A response by the British Bankers Association to the Basel Committee on Banking Supervision's consultative document on:

Identification and Measurement of Step-in Risk

March 2016

Introduction

The BBA is pleased to respond to the Basel Committee's consultation paper on identification and measurement of step-in risk.[1]

The BBA is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. It has over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. Eighty per cent of global systemically important banks are members of the BBA.

As the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management.

Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

Many of our members have relationships with shadow banking entities and therefore have an interest in the BBA responding to this Basel Committee consultation on their behalf.

Key Messages

[1] https://www.bis.org/bcbs/publ/d349.pdf

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The financial crisis highlighted the need to improve transparency not only in the traditional banking sector, but also for shadow banking entities. Furthermore, the provision of financial support from banks to certain shadow banking entities indicated that the transfer of credit risk to the latter was in some cases ineffective. We generally support the Committee's general objective of addressing the risks in banks' interactions with shadow banking entities. Nevertheless, we have serious reservations about whether the proposed requirements in this consultation paper are the most appropriate or indeed necessary measures for addressing the risks presented by banks' relationship with shadow banking entities to the financial system. We recommend that further analysis of the Committee's proposals should be carried out once the Quantitative Impact Study has been completed to develop an informed view of step in risk.

The regulatory architecture has been improved to discourage step-in risk

Our members note that the issue of step-in risk is not as prevalent currently as it was at the height of the financial crisis. The circumstances prevailing during the crisis were extreme for the industry as a whole. Lessons have been learned and risk appetites changed. Capital requirements, particularly in relation to trading book exposures, have been substantially increased, to prohibit if not discourage stepping-in. Thus, the risk of step-in by banks to provide financial support to other entities beyond any contractual obligations is no longer at levels compared to those experienced during the crisis.

In addition to increased capital requirements there is a very comprehensive body of ongoing regulatory work which addresses risks presented by shadow banking and off-balance sheet activities. These include the European rules on enhancing transparency of SFTs (SFTR),[2] the EBA guidelines on limits on exposures to shadow banking entities,[3] the EBA consultation paper on implicit support for securitisations[4], as well as the Volcker Rule in the US. In addition, as recognised in the CP, new accounting standards introduced after the crisis have improved the accounting criteria for consolidation of SPEs and the related disclosure requirements. For example, IFRS 12 states that the new requirements should help evaluate the nature of, and risks associated with, a reporting entity's interest in other entities and the effects of those interests on its financial position. Further, while the proposal acknowledges that the Basel II framework captures reputational risk and implicit support within Pillar 2, it is unclear why Basel considers this framework to be inadequate and how to address this deficiency. Indeed, the Pillar 2 guidance captures the same activities the proposal describes, including when banks provide implicit support to entities that they may sponsor or originate. The Basel II framework also acknowledges that these risks are not easily measureable. Therefore, our members are of the view that the ongoing regulatory developments with respect to shadow banking, complemented by enhanced accounting standards, already act as a mitigant to the risks of implicit support to the financial system. Taking these developments into account, this proposal should assess the probability of step-in risk and the probability of credit or liquidity support that would be provided. Full or partial consolidation methods, as well as the application of conversion factors, are blunt solutions for a residual risk. Assessing the likelihood and extent of support would be consistent with the probability of default and loss given default methodology within the credit risk framework. We question whether further measures, as proposed in the CP, are necessary.

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[2] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2015-0387+0+DOC+PDF+V0//EN

[3] https://www.eba.europa.eu/documents/10180/1310259/EBA-GL-2015-20+GL+on+Limits+to+Exposures+to+Shadow+Banking+Entities.pdf

[4] https://www.eba.europa.eu/documents/10180/1340842/EBA-CP-2016-01+%28Consultation+Paper+on+Guidelines+on+implicit+support%29.pdf

The intended scope of the proposed framework is unclear and the consultation has included a wide range of possible entities including funds, asset managers, joint ventures, special purpose vehicles and critical services providers. The consultation has not provided an impact assessment of the proposals at this stage therefore the current proposals could potentially have wide ranging and high impact. If banks that have sizeable assets under management were to attract punitive capital charges this could pose challenges for their future involvement in the fund management business and result in an unintended outcome.

