

March 17, 2016

Secretariat of the Basel Committee
on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel, Switzerland

Dear Basel Committee members:

Re: CBA¹ Comments on the BCBS consultative document: *Identification and measurement of step-in risk*

We thank you for the opportunity to provide comments on the BCBS's consultative document, *Identification and measurement of step-in risk* ("consultative document"). As an overall comment, we believe the Committee has not adequately communicated what gaps are perceived to exist in the current Basel III regulatory framework in relation to step-in risk, and the work performed by the Committee to assess these gaps. The basis of this work would help in better understanding the motivation behind the framework proposals and what scope they seek to address. With this in mind, we are pleased to note that the Committee considers the proposals to be preliminary and to the extent that the Committee determines to advance the proposals, we would welcome the opportunity to provide additional feedback through a second consultative process.

We are also pleased that the Committee recognizes that concerns over step-in risk may already be addressed through various local reforms ranging from accounting and regulatory capital, to legislative reforms. As such, we encourage the Committee to incorporate in their proposed principles the ability of jurisdictional supervisors to minimize any overlap or duplication with current, pending, or expected future regulations. We also provide our views on the definition of step-in risk, the flaw in categorizing reputational risk as credit risk, implications of the differences between accounting vs. regulatory scope of consolidation, and the regulatory environment in Canada which we believe already addresses the step-in risk the Committee seeks to address. More detailed comments are included in the attached appendix.

¹ The Canadian Bankers Association works on behalf of 59 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

Definition of step-in risk

The Committee suggests that step-in risk exists “beyond or in the absence of any contractual obligations” to provide financial support to certain types of entities. We are concerned with the broad scope of the definition and believe that any requirements need to be practical to ensure effective implementation. We do not believe that regulators should pre-suppose the occurrence of events that are not explicitly provided for in contracts to a great extent and are concerned that the step-in risk proposals, if implemented, would allow for very subjective conclusions about the activities that are scoped in by an entity. Varying interpretations by different banks will only introduce more inconsistency in risk measurement. It is important that any rules (to the extent they are deemed necessary) are clear and can be applied in a consistent manner. In addition, we are extremely concerned that the proposals would be applied to entities that the BCBS did not intend to capture.

Categorizing reputational risk as credit risk

We also note the Committee’s observation that it views reputational risk as the principal cause of step-in risk. However, we note the proposed use of credit conversion factors under the conversion measurement approach suggests the intent may be to categorize reputational risk as a form of credit risk under the proposed framework. Reputational risk is not credit risk and we do not believe it should be included in this category.

We are also concerned that while the Committee’s proposal focuses on how to measure EAD and LGD, it is silent on PD in the assessment of step-in risk. For example, we note that the likelihood of a step-in event is not included as a primary indicator in the framework which we find unusual given the fundamental aim is to ensure accurate risk measurement. Nevertheless, we believe that PD factors are not quantifiable for reputational risk and this further underscores the fact that it is inappropriate to characterize this risk as a credit risk. Moreover, we firmly believe that a Pillar I approach would not be a suitable or appropriate approach to assess regulatory capital on this type of risk.

Accounting vs. regulatory scope of consolidation

We also have concerns over the potentially inconsistent use of the “unconsolidated for accounting purposes” versus “unconsolidated for regulatory purposes”. Initially, the Committee notes that its proposals only apply to unconsolidated entities that “are out of the regulatory scope of consolidation”. Later, however, we note that certain parts of the consultative document focus on accounting consolidation (i.e. paragraph 19) and that full consolidation is one of the measurement approaches proposed. We assume this is notional consolidation for measurement purposes and not actual consolidation as any changes to accounting rules should be driven by the appropriate accounting standard setters.

To this end, we are concerned about the attempt to create a significantly different regulatory consolidation balance sheet versus relying on an audited IFRS balance sheet. This could result in the requirement for two sets of books and would pose a challenge for gathering/maintaining data that has not historically been maintained as envisioned in this consultative document. Currently, many Canadian banks do not have differences between regulatory consolidation and accounting consolidation (with the exception of the required exclusion of insurance subsidiaries under the Basel II framework).

