.

In this context, the European Central Bank (ECB) had conducted a targeted review of CCR processes of 23 financial institutions that were active in securities financing transactions (SFTs) and derivatives with non-banking counterparties (commodity trades, energy utilities, etc.).

It called out 43 sound practices across four focus areas: i) CCR governance ii) risk control, management and measurement, iii) stress testing and wrong-way risk (WWR), and iv) watchlist and default management. See Appendix 1 for details.

Following the review, the ECB highlighted the key areas to improve upon.

These included enhanced customer due diligence, better management of complex CCR exposures, stress test framework covering tail events (WWR, high leverage, maturity mismatch, crowded trades' non-linearity, and so on), and risk mitigation with early warning indicators.

For global banks' response to the key review items, see Appendix 2.

As bad as it gets with the financial markets

Here's a hypothetical case.

A bank's trading desk finances a client to purchase a stock listed on the Tokyo Stock Exchange with a haircut of 20%.

Following the purchase, a systemic shock causes the stock price to start declining with no buyers.

In this scenario, the client will have neither the incentive to continue the contract nor the intention to repay the borrowed principal anytime soon.

Let's further assume that the client is a non-banking counterparty that has commodity derivative positions in the same currency and the exposure to these have become unfavourable.

The bank now faces a high likelihood of counterparty default, which may prompt it to place a request for additional margins with the counterparty.

Such cases are not unusual.

Wilful lowering of margins during favourable markets and high-liquid environments, especially when they last for a long period, will hurt all market participants when the situation reverses steadily and persistently.

The anatomy of market bubbles

The global financial crisis 16 years ago was the thrust point of all regulatory measures.

Since then, barring a few exceptions such as Brexit and Covid-19, the financial markets have not seen any major asset-bubble meltdown.

While many economists attribute the lack of severe shocks to improved regulatory oversight, we must note that the capex investment cycle is yet to return.

For instance, several small steel firms were taken over by larger firms at near-zero book value due to huge debts, and the ones that waded through the tide are still struggling to operate anywhere near peak utilisation levels.

In other words, asset bubble build-ups and eventual breakdowns should not be ruled out in the coming years.

Regulatory review and scrutiny

The ECB has been on its toes, not only establishing guidelines and rules but also reviewing banks regularly.

In its view, capital market services were being offered to more risky non-banking counterparties, hedge funds and family offices, among others.

The ECB has increased its focus on Prime Broking (PB) services given the complex trade booking and settlement methods, especially in the case of triparty arrangements.

On the other hand, the US Federal Reserve has been actively monitoring systemically important banks (SIBs), recently flagging concerns about their contingency plans.

SIBs are important for many reasons, the paramount being the high cost the government has to bear in case of their failure.

Large banks continue to hold trillions of dollars in Derivatives. Curbs and interventions in the banking industry have failed to stop the derivate positions from growing.

That is not a bad sign, but the risk stemming from these derivatives should be managed and approached proactively.

How banks typically translate regulatory requirements

Banks, especially SIBs, have always been sensitive to regulatory requirements, establishing risk-control frameworks.

These frameworks had typical execution cycles and several supervisory layers to produce good-quality risk metrics.

Subsequently, SIBs invested in optimising risk-weighted assets (RWAs) and building pre-emptive systems for proactive risk management. This remains an intended approach, but the ground reality and key deliverables are far from the desired benchmarks.

The key challenge lies in the approach banks take to operationalise risk-control frameworks. We have worked with several large banks and see the same set of weaknesses across.

Once the control frameworks are designed and operationalised, banks tend to view the control artefacts as factory throughputs, whereas the emphasis should be on supervisory scrutiny rather than on automating the production of control results.

Banks are looking to employ robotic process automation (RPA) in the production of risk metrics.

Though not a bad idea, the prime focus of the entire risk-control framework should be on identifying key risks and setting up measures to mitigate them, apart from early warning indicators of risk stress.

Hence, banks should fundamentally rethink the resources it commits to the various horizontals (as reviewed by the ECB recently) and ensure that the spirit of the regulatory mandates is not lost in translation.

Way forward

As economies grow, so would SIBs.

These banks should focus on stress management and spend resources prudently to manage risks proactively.

Legacy systems within banks will remain, operationalisation of control elements will continue, and automation and data analytics will be top priorities.

