BETTER MARKETS

January 31, 2025

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
4051 Basel, Switzerland

Re: Technical Amendment—Hedging of Counterparty Credit Risk Exposures; Basel Committee on Banking Supervision; ISBN 978-92-9259-810-5 (November 27, 2024)

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the consultative document ("Proposal" or "Amendment")[2] cited above, issued by the Basel Committee on Banking Supervision ("Committee") of the Bank for International Settlements ("BIS"). As indicated in the Proposal, the Amendment would better align the treatment of purchased guarantees and credit derivative protection with the treatment of eligible collateral in the Committee's counterparty credit risk ("CCR") framework.

The Proposal's succinct and technical description of the Amendment should not obscure the importance of its subject. For example, opaque and interlinked exposures of megabanks to credit derivatives guaranteed by American International Group ("AIG") were directly responsible for the $180 billion U.S. government bailout of AIG in 2008.[3] Unfortunately, today's CCR framework, with its overly generous recognition of netting, collateral, and derivatives and guarantees to reduce megabank capital requirements, continues to encourage and enable the proliferation of complex, interlinked risks that led to the 2008 bailouts.

The Proposal identifies, and addresses, a conceptual inconsistency in the CCR framework between the capital requirements when credit risk is mitigated by collateral, and the capital requirements when credit risk is mitigated by a credit derivative or guarantee. By removing the inconsistency, the Amendment could increase the required capital for credit risks hedged by credit derivatives or guarantees to a level that is closer to the capital required when the risk is offset by collateral. Better Markets commends the Committee for identifying this inconsistency and we

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance— to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Basel Committee on Banking Supervision, *Technical Amendment—Hedging of counterparty credit risk exposures* (Nov. 27, 2024), https://www.bis.org/bcbs/publ/d584.pdf.

3 Robert C. Pozen, *AIG: The Secret Bailout*, HARVARD BUSINESS REVIEW (Nov. 23, 2009), https://hbr.org/2009/11/aig-the-secret-bailout.

support the finalization of the Amendment, with some technical clarifications recommended in this letter.

At the same time, however, in its recent CCR risk management guidelines ("Guidelines")[4] the Committee itself has described how the CCR framework can set capital requirements that are grossly insufficient to address the risk resulting from changes in the value of collateral backing derivatives positions. Specifically, the Committee used the failure of Archegos Capital Management, and the grossly inadequate capital Credit Suisse ("CS") was required to hold against its Archegos exposures, to illustrate the inadequacy of CCR capital requirements.[5] As explained below, the Committee indicated that CS's assumed future exposure to Archegos was ***less than a tenth of the actual losses*** it incurred when closing out its Archegos positions.[6] As long as the Committee's CCR framework continues to encourage banks to use hedges to manage capital requirements rather than to meaningfully hedge actual economic exposures, debacles like the CS failure will happen repeatedly.

The transparency and candor with which the Committee described the weakness of the CCR framework was commendable. Yet surprisingly, apart from the current relatively narrow Proposal, the Committee has so far shown no indication that it plans to address the larger issues it rightly identified in the Guidelines. The Committee's most recent two-year strategic priorities document,[7] published in late 2022, contained no mention of any work to strengthen the CCR framework. The Committee currently has an opportunity to address the important framework issues it identified in the Guidelines as it considers its workplan for the next two years.

For these reasons, Better Markets reiterates a recommendation it made in a prior comment letter to the Committee.[8] We recommend that the Committee initiate a workstream to address the weaknesses in the CCR framework that are described in its Guidelines. The work should include, among other things, the development of ways to incorporate gross exposure limits into the Basel framework so that problems at a single large counterparty do not cascade into a financial crisis that requires yet another public bailout of megabanks.

BACKGROUND

CCR is the risk of loss resulting from counterparty default or deterioration in a counterparty's credit quality. CCR exists both in traditional lending and in banks' capital markets activities such as trading, securities financing transactions, and derivatives. Measuring and

[4] Basel Committee on Banking Supervision, *Guidelines for Counterparty Credit Risk Management* (Dec. 11, 2024), https://www.bis.org/bcbs/publ/d588.pdf.

