BBVA AND SANTANDER CONSENSUAL COMMENTS ON THE BASEL COMMITTEE CONSULTATIVE DOCUMENT "IDENTIFICATION AND MEASUREMENT OF STEP-IN RISK"

BBVA and SANTANDER appreciate the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) consultative document "Identification and measurement of step-in Risk".

BBVA and SANTANDER agree with the objective of the document to analyse situations in which an institution may decide to provide financial support to unconsolidated entities beyond its contractual obligations. As pointed out, the last global financial crisis manifested evidence that banks sometimes may have incentives to provide credit or liquidity support beyond their obligations.

Both banks are concerned about the Committee's proposal, its scope, and its potential implications for the ability of banks to engage in key financial activities, such as asset securitization and asset management. Both banks consider that the scope of Basel Committee proposal is excessively broad and not focussed on the entities that may potentially give rise to step-in risk. It does not take into account that even during the recent financial crisis step-in risk was limited to singular events and structures, and even in structures that gave rise to step-in actions, such actions were confined to specific banks and locations and were not broad based. In addition, since the recent crisis the financial sector has witnessed a profound transformation that has reduced considerably the potential appearance of circumstances that might give rise to step-in risk.

BBVA and SANTANDER consider that the assessment and measurement of the step-in risk cannot be done through broad based indicators but through a deep analysis that takes into account the specific characteristics of this type of risk. Under their opinion, step-in risk is best treated as an integral part of banks' internal capital assessment adequacy process (ICAAP) and supervisor' review and evaluation process (SREP). Only under these processes this type of risks can be analysed taking into account all its specificities and nuances.

The ICAAP and SREP already include most of the analysis proposed in this consultation document. The BCBS should only ensure that step-in risk is well covered by these processes.

Please, see below a more detailed explanation on the BBVA and SANTANDER consensual comments on the BCBS proposal for step-in risk.

1. Fundamental changes in the financial sector:

Over the last years, the financial sector has been involved in fundamental changes covering banks' governance framework, risk management processes and commercial practices that have substantially reduced the potential occurrence of events that in the past had led banks to decide to take step-in actions. **Enhanced regulation** and **banks expanded internal measures have substantially reduced step-in risk**:

- **Enhanced commercial standards**:

  Some events that caused the step-in actions were related to poor commercial standards. Since the financial crisis, new regulation forces banks to enhance the assessment on the suitability and appropriateness of their financial products to each client[1], on the basis of their personal needs, characteristics and objectives. In addition, banks have to provide fairer information of the characteristics of their financial products and include clearer details on their risks[2].

- **Asset management**:

  Redemption flows from investors in excess of the fund's liquidity capacity is the main event that may lead to step-in risk in asset management. In the last years, regulators and supervisors from almost every location are increasing the oversight on the liquidity profile of mutual funds, ETFs and other asset management products; funds are required to maintain larger liquidity buffers and asset managers are demanded to define and implement liquidity management systems and specific control approaches in their daily activities[3].

  In addition, for money market funds the European Commission is proposing imposing requirements to maintain minimum investments in instruments maturing in one day and minimum investments in instruments maturing in one week.

  The commercialization of asset management products are subject to the enhanced standards described in the previous point. For asset management, these standards place a special emphasis on market risk and liquidity risks; on whether these risks are bearable for investors and on whether they have been subject to sufficient disclosure.

  On top of this, regulators have developed and made available for asset managers a complete set of tools to manage extraordinary restricted liquidity situations in the funds (e.g. redemption gates, swing pricing policies and methodologies, side pockets).

  On the other hand, the EU regulation is also addressing the risk of fraud, reputational and operational impacts in asset management, in an attempt to prevent a broad range of past events. In this regard, the 2014 amendment of the UCITS directive, and other local regulations, introduce higher requirements to institutions taking the role of depositories and custodians of the assets of the funds and have increased their liabilities for wrongdoing, along with the strengthening of their role of direct supervisors of the asset managers they work with.

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[1] MiFID already enhanced transparency in the commercialization process and therefore reduce reputational risk associated with the selling of the products. This has been reinforced by the 2014 amendment of the Directive on markets in financial instruments (MiFID 2).