We also note that IFRS 10 *Consolidated Financial Statements* outlines the requirements for the preparation and presentation of consolidated financial statements, requiring entities to

consolidate entities it controls. Control is a well-entrenched concept which requires exposure or rights to variable returns and the ability to affect those returns through power over an investee. Furthermore, IFRS 12 *Disclosure of Interests in Other Entities* requires banks to disclose significant exposures to unconsolidated structured entities as well as the banks' maximum exposure to loss arising from contractual relationships with these entities. The remainder of the exposure would be taken into account via the banks risk management and mitigation processes. We believe that all stakeholders are currently well served with the quality of disclosure on entities not consolidated.

We therefore believe that the Committee's sole concern should be that entities with step-in risk are being captured within a regulatory framework and the focus should not be on consolidation. As long as similar shadow banking entities (such as sponsored securitization conduits) are being treated consistently under the applicable regulatory frameworks, including capital frameworks, we believe the Committee should be satisfied that any related step-in risk has been addressed or mitigated. Expanding the scope of regulatory consolidation would have implications not only for risk-weighted assets and capital ratios but also for other ratios such as the leverage ratio and the LCR.

Regulatory environment

If the BCBS proceeds with its proposals on step-in risk, we believe that a Pillar II approach is the only way to assess capital requirements for reputational risk with any degree of accuracy. Assessing the likelihood of a bank "stepping-in" is very subjective, and inconsistent with a Pillar I approach which relies on an accurate measurement basis. We also note that banks regulated by the Office of the Superintendent of Financial Institutions (OSFI) in Canada may already hold an element of Pillar II capital as a buffer to cover risk that has been notionally attributed to reputational risk. Reputational risk should be assessed as part of a bank's ICAAP and discussed with national regulators. Banks should consider whether such risk is material and quantify it, if applicable. Requiring entities to hold step-in risk capital using prescriptive approaches may result in holding a higher amount of capital than the empirically observed risk. This is punitive, and does not meet the objective of a more risk sensitive measurement, which we understand underpins the BCBS proposed regulatory reform package.

Prescriptive measurement approaches may also give rise to unintended legal or market consequences by creating an expectation in the financial markets that banks will in fact provide non-contractual support and 'step-in' in a manner consistent with the scenarios contemplated in the consultative document. Requiring banks to provide capital against non-contractual risk as proposed in the consultative document could in effect send a 'false signal' to the market that banks intend, in times of stress, to provide support to the entities contemplated in the consultative document beyond their contractual obligation to do so. As a result, these expectations may give rise to what may be deemed by the market as constructive obligations for banks to provide such 'step-in' support. We believe that such an outcome is a neither desired nor an intended result of the consultative document and proposed requirements.

Existing capital framework for capturing step-in risk

We believe that other elements of the existing regulatory framework address different types of investments, structures, and services that may give rise to step-in risk as described below.

Significant investments

In our view, significant investments should continue to be subject to regulatory capital treatment under the threshold deduction calculation for "significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation". Significant

investments already require a considerable amount of capital in the existing capital framework. Significant investments in commercial entities attract 1250% risk weight and significant investments in financial entities require a capital deduction subject to a 10% individual and 15% basket CET1 threshold. The non-deducted portion of the significant investments in financial entities is then subject to a 250% risk weight. Depending on the extent of significant investments in the credit portion of the basket threshold calculation, banks could already be holding a large amount of capital against an unconsolidated significant entity. Given this Pillar I capital requirement for unconsolidated significant investments, any additional capital requirement would be overly punitive.

We also disagree with defining the concept of significant influence, in part, on the basis of capital ties being greater than 20% and less than 50% as noted in the consultative document. We believe that the requirements for significant investments are more appropriate as noted above.

Securitization vehicles

In the case of securitization vehicles in Canada, whether on or off-balance sheet for accounting purposes, developments subsequent to the financial crisis ensure that these vehicles are subject to the same regulatory framework – the LCR framework and the revised securitization framework, and receive the same capital treatment. For example, we include in the determination of Pillar 1 capital any liquidity facilities provided to vehicles that we do not consolidate for accounting purposes. This is done through a 100% credit conversion factor. This is appropriate as notwithstanding that the vehicles do not contain banks' assets they still reflect credit risk related to 3rd party securitizations. Such vehicles are also subject to the disclosure requirements of IFRS 12.

