Basel Committee
on Banking Supervision

Consultative document

Guidelines

Identification and management of step-in risk

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BANK FOR INTERNATIONAL SETTLEMENTS

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> **Background information on the present consultation**
>
> This consultation follows an earlier consultation issued in December 2015.[1] The Committee has considered the comments received during the first consultation and revised its initial proposals. The revised framework is being issued for a 60-day consultation period with a view to focusing on the supervisory reporting templates and any potential issues that require clarification. The Committee does not envisage making significant changes to the revised framework below, which it views as near-final.

1. Introduction

1.1. Objective

1. In publishing this framework, the Basel Committee on Banking Supervision aims to mitigate potential spillover effects from the shadow banking system to banks. This work is part of the G20 initiative to strengthen the oversight and regulation of the shadow banking system to mitigate systemic risks, in particular, risks arising due to banks' interactions with shadow banking entities.

2. The recent global financial crisis showed that banks sometimes have incentives beyond contractual obligation or equity ties to "step in" to support unconsolidated entities to which they are connected. In some cases, banks preferred to support certain shadow banking entities in financial distress, rather than allow them to fail and face a loss of reputation, even though they had neither ownership interests in such entities nor any contractual obligations to support them. Prominent examples of credit or liquidity support provided by banks were observed during the crisis, including for securitisation conduits, structured investment vehicles, and money market funds (MMFs). With the proposed framework, the Committee does not seek to address specific examples from the past but rather to apply more generic lessons about risk related to banks' connections with unconsolidated entities and, as such, to identify situations where step-in risk exists and needs to be anticipated.

3. The framework is intended to act as a safety net for the situation where step-in risk may remain, emerge or re-emerge. In developing this framework, the Committee has pursued a number of objectives, seeking to combine simplicity of the framework with sensitivity to residual step-in risk (ie step-in risk after consideration of risk mitigants). The framework aims for consistency across jurisdictions but, at the same time, acknowledges the idiosyncratic nature of step-in risk. It therefore allows for banks' one-off assessments of each case and for the supervisory evaluation of such assessments.

1.2. Existing provisions

4. After the 2008 financial crisis, a number of policy developments, many initiated by the Committee, have helped to address step-in risk. Regulatory reforms undertaken by the Committee have responded in various ways to the issues identified. In particular, implicit support and reputational risk are included in the different building blocks of the Basel framework set out below. Taking into account these previous reforms, the Committee believes that this framework will usefully supplement the existing building blocks in

[1] See BCBS, *Identification and measurement of step-in risk*, December 2015, www.bis.org/bcbs/publ/d349.htm.

providing a detailed identification method for step-in risk. Likewise, the supervisory responses to step-in risk, as detailed in Section 4 build on the existing framework.

1.2.1. Capital requirements

5. In December 2014, the Committee issued the *Revised securitisation framework,* which addresses two of the main causes of step-in risk to securitisation entities, by (i) specifying that significant risk transfer (SRT) cannot be recognised for structures securitising revolving credit facilities (such as credit card securitisations) with early amortisation features – where risks returning to the originator increase if early amortisation is triggered; and (ii) requiring that the undrawn portion of all liquidity facilities be converted at a credit conversion factor of 100%, thereby eliminating any preferential treatment for asset-backed commercial paper (ABCP) facilities.

6. *Capital requirements for banks' equity investment in funds*,[2] issued in December 2013, specified a consistent and risk-sensitive capital treatment for banks' investments in the equity of funds, reflecting both the risk of the fund's underlying investments and its leverage. This framework addresses risks associated with banks' interactions with such shadow banking entities by considering the risk of underlying investments and leverage, and ensuring that banks are sufficiently capitalised in that respect. The step-in risk framework would supplement the existing provisions in addressing the broader risks associated with banks' involvement in funds, rather than only risks associated with the ownership of a fund's equity shares.

1.2.2. Liquidity requirements

7. The final framework for the *Liquidity Coverage Ratio,*[3] issued in 2013, includes several provisions relevant in the context of step-in risk.

- The loss of funding, or possible "return" of the assets such as asset-backed securitisations (ABS), covered bonds and other structured finance vehicles originated by the bank, gives rise to an outflow of 100% of the transaction. This applies when the bank issues the assets itself (paragraph 124 of the LCR standard) as well as when the bank uses a special purpose entity (SPE) (paragraph 125 of the LCR standard), whether or not the SPV is consolidated.
- With respect to a bank's high-quality liquid asset (HQLA) holdings, the LCR requires that HQLA be under the control of the treasury function within the bank, which would exclude any assets held and managed by step-in entities (paragraph 33 of the LCR standard).
- The LCR standard explicitly refers to the need for national supervisors to determine the liquidity impact of: "contingent funding obligations [that] may be either contractual or non-contractual and are not lending commitments...[these] include associations with, sponsorship of, products sold or services provided that may require the support or extension of funds in the future under stressed conditions" (paragraph 135 of the LCR standard).
- The LCR standard also mentions that national supervisors should determine which investments in banking, securities and financial entities of a banking group that are not consolidated per paragraph 164 should be considered significant, taking into account the liquidity impact of such investments on the group under the LCR standard.

[2] www.bis.org/publ/bcbs266.htm.

[3] www.bis.org/publ/bcbs238.htm.

1.2.3. Pillar 2, risk management, and stress testing

8. In July 2009, the Committee issued *Enhancements to the Basel II framework*,[4] which included Pillar 2 guidance on reputational risk and implicit support. It noted (in paragraph 48): "Reputational risk can lead to the provision of implicit support, which may give rise to credit, liquidity, market and legal risk – all of which can have a negative impact on a bank's earnings, liquidity and capital position. A bank should identify potential sources of reputational risk to which it is exposed. These include the bank's business lines, liabilities, affiliated operations, off-balance sheet vehicles and the markets in which it operates. The risks that arise should be incorporated into the bank's risk management processes and appropriately addressed in its ICAAP and liquidity contingency plans." The position of the Committee remains the same, and the Committee noted that the implementation of such provisions remains a challenge for banks and supervisors.

9. The *Principles for sound stress-testing practices and supervision*, issued in May 2009, also mentions reputational risk by, for example, stating that a bank should (i) enhance its stress-testing methodologies to capture the effect of reputational risk, and (ii) integrate risks arising from off-balance sheet vehicles and other related entities in its stress-testing programme.

1.2.4. Accounting reforms

10. For the purposes of this framework, the Committee also took into consideration the relevant accounting changes that had occurred since the financial crisis and assessed their implications for the prudential scope of consolidation (often based on the accounting scope of consolidation). While these reforms appear well set out and the accounting frameworks are harmonised in principle, they may not be sufficient to bring all entities and risks adequately under prudential control. In particular, entities for which banks have potential step-in risks might not be included within the accounting scope.

1.2.5. Local provisions

11. In addition, the Committee also considered that specific jurisdictions have taken measures that might mitigate or even eliminate step-in risk in certain cases. The diversity of local rules cannot be considered as filling a gap from an international standard-setting body perspective. However, local rules are considered in the framework as potential collective rebuttals (see Section 2.2).

