Comments

on Guidelines-Identification and Management of Step-In Risk (BCBS 398)

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Berlin, 15-May-2017

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 1,700 banks.

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On 17 March 2017, the Basel Committee on Banking Supervision (BCBS) published the consultative document "Identification and measurement of step-in risk". We are pleased to take the opportunity to give our opinion.

The Basel Committee announced in its work programme that the finalisation of step-in would be an activity for 2017 and 2018. Particularly for this reason we would like to point out that we cannot view the guidelines as near-final (as the Basel Committee proclaims in its Background information on page 1). There are too many unclarified issues and too many questions still open. In addition, we see no urgent need to finalise the paper in its current draft version. We would welcome it, if the following suggestions, comments and examples were taken note of and taken into account in further consultations. This further round should ideally be postponed until the Committee's own assessment of the effectiveness of its post-crisis reforms has been conducted and evaluated, so that respective conclusions can be incorporated.

General Comments

The entities and indicators should basically require merely an in-depth evaluation of step-in risk as part of a self-assessment. Any blanket approached that on a case-by-case basis leads to inadequate results are to be rejected. This applies particularly to potential reputational risks in relation to shared "branding". Various constellations are conceivable here that lead to a totally different assessment of reputational risk and hence related potential step-in risk, so that the concrete evaluation of step-in risk should always hinge on the respective individual case.

So far as an institution arrives at the result that existing risks are appropriately and comprehensively reflected, by mapping in their operational risk capital, for example, or with securitisation of equity capital (own funds), by means of a deduction of the first-loss-position, a regulatory consolidation or application of a conversion approach should be waived.

An individual assessment of step-in risk is justified also because the competent regulatory authority can convince itself of the suitability of the self-assessment and so there is no risk of step-in risks' not being adequately taken into account.

Lastly, it is suggested that, in order to pay due regard to proportionality, potential step-in risks should start to be analysed in depth above a materiality threshold. For this, a suitable method should be developed.

We welcome the fact that, in order to take appropriate account of proportionality considerations, potential step-in risk is to be analysed in depth only above a materiality threshold. We believe the Basel Committee should clarify that materiality relates to a bank's balance sheet. Each bank should be permitted to set its own individual materiality threshold, which is then scrutinised by the competent authorities. The Basel Committee should also specify that a materiality evaluation should be applied to all banks which are supervised by the same competent authority.

We request the Basel Committee on Banking Supervision to give concrete illustrations for the determination of step-in risks. These cases should go beyond the indicators and conceptual examples outlined in the Guidelines. The cases should, for example, also show how one could differentiate (residual step-in risk remain), if similarly structured risks were taken into account in the context of operational/reputational risks. Ideally, these cases should be drawn from practical experience and illustrate clearly and simply the basic concept of the as yet uncovered risk of using capital and liquidity in a reputation-preserving manner

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without any legal obligation. Otherwise, there is a danger that in practice there will be unclarities and that lead to excessive hypothetical assumptions on the part of the regulators in the various jurisdictions that in turn result in theoretical and unpractical case scenarios.

We are critical of the fact that there is no adequate consideration in the form of a cost-benefit analysis evident. Nor has the original objective been met of striking an appropriate balance between simplicity and sensitivity, especially with regard to risk-mitigating measures in other regulatory texts.

We consider it purposeful, furthermore, to conduct a QIS and to allow the industry sufficient time to give its opinion.

Specific Comments

Note 14:
We request clarification as to when exactly step-in risk exists. Does it apply when an affiliated entity in the wider sense is in difficulties and there has as yet been no financial support provided by the bank? In relation to the definition of affiliate entity, we request the Basel Committee to make reference to the FSB Guideline "on shadow banking". The scope implied in the Guideline goes further than the FSB definition.

Note 24:
We recommend limiting the sponsor definition to its original purpose as stated in the footnote by replacing the term "defined broadly to" with "Entities where the bank manages or advises the entity, places securities into the market, or provides liquidity and/or credit enhancements." For the debt or equity investor decision we recommend strengthening the differentiation from regular business with the help of the following wording: "Entities, where the bank is an important investor in their debt or equity instruments, excluding any regular business such as lending relationships and investments arising from market making".

Note 33:
Our understanding of the explanations is that a step-in risk is to be ruled out if no significant effects on the bank's liquidity and capital (own funds) position are to be feared? We request the Basel Committee to specify exactly how "no significant effects" should be determined in quantitative terms. In this context, we refer to the LCR, which requires inter alia non-contractual liquidity risks to be covered, and this particularly in stress situations. Even if one assumes that the LCR regulations do not go far enough, overseers and regulators can already today place additional liquidity demands on the banks.

Note 36/37:
As regards securitisation programmes such as ABCP programmes, we think that it is inappropriate to include an ABCP programme which is fully supported by its sponsoring bank, irrespective of whether or not it is consolidated for accounting or regulatory purposes by such bank into the scope of the "step-in risk" regime as the Guidelines imply and we propose explicitly excluding fully supported ABCP programmes for the following reasons:

The Guidelines define "step-in risk" as the "risk that a bank decides to provide financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support." (Note 14)

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A fully supported ABCP programme should already, by definition, not be an entity/a relationship that is covered by the "step-in risk" regime. When a bank decides to fully support an ABCP programme, such support is nowadays typically done by way of a firm liquidity commitment granted to each transaction (e.g., by means of a receivables pool) under the programme. This means that (i) it is a firm commitment of the bank contractually agreed on day one (not left to the decision or discretion of the bank at a later date), (ii) it covers the entire redemption amount of any ABCP issued and outstandings plus accrued interest and costs and (iii) it is not limited to a borrowing base or similar test. I.e. should an ABCP programme so supported face financial stress, the sponsoring bank must provide sufficient liquidity to the for the issuer to redeem and repay all outstanding ABCP, and this is because the bank is contractually obliged to do so. Unlike with partially supported ABCP programmes (which were the most common form of ABCP programmes in the run-up to the financial crisis in 2007), there is no need to provide any support in the absence or in excess of the contractually agreed support ("full means full"). Hence there remains, emerges or re-emerges no "step-in risk" from such a relationship.