Investment funds and asset management activities

With respect to mutual funds or ETFs in Canada, these products are subject to prudential oversight from recognized regulatory bodies (e.g. Canadian Securities Administrator "CSA") which have implemented a number of regulatory requirement changes in recent years with a similar intent as the BCBS proposal – to improve liquidity and disclosure; restrict securities qualifying as fund underlying assets; enhance maturity limits; and other monitoring requirements to ensure asset management companies or specific funds do not fail in a time of crisis. These prudential regulators exist to protect the investors as well as the sponsoring organizations. We would request that our regulator, OSFI, consider whether the CSA requirements could form the basis for a reasonable collective rebuttal in-line with section 5.2 of the consultative document.

We further note that mutual funds or the provision of asset management services are clearly detailed in offering documents or contracts with the end client. Moreover, the relationship between banks sponsoring mutual funds and providing asset management services is also visible, clearly defined, and understood within the related offering documents and, the economics are disclosed in bank financial results. There are no additional obligations or guarantees that banks provide on these offerings other than where specifically stated in the offering documents.

Finally, it is worth stating that the concern around money market mutual fund failures is not as relevant any longer in Canada or the US given the regulatory changes since the last financial crisis - in particular, recent and proposed changes related to liquidity.

With all of the foregoing in mind, we do not believe that a separate step-in risk framework is necessary as part of banking regulation. In addition to the regulatory measures already in place,

we believe that step-in events may also be addressed through different legislation across jurisdictions dealing with liquidation that may also serve to limit losses.

We thank you in advance for your consideration of our comments, and we would be pleased to discuss our submission at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Daren Hamel". The signature is fluid and cursive, with a long horizontal stroke at the end.

Attachment

cc: Brad Shinn, Managing Director, Bank Capital, OSFI
Joanne Marsden, Director, Policy Performance & Capital Analysis & Reporting, OSFI
Silvano Tittone, Director, Capital Definition & Precedents, OSFI

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

Overall Comments and Key Issues

Step-in risk arises from a non-obligatory event, and the likelihood is very subjective. Mandating that banks hold additional capital for a non-obligatory, non-likely event would introduce a very confusing concept for capital.

Wealth management units could also incur a capital charge because they might encounter higher step-in risks. This could reduce the attractiveness of asset and wealth management as a business line, especially if banks are unable to pass on additional capital costs by increasing fees. To the extent that banks would need to capitalize for the wealth management business, this would also present a disadvantage versus unregulated firms.

The Basel Committee's Liquidity Coverage Ratio ("LCR") already requires banks to determine the liquidity impact of non-contractual contingent funding obligations and asking banks to hold additional capital for step-in liquidity risks could prove too onerous. In implementing the LCR in Canada, OSFI under chapter 2 of the Liquidity Adequacy Requirements notes that the LCR requirements are to address, amongst other things, the potential need for banks to honour non-contractual obligations in the interest of mitigating reputational risk. Accordingly, a potential additional step-in risk framework seems excessive.

We believe that the rules as proposed are prescriptive and the intended reach excessive. For example, Canadian mutual funds including money market funds are not "bank-like" activities and are supported by a robust, complex, and well understood and closely monitored set of securities regulations.

An alternative approach which would better reflect economic risk and market practice would be national discretion for local regulators to include an element of this risk within the Stress Testing scenarios that banks are currently required to complete.

Part 1: Introduction – objectives of the review (p. 2)

1.1 Experience from the financial crisis (p. 2-3)

We do not disagree with the Committee's description of the financial crisis. As a result, we acknowledge that step-in risk with respect to sponsored securitization conduits and other entities should be considered and appropriate measures taken in respect thereof as part of a prudent regulatory framework if the risk has not already been addressed through other regulatory requirements or developments. We believe that this has already occurred in Canada through the development and implementation of accounting and regulatory reforms subsequent to the financial crisis – new securities law requirements in respect of asset-backed commercial paper (ABCP) developed by the Canadian Securities Administrators ("CSA") that restrict the prospectus-exempt distribution of ABCP to a class of highly-sophisticated investors thereby eliminating the step-in risk that existed in respect of non-sophisticated investors investing in ABCP in Canada prior to the

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

financial crisis and the other developments noted in section 1.2 of the consultative document.

