

## New Federal Reserve Guidance on Credit Risk Management in Transactions with Investment Funds – How to Avoid Another Archegos-Type Effect

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In a [guidance letter](#) published on December 10, 2021 (SR 21-19) (the "Guidance Letter"), the Federal Reserve Board reiterated the appropriate credit risk management that financial institutions should consider when dealing with investment fund clients. The Guidance Letter focuses on the proper identification of red flags to enable supervised financial institutions to appreciate risk related to their exposures to funds whose structure and investments may resemble an Archegos Capital Management scenario.

Following the March 26, 2021 default and failure of Archegos Capital Management, a leveraged fund concentrating in a small number of U.S. and Chinese technology and media companies which caused in excess of \$10 Billion in losses across several large banks, the Federal Reserve undertook a supervisory review to assess what led to the losses experienced from Archegos' failure and any consequent guidance for banks.

In its Guidance Letter, the Board of Governors of the Federal Reserve System reminded banks of the supervisory expectations when they carry large derivatives portfolios and relationships with investment funds. (The guidance is generally inapplicable to community banking organizations and banks with insignificant derivatives portfolios or relationships with investment funds.)

The Board shows particular concern with situations where, both at the inception level and during the lifetime of the relationship when periodic credit reviews should take place, banking organizations accept "incomplete or unverified information from the fund, particularly with regard to the fund's strategy, concentrations, and relationships with other market participants." A fund client with a history of concentrated positions and losses, in the Board's view, raises even higher concerns. The Board believes that "these practices represent insufficient due diligence and may be inconsistent with safe and sound banking practices."

At the inception of a relationship as well as on an ongoing basis, supervised financial institutions are expected to "obtain critical information regarding size, leverage, largest or most concentrated positions, and number of prime brokers with sufficient detail or frequency to determine the fund's ability to service its debt." The fund client's refusal to provide such information should raise red flags. While, in such scenarios, the supervised financial institution should consider the termination of the relationship, alternative strong risk mitigation measures, such as more stringent contractual terms, may be appropriate if sufficient under the circumstances. Further, margin terms must be appropriate to the investment fund clients and should reflect sufficient risk sensitivity, allowing the financial institution to improve its margin positions or close out positions quickly if a margin call is missed.

Equally important is maintaining an effective communication framework and risk management functions. The Board reiterated that the supervised financial institutions' risk management and control functions [Fn1] should have the "experience and stature to effectively control risks

associated with investment funds" and that legal and business groups should review contractual terms and practices to assess whether they are sufficient and adequate to the risk that the fund poses (including reputational risk).

Although the Guidance Letter is consistent with the [2011 Interagency Counterparty Credit Risk Management Guidance](#) (SR 11-10) (the "2011 Interagency Guidance"), it specifically draws on the Federal Reserve's review of the Archegos failure and how the losses that many financial institutions suffered could have been avoided. The Guidance Letter reiterates that certain practices that allowed the risk of those losses to go unchecked would not meet supervisory expectations, and that supervised financial institutions are expected to undertake proper internal due diligence (1) as to the existence of the appropriate operational framework within the bank's Legal and Business groups that enables the institution to identify and mitigate counterparty risk appropriately, and (2) as to specific clients in order to take fully into account the risks that the relationship may pose to the bank.

[Fn1] Risk control functions include counterparty limits, margin practices, validating and backtesting models and systems, managing close-outs, managing central counterparty exposures, and controlling legal and operational risks arising from derivatives activities. See 2011 Interagency Guidance (as defined *infra*), at 2-3.