1.3. The continuing need for guidance

12. The Committee concluded that, although the initiatives have generally reduced the likelihood of a bank stepping in to provide financial support, this step-in risk still exists and necessitates a structured approach, which this framework aims to provide. In particular, supervisors are of the view that they should take a forward-looking approach to possible step-in situations that are of a different nature to those seen in the past. Therefore, the framework is designed to create a safety net to inform and supplement already approved reforms, using a forward-looking regime.

13. The Committee also recognises that a bank-specific assessment has to be evaluated by the supervisor, with a view to arriving at a tailored rather than a standardised approach. To this end, this framework entails no automatic Pillar 1 capital or liquidity charge additional to the existing Basel standards. Rather it provides banks and supervisors with a method for identifying step-in risk and with a list of possible responses that leverage existing prudential tools by informing or supplementing them. Banks are responsible for choosing the most appropriate response once step-in risk is identified, while the role of supervisors is to check and challenge the bank's response as necessary.

[4] www.bis.org/publ/bcbs157.htm.

1.4. Structure of the framework

Banks' self-assessment of step-in risk and reporting to supervisors	
1.	Define all entities to be evaluated for potential step-in risk, taking into account their relationship with the bank (see Section 2.2).
2.	Identify entities that are immaterial or subject to collective rebuttals and exclude them from the initial set of entities to be evaluated (see Section 2.2).
3.	Assess all remaining entities against the step-in risk indicators including potential mitigants (see Section 3).
4.	For entities where step-in risk is identified, use the estimation method deemed appropriate to estimate the potential impact on liquidity and capital positions – measurement of the risk – and determine the appropriate internal risk management action (see Sections 4 and 5).
5.	Each bank reports its self-assessment of step-in risk to its supervisor, according to the reporting templates (see Annex 1).
Supervisory response	
6.	After reviewing the bank's self-assessment analysis, where necessary supported by an analysis of the bank's policies and procedures, the national supervisor should decide whether there is a need for additional supervisory response (see Sections 4 and 6).

2. Definitions and scope

2.1. Step-in risk

14. "Step-in risk" is the risk that a bank decides to provide financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations[5] to provide such support. The main reason for step-in risk might be to avoid the reputational risk that a bank might suffer were it not to provide support to an entity facing a stress situation. Indeed, as discussed above, the financial crisis provided evidence that a bank might have incentives beyond contractual obligation or equity ties to "step in" to support unconsolidated entities to which it is connected.

15. The Committee defined reputational risk in 2009[6] as "the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (eg through the interbank or securitisation markets)". As such, step-in risk is one possible source of reputational risk.[7] It arises when a

5 If a bank has a contractual obligation to support an entity, this commitment should already be subject to prudential consideration according to the existing framework. Banks' contractual commitments provided to third parties are subject to capital and liquidity charges.

6 See BCBS, *Enhancements to the Basel II framework*, July 2009, paragraph 47.

7 BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version,* June 2006, paragraph 742 that: "Although the Committee recognises that 'other' risks, such as reputational and

bank considers that it is likely to suffer a negative impact from the weakness or failure of an entity and concludes that this impact is best mitigated, ceteris paribus, by stepping in to provide financial support.

16. If step-in risk is related to reputational risk, it is distinct from operational risk. Operational risk is considered separately within the Basel framework and its definition explicitly excludes reputational risk: "Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk."[8]

2.2. Entities and relationships under scrutiny

17. This section defines the entities and relationships that banks should consider for the purpose of this framework. The initial set of entities under scrutiny contains any unconsolidated entity whose relationship with the bank corresponds to the relationships described below (see Section 2.2).

2.2.1. Unconsolidated entities

18. The scope of application of the present framework includes any unconsolidated entities. For the purposes of this framework, an unconsolidated entity is defined as an entity not within the scope of regulatory consolidation. According to the Basel framework,[9] the scope of regulatory consolidation includes all banking and relevant financial entities meeting regulatory criteria or threshold for triggering consolidation.[10]

19. The scope of regulatory consolidation might differ from the accounting scope of consolidation. The scope of accounting consolidation includes all the entities that are consolidated according to the relevant accounting frameworks and as reflected in the consolidated financial statements of the group. From an accounting standpoint, consolidation is currently based on the notion of control, as defined by the relevant accounting standards.

20. Differences between the accounting and regulatory scopes may arise from: (i) the types of entity that should be included within each scope; and (ii) the required method of consolidation. Unless otherwise noted, entities included in the scope of accounting consolidation but excluded from the regulatory scope of consolidation should be subject to the assessment.

21. For the purposes of this document, all entities that a banking group has consolidated for accounting purposes by using the equity method or proportionate consolidation are to be subject to a step-in risk review. For example, a joint venture included in the bank's balance sheet via the equity method or proportionate consolidation is not considered to be consolidated and should be evaluated.

2.2.2. Types of entity

22. This work contributes to addressing concerns about the "shadow banking system", which is described by the Financial Stability Board as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system". However, there is neither a commonly established definition nor a comprehensive list of entities in this category, and step-in risk could involve a variety of entities.

strategic risk, are not easily measurable, it expects industry to further develop techniques for managing all aspects of these risks."

8 See BCBS, *Principles for the Sound Management of Operational Risk*, June 2011.

9 See BCBS, June 2006, ibid, paragraphs 20–39.

10 The term **consolidation** usually describes the accounting procedure aggregating the components of financial statements (eg balance sheet items such as assets and liabilities) of different entities line by line, while eliminating any inter-entity balances and transactions in order to produce a group's single aggregate record, as if it were that of a single legal entity.

Therefore, for the purposes of this framework, the Committee focuses on the situations that give rise to step-in risk, rather than trying to provide a definition of a category of entities that should be considered.

23. As a result, there is no prescribed list of entity types that should be subject to the identification and assessment. As a minimum, banks are expected to scrutinise securitisation vehicles, investment funds and other entities as described in Annex 2. This list is provided for indicative purposes and is not comprehensive.

2.2.3. Relationships between the bank and the entity that prompt inclusion in the initial set of entities

24. A bank is not required to evaluate all entities with which it has a relationship, but those where the bank has a relation to an entity through one or more of the following relationships:

- **Sponsor**[11] – Defined broadly to include entities where the bank manages or advises the entity, places the entity's securities into the market, or provides liquidity and/or credit enhancements to the entity.
- **Debt or equity investor** – Defined broadly to include entities where the bank is an important investor in their debt or equity instruments. However, banks should exclude regular business such as a lending relationship to operating entities (eg a wholesale loan to a corporate entity) and investments that arise from market-making (eg equity shares held in the trading book).
- **Other contractual and non-contractual involvement** – Exposes an entity to the risks or to equity-like returns from the assets of the entity or related to its performance.