We also note that transactions funded through the bank-sponsored ABCP market in Canada performed well during the financial crisis. In most if not all cases, the conduits remained off the banks' balance sheets, other than due to the adoption of new accounting standards (IFRS).

One of the areas that has been cited as banks' rescuing vehicles is the structured investment vehicle (SIV) market. Since the financial crisis, though, we have seen these vehicles exit the market. We do not anticipate seeing any type of re-emergence of this type of vehicle.

We also note that funds in Canada may not follow the same rules and regulations as US mutual funds and therefore were not required to support the fund value or offer liquidity during the financial crisis. Moreover, as evidence of strong governance, increased monitoring was implemented as early warning for potential liquidity issues. As further protection to sponsoring banks, fund returns are not generally guaranteed, other than where specifically stated in the offering documents, and this disclaimer is included in all offering documents.

1.2 Subsequent accounting and other developments since the financial crisis (p. 3)

1.2.1 Accounting developments (p. 3-4)

We disagree with the BCBS's comment that "stringent interpretations of the accounting requirements" [para. 13] would result in vehicles being scoped out of accounting consolidation. In fact, in some cases, consolidation is required under the IFRS 10 rules when this was previously not required. In particular, an entity no longer needs to have the majority of risks and rewards in order to have "significant variable returns" which, when combined with power over an investee's key economic activities, would result in consolidation. We believe that IFRS rules which are principles-based would not be blindly applied stringently. Each transaction/vehicle is unique and requires an assessment.

Again, we do not believe the Committee should be targeting off-balance sheet entities (see para. 19) provided they are adequately addressed under a regulatory framework and properly disclosed in accordance with IFRS 12. We believe this is the Committee's intent, but it is not always clear.

1.2.2 The Basel Committee reforms (p. 4)

We suggest that the reforms reflected in the LCR framework related to "contingent funding obligations [that] may be either contractual or non-contractual and are not lending commitments" and the revisions to the securitization framework would be sufficient to cover issues related to step-in risk surrounding securitization conduits and SIVs.

Recent Basel Committee reforms (Liquidity, Revised Securitizations Framework) have addressed "step-in" risk from the position of a sponsor

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

of a conduit funded through ABCP irrespective of whether the conduit is on or off balance sheet for accounting purposes. The overlap is confusing. Please clarify as to when each standard should apply and what has changed to override the recently revised securitizations framework.

1.2.3 Other reforms (p. 5-6)

No comments.

1.3 The continuing need for a prudential approach (p. 6-7)

We believe it will be difficult to apply the proposed framework consistently across jurisdictions. More defined requirements would also be necessary for measuring step-in risk. We believe the Committee should focus on key relationships that are considered problematic.

Part 2: Proposed conceptual framework: overview (p. 8)

2.1 Principles for the review (p. 8)

The cost of implementing the principles (i.e. cost of capital required, monitoring controls, loss of performance within the fund), could exceed the return for operating MMFs. This potential outcome would negatively impact the profitability of a sector which is already well governed by national prudential regulators such as the CSA and has demonstrated low risk historically.

The nature and magnitude of step-in risk for MMFs varies across jurisdictions due to the nature and use of these types of funds within each market. For example, the more retail-purchased/longer holding term within Canada presents a lower risk profile than the more institutional-purchased/short holding term in the US. Calibrating the risk across jurisdictions using prescriptive "one size fits all" rules may result in an unequal playing field and reduce meaningful risk comparability which is the stated intent of the overall BCBS reform package.

Q1. What are commenters' views on the four overarching principles? Are there any others that should be included? (p. 8)

Overall, we believe that the principles are written in a conceptual manner but may be difficult to implement in practice.

Principle 1 does not address the likelihood of the step-in event, and assumes that it has occurred. Ignoring the likelihood results in an extremely conservative view. We also find that Principle 1 is overly conservative if the objective is to replicate the regulatory capital required for the bank assuming step-in has occurred. If the Committee decides to retain this Principle, it should fall within Pillar 2.

For Principle 2, we question how the framework can be implemented in a consistent manner across jurisdictions and banks. Determining

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

step-in risk is a matter of judgment.

