EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Template for comments

ECB report on "Sound practices in counterparty credit risk governance and management"

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General comments

The collapse of Archegos Capital Management exposed a range of weaknesses in counterparty credit risk management. While there are many learning points from the incident, non-bank financial institutions (NBFIs), hedge funds and family offices remain vitally important participants in supporting market functioning and it is imperative that they continue to be supported by the regulated banking sector.

The recommendations identified in the ECB SSM's Sound practices in counterparty credit risk governance and management strike the right balance in addressing the lessons learned, while maintaining an appetite to support the broad base of financial market participants necessary for efficient market functioning. Notwithstanding, there are elements which we don't feel have received adequate attention in the recommendations and we welcome the opportunity to highlight these as part of the consultation process for the document.

Due diligence on liquidity risk

While hedge funds, family offices and a subsection of other NBFIs remain unregulated, there is an indirect oversight role to play for the banking institutions who trade with them, through the client due diligence activities. Given the robust CCR management requirements and standards expected of regulated banking institutions, one would expect that the banks themselves should be imposing similar standards on their clients as a condition of the trading relationship. To the extent that clients cannot meet those standards, this should have tangible consequences through adverse counterparty ratings, more conservative risk limits, faster acceleration to watchlist, and more punitive stress testing (stress loss) outcomes. We are encouraged by the strong focus in the document on due diligence of clients as part of the broader CCR management framework. However, the numerous heatmaps in the document clearly illustrate the divergence of CCR management practices across the large banking institutions surveyed, and due diligence may mean different things to different institutions. We would challenge whether the due diligence conducted by many institutions has sufficient breadth and depth to provide a practical, real-world view not only of the client's solvency position and financial resources, but also its operational capability to manage and mobilize those resources in times of market stress.

Considering liquidity risk as an example, since the implementation of clearing mandates and the more recent implementation of the uncleared margin rules, CCR and liquidity risk have become inextricably linked. A banking institution's due diligence may verify that a client has a sufficient liquid asset buffer, but may pay scant attention to the client's access to tools to actively manage the buffer and the capabilities to mobilize those assets in times of stress. The client should have to demonstrate as part of due diligence that it has a suite of management and mobilization solutions available and that it has regularly tested those capabilities. Centrally-cleared repo funding and financing markets, as an example, have shown themselves to be remarkably resilient in periods of stress. With the latest innovations in direct access clearing models for repo, specifically designed for the buy side, we would expect such solutions to be high on the agenda of clients (Eurex Repo GmbH, "Capital efficiencies through direct access repo clearing models for the buy-side"; available here: https://www.eurex.com/resource/blob/2714814/de334a664bcfa870f2e4c2710906bb9a/data/download-isa-direct-whitepaper.pdf).

Valuation haircuts on collateral

The document highlights that institutions "should enter transactions with a customer based primarily on the strength of the borrower's repayment capacity, because collateral is neither a substitute for the comprehensive assessment of the counterparty's creditworthiness, nor can it compensate for insufficient information." We fully agree with the point, but at the same time we are astounded at the lack of conservatism in valuation haircuts applied for repo/SFT transactions, with zero percent haircuts for overnight government bond repo transactions seemingly commonplace in the market, even against risky counterparties such as hedge funds.

While some banking institutions would argue that capital (own funds) requirements are applied to institutions to the extent that valuation haircuts are lower than the volatility adjustments for eligible financial collateral (per the Financial Collateral Comprehensive Method, EU Capital Requirements Regulation Article 223), our view is that capital requirements should be a last resort (backstop), after the application of prudent risk management practices, rather than a compensatory measure. The experiences of the September 2022 UK mini-budget / LDI crisis and Q2 2023 US Debt Ceiling uncertainty serve as stark reminders that no government bonds are completely immune from the threat of market shocks.

While we are not advocating for minimum haircuts for SFTs, we think banking institutions should be required to apply a risk-sensitive framework in the determination of valuation haircuts for their client SFT transactions, which in turn would require institutions to justify their existing (zero percent) valuation haircuts applied in the market. The ECB's own valuation haircut calibration, incorporating liquidity risk, market risk, credit risk and concentration risks serves as a useful benchmark against which to assess institutions' practices (ECB, "The valuation haircuts applied to eligible marketable assets for ECB credit operations." Occasional Paper Series No. 312. https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op312~3f4457b95c.en.pdf).