2.2.4. Specific entities (insurance entities, securitisation entities, immaterial entities, collective rebuttals)

25. Insurance entities that are currently specifically excluded from the regulatory scope of consolidation while attracting a specific prudential treatment are presumed not to be included within the types of entity considered here. As they are already subject to specific prudential treatment, the same applies to banking regulated entities supervised by banking supervisors.

26. Securitisation entities are subject to the framework. When the securitised assets of a vehicle meet operational requirements for the recognition of significant risk transfer (SRT), the bank still needs to assess the step-in risk associated with such an entity since non-contractual step-in risks might remain under specific circumstances. Indeed, the SRT criteria focus on credit risk transfer and may ignore other risk factors considered in the step-in risk framework. The existing prudential treatment of the securitised assets that meet SRT criteria for risk-based capital requirements purposes and for Basel III leverage ratio measure purposes are not be modified by this provision.

27. Commercial entities and operational service providers (eg a telecommunications company) may in general be excluded from the step-in risk analysis. However, an exclusive provider of an operational service critical to the business continuity or financial stability of the bank, or a non-financial undertaking bearing significant bank-like risk for the bank should be considered in the scope of the framework.

28. An entity may be excluded from the step-in risk analysis if, given the size of the entity, stepping in to support that entity would not be material to the bank's liquidity and/or capital positions. This materiality analysis should consider both the liquidity and capital requirements that would arise from stepping in to support the entity as well as the broader adverse consequences of not stepping in. In performing this materiality evaluation, similar entities should be evaluated in aggregate. This is because

[11] This definition was introduced in the Basel framework for securitisation purposes (see BCBS, *Revisions to the securitisation framework,* December 2014, paragraph 7) and is used in this document in the broader context of step-in risk.

the step-in risk might be significant when considering the "contagion" risk to similar entities, even when the step-in risk seems insignificant for a single entity. Each bank should define the criteria in its risk management policy, and supervisors may elect to establish absolute and/or relative quantitative materiality thresholds and associated qualitative considerations for their specific jurisdictions, on the basis of the relevant prudential regulatory regime. Entities considered as immaterial for step-in risk purposes should still be subject to an aggregate reporting to the supervisor.[12]

29. National jurisdictions may explicitly prohibit banks from stepping in to support certain entities. In such cases, the banks are not required either to analyse or to report the step-in risk associated with such entities.

30. Only a law or a regulation, which is clearly enforceable, of general application and which explicitly prohibits the provision of support, can be considered as a collective rebuttal. Its rebuttal effect can only be recognised for those types of entity that are affected by these rules. If there are legislative changes, so that regulations that provided the basis for the exclusion no longer apply, the step-in risk framework should be applied immediately after the changes. The bank should specify in its policies and procedures the types of entity excluded due to a collective rebuttal and keep a list of such entities available on supervisory request. However, entities excluded due to a collective rebuttal do not have to be reported to the supervisor on a regular basis (they are excluded from the scope of Template 1 in Annex 1).

31. Contract law or industry standards on their own are not be considered eligible for collective rebuttal, and the prohibition must not vary based on a bank's capital or liquidity position and planning process or risk management approach.

3. Identification of step-in risk

32. This section describes the indicators banks should use in identifying entities bearing step-in risk for the bank. These indicators might be adapted for inclusion in the bank's policies and procedures for managing step-in risk.

33. The purpose of the step-in risk analysis is to identify only those instances where stepping in would significantly impact the bank's liquidity and/or capital positions. In order to identify the entities that warrant a response with regard to step-in risk, a bank must evaluate them by considering the indicators.

34. In performing the evaluation, the bank should focus on the purpose and design of the entity, considering in particular the relevant activities carried out and administered by the entity, how decisions about those activities are made, who has the current ability to direct those activities, the bank's relationships (contractual or otherwise) with the entity, and who is entitled to contractually receive the expected returns or is otherwise exposed to the risks of the entity.

35. The initial set of entities to be scrutinised identified in Section 2.2, should be assessed against the indicators listed below. The indicators are not ordered by importance, nor should they be considered exhaustive; all indicators, including the additional or adapted ones, are nonetheless necessary to appropriately evaluate specific structures. Generally, all the indicators need to be considered in combination to reach a conclusion. However, in certain situations, one indicator alone may be sufficient to trigger the identification of step-in risk.

12 See Template 1 in Annex 1.

3.1. Nature and degree of sponsorship

36. This indicator refers to the nature and degree of a bank's sponsorship of an entity. In its role as sponsor, the bank may be exposed to a greater degree of step-in risk in certain cases, such as when it (i) provides full sponsor support,[13] via a guarantee or other credit enhancement, or (ii) provides partial credit enhancements and liquidity facilities while playing a role in decision-making.

37. Examples: *The bank is a full sponsor of an entity. The bank provides partial upfront facilities to an entity where the bank is also, to a relevant degree, a decision-maker.*

3.2. Degree of influence

38. This indicator refers to the degree to which the bank exercises influence over the entity. This indicator is not meant to be synonymous with the accounting notion of power/control that is a prerequisite for accounting consolidation but rather a lower threshold (eg significant influence). A greater degree of influence over an entity may be indicative of a greater incentive to step in during a time of financial stress.

39. Examples: *Capital ties < 50% and power to exercise a significant influence over the management. Capital ties > 50% but no regulatory consolidation. No capital ties but ability to remove and appoint board of directors. In the case of SPEs (including "autopilot" vehicles), existence of organisational and financial relationships that effectively transfer to the bank most of the risks and/or benefits of the vehicle's activities.*

40. Counterexample: *The bank is merely an agent, making decisions subject to a contractual mandate, and has no other exposure to the entity's variable returns. This does not preclude the bank from assessing other indicators, as other indicators might point to the existence of step-in risk.*

3.3. Implicit support

41. This indicator takes into account whether the bank is providing an implicit guarantee, for instance in investors' rate of return expectations. For instance, the bank would evaluate, by comparison with other similar entities, whether the investor is accepting a lower rate of return on its investment relative to risk, potentially indicating that the investor expects the sponsoring bank to support the entity in a stress scenario. This indicator should also take into account any evaluation performed by a rating agency, specifically the extent to which the entity's rating is dependent on the bank's and/or parent company's credit rating.

42. Examples: *Entities where a rating agency assigns the entity a better rating than would have been the case without considering the relationship with the bank (ie the entity's rating is reliant on the bank's or parent company's rating to an extent that exceeds a contractual arrangement). Entities where the rate of return accepted by investors is materially lower than what is indicated by the risks of the entity's assets.*

3.4. Structured entities/ variable interest entities and highly leveraged entities

43. An entity may be highly leveraged at its inception relative to the risks associated with the assets it holds. These entities are often characterised by control being exercised through means other than traditional voting rights. Although these entities are already evaluated under accounting consolidation

[13] In most cases, the provision of full credit or liquidity support to a structured vehicle would result in accounting consolidation. Any exclusion of such entities from regulatory consolidation would thus be the result of regulatory guidance allowing or requiring such treatment (eg Article 248 of the Capital Requirements Regulation on significant risk transfer securitisations).

requirements, this indicator is meant to highlight that these types of entity are more prone to step-in risk than adequately capitalised entities.