Impact on Market Liquidity

The CP should also consider the potentially far-reaching implications for market liquidity, which is already suffering in the wake of financial reforms and the low interest rate environment. As banks continue to digest the suite of regulations which have compounding impacts on various asset classes, it would be helpful if the Committee paused to consider the combined effects before proposing such a sweeping regulation. For example, when a bank participates in a securitisation as an agent, there is no presumption of reputational risk on the part of the bank in spite of one or several indicators being triggered. Indeed, banks acting as agents do not support these securitisations vehicles, and there is no investor expectation that they do so. This proposal could considerably restrict EU banks' ability to sponsor securitisations, further impeding securitisation issuance in that region broadly.

Existing Legal Frameworks

Added to the above points, the CP could also serve to undermine existing legal frameworks. Typical contractual arrangements outline the protocol and unwind mechanisms in an entity's bankruptcy scenario and banks have governance processes to consider and limit the potential for implicit obligations outside of contractual arrangements. A regulatory presumption of support based on the indicators could interrupt these legal arrangements, and have the potential to cause confusion and inconsistencies if not also additional legal and operational risk. For example, if legal contracts outline appropriate creditor loss arrangements, how would a bankruptcy judge consider a bank that holds capital for the potential support of an entity? This interplay is further complicated by various jurisdictions' differing bankruptcy codes.

It is not all about reputational risk

The consultation asserts that the sole driver of banks 'stepping-in' is reputational risk mitigation. While it may be true historically that in many cases banks opted to support certain shadow banking entities as opposed to allowing them to fail so as not to face reputational damage, this should not be regarded as the only motive of step-in risk. Rather, such implicit support could also have been provided as a mechanism to prevent a risk from becoming more systemic. Without practically linking the framework to reputational risk, it is unclear how step-in risk is different from the support of unconsolidated entities motivated purely for economic reasons and not rooted in reputational risk. For example, a bank may have an equity investment in an entity which is experiencing idiosyncratic stress (regardless of the market environment). This bank may elect to extend a loan to the entity to protect its investment and/or because the terms of the loan itself are expected to be profitable to the bank. This is no different from any transaction a bank may normally enter, as a risk-taking institution, but only upon entering such a transaction would the bank be expected to capitalise for it. For this reason, the consultation should recognise that implicit support can, in some circumstances, actually be supportive of systemic stability and thus for financial institutions generally, but that capital need not be held against such an outcome. Linked to this point, it should be mentioned that banks sponsoring an investment vehicle may intervene in case of the latter's default not in order to support it, but to liquidate it and realise the collateral it may be holding. Thus, such a case would not be a result of reputational risk.

Incorporating the step-in requirements

We do not accept that upfront capital requirements are the appropriate mitigant for addressing step-in risk. Placing up-front capital requirements on banks could be misconstrued by the market that banks would inevitably step in to support the shadow banking entities irrespective of whether the banks intend to or not.

Were the Committee to insist on incorporating step-in risks within the Basel framework, and we do not believe they should, BBA's members are of the view that they should not be Pillar 1 requirements. Rather, the requirements should be incorporated under Pillar 2, since, the circumstances for each bank's step in risk would have to be assessed individually using supervisory judgement and would align to existing Basel II Pillar 2 guidance for addressing reputational risk and implicit support. As mentioned above there already exists current provisions within Pillar 2 to address reputational risk and implicit support and we recommend that the Committee focus its efforts on operationalising the guidance with the proposed indicators to help firms and supervisors assess step-in risks. After a further iteration of the proposals, which we strongly recommend, we would be happy to engage with the Committee about the optimum route to implementation should the Committee continue to believe it is necessary to incorporate step-in risk in the capital framework.

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

Our members generally support the principles upon which the framework has been built, except for Principle 1, which proposes that the framework should anticipate the situation after step-in, which we wholly disagree with. Nevertheless, the principles must recognise that implicit support does not occur solely due to reputational risk factors, and as a result that stepping in may in certain cases lead to a favourable outcome for the financial system as a whole. It is important for this point to be highlighted in the principles, should they be introduced, so as not to prevent institutions from stepping in where doing so may be more widely beneficial. Furthermore, comparability also needs to be a key component of the framework – while we do recognise that it is covered by Principle 2, a more explicit reference would be welcome to ensure requirements could be implemented consistently.

