HAYNES BOONE

# FINANCIAL REGULATORY ROUNDUP

January 2025

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## Basel Committee Publishes Guidelines for Counterparty Credit Risk Management – *Giorgio Bovenzi*

On Dec. 11, 2024, the Basel Committee on Banking Supervision ("Basel Committee") issued its "Guidelines for Counterparty Credit Risk Management" (the "CCR Guidelines").[1] The CCR Guidelines are the result of a public consultation that started in April 2024[2] and replace the Basel Committee's "Sound Practices for Banks' Interactions with Highly Leveraged Institutions" published in January 1999.[3]

The CCR Guidelines address the critical aspects of managing counterparty credit risk ("CCR") in banking. CCR is the risk that a counterparty to a transaction could default before the final settlement of the transaction's cash flows. By issuing the CCR Guidelines, the Basel Committee stated the objective of addressing the perceived inadequacy of certain CCR practices in the face of recent incidents (such as the failure of Archegos Capital Management and the commodities market volatility resulting from the Russia-Ukraine conflict). The CCR Guidelines emphasize the need for comprehensive due diligence, effective credit risk mitigation strategies, robust governance frameworks and accurate exposure measurement to enhance CCR management practices across diverse banking institutions.

The Basel Committee stated that the CCR Guidelines are intended to be applied proportionately and to a diverse range of banks, depending on the size, complexity and materiality of the counterparty credit risk profile of banks. This represents an important clarification added to the original consultation document, reflecting industry concerns.

The CCR Guidelines are complex, and the below outline merely identifies some of the key points. Readers interested in more detailed information should refer to the original document.

- **Due Diligence and Monitoring:** As the starting point of a bank's relationship with its clients, thorough due diligence is essential for managing CCR. Banks must conduct comprehensive due diligence at both initial onboarding and on an ongoing basis (in both business-as-usual and stressed-market conditions, with the appropriate frequency to be determined by the bank) to ensure that they understand the risks they are taking. This includes collecting and reviewing financial and non-financial information, understanding the rationale and economics of underlying exposures and monitoring material developments, such as changes in the counterparty's trading activities and leverage. The Basel Committee pointed out that this represents a departure from managing counterparties purely on a portfolio basis and from relying solely on strong contractual terms and the ability to close out transactions. To ensure the soundness of information disclosures, banks should establish a risk-based disclosure framework that identifies minimum standards on counterparty disclosures that take into account the counterparty's sector and the risk profile of the counterparty. Here, the Basel Committee explained that financial statements alone may be insufficient to establish the riskiness of a counterparty, and that particularly with respect to risky and complex counterparties such as hedge funds, additional disclosures and risk metrics should be provided.