[5] *Id*. at 14, 16.

[6] *Id*. at 14.

[7] Basel Committee on Banking Supervision, *Basel Committee Work Programme and Strategic Priorities for 2023/24* (Dec. 16, 2022), https://www.bis.org/bcbs/bcbs_work.pdf.

[8] Better Markets Comment Letter, *Guidelines for Counterparty Credit Risk Management* (Aug. 23, 2024), https://bettermarkets.org/wp-content/uploads/2024/08/Better-Markets-Comment-Letter-BCBS-Counterparty-Credit-Risk-Management.pdf.

modeling CCR from such capital markets activities is complex but also critically important. In fact, longstanding weaknesses in megabanks' management of CCR have contributed repeatedly to financial crises.[9]

As noted above, the Committee recently published guidance on banks' risk management of CCR. In the process of describing how banks should manage CCR, the Committee advised banks not to place sole reliance on regulatory measures of risk because of the severe shortcomings of those measures. The Committee focused particular emphasis on shortcomings in the way the Basel framework computes Potential Future Exposure ("PFE") for derivatives.

Generally speaking, the Basel framework sets capital requirements by starting with an exposure at default ("EAD") measure, applying a risk weight to the exposure to calculate risk weighted assets, and finally setting required capital as a percentage of those risk weighted assets. EAD is thus the starting point for the capital calculation. Importantly, an unrealistically low EAD will result in an ***inadequate capital requirement***.

EAD can be as simple as the amount contractually owed to the bank on a loan. With a derivative, EAD includes two components. One is the current replacement cost, which is the greater of zero or the amount the bank would lose if its counterparty defaulted and there were no recoveries from the counterparty.[10] The other component of EAD for derivatives is the PFE, which attempts to capture the possibility that changes in market prices could cause the bank to have greater exposure to the counterparty in the future (and in particular after the counterparty has defaulted and enough time has passed to close out or rehedge the counterparty's positions). PFE has been described conceptually as "the maximum exposure estimated to occur on a future date at a high level of statistical confidence."[11] Operationally, PFE is the result of a mathematical calculation prescribed in the Basel framework, or in some cases generated by a bank's models.

Significantly and of great concern, the Committee's recent CCR guidance notes severe shortcomings of the Basel framework's PFE calculations. It cites the capital requirements computed by the failed CS for its exposures to Archegos Capital Management as an example: forecasted PFE was less than a tenth of the realized closeout losses (about $500 million forecast vs. over $5 billion actual) incurred by CS.[12] The Committee explained that the calculated PFE for collateralized counterparties may often be zero, or negligible amounts, because the calculation methodologies do not account for one of the most important types of counterparty risk, namely the

9 *See id*. for a description of the CCR risk management criticisms made by supervisors over a quarter century of supervisory CCR guidance.

10 *CRE50 - Counterparty credit risk definitions and terminology*, BASEL COMMITTEE ON BANKING SUPERVISION, https://www.bis.org/basel_framework/chapter/CRE/50.htm (last visited Jan. 24, 2025).

11 Basel Committee on Banking Supervision, *Consultative Document: The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (Apr. 2005), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD196.pdf.

12 Basel Committee on Banking Supervision, *supra* note 4 at 14. The dollar amounts cited here are not included in the final Guidelines. For those amounts, see the guidelines the Committee previously issued for public comment, Basel Committee on Banking Supervision, *Guidelines for Counterparty Credit Risk Management* 13 (Apr. 30, 2024), https://www.bis.org/bcbs/publ/d574.pdf.

possibility of margin-driven defaults caused by abrupt large price moves in relevant asset classes.[13] The discussion of PFE in the Guidelines sends a clear message that banks relying on it to measure CCR should understand its limitations, and should use their own risk management methodologies to compensate for these shortcomings.[14] Notably, the Guidelines contain (as a few words within a single sentence) the gentle suggestion that banks' internal risk limits "can include," for example, gross exposure measures.[15]