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

The current primary indicators included in the CP are for the most part based on the concepts of sponsorship and influence of the bank over the entity. BBA members believe that these indicators could be simplified, by merging some of the indicators within the sponsorship/influence categories and reducing the total number of primary indicators. This will bring the framework to greater alignment with principles 2 ("the framework should be simple and should foster consistent implementation") and 4 ("the framework should be readily operational"), as reducing complexity (which we support in all regulatory initiatives) will allow step in risk situations to be more easily identified.

Moreover, we note that some indicators seem to apply to already consolidated entities, such as indicator 7 (Dominant influence with capital ties > 50%). Since such a relationship would be already captured by the accounting framework (as recognised by the CP), it is unclear why it is considered as an indicator. In addition, in cases of full sponsorship, banks would already be holding capital against entities, suggesting that additional capital on top of this may not be required.

Lastly, our members are unclear about the scope of "exclusive critical services providers" under indicator 11. In addition, it is not always obvious how a relationship with a critical services provider may indicate risk of stepping in. For example, the CP states that if there is a substitute for the entity's services, but it would be highly costly to implement these new services, then it may be presumed that step-in may occur – however, more clarity is required on how 'highly costly' can be defined and the threshold after which step in risk is deemed likely. Therefore, we would welcome further clarification on this indicator.

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?

Overall, the secondary indicators included in the CP are in our view quite subjective, making them difficult to apply on a consistent basis. Furthermore, for some of these indicators, it will be difficult for the regulator to assess whether or not they are applicable in each case, particularly because, in some cases, there is a lack of clarity on the information sources regulators will use in assessing whether a secondary indicator applies. For example, it may not be easy for regulators to assess indicator 'k' ("Investor ability to freely dispose of their financial instruments"). This conflicts with principle 4, which argues that the framework should be readily operational. It should also be noted that IFRS 12 already presents implications for capital, thus questioning the need for indicator 'l' ("Assessment of IFRS 12 disclosure"). Lastly, the 'Branding' indicator hints at sponsorship of the entity, and thus could potentially fall under the primary indicators.

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?

We believe that the full consolidation approach is not an appropriate mechanism to reflect step in risk. As mentioned in the CP, it may not be feasible in some cases, as the entity to which support was provided may already be consolidated by another group. With respect to proportional consolidation, it should in theory have a higher impact than the conversion approach, as the latter applies to cases with low implicit support. However, it may often be the case that banks do not have access to the information on some entities necessary to consolidate This is recognised as a possibility in the CP, albeit that it is stated that the cases where a bank cannot gather the necessary information from an entity, over which it is exposed to a relevant risk of step in, are not common in practice. Given the shortcomings in the consolidation approach, conversion could potentially be the more plausible approach. In assessing the different approaches for countering step in risk, the Committee should consider however the mitigants already in place under other regulations, such as the previously discussed limits to individual exposures to shadow banking entities, set by the EBA, which is applicable from the beginning of 2017).

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

As mentioned earlier, because there are already many global initiatives already in place to counter the risks posed by shadow banking entities, the measures included in this consultation appear to be superfluous and should be completely withdrawn, if not simplified at least. Our view is that a consolidation approach (either full or proportional) is not an appropriate measure, and thus the conversion approach could potentially be utilised to reflect step in risk. As a result, this should be taken into consideration in the proposed mapping of indicators to their respective measure. Another aspect to take into consideration in this mapping process is the proposed simplification of the list of primary indicators by merging different indicators under the 'sponsorship' and 'influence' categories, as discussed earlier.

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

Our members note that with respect to financial support, proportionate consolidation is already the approach used in respect of investments in joint ventures. Nevertheless, our members argue for the use of the conversion approach where step-in risk would need to be reflected even in the case of Joint Ventures currently outside of the scope of prudential consolidation.

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

With respect to the additional indicators specifically for asset management entities, our members note that where the bank has provided explicit guarantees to meet a shortfall in the fund's returns, then capital against this contingent exposure would already be held. We remain unconvinced that the measures proposed in the consultation are necessary in the light of the range of measures that have already introduced to mitigate step-in risk.

We would of course be delighted to discuss our response with the Committee in due course but importantly believe that a range of new measures introduced since the global financial crisis have significantly reduced the likelihood of step-in risk crystallising and removed the need for further regulatory requirements in this area.

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