[2] MiFID, MiFID 2 and the Regulation on packaged retail and insurance-based investment products (PRIIPs)

[3] UCITS directive, AIFM directive and local related regulation

Finally, the risks of the asset management activity are capitalised through operational risk. The BCBS has recently published a review on this framework, which proposes to eliminate the Advance Measurement Approach (AMA) and to force institutions to use the revised Standardised Measurement Approach (SMA). The new SMA would increase capital charges for banks that in recent years have suffered larger operational losses; it would incentivise banks to enhance their risk management and control functions (in addition to the requirements that impose the specific asset management regulation[4] in these areas).

Since mid-twentieth century, the asset management industry has taken an increasingly predominant role in instrumenting investment vehicles to savers. Over this long period of time, the industry has witnessed a vast number of extreme events (e.g. massive defaults, stock markets collapses, large increases of interest rates to tame double-digit inflation, quantitative easing to prevent deflation, the break of the Bretton Woods system and of the European Currency Union, emerging market crisis, slumping commodity prices) that have provoked sharp falls in funds' NAVs. In some circumstances, under deep liquidity crisis or in periods where there are no reliable prices for funds' assets, the industry has had to take difficult measures, such as temporary suspension of redemptions, temporary suspension of the calculation of NAVs or placing funds on liquidation. However, only on very rare occasions banks have decided to step-in providing support to funds they manage and/or they commercialise. This long historic track-record of the asset management industry should be taken into account when assessing and evaluating step-in risk.

- **Securitization**:

  Risk retention rules for originators, sponsors and original lenders (included in the CRR in the EU and in the Dodd-Frank Act in the US) align interests between these entities and the final investors, reducing the probability of the issuance of poor quality securitization vehicles.

  In addition, in the EU the CRR explicitly includes restrictions on providing support to any securitization beyond existing contractual obligations, what is referred to as "implicit support". Furthermore, the prudential regulatory framework envisages ex-post capital penalties if "implicit support" is provided.

- **Contingency plans**:

  Banks continuously review their contingency plans in order to prevent the occurrence of situations where the continuity of critical functions is at risks and to foresee the actions to take when these situations occur. These plans, that are increasingly being scrutinised by supervisors[5], already (i) analyse the profile of the entities that provide critical functions, (ii) anticipate the occurrence on an event on these entities and (ii) provide guidance on the actions to take to prevent at the minimum cost the discontinuity of the critical functions when any of such events occurs.

[4] AIFM directive and national regulation
[5] See EBA December 2014 guidelines on common procedures and methodologies for SREP, point 107 in title 5.

- **Supervisory review**:

  Published by the BCBS on July 2009, the "Enhancements to the Basel II framework" document, in the Supplemented Pillar 2 Guidance section, instructs banks to include reputational risk that may lead to the provision of implicit support in their risk management process and in their ICAAP and liquidity contingency plans[6]. It also instructs banks to include in their stress testing exercises measures of reputational risk and of non-contractual off-balance sheet exposures[7].

  EU regulators also instruct supervisors to assess whether at consolidated basis group risk management covers all material risks regardless of whether the risk arises from entities not subject to consolidation[8].

- **Governance and risk management framework**:

  The BCBS publication on October 2014 of the "Review of the Principles for the Sound Management of Operational Risk" and on July 2015 of the Corporate governance principles for banks, also contribute to banks' on-going enhancement of their risk management practices and should have an effect on lowering step-in risk.

2. Particular characteristics of step-in risk:

BBVA and SANTANDER support BCBS view that banks should conduct an assessment of the contractual and non-contractual relationship with unconsolidated entities and evaluate whether these relationships may give rise to step-in risk. However, **the measurement of this risk cannot be done through broad indicators and simple methodologies, it has to be flexible enough to take into account the particular characteristics of the step-in risk**:

- Step-in risk is a very low probabilistic risk and step-in decisions are taken in very rare and specific circumstances. This makes inappropriate the consolidation approach for the estimation of the magnitude of the step-in risk. Only the conversion approach could capture this low probability. However, the value of conversion factors on rare, low probabilistic events is difficult to calibrate with accuracy.
- The assessment of step-in risk has to be based on the analysis in two angles:
  - The potential occurrence of events that force banks to a decision on whether to take step-in actions
  - The circumstances that determine their decisions.