We stress that any framework developed should foster consistent interpretation and be readily operationalisable in order to effectively ensure this type of risk is reflected in banks' regulatory capital. Consistent with the principle of simplicity, the Committee should also be conscious of minimizing the time and resources banks would need to devote to monitoring and evidencing compliance. The Committee should also be mindful of any unintended consequences of misleading the market from the introduction of a new step-in risk framework.

2.2 Terms used in this document (p. 9-11)

We believe that any proposed framework should be simple, straightforward, and not be open to interpretation to ensure consistency across jurisdictions in alignment with Principle 2 in the consultative document.

The proposed definition of shadow banking entities includes mutual funds and asset managers. This appears to be a stretch of the term since neither of these are banking activities, nor do they include in general an element of guaranteeing any set return (other than where specifically stated in the offering documents). They do operate under offering documents or contracts that clearly articulate to the investor the details of what is being provided and they do operate very publically – i.e. they do not operate in the shadows, and are not hidden or masked in any way as to which financial entity is providing the offering, the connection of those entities to each other and to the financial institution that they are owned by.

2.3 Overview (p. 12)

It is unclear how any step-in risk would be measured to ensure that it only captures the incremental risk above and beyond what is already captured as part of the off-balance sheet exposures. A few examples:

- Liquidity facilities of securitization exposures (at 100% of exposure) are fully captured for both risk-capital and leverage.
- For equity-accounted investments (unconsolidated), banks already capitalize the equity investment.
- Critical service providers – associated operational risk is already captured.

It would be useful in the assessment of this conceptual framework to identify how step-in risk would be quantified and how the framework would be operationalized.

Paragraph 37 indicates “contractual” and “non-contractual” relationships. As noted above in Section 2.2, the services or products offered - whether they are mutual funds or the provision of asset management services - are clearly detailed in the offering documents or contracts

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

with the end client. Furthermore, the relationships between banks sponsoring the funds or providing asset management services and the products or services offered are also visible, clearly defined and understood, with the economics disclosed in bank financial results. As well, as asserted previously, there are no additional obligations or guarantees provided by banks on these offerings (other than where specifically stated in the offering documents).

Paragraph 37 also illustrates the concern over the inconsistent approach to accounting versus regulatory consolidation – should the second sentence not read “in spite of adopted accounting or regulatory treatment” rather than just referencing “accounting treatment” in order to be consistent with the opening sentence of paragraph 37 which provides that a step-in risk assessment would only include entities “not consolidated according to accounting and regulatory frameworks”? We believe that if any perceived step-in risk is being addressed through an existing regulatory framework, further expanding the scope of regulatory consolidation would not be appropriate.

As bank-sponsored ABCP conduits are a part of the securitization framework irrespective of accounting treatment, should we now treat on vs. off balance sheet conduits differently?

Part 3: Identification of step-in risk (p. 13)

We believe step-in risk with respect to Canadian banks has already been adequately addressed by intervening measures since the financial crisis – for instance LCR requirements and the revised securitization framework effectively mitigate step-in risk that banks may have in respect of securitization vehicles through the application of additional capital requirements, while IFRS 10 and 12 deal with the appropriate accounting treatment and disclosure respectively in connection with these vehicles. If not already consolidated from an accounting perspective, Canadian banks treat securitization vehicles as consolidated from a regulatory capital perspective in accordance with existing requirements, thereby having already addressed any step-in risk that may exist.

Also, as noted above, the CSA's new short-term securitized product prospectus exemption that restricts prospectus-exempt distributions of ABCP to a class of highly-sophisticated investors has addressed the step-in risk that existed pre-financial crisis in respect of non-sophisticated investors investing in ABCP in Canada.

The Committee should give careful consideration to the question of whether there is an underlying incentive to provide step-in financial support. In extraordinary circumstances and on an exception basis in limited situations, banks may voluntarily choose to step in, to mitigate a situation – but this action is extremely rare. It seems over reaching for the BCBS to propose mandatory capture subject to a prescriptive set of indicators.