44. Examples: *Structured vehicles under IFRS and variable interest entities under US GAAP.*

3.5. Liquidity stress/first-mover incentive

45. The potential that a bank's liquidity stress might be increased and exacerbated is a key element for consideration in the step-in analysis. This indicator refers to entities with a limited capacity to access liquidity when facing an unanticipated increase in redemption requests (ie they cannot sell enough assets to meet the redemption) and which would therefore impact the bank's liquidity should it conclude that it must provide step-in support. This would include situations where long-term assets are funded with short-term liabilities (ie maturity mismatch). Ceteris paribus, off-balance sheet entities that engage in maturity transformation by holding non-risk-free assets (ie those other than sovereign-backed bonds) increase the potential for step-in. Entities holding large cash reserves or high-quality liquid asset (HQLA) equivalents for regulatory reasons would be less likely to increase step-in risk because their increased liquidity needs during stress periods would already be covered, at least in part.

46. As a corollary to liquidity concerns, liability run risks are heightened when it is advantageous for an investor to exit the entity before others do. This scenario is more acute when there are no potential barriers to redemptions (ie redemption gates). Also of note are entities whose performance depends on an illiquid benchmark and which are hence more prone to volatile valuations and large drops in value during periods of liquidity stress (eg emerging market equity index funds, corporate bond funds and high-yield bond funds).

47. Examples: *Structured investment vehicles (SIVs) during the financial crisis were particularly prone to investor runs. Funds redeemable at constant net asset values (NAV) (eg 1 CU). Funds that do not exercise any type of redemption penalty (eg redemption fees, swing prices). Significant mismatch between asset and liability maturities.*

48. Counterexamples: *Index funds. Passive investment funds (eg ETFs). Funds that have floating/variable NAVs (eg open-end mutual funds). Funds with substantial redemption costs or the legal ability to impose redemption gates. Pass-through securitisations. Separately managed/segregated funds (ie funds that legally have only a single customer).*

3.6. Risk transparency for investors

49. This indicator refers to an entity's degree of transparency, and the extent to which investors are provided with detailed information that allows them to understand and assess its risk-adjusted returns. Disclosures are also made to investors within investment offering documents (ie in an investment prospectus) regarding any restrictions on the bank's contractual obligations to support the entity.

50. Examples: *Entities where the risk in underlying investments is opaque. Entities that cannot be rated or where the rating depends on a range of unsupported assumptions. Entities with a return that depends on indirect factors which are difficult to quantify.*

51. Counterexamples: *Entities subject to a robust disclosure regime under a regulatory regime that sets out the risks to be absorbed by investors. Entities that provide clear and frequently updated disclosure of their assets and liabilities.*

3.7. Accounting disclosures

52. Accounting disclosure requirements could provide meaningful information to evaluate the nature and risks of a bank's involvement with unconsolidated entities.

53. Examples: *Exposures towards unconsolidated entities disclosed under IFRS 12 or US GAAP VIE disclosures. US GAAP disclosures associated with constant-NAV money market funds. Contingent liabilities that meet disclosure requirements but do not meet the loss recognition thresholds under accounting standards.*

54. Counterexamples: *Exposures already recognised in capital through recognition of associated contingent liabilities, with associated reduction in capital.*

3.8. Investor risk alignment

55. This indicator refers to entities whose activities do not sufficiently match the risk profiles of their clients/investors with those of the risk exposures of the entity. This risk is not restricted to the narrow case of mis-selling (if such a concept exists in a given jurisdiction); rather, a broad analysis is required of whether the entity's risk exposures are aligned with investors' risk appetites to establish whether the risk exists.

56. Examples: *Funds that mix different term and/or wealth expectations into a single fund type. Banks that provide investment products to investors who are loss-averse (confidence-sensitive products). Instances where investors have not received any proper explanation of risks (eg mis-selling). Banks selling to retail customers products that have bundled, hard-to-price features (eg subordinated debt, preferred shares, debt instruments with embedded optionality).*

57. Counterexamples: *Entities in jurisdictions where banks are obliged by law to ensure that particular investment products are appropriate and correspond to the needs of the investors to whom they are sold.*

3.9. Reputational risk from branding and cross-selling

58. This indicator refers to the potential harm to a bank's reputation when an entity has clients in common with the bank and also carries the bank's brand (eg corporate name, logo/symbol). Different brand strategies create different risk profiles.

59. Branding could strengthen the presumption of step-in support, especially if the brand is associated with a deposit-taking institution in the same banking group. A distinction could be made between a "branded house" strategy and a "house of brands" strategy. Under the "branded house" strategy, the bank maintains a corporate master brand that acts as a single unifying banner, source of reputation, and federating force for all product and service offerings. On the other hand, in a "house of brands" strategy, a bank operates through an independent set of standalone brands while keeping the corporate brand itself discrete. To the extent that a branded house strategy aggregates numerous products and business lines, it can be associated with a higher incentive for the bank to step in should one of its products or businesses be compromised, in order to protect its reputation and brand.

60. The evaluation of this indicator should consider the degree to which cross-selling is part of the bank's overall strategy, as a greater degree of cross-selling increases reputational risk and, thus, the incentive to provide step-in support. This is particularly the case if a bank or banking group has standalone deposit-taking institution(s), broker-dealer(s) and asset management unit(s) that cross-sell products.

61. Examples: *Banks that aggressively and successfully cross-sell both on-and off-balance sheet products to its key clients. Banks that use a "branded house" strategy, where the brand is attached to the entity.*

3.10. Historical dependence

62. This indicator refers to documented instances where step-in support has been provided previously to specific types of entity.

63. Example: *Step-in support was provided to money market mutual funds and structured investment vehicles (SIVs) during the financial crisis.*

3.11. Regulatory restrictions and mitigants

64. Outright regulatory prohibition on step-in risk and associated consequences are described in Section 2.2 on collective rebuttals. This indicator refers to regulations that restrict, without prohibiting, a bank's ability and/or propensity to support an entity on terms that are unfavourable to the bank.

65. Examples: *Entities for which higher capital requirements are set in order to cover potential step-in situations (in the EU-CRR, for example, the calculation of own funds requirements for operational risk includes reputational risk, which may be taken into account, provided that the bank can demonstrate and document that the specific step-in risk identified enters into the calculation of requirements). Entities where a step-in action would be subject to the Federal Reserve Act 23A and 23B (Regulation W).*[14]

4. Potential responses to step-in risk

66. The present framework is intended to leverage existing provisions in the Basel framework. The July 2009 *Enhancements to the Basel II framework* already requires banks to measure the amount of support they might have to provide or the losses they might experience. This framework will complement the existing provisions by enhancing the step-in risk identification process and providing a set of options according to which banks can manage the risk and take action.

67. A bank's approach to step-in risk management and measurement should be sensitive to the residual risk, ie after taking into account of possible risk mitigants. Banks should consider the degree and effectiveness of any mitigants for step-in risk, including the scope for mitigants to reduce the potential impact on the bank if step-in risk support were provided.