  Only a deep analysis on the factors that influence these two angles may provide a valid measure of the risk. For example, for investment instruments, it is necessary at least to analyse the riskiness of the instrument, its complexity, the investor base, the adequacy of

[6] Point B "Off-balance sheet exposures and securitization risk" and point C "Reputational risk and implicit support".
[7] Point F "Sound stress testing practices".
[8] See EBA December 2014 guidelines on common procedures and methodologies for SREP, point 110 in title 5.

the bank's commercial practices and the information provided to clients. Without a thorough analysis that covers all these points, it is impossible to get close to an accurate measure of step-in risk.

- The structure of the local market may have an impact on this type of risk. For example, in countries where money market funds' NAVs were marked-to-market in the financial crisis, no financial support to these instruments was necessary. Broad methodologies that do not take into account local market structures will not correctly reflect step-in risk.
- In some instances there may not be a clear line between legal risks and reputational risk; decisions that may be considered step-in actions may basically be taken to prevent expected future unfavourable court sentences that, on top of the legal costs, could damage bank's reputation and imply large legal expenses. Legal risks are already covered through operational risk.

A thorough analysis that takes all the points above under consideration, would exclude most of the entities that fall into the scope of the proposed primary and secondary indicators from the true list of entities that may potentially give rise to situations of step-in risk. In this vein, the current step-in risk section of the **BCBS Basel 3 data collection exercise**, based on these primary and secondary indicators, **may largely overestimate the step-in risks and not represent the valid measure of this type of risk**. A data collection exercise that focuses only on entities and activities that may potential give rise to step-in risk would be more appropriate for this analysis.

3. Assessment of step-in risk:

Banks' Internal Capital Adequacy Assessment Process (ICAAP) and Supervisors' Review and Evaluation Process (SREP) are already required take into account risks covered in this consultation paper:

- The BCBS document "enhancements to the Basel II framework" already instructs banks:
  - To include reputational risk that may lead to the provision of implicit support in their risk management process and to their ICAAP and liquidity contingency plans
  - To include reputational risk and off-balance sheet exposures in their stress testing practices.
- The EBA Guidelines on common procedures and methodologies for the SREP instruct competent authorities to assess whether:
  - Group risk management covers all material risks regardless of whether the risk arises from entities not subject to consolidation.
  - The institution has established effective business continuity management with tested contingency and business continuity plans as well as recovery plans for all its critical function and resources.

In BBVA and SANTANDER's opinion, **any new text in the Basel framework dedicated to step-in risk should be limited on ensuring that all existing Pillar I charges, plus the ICAAP and the SREP contain a full coverage of this type of risk**. The text has to be **principles-based** in order to leave banks enough flexibility to incorporate in the assessment all the particularities and nuances of this type of risk.

Banks should only be subject to pillar 2 capital charges to cover step-in risk when (i) banks internal assessment determines that risks are material or (ii) their supervisor's review determines that there are material deficiencies in their assessment. In addition, no pillar 2 capital should be publicly directly linked to step-in risk, otherwise this link may create the **perception** that banks provides an **implicit guarantee** to any entity or activity covered by the step-in risk framework, increasing the pressure for banks to decide on taking step-in actions when an event breaks out.

CONSULTATION PAPER QUESTIONS:

Q1. What are commenters' views on the four overarching principles? Are there any others that should be included?

BBVA and SANTANDER agree with the principles stated in the consultation paper, however both think that their implementation in the framework has to be commensurate with the complexities and specificities of the risks addressed.

Given the complexities in the analysis of step-in risk (described above), BBVA and SANTANDER believe that only a framework that relies on the ICAAP and SREP to cover step-in risk can comply with the principles of risk-sensitivity and be readily operational (no pillar 1 charge can be both simple and risk-sensitive). The BCBS may, in addition, foster consistency and proportionality by setting global, principles-based standards on the way to cover step-in risk in both processes.

Not all banks' relationship with unconsolidated entities may potentially give rise to step-in risk. The ICAAP and SREP should focus on relationships where step-in risk is possible (see answer Q2).

Q2. What are commenters' views on the proposed indicators for step-in risk? Are there any additional ones that the Committee should consider?

BBVA and SANTANDER consider that the proposed indicators are too broad and bring into scope many non-consolidated entities that pose no step-in risk to the bank.

In addition, the proposed framework fails to consider the existence of "indicators in the opposite direction", that would make highly improbable the scenario of a step-in by the bank: qualified type of investors, characteristics of the vehicle, nature of the transaction, etc. The framework should acknowledge the existence of these other indicators and include a section on this.