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification
3.1 Primary indicators (p. 13)
3.1.1 Use of the sponsorship concept (p. 13)
Based on the listing of indicators, mutual funds and asset management services are likely in scope of the proposed rules; however, as noted above where the likelihood or risk is exceptionally low and totally voluntary, it seems inappropriate to assign prescriptive approaches to capture risk on a mandatory basis. Contractual obligations of sponsorships may differ from other relationships (ownership). We do not see a need to expand capital requirements in excess of contractual obligations.
3.1.2 Table of primary indicators (p. 14-16)
We are concerned about when an entity is to be assessed against these indicators. We expect this would be done initially and only revisited if there is a significant change in the relationship. The primary indicators to define sponsorship are quite broad. It would be beneficial to provide some clearer boundaries for the identification of a sponsor, in particular: • Clarify that both decision-making powers <i>over key strategic and management decisions</i> <u>and</u> provision of <i>significant</i> financial support are required; • More clear distinction is required between situations where the Bank is acting as an agent and as a principal; • Clarify if the expectation is that only one sponsor exists for any entity or if it is possible to have multiple sponsors, and when these situations would arise.
Q2. What are commenters' views on the proposed indicators for step-in risk? Are there any additional ones that the Committee should consider? (p. 16)
In addition to the concerns noted above, we believe that the likelihood of step-in should be included as a primary indicator. With that being said, we do not believe that step-in risk should fall within the credit risk framework and that it is more appropriately categorized as part of operational risk. We also believe that the BCBS's proposal should distinguish between regulated and non-regulated investments. For example, unregulated

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

unconsolidated entities may have relationships with investors and an obligation to make them whole in the event of a failure. In a regulated environment, there are existing measures in place (i.e. securitization framework) and requirements to file prospectuses, adhere to know-your-client rules, etc.

3.2 Secondary indicators (p. 16-19)

We seek clarification that where a bank has addressed the primary indicators and rebutted the presumption of step-in risk and also made a good faith assessment that it would not support an entity beyond its contractual obligations, that it would not be subject to the step-in risk framework. We note that many of the secondary indicators have a subjective component to them (originator incentives, implicit recourse, composition of investor base, as examples) and we believe they should not be used on their own in assessing step-in 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 (p. 19)

It is unclear why we divide the indicators into primary and secondary indicators given that all applicable indicators would be considered in assessing the extent of the step-in risk. We also question how this can be implemented in a consistent manner across jurisdictions and banks. Assessment of these secondary indicators is a matter of judgment.

3.3 Application and examples (p. 19)

While the examples in this section are all positioned as circumstances that increase step in risk, we also urge the Committee to consider elements where step-in risk is less likely or already provisioned for. This consideration would limit the scope of assets under management subject to step-in risk and reduce potential regulatory capital burden from the proposed rules. For example, we request that the BCBS consider exclusion from step-in risk based on the following criteria:

- Composition of the investor base – i.e. apply step-in risk only where the investor base is not composed of sophisticated investors. This approach may actually reduce the likelihood of banks having to extend financial support to funds beyond contractual agreements or in the absence of contractual agreements. Level of risk and complexity of the fund, where the funds are high risk - if investors have accepted and documented their risk tolerance as high, then the level of step-in risk would likely be low to zero.
- When the entity in a joint venture (e.g. critical service providers) is a regulated banking entity subject to BCBS Pillar 1 minimum capital (including capital buffers) and Pillar 2 requirements for their operations, they should be judged as sufficiently covered with no need to hold additional step-in risk capital.

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

- Materiality threshold – e.g. the number of customers impacted, might be a factor that could contribute to considering step-in risk.

Example 2 illustrates the risk of over conservatism as Bank B is capitalizing its risk facing the SPV by way of accounting consolidation and Bank A might also capitalize its risk facing the SPV if it concludes that it is facing step-in risks.

Part 4: Measurement approaches for step-in risk (p. 20)

4.1 The range of measurement approaches and their comparative advantages (p. 20-21)

It is not clear what method would be applied to money market funds, as they are off-balance sheet, not owned by the bank, and carry relatively low risk (holding high quality short term investments). We urge the Committee to not include requirements (e.g. via high credit conversion factors) akin to a full consolidation. A full consolidation would be unfairly punitive and likely misleading. Attempting to quantify the exposure would be challenging and would include many subjective judgements.

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? (p. 21)

We disagree with either the full or proportionate consolidation approaches as they are overly conservative. The conversion approach is preferable amongst the 3 proposed approaches. Overriding a well-entrenched and understood concept of control and bringing in an ambiguous concept of step-in consolidations would be a far too conservative measure especially when the likelihood of step-in has not been assessed.