The dangers of basing capital requirements on overly optimistic assumptions about collateral can go far beyond one-off examples like CS's experience with Archegos. The 2008 Crisis provides an example—on a massive and catastrophic scale—of how the assumed risk mitigation benefits of collateral may prove illusory in a crisis. For example, researchers found that rapidly increasing collateral haircuts fueled by fears about collateral quality, and by counterparties' fears about the solvency of banks, contributed to a run on repo that was tantamount to a massive withdrawal of funding from banks.[16]

Also of great concern is that the Committee's Guidelines do not include a meaningful discussion of the pitfalls of using netting to reduce measured EAD for regulatory capital or risk management purposes. The 2008 bankruptcy of Lehman Brothers provides an example of the practical obstacles to netting effectiveness during times of severe market stress. Reports describe how the day before the Lehman bankruptcy, its largest counterparties met to try to reduce their exposures to each other through netting, but, they note, "the netting effort largely failed as there was little trading during the session."[17] For netting to take place, the counterparties must agree on amounts owed, and with the stressed and illiquid markets prevailing at the time, agreeing on valuations proved difficult. In contrast to the rosy assumptions in the Basel framework about the efficacy of netting, in reality the final settlement of Lehman's OTC derivatives took years.[18]

SUMMARY OF THE PROPOSAL

The Proposal notes that when a bank uses an eligible guarantee or credit derivative to hedge against a CCR exposure, and when the protection amount is either fixed or capped, the bank faces the risk that the protection amount at the time of default may not cover the full exposure to the counterparty. The Proposal also notes that under the current Basel framework, for capital purposes the bank may substitute its exposure to the original derivative counterparty with an exposure to the protection provider, resulting in its not having to recognize any exposure to the derivative

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[13] Basel Committee on Banking Supervision, *supra* note 4 at 14.

[14] *Id*. at 14-17.

[15] *Id*. at 16.

[16] Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run On Repo* 23, NBER Working Paper 15223 (Aug. 2009), https://www.nber.org/system/files/working_papers/w15223/w15223.pdf.

[17] Michael J. Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers* 185, FEDERAL RESERVE BANK OF NEW YORK ECONOMIC POLICY REVIEW (Dec. 2014), https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf.

[18] *Id*. at 184.

counterparty. It explains that as a result, the risk that a derivative increases in value and exceeds the fixed value of the credit protection is left unaddressed. In contrast, it explains, that if the risk had been hedged with collateral instead of a guarantee, the framework would have provided at least some required capital to offset the risk that the exposure to the counterparty would exceed the value of the collateral.

The Proposal would make technical amendments to the Basel framework to address this inconsistency. First, it states that when a bank purchases credit protection, its EAD for the transaction for purposes of the CCR framework would be zero, but that the bank would calculate its capital requirement for the hedged credit risk using the criteria and general rules for the recognition of guarantees and credit derivatives within the normally applicable credit-risk capital rules (either standardized or models-based depending on the bank).[19]

Under these normally applicable rules, the unprotected portion of the exposure is to be assigned the risk weight of the underlying counterparty (i.e., not of the protection provider but of the entity for which the bank is attempting to hedge its exposure).[20] That unprotected portion must be calculated as the higher of two numbers: the EAD calculated under applicable rules but treating the amount of the fixed or capped credit protection as if it were cash collateral within the netting set, or the EAD calculated under applicable rules minus the amount of the fixed or capped protection.[21]

SUMMARY OF COMMENTS

Better Markets commends the Committee for identifying this prudential gap in the Basel framework and proposing changes to address it. Unfortunately, the starting point of the Committee's proposed calculation of unprotected exposure is the EAD calculated under the Basel CCR framework. An important component of EAD in that framework is Potential Future Exposure or PFE. As the Committee explained in its Guidelines, PFE as calculated under the Basel framework can grossly understate a bank's actual exposure under severe scenarios. As a result, the EAD used in the Amendment as the starting point for the calculation of unprotected exposure may be far too low, and as a result the unprotected exposure calculated under the Amendment could also far understate the actual unprotected exposure.