The step-in risk framework and the BCBS data collection exercise should focus on the entities that may potential lead to step-in risk, disregarding all other entities the bank can demonstrate they poses no risk.

Q3. What are commenters' views on the proposed secondary indicators for step-in risk? Are there any additional ones that the Committee should consider? Should any of them be considered as primary indicators?

See answer Q2.

Q4. What are commenters' views on the different potential step-in risk assessment approaches? Are there any other approaches that the Committee should consider to account for step-in risks?

BBVA and SANTANDER consider that step-in risk is a very low probabilistic event, only in rare occasions and on specific circumstances banks decide to take step-in actions; therefore a full or proportionate consolidation approach is not appropriate.

A conversion approach seems reasonable, however the CCFs can only be established after a careful and individual analysis of the factors that:

- May create situations in which banks have to face a decision on whether to take a step-in action.
- The circumstances that may lead banks to decide on providing non-contractual credit or financial support.

Q5. What are commenters' views on the proposed mapping between the primary indicators and the potential approaches?

See answer Q4.

Q6. What are commenters' views on proportionate consolidation for joint-ventures?

Both full and proportionate consolidation approaches assume that banks will provide support to unconsolidated entities when they fall into trouble; it does not consider that banks decide to provide support beyond their contractual agreement only in specific circumstances. No approach that does not analyse these circumstances should be applied.

As mentioned in the answers to previous questions, BBVA and SANTANDER do not consider appropriate the consolidation approaches for step-in risk.

Q7. What are commenters' views on risks stemming from banks' relationships with asset management activities and funds and the appropriateness of the direction envisaged?

<u>Since the crisis, enhanced standards and regulations have addressed the commercialization of products in asset management activities</u>, and this regulation is evolving over time, as new risks become more evident, to enhance degree of protection to investors. For example in the EU:

- The 2014 amendment of the UCITS directive introduces higher requirements to the institutions taking the role of depositories of the assets of the funds, and has increased their liabilities for wrongdoing.
- UCITS directive was previously amended in 2009 to update the conduct rules for asset management companies and to enhance the disclosure of information to investors.

- On 2010 the Directive of Alternative Investment Funds Managers (AIFM) was approved to impose an exhaustive regulatory framework to retail non-harmonized funds, hedge funds and private equity funds, and their asset managers in the EU.

On top of that, supervisors are increasing monitoring the liquidity profile of EU funds, in order to prevent situations in which funds cannot satisfy the flow of redemptions from investors.

In addition to specific asset management regulation and supervisory process, entities have also to comply with general financial sector regulation on conduct rules; the amended MiFID enhances the analysis entities has to perform to determine the suitability of financial products to investors' needs and characteristics. Both, MiFID and PRIIPS regulation impose minimum standards for the information to be provided to investors.

All these updated regulation reduces step-in risk.

- By lowering the probability that banks have to face step-in situations (monitoring on liquidity profile, anti-fraud regulation)
- By diminishing the probability that banks are forced to provide support to funds they have commercialised (enhanced commercial practices and better information to investors).

Any framework assessing and evaluating banks' step-in risk on the asset management industry has **to take into account all the regulation in place minimizing this risk**.

Moreover, it has to take into account **banks' track-record in their involvement with the asset management industry**; since mid-twentieth century, asset management industry has taken an important and increasing role in instrumenting investment vehicles to savers. Over this long period of time, the industry has witnessed a vast number of extreme events (e.g. massive defaults, stock markets collapses, large increases of interest rates to tame double-digit inflation, quantitative easing to prevent deflation, the break of the Bretton Woods system and of the European Currency Union, emerging market crisis, slumping commodity prices) that have provoked sharp falls in funds' NAVs. In some circumstances, in the event of deep liquidity crisis or unavailability of reliable asset prices, the industry has had to take difficult measures, such as temporary suspension of redemptions, temporary suspension of the calculation of NAVs or placing funds on liquidation. However, **only on very rare occasions banks have decided to step-in providing support to funds they manage and/or they commercialise**.

Finally, banks' capitalization of the risks of their asset management activity are already under review after the publication of the consultation paper of the measurement of operational risk; the paper proposes to make mandatory the use the revised Standardised Measurement Approach (SMA) that takes into account the level of historical operational losses, which incentivises banks to enhance their risk management and control functions.