Another alternative would also be to include some component of step-in risk as a required element within regulatory stress testing scenarios. The Committee should also consider requiring enhanced note disclosures similar to other financial instrument risk disclosures using sensitivity analysis based on value of funds exposed to step-in risk, or a prescribed or other percentage-calculated value at risk approach.

Fundamentally, we understand the need to consider situations where the bank might have an incentive to step-in and capitalize accordingly. For example, a bank might securitize a portfolio of assets. One could argue that the bank has an incentive to step-in and support the assets in the event of an unexpected change in underlying asset performance. But the bank likely has strong governance processes in place and has made very clear disclosures that it will not provide support. It would be most unfortunate if the effect of the assessment approach was to disincite the risk mitigation effort of the securitization. We believe most of these risks are adequately covered elsewhere in the Basel framework.

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification
4.2 Mapping of primary indicators with measurement approaches (p. 22-23)
If MMFs were required to be consolidated, this could lead to low-risk products being charged punitive financial reporting and regulatory capital treatment, which could result in banks no longer offering these funds as part of their product line-up.
<i>Q5. What are commenters' views on the proposed mapping between the primary indicators and the potential approaches? (p. 23)</i>
We disagree with either the full or proportionate consolidation approaches as they are overly conservative. With either approach (but more acutely in the full consolidation approach), there is a possibility for multiple banks to be required to capitalize for the same risk in an entity. The conversion approach is preferable amongst the 3 proposed approaches. Further, the recognition of goodwill and other intangible assets that result from consolidation accounting could give rise to unwarranted levels of required capital, perhaps exceeding the carrying value of the investment.
Part 5: Other matters, including consideration of specific cases (p. 24)
5.1 Inclusion of other cases based on supervisory judgement (p. 24)
We do not believe section 5.1 is appropriate. The primary and secondary indicators and the presumption of step-in risk provide a sufficiently robust assessment process. We do not believe that a regulator should have the ability to override this assessment process and determine that a step-in risk exists where a bank has successfully rebutted the presumption. We recognize that practically, especially given the subjective nature of certain of the secondary indicators, a regulator will have this power anyway, but in principle we do not believe this arbitrary power should be specifically given.
5.2 Collective rebuttals (p. 24-25)
As noted earlier, mutual funds in Canada are highly regulated by securities regulation (National Instruments) which are well understood, and supported by robust regulatory audit programs to ensure compliance with those regulations. There are strict regulations around the

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

requirements to provide clearly defined offering and continuous disclosure documents to all clients. Given these facts it seems unfair to introduce what is essentially a BCBS regulatory capital "buffer" that ignores well established industry governance practices, empirical evidence of immaterial losses from step-in risk, and that assumes additional financial obligations that go above and beyond what is mandated and publicly disclosed. Moreover, as noted previously, given the BCBS has implemented comprehensive requirements under the LCR to address reputational risk, the proposed step-in risk requirements seem punitive and duplicative.

5.3 Joint-ventures and proportionate consolidation (p. 25)

No comments.

Q6. What are commenters' views on proportionate consolidation for joint-ventures? (p. 25)

We are concerned about the BCBS's attempt to create a significantly different regulatory consolidation balance sheet versus relying on that prescribed by the IFRS or FASB. The requirement for two sets of books, a regulatory one and an accounting one, would pose a challenge for gathering/maintaining data. As noted in the comments for Section 3.3, joint ventures that are part of a consolidated entity subject to OSFI or BCBS regulatory capital rules should be out of scope for the proposed rules.

5.4 Asset management activities and funds under management (p. 26)

Asset management of funds at market risk are not subject to step-in risk under anything except the most extreme circumstances. The instances of banks having to step in during market events for their funds (including money market funds) are rare to nil.

Funds managed by banks (excluding money market) are held by investors and are redeemable at their option. However, funds in Canada are permitted up to 5% overdraft to fund redemptions, providing liquidity to manage flows in an orderly manner.

The funds regulator in Canada permits fund managers to apply to suspend redemptions in the event of disorderly markets. This stop-gap measure was used by the fund industry in Canada during 9/11 events.

