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

Re: Identification and measurement of step-in risk

Dear Committee Members:

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("Federated") with respect to the Basel Committee on Banking Supervision's ("BCBS" or "Committee") preliminary consultation regarding the identification and measurement of step-in risk (the "Consultation").[1] Federated is an investment management firm with operations based in the United States and Ireland. Federated provides comprehensive investment management services to institutions and intermediaries in the U.S., Europe and around the world, including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers.

In relevant part, the Consultation proposes that: (i) banks and bank holding companies incur "step-in" risk if they are likely to provide discretionary support to investment products that are advised by affiliated entities; and that (ii), in light of the risk created by this implied liability, a margin of bank regulatory capital should be required. Federated believes that adopting such a requirement for banks and bank holding companies would be a grave policy error. Instead, Federated suggests that BCBS recommend a ban on banks and bank holding companies engaging in step-in transactions with their advised and sponsored investment funds.

Set forth below is a summary of our specific comments and suggestions with respect to the Consultation.

I. A Regime Of Step-in Capital Would Increase Systemic Risk and Have Damaging Effects On Competition.

The U.S. capital markets are more diverse and resilient compared with many other developed market economies. In particular, savings and investment are intermediated directly through the capital markets and regulated investment vehicles to a far greater extent than in most other countries. This has allowed the banking system to play a relatively smaller role in the U.S. financial system; and this has led to significant gains in overall economic efficiency, competition and capital formation. Furthermore, while the systemic risk posed by the U.S. banking system is still significant, it is less than would be the case if a vibrant marketplace for regulated investment vehicles did not exist. In particular, the direct intermediation of savings through the

[1] BCBS, *Consultative Document: Identification and measurement of step-in risk* (Dec. 2015) ("Consultative Document"), available at https://www.bis.org/bcbs/publ/d349.pdf.

capital markets has enabled investment risk and return to flow directly from issuers to investors without putting government-insured depository institutions at risk.

Step-in capital would inevitably increase the perceptions of a guarantee by the banking entity. For products such as money market and other investment funds, rating agencies and investors would view step-in capital as a credit enhancement. Asset management affiliates of bank holding companies would be reluctant to dissuade investors from this view as it creates a competitive advantage over non-bank advisers. Bank managers would expect a return on the additional required capital. The presence of capital very quickly turns discretionary support to an effective practical requirement.

For these reasons, step-in capital could cause assets to flow to bank-affiliated advisers. Competition would likely be dominated by a few large SIFI banks, similar in outcome to the share that largest U.S. banks currently have in deposits. Smaller bank-sponsored advisers facing higher capital cost would likely be driven from the market, or otherwise exit being ill-equipped to cope with the expectation of support, further reducing diversification in the industry. The "too big to fail" problem would be made still worse as systemic risk would accumulate in the banking system and the efficiency gains from non-bank financial intermediation would be eroded. In order to compete, non-bank affiliated providers could also be forced, by rule or the tilted marketplace, to provide capital. This would have the likely effect of artificially increasing costs and even driving non-bank advisers from the market, thus further reducing competition within the asset management industry.

II. A Step-in Capital Regime Is A Fundamentally Flawed Approach To Address Banking Risks.

Capital requirements can increase a bank's strength, but they must be designed to discourage investors from believing that their investments will be bailed out by a bank sponsor. In the United States, Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Board Regulation W prohibit insured banks and their subsidiaries from providing bailouts to publicly-offered or private investment funds that they sponsor.[2] Likewise, Section 13 of the Bank Holding Company Act of 1956 (also known as the "Volcker Rule") and implementing regulations prohibit banks and bank affiliates from lending to, or guaranteeing non-registered private investment funds that they sponsor.[3] These restrictions must be clearly disclosed to investors, so that they are aware that they may not expect any such bailout of their investment. In addition, U.S. law generally prohibits the Federal Reserve Board from establishing capital requirements for bank holding companies to reflect the activities of sponsored mutual funds.[4]

[2] 12 U.S.C. § 371c; 12 C.F.R. § 223.

[3] 12 U.S.C. § 1851; 12 CFR Part 248.

