Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

17-1041

Brussels, 12 May 2017

Dear Madam, Dear Sir,

Key observations on the BIS second consultative document on the Identification and management of "step-in risk"

The European Fund and Asset Management Association (EFAMA) welcomes this second opportunity to comment on the BIS near-final *Guidelines* relating to the identification and management of "step-in risks" stemming from banks' possible exposures to unconsolidated non-bank financial entities. The present comment letter wishes to be a concise follow-up to our more extensive response to the first BIS consultation of December 2015.

As a first preliminary consideration, we commend the work of the BIS in substantially refining its initial views around the risks posed by unconsolidated funds to the viability of banks on a going concern. We are glad to note that several of the key considerations expressed in our response to the BIS in March 2016 - notably around the "agency" nature of the asset management business model and around the specific EU regulatory requirements for our industry – have been adequately reflected into the revised version of the *Guidelines*.

A second important consideration is that a bank's potential exposures to investment vehicles and consequent step-in risks deserve to be firstly assessed more accurately on the basis of contractual commitments and in light of the relevant IFRS accounting rules. Although we welcome the fact that the proposed framework is intended to function as a residual "safety net" – and as such would come under the Basel Pillar 2 requirements for those parent bank-licensed institutions – we argue that step-in risk measured purely on a hypothetical basis against the indicators under section 3 of the near-final *Guidelines* would deny the initial purpose of differentiating between consolidated and non-consolidated exposures under existing accounting treatments. As mentioned in our earlier response to the Committee, attempting to model step-in risk would ignore a full range of contingent assumptions which may not be foreseen in advance and which would also largely depend on human judgment. Any *ex ante* estimate therefore risks being partial, if not a gross oversimplification, especially when psychological factors as those tied to brand communication come into play.

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As a final preliminary consideration, with regard to the entity types listed under Annex 2 of the near-final *Guidelines* for which greater scrutiny from the consolidating institution would be warranted, we would exclude all those entities that presently already benefit from a comprehensive regulatory regime under the direct supervision of securities supervisors, especially mutual funds, money market funds, ETFs, certain hedge and private equity funds, REITs and other forms of collective investment schemes (whether open-end or closed-end) (see *infra*).

With the present follow-up response, we nevertheless wish to re-iterate the following key points that in our opinion would still need to be addressed in the Committee's final *Guidelines*.

I. Entities under scrutiny

We would welcome a slight revision of the accompanying Annex 2 to the near-final *Guidelines*, suggesting a range of different "entity types" that would deserve to be assessed based on their step-in risk potential for the consolidating institution. More specifically, we would exclude mutual funds, money market funds, ETFs, certain hedge and private equity funds[1], REITS, as well as other forms of collective investment schemes (whether open-end or closed-end) from the indicative list of Annex 2 altogether, albeit only to the extent these are already subject to their own specific supervisory treatment under existing securities regulations. For the sake of also guaranteeing a level playing-field between those bank groups that include such entities and those that do not, we would therefore suggest that the wording of paragraph 25 of the near-final *Guidelines* be amended to additionally include the regulated fund types above, alongside insurance and bank-regulated entities.

II. Moral hazard

As to the purpose of identifying sources of step-in risk *ex ante*, we observed in our previous response that the *ad hoc* framework intended to anticipate and possibly also quantify step-in risks by prudential regulators risked distorting investor signals by creating moral hazard through announcing, or more subtly manifesting, a parent institution's intent to stand behind any losses deriving from intra-group activities in the absence of an expressed contractual commitment. Assuming, as investors would, that a group parent bank could face extra requirements to shore-up losses in connection with non-consolidated entities would *de facto* alter a fund product's risk profile altogether. The new wording of paragraph 89 under sub-section 4.2.6 of the near-final *Guidelines* attempts to avert the risk of moral hazard "(…) 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". We would question the rationale of such disclosure as it is dubious that market participants would believe it, knowing that a bank and its supervisor have previously gone through the efforts of designing and agreeing on a step-in risk framework intended to confront dwindling market confidence.