That said, banks must strengthen their supervisory review and strategic alignment.

They should also bear in mind the fundamental reason why a risk management framework exists, i.e., a safe and sound economic environment for all market participants.

Appendix 1: Sound practices across focus areas

#	Area	Sound practice
1	CCR governance	Presence of a three lines of defence model for CCR
2		Dedicated CCR framework with clear responsibilities for 1LoD and 2LoD
3		Sufficient 1LoD and 2LoD resources for all CCR counterparties
4		Daily monitoring and management processes for high-risk clients
5		Dedicated coverage of CCR in relevant committees
6		Sufficiently detailed CCR-related reporting to senior management
7		Appropriate collateral management processes and reporting
8		Inclusion of the risk assessment of CCR exposures in the credit risk assessment
9		Inclusion of the results of customer due diligence processes in credit decisions and recognition of CCR in customer due diligence processes
10		Assessment of CCR in new product processes
11		Effective processes for NBFI client identification and monitoring
12		Explicit assessment of the CCR framework by 3LoD, i.e., internal audit
13	Risk control, management and measurement	Identification of CCR sources and assessment of materiality
14		CCR framework commensurate with CCR risk profile
15		Adequate recognition of CCR in the RAS
16		Policies addressing risk acceptance for CCR as an integral part of the RAF
17		Adequate limit framework for CCR
18		Appropriate choice of CCR metrics
19		Effective monitoring of counterparty concentrations to margin shocks
20		Adequate identification and monitoring of illiquid and concentrated positions
21		Appropriate economic measure for costs of CCR portfolio wind-down
22	Stress testing and WWR	Documented governance for stress testing framework
23		Explicit consideration of the CCR component in stress testing
24		Comprehensive set of CCR-relevant stress scenarios
25		Use of stress testing framework for the identification and monitoring of increasing risks for high-risk clients
26		Explicit stress testing of CCR exposures in the ICAAP to identify clients vulnerable to tail risk events
27		Adequate WWR framework included in the RAF
28		Identification and monitoring of GWWR with well-defined models and data
29		Identification of GWWR under specific market stress events
30		Sound SWWR assessment and monitoring
31		SWWR identification without legal connection
32		Documented watchlist policy

#	Area	Sound practice
33	Watchlist and default management	Definition of relevant watchlist indicators including CCR
34		Defined actions based on watchlist classification
35		A posteriori review of watchlist performance
36		Clear ownership of DMP policy
37		DMP policy implementing governance of default management
38		Description of a binding process and identification of clear responsibilities
39		Integration of risk management functions in DMP decision-making
40		Procedures conducive to effective information flows and default management
41		Post-default process ensuring minimal losses and legal risks
42		For market-makers, assessment of (local) close-out capabilities
43		Regular fire drills for the DMP

Top practice in each area where most banks are considerably compliant

Top practice in each area where banks have considerable room for improvement

Appendix 2: Global banks' response to key review items

Increased oversight and technology overhead

Improvements in key focus areas call for review leadership and hence higher oversight cost

Several banks are adopting change projects with significant budgets to meet the ECB's expectations

Banks require an insights-driven approach to adapt well

Better risk management should come at a reasonable cost

CCR governance

- Current reporting process is being revisited to improve (i) turnaround of reporting type, and (ii) accuracy of reported items
- Legacy systems and assets being held for sale continue to pose significant overheads in terms of risk corrections and manual adjustments
- Adoption of strategic tools for valuation, risk calculation and reporting

Risk control management and measurement

- Strategic tools to manage business restructuring, including sell-offs and acquisitions
- Leverage finance infrastructure to adequately test and scale risk scenarios
- Significant investments in front-office technology projects to resolve issues at source

Stress testing and WWR

- Investment in significant technology tools which are scalable and use optimal server capacity
- Development of an extensive stress testing framework across products and asset classes for both PB and non-PB businesses
- Risk simulation for edge cases to understand economic value and accuracy of risk and valuation engines

Watchlist and default management

- Risk managers integrate results from multiple programmes for better default management
- Use of stress testing tools to simulate multiple scenarios on default
- Increased focus on PB exposures to manage not only net risk but also collaterals
- Improved governance on existing DMPs

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CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil-global-research-&-risk-solutions @CRISILGRRS /CRISILLimited /user/CRISILLimited /lifeatcrisil