68. The bank's risk measurement and management process is designed to ensure that the bank has adequate resources available in advance of potential step-in support, which would thus reduce the procyclicality of such a stress. The aim is to avoid a situation where unanticipated support provided by a bank weakens its ability to meet its own contractual commitments, and its liquidity and/or their capital requirements.

69. When a bank identifies significant step-in risk to an entity, it can apply a range of potential risk measurement and management measures. Some of the measures discussed below have a more all-encompassing effect on banks than do others, as they could impact various regulatory metrics. Other measures might have a more targeted impact. Banks can determine the appropriate choice of measure(s) (subject to potential supervisory scrutiny), based on the nature and extent of the anticipated step-in support in each case.

[14] Regulation W requires that transactions with affiliates be conducted on an arms' length basis and sets limits for credit relationship exposures between the insured depository institutions and its affiliates

4.1. Comprehensive measures

4.1.1. Inclusion in the regulatory scope of consolidation

70. Where a bank already has substantial contractual obligations to provide support to another entity at a time of stress, augmented by a significant risk that the bank would go beyond these contractual obligations, inclusion of the entity in the regulatory scope of consolidation may be the most appropriate measure, in particular where the entity's balance sheet structure and activities are amenable to banking regulations.

71. Such treatment may be used, taking into consideration the following aspects:

- The entity appears to have been designed to specifically avoid regulatory consolidation (or exhibits characteristics common to entities that are used to arbitrage regulatory requirements).
- There have been previous and documented step-in cases in similar circumstances.
- There are organisational and financial relations that, in substance, assign to the bank the majority of the risks and/or of the benefits arising from the activities of the entities.
- There is investor expectation of full or significant support during a stress period.
- There is an expectation that the nature and extent of step-in support would trigger accounting consolidation of the entity and, as a consequence, the inclusion of the entity in the regulatory scope of consolidation.

72. The cases above would generate a strong presumption that consolidation ought to be applied. However, the expectation is that such cases should be limited in practice. The treatment could be considered as a backstop addressing issues related to the incomplete implementation of existing accounting and regulatory frameworks.

73. This measure might not be appropriate when consolidation would artificially improve capital or liquidity position of the bank, because the entity's resources might not be available to the bank.

Practical implementation

74. Depending on the jurisdiction, the inclusion of a given entity could occur in the accounting scope of consolidation[15] or in the regulatory scope of consolidation.

75. Provided that the entity's leverage and its assets and liabilities composition can be captured in regulatory metrics, this measure would be implementable. It does not require any further quantification of the step-in risk because the risk is essentially addressed through the entity's consolidation.

76. Consolidation would have an impact on all regulatory metrics that use the regulatory scope of consolidation as a starting point (ie capital requirements, leverage ratio, liquidity requirements, large exposures, G-SIB identification). It will essentially exclude the use of any other measure.

4.1.2. Conversion approach

77. When the step-in risk identification and assessment process concludes that significant step-in risk exists in relationships with certain unconsolidated entities, but that consolidation would not be appropriate, using a conversion factor to estimate the risk might be appropriate. For instance, the conversion approach might be appropriate in cases where the bank's anticipated step-in support would be the provision of a liquidity facility up to some portion of the entity's liabilities. A conversion factor

15 In jurisdictions where supervisors challenge the implementation of the accounting framework and/or do not permit any difference between the accounting and the regulatory scopes of consolidation.

would be applied to the entity's exposures and will be used to determine a response in terms of increased capital requirements and/or liquidity requirements.

78. The degree of step-in risk may differ substantially depending on the entity's design and on its related transactions. A bank (or supervisor) would be able determine an appropriate conversion factor and apply it to a specific set of circumstances, since neither a uniform "one size fits all" conversion factor nor full consolidation may be sufficiently case/risk-sensitive. This flexible approach would be simple to implement, with only a few data requirements. A relatively high conversion factor would be assigned in cases where the impact on the bank of stepping in is deemed high, whereas a relatively low conversion factor could be assigned where step-in risks would have less impact.

Practical implementation within a jurisdiction

79. Banks and supervisors would have to adjust this measure so that it is consistent with the step-in risk framework applicable in their jurisdiction. A further challenge relates to measuring any risk that is not tied to a contractual exposure.

80. The starting point of this measurement would be to convert the total assets of the unconsolidated entity and its off-balance sheet exposures into asset equivalents as a single figure. This figure would then be adjusted by subtracting the amount of any assets held by the entity in the banking group and the amount of any off-balance sheet exposures (assets) held by the banking group in the entity that already give rise to a capital charge or a capital deduction and or to a liquidity cash outflow. The resulting sum would then be subject to a conversion factor, similar to off-balance sheet items.

81. Such a method provides a measure that could be used to reflect the potential impact of step-in on the bank's regulatory capital requirements (eg by assigning a conversion factor to this amount) but also, where appropriate, to reflect the potential impact of step-in risk on the bank's liquidity requirement (eg by assigning a certain cash outflow rate to this amount).

4.2. Targeted measures

82. Banks and supervisors may also consider further approaches as a supplement or alternative to the measures detailed above.

4.2.1. Liquidity requirements

83. The existing provisions in the liquidity standards could be used to account for step-in risk and better reflect the outcome of the step-in risk assessment. In order to apply the existing provisions, banks and supervisors should first identify the non-contractual obligations; for this purpose, the identification framework for step-in risk should be relevant. Liquidity regulations require the measurement of "contingent funding obligations [that] may be either contractual or **non-contractual** and are not lending commitments…" (emphasis added). In particular, the Liquidity Coverage Ratio contains several paragraphs (134–137) that address the potential need for the bank to buy back debt or honour non-contractual obligations in order to mitigate reputational risk. However, the LCR does not prescribe the methods for identifying such step-in risks.

84. Similarly, the Net Stable Funding Ratio (NSFR) requires stable funding factors for off-balance sheet exposures (paragraphs 46 and 47 and Table 3). Off-balance sheet exposures include non-contractual obligations, which could be identified through the step-in risk assessment. The NSFR allows national supervisors discretion to determine the required stable funding factors for other contingent funding obligations, such as potential requests for debt repurchases of conduits, securities investment vehicles and similar financing facilities; structured products where customers anticipate ready marketability; and, management funds marketed with the aim of maintaining a stable value.

4.2.2. Stress testing

85. Banks and supervisors may decide to include in their stress-testing framework entities that are not part of the regulatory scope of consolidation of the banking group. In doing so, the main aim is to ensure that any procyclical effects are covered by ex ante capital holdings (and, where appropriate, liquidity), even in regimes that do not use Pillar 2 capital charges. This can lead to an evaluation of the potential impact of banks' relationships with unconsolidated entities on their financial resources in market stress tests or scenario analysis.[16] The results of such stress testing and scenario analysis would be expected to help a bank consider whether it needs additional capital or liquidity in respect of these unconsolidated entities, and also to highlight whether specific measures should be taken to mitigate adverse effects if the risks covered by the stress or scenario test materialise.