Fund regulations in Canada provide a strict regulatory framework to ensure funds are adequately managed to ensure liquidity. To that end, the OSC conducted a market review and published their findings and recommendations^a. As noted throughout this response,

CBA Members' Comments and Requests for Clarification

additional regulations from the BCBS would be duplicative, punitive, and overstep local securities regulations:

^a https://www.osc.gov.on.ca/documents/en/Securities-Category8/ni_20150625_81-727_portfolio-liquidity.pdf

The Amendments introduce new investment restrictions for money market funds under new section 2.18 of NI 81-102. That section includes new liquidity provisions requiring a money market fund to have at least 5% of its assets in cash or readily convertible to cash within one day and 15% of its assets in cash or readily convertible to cash within one week. It also includes a new dollar-weighted average term to maturity limit of 180 days that is to be calculated based on the actual term to maturity of all securities in a money market fund portfolio.

These new requirements are intended to respond to the 2008/2009 credit crisis and its specific impact on Canadian money market funds and also keep pace with similar regulatory changes implemented for money market funds in other major markets. We anticipate the new requirements will benefit Canadian money market funds by making them more resilient to certain short-term market risks, including interest rate risk, liquidity risk and credit risk. The CSA will continue to monitor ongoing regulatory developments impacting money market funds in other global jurisdictions and consider the need for similar changes in Canada.

Related to the new money market fund requirements is an amendment to NI 81-106 which now no longer permits an investment fund to aggregate certain types of short-term debt in the fund's statement of investment portfolio. This change will increase the transparency of investment fund portfolio holdings and allow investors to better evaluate the risks associated with an investment fund's short-term holdings.

SEC adopts Money Market Reform Rules (July 2014)

<https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679>

SEC proposes liquidity management rules for mutual funds and ETF's (Sep 2015)

<http://www.sec.gov/news/pressrelease/2015-201.html>

5.4.1 Additional indicators specific to asset management (p. 26)

**CBA Comments on BCBS's Consultative Document
'Identification and measurement of step-in risk'**

CBA Members' Comments and Requests for Clarification

Where banks offer guarantees or investor expectations are likely higher than standard 'at risk' funds (e.g. RRSP funds), specific de-risking investment management techniques are employed to mitigate any step-in risk. In addition, where the bank provides guarantees, guarantee exposures are already captured in consolidated bank financials and OSFI regulatory capital. Requiring additional step-in risk would be duplicative and punitive in these circumstances.

5.4.2 Specific approach to asset management entities and funds (p. 26-27)

The application of prescriptive, arbitrary notional factors (e.g. the 1.0% of total asset value) and credit conversion factors does not differentiate between organizations that prudently manage the value-at-risk vs. those that do not, and goes against the BCBS' stated intent of increasing risk sensitivity in their regulatory reform package.

We urge the Committee to lower the proposed step-in risk capital burden, where there is demonstrated regulatory oversight, by first considering the exclusion from scope of those assets under management with low to zero step-in risk as noted in Section 3.3, and also by considering a reduction in the proposed arbitrary notional factor of 1.0%.

Q7. What are commenters' views on risks stemming from banks' relationships with asset management activities and funds and the appropriateness of the direction envisaged? (p. 27)

Currently included in regulatory consolidation are all guarantees provided to a client including those given to asset management funds. We believe proposing a threshold for inclusion of 1% of the asset management entity/fund based on a conversion inclusion approach for the assets is not considered a conservative approach.

Instead, we believe any form of commitment/guarantee given should be considered for inclusion in risk-weighted assets. We note that in the variable rate demand note market (VRDN) investors put VRDNs back to remarketing agents due to the credit deterioration of monoline bond insurers and certain banks (i.e. Dexia, Depfa). While initially banks temporarily increased their inventory levels, they were quickly tendered to non-bank financial institutions. We believe that even during the financial crisis such "step-in" risk was mitigated based on the ability to draw upon non-bank financial institutions. Recent crisis situations (e.g. Spanish banks) did not result in any step-in risk.

As noted earlier, the offerings - whether they be mutual funds or the provision of asset management services - are also clearly detailed in the offering documents or contracts with the end client. Moreover, the relationship between banks sponsoring mutual funds and providing asset management services and those offerings are also visible, clearly defined, and understood, with the economics disclosed in bank financial results. As well, there are no additional obligations or guarantees that banks provide on these offerings (other than where specifically stated in the offering documents).