[4] "In developing, establishing, or assessing bank holding company capital or capital adequacy rules, guidelines, standards, or requirements for purposes of this paragraph, the [Federal Reserve] Board may not take into account the activities, operations, or investments of an affiliated investment company registered under the Investment Company Act of 1940 unless the investment company is— (i) a bank holding company; or (ii) controlled by a bank holding

Thus, U.S. regulation addresses systemic risk by taking the opposite approach from that suggested by the Consultation: it affirmatively separates a bank from "step-in" risk. This approach properly distinguishes between principal risks, for which capital is an appropriate safeguard, and agency risks, where the underlying investment performance should be borne by investors. The failure to adequately separate these risks will lead to an opaque accumulation of systemic investment risk inside bank holding companies, particularly if affiliated advisers offer higher risk products that attract investors who are swayed by the allure of a guarantee by the parent entity.

Banking regulators sometimes refer to "macro-prudential" regulation as a means of controlling risk-taking. In fact, the securities laws and regulations overseen by the SEC constitute a highly effective regime of "micro-prudential" regulation in which investment advisers have fiduciary responsibility. Arguably, this regime has been responsible for preventing widespread fraudulent activity in asset management, such as we have witnessed within the banking industry in recent years. Moreover, the SEC's amended rules for money market funds, and the ongoing rulemaking for liquidity risk management, derivatives and other forthcoming initiatives such as stress-testing, serve to further strengthen regulated vehicles and make the circumstances for step-in risk ever more remote in the U.S. It would be a mistake to interfere with this successful agency oversight model of asset managers by introducing the incentives to instead rely on a principal backstop.

Furthermore, the capital market regime in the U.S. has successfully promoted efficiency, capital formation and competition, which is a statutory objective of the SEC. This statutory objective is consistent with the European Commission's goal of establishing a European Capital Markets Union.[5] The proposed step-in regime would undermine these goals as risk transfers within investment products become less transparent and bank-affiliated asset managers gain a competitive advantage based on an implied (but not contractual) obligation of the parent. Moreover, across the economy, the cumulative amount of capital reserved for this purpose could be quite substantial and socially wasteful as the investment risks should be entirely borne by the fund shareholders directly and not on the banking system or the government safety net.

The step-in risk capital regime proposed by the Committee would therefore have the potential to severely damage the regulated fund industry and the financial system more generally. Regulatory frameworks are not served by confusing the distinction between agency and principal risks. The appropriate resolution of step-in risk for banks and their affiliates is not to reserve capital against it, which would create a financial motivation to engage in the very behavior that the capital is meant to cushion, but to cleanly separate it from other banking activities. This can be accomplished most easily by prohibiting any bank or bank affiliate from providing support to

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company by reason of ownership by the bank holding company (including through all of its affiliates) of 25 percent or more of the shares of the investment company, and the shares owned by the bank holding company have a market value equal to more than $1,000,000." 12 U.S.C. § 1844(c)(3)(C).

[5] European Commission Green Paper, *Building a Capital Markets Union*, (18 February 2015).

investment products managed directly or by affiliated entities. Such an approach would treat all financial institutions equally.[6]

III. Conclusion.

Federated strongly agrees with the existing approach taken in U.S. law and regulation. Investment products should be designed and sold in a manner that allows all their inherent risks to be fully transparent and directly borne by shareholders of these funds. Suggesting otherwise would represent an inherently flawed approach that increases opaque systemic risk while putting in jeopardy the strength and resilience of existing capital market frameworks. The most effective means for banking regulators to address any perceived step-in risk to banks and bank affiliates resulting from asset management is to prohibit financial support for sponsored investments, rather than to enable and ultimately promote such support through capital requirements.

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Federated hopes that the Committee finds these comments helpful and constructive and is happy to provide additional information relating to our comments or discuss any questions you may have.

Respectfully submitted,

Gregory Dulski
Senior Corporate Counsel
Federated Investors, Inc.

[6] If such a ban on bank support for investment products was deemed to create an unfair advantage for nonbank financial institutions, other national regulators responsible for oversight of investment advisers could similarly ban such support by nonbanks.