4.2.3. Provisioning

86. Banks and supervisors might build upon the accounting framework for provisioning to measure the impact of a step-in event. For instance, this might take the form of estimating the potential cash outflows resulting from a step-in, assessing these outflows against the expected fire-sale value of the entity's assets. This method could potentially be compared with the conversion approach described above. However, the practical implementation would necessitate a deduction from CET1 (as it is the case for prudent valuation adjustments, for example) rather than an increase in the appropriate capital charge.

4.2.4. Punitive ex post capital charges

87. A supervisor might decide to apply a punitive capital charge if a bank actually steps in to support an entity beyond its contractual obligations (ie ex post). Supervisors may use this approach as a way of reducing step-in risk by deterring banks from stepping in. The supervisor might need to require either that the post-step-in exposure to be risk-weighted at a considerably higher level than under the default rules, or that the entity's total assets are brought onto the bank's balance sheet at the prevailing risk weight (ie similar to the conversion approach outlined above). Supervisors would, however, need to consider whether such a measure would clash with the objective of reducing procyclical effects. However, this would be balanced against the fact that it would incentivise banks to identify and assess their step-in risks. This would particularly be the case if supervisors established it as a credible prudential measure through its consistent use in cases where banks step in to provide support to unconsolidated entities.

4.2.5. Large exposure-like internal limit

88. This specific measure – already in place in certain jurisdictions[17] – builds upon the Committee's large exposures framework.[18] It requires a bank to apply an internal limit to all of its contractual exposures and/or estimation of step-in risk to shadow banking entities. Such an approach can be useful to limit bank's concentration risk towards shadow banking entities.

[16] It may also be appropriate to consider scenarios in relation to adverse events in sectors where a particular sectoral concentration is identified as part of the step-in risk self-assessment. So, it could also be appropriate for a bank to amend and/or add some stress tests to those that it currently carries out to reflect risk concentrations.

[17] See the EBA Guidelines – *Limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013*.

[18] See BCBS, April 2014, *Supervisory framework for measuring and controlling large exposures*.

4.2.6. Disclosure

89. To mitigate step-in risk through strengthened market discipline, banks and supervisors might also decide to require specific public disclosures, such as the number, size and nature of unconsolidated entities in terms of the step-in risk, and of banks' own risk assessment and their management of such exposures. As a potential downside, public disclosures might cause "self-fulfilling prophecies" or moral hazard, as market participants could interpret them as implying that a requirement exists to step in to provide support even where there is no contractual commitment to do so.[19] However, this risk could be mitigated if banks make it clear that step-in risk disclosure does not imply any commitment to step in if an unconsolidated entity finds itself in distress.

5. Role of banks

90. This section describes the key components of the framework that requires banks to establish their own policies and procedures to identify and assess step-in risk as part of their risk management processes. These policies and procedures ensure that banks can regularly report to their supervisors the results of their self-assessment. In addition, supervisors will review and assess banks' policies and procedures. Banks will be required to take action where step-in risk is considered to be significant.

5.1. Banks' policies and procedures for identifying and managing step-in risk

91. Banks must establish and maintain, as part of their risk management framework, policies and procedures that describe the processes used to identify entities that are unconsolidated for regulatory purposes and the associated step-in risks. These policies and procedures should:

- Clearly describe the identification criteria that banks use to identify the step-in, which should include, at at a minimum, the indicators described in Section 3.
- Not be prescriptive or geared towards any particular type of entity. (Given the case-by-case nature of the evaluation, the framework is envisaged as flexible enough to capture all entities that are unconsolidated for regulatory purposes and which pose significant step-in risk.)
- Clearly describe the specific provisions of the laws or regulations acting as collective rebuttals and list the types of entity covered by those laws or regulations (see Section 2.2).
- Describe the internal parties responsible for identifying, monitoring, assessing, mitigating and managing the potential step-in risk.
- Clearly describe the the bank's own definition and criteria of "materiality", as used to exclude immaterial entities in the bank's step-in risk assessment, and their rationale.
- Document the process to obtain the necessary information to conduct the regular self-assessment.
- Be reviewed regularly, and whenever there is any material change in the types of entity or in the risk profile of entities. If there have been no material changes, the policies and procedures should be reviewed in accordance with the bank's own policy on frequency of review of key policy documents, or at least every three years.

[19] This issue may, however, exist with any type of ex ante policy tool.

- Require the step-in risk self-assessment to be included in the internal risk management processes, subject to independent controls, and to be discussed by the appropriate risk committee of the bank's board (or similar organisation) as a separate agenda item.
- Be documented and available for supervisory review upon request.

5.2. Regular step-in risk identification and assessment

92. In accordance with their policies and procedures, banks must regularly identify all entities giving rise to step-in risk. For all these entities, they should estimate the potential impact on their liquidity and capital that step-in risk could entail. The bank should use the estimation method it sees as most appropriate. The list of responses and, in particular, the comprehensive measures described in Section 4.1[20] might suggest appropriate methods for estimating this impact. Banks should describe the method used to estimate the financial impact of step-in risk in each case.

5.3. Reporting to the supervisor

93. Banks must regularly report the results of their self-assessment of step-in risk to their supervisor. The expectation is that this reporting becomes mandatory and should be submitted annually. The reporting includes two templates as follows.

94. Template 1 details the number and types of entity that were initially identified for review purposes (ie those entities identified as being within the initial set of entities to be scrutinised under Section 2) except those excluded because step-in is prohibited by law (see Section 2.2.4 on collective rebuttals). These entities should be grouped under three categories:

(a) Entities were deemed immaterial (for which no step-in risk assessment process conducted);

(b) Entities are material but step-in risk is insignificant;

(c) Entities are material and step-in risk is significant (to be reported in Template 2).

95. Template 2 details, for each entity or group of similar entities corresponding to category (c) above; the nature of the step-in risk, and the action taken by the bank to limit, mitigate or recognise this risk.

6. Role of supervisors and implementation of the framework

6.1. Review of banks' policies and procedures

96. Upon a frequency to be determined, supervisors may request a bank's step-in risk identification and assessment policies and procedures and assess banks, for example, on some or all of the following items:

- Adequacy and quality of policies and process with regard to the identification, assessment, management and control of step-in risk.
- Adequacy of risk management and measurement system (eg ability to keep track of the unconsolidated entities on a timely basis).

[20] For example, where no other estimation method appears suitable, a bank may decide to consider what the impact would be if the entity were to be fully consolidated.

- Integrity of management information systems.
- Conceptual soundness of internal capital and liquidity assessment and adequacy processes.
- Soundness of internal controls and internal audit, and any findings of internal controls and internal audit with regard to step-in risk assessment.
- Previous provision of step-in support to entities, particularly to those which are still extant and are still subject to the same regulatory regime as during the previous period of step-in support.

97. In reviewing a bank's policies or procedures, supervisors may make use of its internal findings, including those from the bank's internal control or audit areas.

