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Vice Chair Barr Delivers Remarks on Fed's Counterparty Credit Risk Supervisory Priorities

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Last week, we attended the invitation-only conference on counterparty credit risk ("CCR") cohosted by the Basel Committee on Banking Supervision and the Federal Reserve Bank of New York. Michael S. Barr, the Fed Vice Chair for Supervision, delivered opening remarks regarding how the financial system has become ever more complex due to an "increasingly varied and evolving collection of nonbank clients," requiring banks to develop new approaches to CCR management.[1]

By way of background, CCR is the risk that a transaction counterparty defaults before final settlement. Under current U.S. capital rules, large banks are required to identify transactions that expose them to CCR and maintain corresponding regulatory margin for derivatives, long settlement transactions and securities financing transactions. CCR is one of many components of the capital rules that are set to change (and require banks to maintain more margin than they do today) when the prudential regulators implement their final Basel III Endgame rules.

Mr. Barr stated that the Fed will focus on the following risk management practices in their ongoing supervision of banks:

(1) *Thorough due diligence at onboarding*. Banks should seek information and disclosures from their counterparties in order to enable them to understand counterparties' risk profiles, and take it into account if counterparties will not provide such disclosures. Vulnerabilities such as excessive concentrations and leverage could lead to major losses.

(2) *Measuring risk and the importance of margining through a counterparty relationship*. In order to appropriately measure counterparties' risk profiles, banks should have at their disposal a range of risk measurement tools that can aggregate

risk across and within products, business lines and clients, and capabilities to understand and assess such tools in order to maintain appropriate margin.

(3) *Setting and responding to prudent risk limits*. Banks should establish limits on the amount of risk they are willing to accept, and internal escalation and remediation processes when limits are reached. Further, banks should be proactive, have multiple measures of CCR and maintain adequate staffing, strong documentation and clear roles and responsibilities to facilitate accountability.

The Fed also uses its own tools for assessing CCR, and plans to publish the results of several exploratory analyses alongside this year's stress test results, which include an analysis of the resilience of the G-SIBs to the simultaneous default of their five largest hedge fund counterparties.

Mr. Barr shared that the conference was, in part, a byproduct of the default by Archegos Capital Management that rippled through the global financial system in March 2021 and exposed weaknesses in banks' CCR management practices. Mr. Barr also highlighted the liquidation of leveraged Treasury positions by hedge funds in 2020, losses in the liability-driven investments of pension funds in the United Kingdom in 2022 and recent volatility in global commodities markets as events that demonstrate the importance of margining practices for all asset classes—even those that are highly liquid or traditionally thought of as safe exposures.

Some other significant takeaways from Mr. Barr's remarks are that internal risk managers should have real influence on banks' risk decisions such that risks are not ignored; margining practicing should be "conservative"; and "weakening standards on margin or terms and conditions should not be a negotiation point to win business."

Lastly, we note that Lary Stromfeld was a panelist on "Legal Perspectives" at the conference. If you have any questions about CCR or how it could affect your bank's regulatory capital requirements, please don't hesitate to reach out to Lary and the other members of Cadwalader's Basel III Endgame Taskforce.

[1] As the two-day conference was held under "Chatham House" rules, our summary is limited to those remarks of Mr. Barr's that were made public.