[1] Available at https://www.bis.org/bcbs/publ/d588.pdf

[2] Available at https://www.bis.org/bcbs/publ/d574.pdf

[3] Available at https://www.bis.org/publ/bcbs46.pdf

- **Credit Risk Mitigation:** Credit risk mitigation is crucial for managing CCR. Margining is the primary component of risk mitigation, but the Basel Committee noted that it may not be sufficient without considering the counterparty's creditworthiness, the frequency and quality of the disclosures, the transparency in the risk profile and the riskiness of the positions relative to market depth and conditions. Bank policies should calibrate contractual terms that also help mitigate CCR, and banks should ensure the enforceability of such contractual terms under various conditions. Banks should develop and implement a transparent and robust margining framework that is commensurate with the complexity and materiality of the portfolio and captures the risks associated with the counterparty's underlying exposure, the quality of collateral received and the credit risk associated with the counterparty. The margining framework should be sensitive to changes in the counterparty's risk profile and market conditions, based on information from financial statements, NAV trends and volatility. Margining frameworks and methodologies should be periodically reported to the bank's senior management.
- **Exposure Measurement:** CCR exposure measurement requires banks to look holistically at a variety of complementary risk metrics to obtain a comprehensive view of risk. Exposure metrics should be independently reviewed and undergo the appropriate level of internal governance. They should be computed frequently and include all trades giving rise to CCR across product types, business lines and legal entities. The Basel Committee noted that this includes the evaluation of idiosyncratic risks, such as excessive concentration to a single name or single risk factor, material difference in volatility between long and short positions, lack of liquidity due to limited trading volume, complex or bespoke positions in the portfolio or the size of a position. These metrics should also account for contractual terms, netting and collateral enforceability. Banks should quantify CCR exposure daily. Potential future exposure is a key metric to quantify how sizeable the CCR exposure may become upon default, also taking into account contractual terms and credit risk mitigants (including netting and collateral requirements). Banks should also conduct CCR stress testing (across all business lines and product types and, where necessary, also designing bespoke stress tests to capture any risk dynamics that are not captured by the standard stress scenarios) to assess exposures under stressed market conditions and integrate the results into their risk management processes. The Basel Committee instructed that the bank's senior management should take a leading role in integrating CCR stress testing into the risk management framework and risk culture.
- **Governance:** Given the importance of effective governance for managing CCR, the Basel Committee directed banks to foster a risk culture that ensures understanding of all risks and accountability for risk management actions. CCR management should involve strong collaboration between market risk and credit risk functions. Banks should establish a clear CCR strategy and an effective CCR management process approved by the board of directors and implemented by senior management, with clear identification of ownership, roles and responsibilities and clear guidelines for credit approval authority, remediation and escalation processes. The CCR strategy should define the bank's risk appetite, the desired risk-return trade-off and the mix of products. This includes setting risk limits, monitoring exposures and ensuring that risk committees have the authority to oversee all risk-taking aspects of trading businesses.
- **Infrastructure, Data, and Risk Systems:** Banks should ensure that their risk systems and data management capabilities are commensurate with the size and complexity of counterparty exposures. This includes having robust processes for data aggregation, measurement and reporting that are sophisticated enough to enable CCR measurement also in stressed-market conditions. Importantly, the Basel Committee observed that banks' sound practices include the ability to aggregate and measure risk across products, businesses and geographies to enable monitoring both at the counterparty and portfolio levels and enable credit risk officers and front office traders to make informed risk-appetite decisions. Banks should also have strong governance practices with controls to identify, monitor and remediate system, data and model issues, and they should regularly assess the relevance and quality of CCR reporting.
- **Closeout Practices and Default Management:** Banks should be prepared to act quickly to close out a counterparty when necessary and with the involvement of staff from the business, legal and risk functions.

In particular, declaring a counterparty default and initiating a closeout requires seasoned professionals familiar with the legal processes. The Basel Committee stressed the importance of maintaining up-to-date closeout playbooks and of conducting mock closeout exercises to uncover potential issues and compile lessons learned to enhance existing playbooks. Finally, the Basel Committee recommended that closeout provisions should be calibrated based on the counterparty's creditworthiness, and any concession that the bank wishes to make to the counterparty should preserve the bank's need to maintain flexibility.

- **Conclusion:** The CCR Guidelines' recognition of banks' flexibility in implementing the CCR Guidelines across different jurisdictions, with proportionality reflecting the diverse nature of banks and their counterparties, is fundamental to foster the implementation of the CCR Guidelines without generating an overly burdensome CCR framework that could defeat the Basel Committee's purposes. It will be equally important for bank supervisors to proactively engage with banks to understand industry practices on a jurisdiction-specific basis and evaluate how proportionality and discretion apply to specific CCR practices and situations. Read the CCR Guidelines here.

### CFTC Issues Advisory on Use of Artificial Intelligence in CFTC-Regulated Markets – *Brian Sung*

On Dec. 5, 2024, the CFTC issued a Staff Advisory on the use of artificial intelligence ("AI") in derivatives markets to "remind CFTC-regulated entities of their obligations under the Commodity Exchange Act ("CEA") and the CFTC's regulations."

The Staff Advisory applies to both registered entities[4] and registrants,[5] and it is informed by comments received in response to the CFTC's Request for Comment issued on Jan. 25, 2024, seeking input from market participants.

The Staff Advisory notes that it is not a compliance checklist or a substitute for appropriate risk assessments or governance, and it is not intended to create any enforceable rights or create or amend any binding rules or regulations, but rather is intended to provide a non-exhaustive list of existing statutory and regulatory requirements that may be potentially implicated by CFTC-regulated entities' use of AI. The Staff Advisory reminds CFTC-regulated entities that they must maintain compliance with applicable requirements whether or not they deploy AI or any other technology, either directly or through a third-party service provider. The CFTC expresses its expectation that CFTC-regulated entities will assess risks of using AI and update policies, procedures, controls and systems, as appropriate, under applicable CFTC statutory and regulatory requirements.