98. Supervisors are expected to review banks' policies or procedures to ensure that banks have conducted appropriate self-assessment of the eligible collective rebuttal presumptions, including the appropriate interpretation and application of relevant laws and regulations. In addition to these collective rebuttals, banks may also provide evidence that the step-in risk to a particular entity has been mitigated.

99. Supervisors are also expected to review the banks' policies and procedures about "materiality'" criteria to ensure that they are reasonable, conservative and appropriately applied.

6.2. Review of the banks' regular step-in risk self-assessments and remedial actions

100. Regardless of the frequency or granularity of the regulatory reporting requirements, banks should regularly assess step-in risk.

101. When reviewing a bank's assessment of step-in risk, a supervisor will consider each particular case and its specific features as a one-off assessment. It will exercise judgment on each case based on the bank's presentation of the facts. If the supervisory assessment reveals that significant residual step-in risks have not been appropriately estimated or mitigated, a supervisor may use the measures that it determines appropriate in the circumstances. The choice of measures will be based on the nature and extent of step-in risks, taking into account the probability and magnitude of step-in risk and the reliability of estimating it. Supervisors should be additionally concerned if the assessed risk could have group-wide or systemic implications.

102. Reporting is to be used by supervisors to assess the adequacy of the banks' self-assessment and the magnitude of residual step-in risk identified. Supervisors will, for instance, evaluate whether step-in risk assessments are consistent across banks/jurisdictions or whether certain types of off-balance sheet activity are increasing in frequency and volume. This will help them identify emerging firm-specific and systemic risks.

103. Supervisors should have the authority to ask banks to remedy any deficiencies in their risk management approach. Although the specific supervisory action will vary according to the circumstances, the types of response that supervisors may consider are outlined in Section 4 above.

6.3. Cooperation and exchange of information

104. Supervisors should share information with supervisors in other jurisdictions regarding the supervision of step-in risk for banking groups with branches or subsidiaries across multiple jurisdictions. Sharing of such information could take place on a bilateral or multilateral basis (eg through supervisory colleges), using data obtained from the regulatory templates. The information shared could include supervisory experiences from assessing and monitoring a bank's step-in risk identification and risk management in different parts of its group, banks' estimation methods, any impediments to the supervision process, rules/criteria for evaluating banks' responses, and examples of good practice observed in banks' management of step-in risk.

6.4. Implementation date and review

105. The present framework should enter into force as soon as possible and no later than end-2019. The Committee intends to monitor jurisdictions' progress in implementing these guidelines in order to keep itself informed of the approaches taken to identify step-in risk and the range of supervisory responses employed.

Annex 1

Supervisory reporting templates

Template 1 – Overview of the initial set of entities under scrutiny

Instructions: the bank must report in this template all entities that meet the provisions in Section 2.2, ie all entities:

- that are not part of the scope of regulatory consolidation;
- with which the bank has one or more of the following relationships: sponsor, debt or equity investor, other contractual or non-contractual involvement;
- unless they are excluded due to collective rebuttals.

Entities outside the scope of the step-in risk framework should not be reported. These entities are insurance and regulated banking entities, entities subject to collective rebuttals and entities that do not meet the relationship criteria described in Section 2.2.3.

Entity types (choose from list in Annex 2 or include a meaningful entity category)	Number of entities	Total asset size of entities	Typical contractual exposures to the entities	Explanations of the assessment For (a), include explanations and criteria why the entities were not considered material.
(a) Entities were deemed immaterial (no assessment process conducted)				
…				
Total				
(b) Entities are material but step-in risk was estimated not significant				
…				
Total				
(c) Entities are material and step-in risk estimated as significant (to be reported in Template 2)				
…				
Total				

Template 2 – Detailed reporting of material entities posing significant step-in risk

Instructions: the subset of entities where step-in risk exists and is significant should be reported in Template 2. This template should be replicated for each entity/group of entities identified in category (c) of Template 1. On the basis of these templates, supervisors are expected to challenge the bank's own assessment and responses.

Entity name(s): If multiple similar entities evaluated, total number of entities: Entity type/category (choose from list in Annex 2 or include a meaningful entity category): Purpose and design (include general description of assets, liabilities, key customers, investors and other stakeholders):

Estimation of the step-in risk potential impact:

Date: ____________	
(1) Entity / group of entities	
Asset size of the entity/entities	
Description of the methodology to estimate potential impact	
Type of support anticipated	
Size of support anticipated (nominal amount)	
Bank's assessment of step-in (difference between before and after materialisation of step-in support)	
Impact on CET1 ratio (percentage points)	
Impact on leverage ratio (percentage points)	
Liquidity position	
Impact on LCR ratio (in percentage points)	
Impact on NSFR ratio (in percentage points)	

Nature of bank's relationship with the entity (mark all that apply):

Yes/no	Attachment	Description
	Sponsor	
	Debt investor	
	Equity investor	
	Other contractual/non-contractual relationship	

Risk indicator analysis:

Indicator	Relevant to entity? (Y/N)	Discussion and analysis
Nature and degree of sponsorship		
Degree of influence		
Implicit support		
Capitalisation and reliance on leverage		
Liquidity stress/first-mover incentive		
Transparency and disclosure		
Investor disclosure		
Accounting disclosure		
Investor risk alignment		
Reputational risk from branding and cross-selling		
Historical dependence		
Regulatory restrictions		

Conclusion and risk management actions undertaken by the bank:

Annex 2

Entity categories

Entities issuing residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) or other assets (ie credit cards, auto loans)

This structure is especially used under the "originate and distribute model". The proceeds received by the SPE on the issuance of mortgage-backed securities (there are often several tranches of securities, depending on the subordinated rank) are used to buy loans originated or bought by a bank (the seller). The seller uses the proceeds for other purposes, including making loans to other borrowers. The principal and interest payments from the underlying loans are passed through to the securities holders, who are exposed to the delinquency risk of the original borrowers (depending on the tranches they have invested in).

During the financial crisis, the ratings of many RMBS/CMBS collapsed. In order to achieve higher ratings for regulatory risk capital purposes, several RMBS/CMBS were converted into re-securitised real estate mortgage investment vehicles (re-REMICs).

Entities issuing covered bonds

Covered bonds are quite similar to mortgage-backed securities. The differences are that they are not always structured through a SPE (ie they can be issued directly by the bank) and they are direct obligations of the issuing entity. In other words, the underlying financial assets act as collateral and the covered bondholders are not exposed to the credit quality of these assets unless the issuing entity becomes insolvent.

Entities issuing collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs)

There are two types of CDO: "cash CDOs" and "synthetic CDOs". In a cash CDO, the proceeds of the securities issued by the SPE are used to purchase the underlying portfolio of financial assets. By contrast, in a synthetic CDO, the SPE (seller of protection) enters into a CDS contract on a reference portfolio of assets with the protection buyer and uses the proceeds of the issued securities to buy highly liquid and high-quality financial assets to cover the SPE's obligations under the CDS.