It would also be inappropriate, in the light of the objective and purpose of the "step-in risk" regime, to include fully supported ABCP programmes because there is no regulatory "gap" that needs to be closed. The regulatory requirements for liquidity commitments to ABCP programmes have changed dramatically over the last few years since the financial crisis. As a consequence, a liquidity facility which a sponsor bank grants to its fully supported ABCP programme is already subject to intensive regulatory scrutiny and comprehensive measures for all relevant regulatory purposes, including enhanced capital adequacy, liquidity, large exposure, disclosure and risk management requirements. We do not think that the "comprehensive measures" (now proposed under Note 70 et seq. of the Guidelines) can add anything of value here. On the contrary, we fear that measures in addition to the existing regulatory framework would ultimately prejudice fully supported ABCP programmes, making them less attractive and thereby eliminating an important funding tool in the real economy.

We understand the remarks in Note 36 that even agreements on collateral are to be included in the assessment of step-in risk. Here, we include the collateral type "hypothecation of shares/stocks in companies/enterprises" too. In this case, all financial transactions based on this type of collateral would be classified thereunder (irrespective of whether the entity was distressed). We consider the scope far too extensive and oppose such a definition. We request clarification from the Basel Committee.

Note 38/39:
The example should make it clearer that it relates to the appointment of a bank's employees to the board of directors.

Note 63:
The reference to historical occurrences should be limited to cases which since then have not been explicitly regulated, e.g. proposed European legislation on money market funds[1], by referencing par. 29.

Note 64:
Given that the quoted examples only cover existing regulation focused on step-in risk, we recommend removing this indicator.

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[1] Proposal for a regulation of the European Parliament and of the Council on Money Market Funds (http://data.consilium.europa.eu/doc/document/ST-14939-2016-INIT/en/pdf), which includes a ban on external liquidity support to address concerns that other financial institutions might 'step-in' if MMFs experience difficulties.

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Note 72:
According to Note 72, a consolidation ought to be applied in those Note 71-cases to close gaps in issues relating to the incomplete implementation of existing accounting and regulatory frameworks. In this regard, the third bullet point in Note 71 is particularly problematic. This calls for a regulatory full consolidation if the entity is entitled to the majority of the risks and/or of the benefits arising from the activities of the other entity. This is essentially equivalent to the old IAS 27 in conjunction with SIC 12, which with SPVs in the context of securitisation programmes provided for a full consolidation according to commercial law. Even pursuant to IFRS 10, a commercial-law full consolidation has to be made in most of such cases. According to existing supervisory regulations, such SPVs subject to a commercial-law full consolidation are not to be included in the regulatory scope of consolidation, since SPVs are generally not financial institutions pursuant to Art. 4 Para. 1 (26) CRR that are subject to inclusion in the regulatory consolidation. Such entities subject to a commercial-law full consolidation should, for regulatory purposes, then be deconsolidated. Here, the deconsolidation is a prerequisite for capital adequacy relief as a result of an effective transfer of risk from the institution in its function as originator to the SPV.
Without a deconsolidation, the exposure effectively transferred to the SPV would still need a capital charge. Capital adequacy relief would then be impossible.

Whether the sale of receivables to the SPV involved an effective transfer of risk and the securitised exposure can be excluded from the capital charge have in traditional securitisations to be assessed pursuant to Art. 243 CRR. In any case, this must always be assumed, if, for all securitisation positions that it still holds after a sale of securitised exposure, the originator applies a 1,250% risk weight or deduct withdraws these securitisation positions from its CET 1 capital. In this case, the originator's risk is limited to the first-loss position that is assigned the maximum risk weight of 1,250% or deducted from the originator's CET 1 capital. A step-in risk over and above this definitely does not exist in such constellations. In this respect, in constellations in which, owing to the retention of the first-loss position, the originator is entitled to the majority of the opportunities or risks a consolidation of such SPVs should be waived if the resulting risks are already taken fully into account by the maximum risk weight of 1,250% or by the deduction from CET 1 capital. Otherwise, capital adequacy relief by means of securitisation would in fact hardly be possible in the future, since the originator typically holds the first-loss position by virtue of the excess collateral and the funding of a cash deposit. This is not functionally justified in the light of the lacking step-in risk.

Note 77:
If step-in risk exists, then the bank should have the option of choosing the regulatory consolidation or the conversion approach.

Note 87:
We recommend the committee to reconsider the supervisory option to rather apply ex-post punitive charges as a viable priority and superior strategy, which will also balance materiality and proportionality.

Note 89:
Given the highly problematic character of the disclosure we recommend deleting the entire paragraph as this should already be taken care of by existing regulation.

Template 1:
- It is unclear to what the figure "Number of entities" refers. We request clarification.

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- It is, furthermore, not evident where the difference between "Entities were deemed immaterial (no assessment process conducted) and "Entities are material but step-in risk was estimated not significant" lies. Here, too, clarification is requested.

Template 2:
Taking account of every possible entity on which a step-in risk is based and to quantify the impact on CET1, Leverage Ratio, LCR and NSFR would require an unjustifiable effort. We do not consider this appropriate and suggest that a materiality threshold be considered.