For these reasons, Better Markets makes two recommendations.

- The Committee should finalize the Proposal while providing additional information about its likely quantitative significance.
- The Committee should initiate a workstream to address weaknesses in the Basel CCR framework that the Committee identified in its CCR Guidelines.

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19 *Technical Amendment—Hedging of counterparty credit risk exposures*, *supra* note 2, at Amendment text CRE51.16 and CRE51.18.

20 *Id.* at Amendment text CRE22.79.

21 *Id.* at Amendment text CRE51.19.

COMMENTS

I. THE COMMITTEE SHOULD FINALIZE THE PROPOSAL WHILE PROVIDING ADDITIONAL INFORMATION ABOUT ITS LIKELY QUANTITATIVE SIGNIFICANCE.

With this Proposal, the Committee has identified a conceptual inconsistency in how the Basel framework recognizes the risk-mitigation benefits of guarantees and credit derivatives on the one hand and collateral on the other. Its approach to address this issue is conceptually consistent with the rest of the Basel framework, and in particular it does not involve any change to the calculation of EAD for counterparty credit risk exposures that is already used in the Basel CCR framework.

However, with this approach, the Amendment's calculation of unprotected exposure will inherit all the shortcomings of the framework's current calculation of EAD. In particular, as the Committee explained in its Guidelines, calculated EAD may be much lower than actual exposure. As a result, under the Amendment, calculated unprotected exposure may be much lower than actual unprotected exposure. Conversely, there may be some types of exposures for which the weaknesses of the CCR framework are less relevant and the Amendment results in an adequate capital requirement.

The Committee has thus far not indicated that an overhaul of the Basel CCR framework is on its agenda (although as Better Markets recommends below, it should be on the Committee's agenda). That being said, discussion and context about how the PFE shortcomings described in the Guidelines may affect the Amendment's calculation of unprotected exposure, and how calculated amounts may compare to actual unprotected exposure, would help regulatory supervision staff, bank risk managers, and policymakers to better understand the Amendment and its likely quantitative implications.

A closely related point, that is not obvious from the red-lined language presented in the Proposal, is why the measurement of unprotected exposure would not result in the perverse and undesirable outcome of resulting in a negative number. While the introduction to the Proposal seems to suggest this will not happen, the question arises when the EAD calculated under the Basel framework is less than the fixed guarantee amount—and the framework's generous recognition of netting and the PFE shortcomings described in the Guidelines make this a plausible scenario. Presumably, the answer depends, as the introduction to the Proposal suggests, on how the framework would treat cash collateral equal in amount to the fixed guarantee, but this point would be helpful to explain more fully, including with numerical examples.

II. THE COMMITTEE SHOULD INITIATE A WORKSTREAM TO ADDRESS WEAKNESSES IN THE BASEL CCR FRAMEWORK THAT THE COMMITTEE IDENTIFIED IN ITS CCR GUIDELINES.

As Better Markets has previously recommended, the Committee should establish a workstream to strengthen its CCR framework.[22] Experience in financial crises and bank failures has brutally exposed the falsity of rosy assumptions about the efficacy of collateral, netting arrangements, as well as credit derivatives and guarantees, in reducing banks' risk exposure. In periods of extreme market stress, these arrangements have failed catastrophically when they were needed most. Yet the Basel framework encourages the buildup of opaque and interconnected risks associated with these practices by rewarding banks with excessive reductions in capital requirements based on these very types of assumptions. Even the Committee itself has noted the gross inadequacy of calculated PFE resulting from the framework's approach to collateral.