Several potential AI use cases for each category of regulated entity are identified and discussed in the Staff Advisory, together with a brief discussion of related duties and responsibilities and applicable so-called "Core Principles" under the relevant CFTC regulations.

The CFTC noted that the Request for Comment and the Staff Advisory were motivated, in part, by the Biden administration's Oct. 30, 2023 Executive Order on the Safe, Secure and Trustworthy Development and Use of Artificial Intelligence, which encouraged federal agencies to "consider using their full range of authorities to protect American consumers from fraud, discrimination and threats to privacy and to address other risks that may arise from the use of AI." The Staff Advisory also indicated that the CFTC staff is closely tracking the development of AI technology and potential benefits and risks, and it observed that technological evolution could lead to reevaluation of this Staff Advisory, additional staff guidance and/or recommendations for the CFTC to propose new regulations. With the imminent change in presidential administration and an anticipated change in leadership on the Commission looming, market participants seeking to utilize AI in CFTC-regulated activities should continue to monitor developments and any further AI guidance and public statements closely during and after such transition.

Read the CFTC's Staff Advisory here. Read the Earlier Request for Comment here.

### Banks Ask for Temporary Block on CFPB Overdraft Fee Rule – *Krista Garcia, Leel Sinai*

On Dec. 12, 2024, the Consumer Financial Protection Bureau ("CFPB") issued a new rule capping overdraft fees at $5 for banks and credit unions with assets exceeding $10 billion. This regulatory action, aimed at addressing concerns over excessive fees, immediately faced legal pushback. Plaintiffs, including the Mississippi Bankers Association, Consumer Bankers Association, American Bankers Association and America's Credit Unions, among others, filed a Complaint for

[4] "Registered entities" include designated contract markets, derivatives clearing organizations, swap execution facilities and swap data repositories.

[5] "Registrants" include commodity pool operators, commodity trading advisors, futures commission merchants, introducing brokers, leverage transaction merchants, floor brokers, floor traders, major swap participants ("MSPs"), retail foreign exchange dealers, swap dealers ("SDs") and associated persons of any of the foregoing other than SDs/MSPs.

Declaratory and Injunctive Relief in U.S. District Court of the Southern District of Mississippi (the "Original Complaint").

The Original Complaint, filed on the same day the rule was announced, challenges the CFPB's final rule, "Overdraft Lending: Very Large Financial Institutions" ("Final Rule"). The Final Rule primarily relies upon the Truth in Lending Act ("TILA") statute regarding disclosure obligations for credit products.

Plaintiffs assert, however, that TILA does not provide a basis for regulating overdraft fees because overdraft services do not meet the statutory definition of "credit." Plaintiffs argued that overdraft fees are a discretionary courtesy within the financial institution, "lack the hallmarks of a credit transaction" and should therefore be excluded from the credit disclosure requirements of TILA.

Second, Plaintiffs claim that the Final Rule exceeds the scope of TILA by "imposing price caps and significant substantive restrictions on terms under which the services can be offered." Importantly, Plaintiffs note that financial institutions "retain discretion to pay or decline items that would overdraw a customer's account in exchange for a fee disclosed in the customer's account agreement." Plaintiffs allege that such agreements "do not require financial institutions to cover overdrafts or give customers the right to defer payment of overdraft amounts." Additionally, Plaintiffs argue that TILA is "only a disclosure statute and does not substantively regulate consumer credit but rather requires disclosure of certain terms and conditions of credit."

They further alleged that CFPB acted arbitrarily and capriciously by failing to consider the costs and benefits associated with the Final Rule.

On Dec. 18, 2024, Plaintiffs escalated their challenge by filing a Motion for a Preliminary Injunction ("Plaintiffs' Motion"), seeking to halt the implementation of the Final Rule in its entirety while the case proceeds. Defendants had until Jan. 14, 2025 to file response and supporting memorandum addressing the Plaintiffs' Motion. This upcoming deadline will mark the next critical phase in what is likely to be a closely watched legal battle with significant implications for the financial industry and regulatory landscape.

Read the Complaint for Declaratory and Injunctive Relief, the Joint Scheduling Motion, the Memorandum of Law in Support of Plaintiffs' Motion for a Preliminary Injunction and the Plaintiffs' Motion for Preliminary Injunction here, here, here and here, respectively.