Cash CDO

The structure of the transaction is similar to the basic securitisation structure, except that the nature of the underlying assets could be more diverse (RMBS, CMBS, corporate bonds, CDOs issued by other SPEs etc). Depending on the type of underlying asset, these SPEs may also be known as CLOs (when the underlying assets are loans) or CBO (when the underlying assets are bonds). Banks may execute interest rate derivatives with the SPE to eliminate mismatches in the collateral and funding instruments.

Synthetic CDO

As mentioned above, the SPE enters into a CDS contract and invests in highly liquid and high-quality assets to collateralise its commitments under the CDS. The premium received on the CDS together, with the revenue on the assets, allows the SPE to pay the interest on the issued securities. In the case of a credit event on the CDS, the SPE pays the protection buyer (the cash comes from the sale of some of the highly liquid and high-quality assets for the corresponding amount) and writes down the issued securities according to the subordinated rank of each. Significant leverage through the use of credit derivatives is often employed as part of the overall strategy for synthetic CDOs.

Entities issuing tender option bonds (TOBs)

TOBs are essentially a way to fund long-term municipal bonds in the short-term market. Typically, a TOB sponsor will buy a portfolio of fixed-rate, long-term municipal bonds (rated between AA and AAA) and combine them with an interest rate swap and create, through securitisation in an SPE, senior short-term tax-exempt floating-rate notes that are sold to investors. Two tranches of notes are issued (with different subordination ranks): senior securities and junior notes. Investors in the latter have a leveraged exposure to the underlying municipal bonds. The senior note holders have a put option (the tender option), which allows them to put their bonds back to the issuer at par at any time. Banks may also provide liquidity guarantees and interest rate derivatives to these types of SPE.

Entities issuing asset-backed commercial paper (ABCP)

Under an ABCP programme, a SPE buys and funds assets using the basic securitisation framework. However, unlike a "term" securitisation, ABCP programmes generally have no maturity and are intended to be essentially perpetual. As the duration of commercial paper is shorter than the maturity of the assets, the issued securities are rolled over, meaning that the proceeds of new commercial paper are used to repay maturing commercial paper. In most cases, when the conduit is unable to issue new commercial paper, it can use a back-up liquidity facility or asset purchase agreement provided by a large commercial bank.

On the asset side, the SPE buys financial instruments sold by one or multiple sellers. In the former case, a bank securitises its own assets. In the latter, the bank administers a SPE that is used to provide funding for its clients (through the securitisation of the clients' receivables).

Securities arbitrage conduits

Securities arbitrage conduits allow sponsors, typically banks, to finance an investment in highly rated securities with short-term borrowing. These conduits can be on or off-balance sheet. They enable the bank to benefit from the term structure of interest rates and credit spreads. Similar to single- and multi-seller conduits, these types of programme rely on the existence of liquidity facilities to ensure that the commercial paper investors can be repaid if the issuer cannot issue new commercial paper.

Structured investment vehicles (SIVs)

SIVs are similar to securities arbitrage conduits in the sense that they invest in highly rated securities. However, the structuring of the transactions differs significantly, and SIVs are among the more complex of structured finance arrangements.

SIVs are leveraged investment vehicles. Unlike securities arbitrage conduits, SIVs raise third-party capital and leverage this capital by issuing both short-term (commercial paper) and medium-term notes.

In addition, they do not rely exclusively on bank liquidity facilities to manage their liquidity risk; they also implement a dynamic liquidity management process (ie maintenance of liquid assets and bank facilities to cover the upcoming two or three weeks of cumulative net cash outflows).

Repackaging vehicles

Repackaging vehicles are a client-driven business for banks. They allow banks' clients to access markets and to invest in specific assets that, for regulatory or tax reasons, they may be unable or unwilling to invest in directly. The basic structure entails the purchase by an SPE (established by the structuring banks) of one type of security from another entity. The SPE then issues its own debt or equity securities (the "repackaged securities"). This structure allows the benefits of the underlying security to pass on to the holders of the repackaged securities (the banks' clients) and provide them with a mechanism to acquire exposure to many asset classes and risk profiles in a single instrument.

Example of the use of a repackaging vehicle: transaction implying "auction rate securities", when they are structured through a SPE.

Real estate investment trusts

Real estate investment trusts (REITs) are entities that invest in different kinds of real estate or real estate-related assets, including shopping centres, office buildings, hotels, and mortgages secured by real estate. There are basically three types of REIT:

Equity REITs, the most common type, invest in or own real estate and provide a return to investors from the rents they collect;

Mortgage REITs lend money to owners and developers or invest in financial instruments secured by mortgages on real estate, while hybrid REITs are a combination of equity and mortgage REITs.

Mutual funds

A mutual fund is an investment vehicle made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. The following two types of mutual fund have unique characteristics that bear mention:

Money market funds (and the equivalent mutual funds in other jurisdictions)

A money market fund is a type of mutual fund that is required by law to invest in low-risk securities. These funds have relatively low risks compared with other mutual funds and pay dividends that generally reflect short-term interest rates. Money market funds typically invest in government securities, certificates of deposit, corporate commercial paper, or other highly liquid and low-risk securities.

Exchange-traded funds

An exchange-traded fund (ETF) is an indexed fund listed on a stock exchange market. An ETF can track an index (eg the S&P 500), a commodity or a basket of assets. ETFs experience price changes throughout the day as they are bought and sold. ETFs may also employ leverage, with derivatives or debt as part of their investment strategy.

Hedge funds

Hedge funds are frequently defined as "any pooled investment vehicle that is privately organised, administered by professional investment managers, and not widely available to the public". Unlike mutual funds, hedge funds are not subject to stringent legal or regulatory guidelines concerning their investment strategies. There is a wide variety of investment styles in the hedge fund industry (eg global macro funds, market-neutral funds, event-driven funds, short sellers) and a large diversity of trading strategies within the same investment category. The amount of leverage used by hedge funds largely depends on their trading strategies. Hedge funds that invest mostly in debt securities or equivalent products are known as credit hedge funds.

Some banks have set up hedge funds within their asset management businesses. In addition, some have built up extensive businesses with hedge funds as clients: counterparty trading, derivatives activity, brokerage services, direct equity investments, and direct lending ("prime brokerage").

Private equity funds

Private equity funds make investments directly in the capital of private companies or conduct buyouts of public companies that result in either majority ownership or full ownership and the delisting of public equity. Capital for private equity is raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within a privately owned company, make acquisitions, or strengthen a balance sheet.

Finance companies

Finance companies include non-bank entities that grant loans (mortgage loans, auto loans etc) or offer financial leasing contracts. This category also includes factoring companies (prepayment of commercial receivables).

Securities firms

Securities firms include investment firms, as defined by Article 4 of the Directive 2004/29 EC: "'Investment firm means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis." In the United States, the Securities Exchange Act generally defines a broker as any person engaged in the business of effecting transactions in securities for the account of others (in the role of agent). By contrast, a dealer acts as a principal and is defined as any person engaged in the business of buying and selling securities for his own account, through a broker for instance.