Thus, the CCR framework needs repair, and the hope that supervisory guidance can compensate for its shortcomings is doomed to failure. History has demonstrated that supervisory CCR guidance has been ineffective in inducing banks to constrain the buildup of interconnected counterparty risks.[23] As discussed below, the failure of guidance is not surprising and there is no reason to expect this situation to change. A prudentially conservative CCR measurement framework in conjunction with appropriate exposure limits, implemented by regulation in national jurisdictions, would have the force and effect that supervisory jawboning has been unable to achieve. Conversely, an inadequate regulatory CCR framework will continue to expose the public to the devastating effects of financial crises and the enormous costs of bailing out the largest banks.

There are several reasons to expect supervisory guidance to be of limited effectiveness. First, as the Counterparty Risk Management Policy Group ("CRMPG")—a private-sector group consisting of representatives of twelve of the world's largest banks—wrote in a 1999 report recommending banks strengthen their CCR management:

> [I]n a highly competitive marketplace it is very difficult for one or a few institutions to hold the line on best practices or to stand on the sidelines in the face of booming markets.[24]

Put differently, banks are in a money-making business and are unlikely to constrain their own activities based solely on the encouragement of "sound practices."

Moreover, some national supervisors may be under real or self-imposed limits on their legal authority to enforce changes in bank behavior if they cannot cite a specific violation of law

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[22] Better Markets Comment Letter, *supra* note 8.

[23] *See id*. for discussion of supervisory CCR guidance issued over the last quarter century and its track record of ineffectiveness.

[24] Counterparty Risk Management Policy Group, *Improving Counterparty Risk Management Practices* at iv (June 1999), https://fimmda.org/pdf/CDS/Improving-counter-party-Risk-Manangement-Practices.pdf.

or regulation. For example, the Swiss prudential regulatory authority's report on the CS collapse is a notable illustration. The report describes at length the many formal actions taken over a period of years by the Swiss regulator to correct CS's risk management deficiencies, that it exhausted the remedies available to it, and that these efforts were unsuccessful.[25] As another example, the U.S. banking agencies have taken the clear view that ***guidance is not legally enforceable***.[26] Better Markets has noted that while this has long been generally understood, the U.S. agencies' approach undermines the role of guidance as a basis for supervisory criticism.[27]

While national supervisors' authority is jurisdiction-specific, many supervisors may be less prescriptive than their statutory authorities allow them to be in regard to forcing changes in bank behavior. In other words, supervisors may wait to take decisive action until they have the factual evidence of an unraveling bank. At this point, however, supervisors' actions are too late and often society is left to pay for the bank and supervisors' failures to act.

Regardless of the various reasons for the ineffectiveness of supervisory guidance related to CCR, the record shows it is a settled fact; an effective regulatory framework is needed to address this important risk. In its Proposal, the Committee has identified serious deficiencies with its CCR framework, and it should institute a workstream to correct them.

Moreover, given that the collateral, netting, and guarantees used to reduce calculated exposure within the Basel framework can be severely compromised when they are most needed, and these failings may give rise to a catastrophic system-wide cascading of liquidity runs and defaults, a prudent approach to limit-setting must include gross exposure limits. As noted above, the Committee's Guidelines gently nudged banks to consider gross measures of exposure as they manage risk. However, far more than a nudge is needed in this case; the Committee urgently needs to begin work on a rule-based framework for gross exposure limits.

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25 Swiss Financial Market Supervisory Authority, *FINMA Report: Lessons Learned from the CS Crisis* 52 (Dec. 19, 2023), https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/cs-bericht/20231219-finma-bericht-cs.pdf.

26 *See, e.g.*, Press Release, Board of Governors of the Federal Reserve System, *Federal Reserve Board Adopts Final Rule Outlining and Confirming the Use of Supervisory Guidance for Regulated Institutions* (Mar. 31, 2021), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210331a.htm.

27 *See, e.g.*, Better Markets Comment Letter, *Role of Supervisory Guidance* (Jan. 4, 2021), https://tinyurl.com/253te2gf.

CONCLUSION

We hope these comments are helpful as the Committee proceeds to finalize this Amendment.

Sincerely,

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