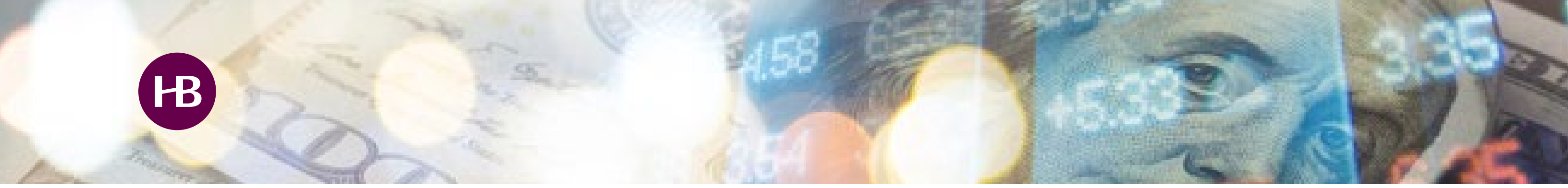
### Federal Bank Regulatory Agencies Extend Statement Regarding Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O and Reporting Requirements – *Leel Sinai*

On Dec. 27, 2024, the Federal Reserve Board, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Federal Agencies") issued an interagency statement to further extend the Extension of the Revised Statement Regarding Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O and Reporting Requirements under Part 363 of FDIC Regulations, which they issued on Dec. 15, 2023, and was set to expire on Jan. 1, 2025 (the "Interagency Statement"). Under Sections 22(g) and 22(h) of the Federal Reserve Act, as implemented by Regulation O, extensions of credit by banks to executive officers, directors and principal shareholders (and related interests of such persons) (collectively, "insiders") must comply with certain individual and aggregate lending limits, and large extensions of credit by banks to insiders must be approved in advance by a majority of their boards of directors in a vote in which interested directors may not participate.

The Interagency Statement cites certain industry concerns regarding the application of Regulation O to companies that sponsor, manage or advise investment funds and institutional accounts that invest in voting securities of banking firms (such investment vehicles, collectively "funds," and, together with the company that sponsors, manages or advises them "fund complexes").

Where a fund complex acquires more than 10 percent of a class of voting securities of a banking firm, such fund complex would be a "principal shareholder" of the bank under Regulation O, and any company in which a principal shareholder owns more than 10 percent of a class of voting securities could be a "related interest" of the fund complex ("fund complex-controlled portfolio company.") Under such circumstances, all of the foregoing parties would be insiders of the bank for purposes of Regulation O, and the bank's lending to such parties would be subject to the lending limits and other restrictions and standards of Regulation O. The Interagency Statement further cites industry concerns that treatment of fund complex-controlled portfolio companies as "related interests" may require "sudden and disruptive unwinding" of pre-existing lending relationships in addition to reducing credit availability to financial and non-financial companies.

Accordingly, to provide banks the ability to lend to certain related interest fund complex-controlled portfolio companies, the Federal Agencies have extended their prior no-action guidance concerning compliance with Regulation O as it relates to such lending arrangements only with respect to such fund complex-controlled portfolio companies, outlining eligibility criteria in the Interagency Statement. The Federal Agencies note that, as the Federal Reserve Board continues to consider amendments to Regulation O, they would not take action against banks or principal shareholder fund complexes with respect to extensions of credit by the banks to fund complex-controlled portfolio companies that otherwise would violate Regulation O, provided the fund complexes and banks satisfy the outlined criteria.
Read the Interagency Statement here.



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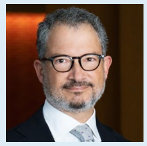

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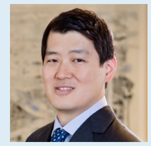

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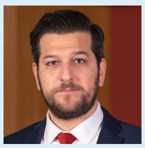

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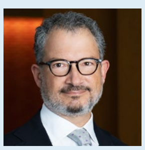

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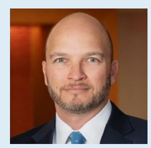

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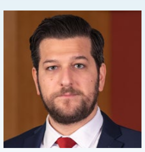

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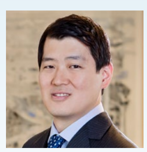

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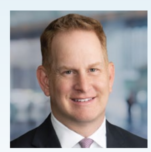

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