III. Liquidity stress/first-mover incentive

Regarding sub-section 3.5, *Liquidity stress/first-mover incentive*, we greatly welcome the references to liquidity management tools – *inter alia*, of redemption gates – to further reduce instances where a

[1] Under the EU AIFM Directive, hedge funds and private equity funds would be classified as alternative investment funds (AIFs). Although these embrace a broad category of investment vehicles, we would definitely exclude step-in risk considerations for those AIFs that are not leveraged on a "substantial" basis (i.e. with a leverage factor of less than 3-times NAV).

bank may need to provide forms of support to unconsolidated structures. However, we continue to question the correctness of the "first-mover" advantage hypothesis, especially with reference to investment portfolios holding less liquid securities as corporate/high-yield bonds. Historically, such hypothesis fails to stand up to scrutiny and largely ignores the sheer diversity of end-investor profiles, each with its own risk tolerance and investment horizon[2]. More generally, one should assume that individual investors deliberately seek market exposures to less-liquid asset classes when acquiring the services of a professional asset manager to manage their savings – whether these be cash reserves, medium- to long-term savings and/or private wealth - in return for a fee. To the extent that financial market risks are borne upfront by investors and duly disclosed in light of extensive regulatory reporting requirements - as presently under the EU's own UCITS and AIFM Directives - any occasion for a parent institution to "step-in" or "bail-in" investors on par with deposit-holders is plainly at odds with the investment rationale and with the *raison d'être* of our industry.

IV. Reputational risk from branding and cross-selling

Based on our reasoning above, investors should also not expect a "bail-in" from a parent bank purely from the fact that a troubled entity shares the same brand. Unlike described under paragraphs 58 and 59 of the Committee's follow-up document, we do not consider risks from branding to be material, also given the strict operational independence between a parent bank and its asset management subsidiaries. Within a financial group, we note that the authorised asset management subsidiary has full decision-making authority (and consequent responsibility) over its own business, from the initial launch to the daily management of its fund product range, adjusting it accordingly to reflect multiple factors, such as investor demands, market conditions and competitive pressures, etc. to name only a few. A bank parent thus neither manages, nor advises the group's asset management business which remains at all times functionally and hierarchically independent accountable to different Boards. That mere branding concerns would suddenly lead a parent entity to pledge uncommitted resources to support a subsidiary, in spite of the strong corporate governance constraints we have alluded to above, would in our view not be realistic. For these same reasons, we would exclude the Committee's analogous considerations made with regard to the parent's "degree of influence" (see sub-section 3.2) and "implicit support" (see sub-section 3.3).

Additionally, there are instances where funds are managed on behalf of independent distributors and branded with the latters' own name or logo, raising the question of whether even fund distributors would deserve to benefit from a "bail-in" regime extended from the management company's parent. The same considerations would hold true with regard to "cross-selling".

V. Historical dependence

With regard to the example referencing money market mutual funds under paragraph 63 of the near-final *Guidelines*, we would note that the European Commission's proposed Money Market Fund Regulation (MMFR) – now formally agreed upon by the EU Council and European Parliament – will expressly foresee a ban on any form of sponsor support, *de facto* making a repetition of banks' support

[2] In this regard, please refer to the EFAMA response to the FSB Consultative Document on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, published in September 2016; available at:
http://www.efama.org/Publications/Public/EFAMA_Reply_FSB_Structural_Vulnerabilities.pdf

of affiliated money market funds for reputational reasons more difficult to fathom. Consequently, we would argue that money market funds offered by an intra-group asset management subsidiary should not, at least in Europe, be classified as contingent funding obligations for the purpose of calculating a bank parent's Liquidity Coverage Ratio (LCR) as per paragraph 82. Similarly, we would dismiss the considerations under the following paragraph 83 with regard to the Net Stable Funding Ratio (NFSR).

VI. The (potential) application of the conversion approach

On the merits of our reservations presented above, EFAMA would dismiss the need for additional potential risk-management measures described under section 4 of the near-final *Guidelines*. For instance, with regard to the conversion approach defined under sub-section 4.1.2, paragraph 80 posits that such measurement should begin by summing-up the total asset (size) of the unconsolidated entity and its off balance-sheet exposures into a single figure. We would firstly note that such an approach in the real context of client portfolio management would inevitably blur the fundamental separation between the balance sheet assets of the consolidating parent entity and the assets under management (AUM) of the fund as an unconsolidated entity. Furthermore it would be inexact to assume that fund entity would inevitably hold assets in the banking group, when the fund's underlying portfolio composition would legally and necessarily need to reflect the chosen exposure agreed in the investment mandate entrusted by the end-investor to the portfolio manager. Secondly, the proposed approach makes another non-realistic assumption, i.e. that the potential impact of step-in risk for a bank could be as large as the fund's AUM *cum* its off-balance sheet exposures. As to the fund's AUM, we again caution the Committee against the risk of moral hazard were AUM to be considered - as per paragraph 80 – as an indicator to gauge the expected size of a bank's possible "bail-in" according to the logic of the proposed framework. Apart from these considerations, we urge the Committee to acknowledge that it is investors, and investors alone, which should bear the brunt of any losses deriving from their investment activity.

Thanking you once again for the opportunity to comment on the substance of the Committee's near-final *Guidelines*, please do not hesitate to contact us for any further clarifications or questions with regard to any of the above views.

Kind regards,

Peter De Proft
Director General