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Comments on Consultative Document:

16 March 2016

here: Identification and measurement of step-in risk

Dear Sir or Madam,

Enclosure
GBIC comments

The German Banking Industry Committee (GBIC) very much appreciates the opportunity to comment on the Basel Committee's consultative document on Identification and measurement of step-in risk.

Please find enclosed our response to this consultation.

We hope you will find these comments helpful and would be happy to discuss these with you.

Yours sincerely,
on behalf of the German Banking Industry Committee,
Association of German Banks


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Comments Draft

on the BCBC's consultative document
"Identification and measurement of step-in risk"

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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 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 approximately 1,700 banks.

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Comments on the BCBC's consultative document "Identification and measurement of step-in risk"

General comments

We appreciate that the Basel Committee is using its consultative document to put forward some initial ideas on how step-in risk might in future be reflected in the prudential framework. We therefore welcome the opportunity to respond to the consultation and be involved in the discussions at an early stage.

The Basel Committee is currently working on various areas of regulation (Trading Book Review, CVA, operational risk, the Standardised Approach for credit risk, capital floors, interest rate risk in the banking book), all of which could lead to an additional increase in already high capital requirements. Even if it has not yet been decided whether to address step-in risk under Pillar 1 or Pillar 2, there is nevertheless a danger of this project resulting in raising capital charges further. All the more so if blanket approaches to quantifying step-in risk are pursued which are likely to regularly overstate the actual risk. An inherent characteristic of step-in risk is, after all, that banks weigh and decide on a case-by-case basis whether to provide support or not.

The key criterion in this context is whether, by stepping in, the bank will be able to reduce any possible damage to its reputation. If the support required would exceed the potential loss of reputation, the bank will refrain from intervening.

It therefore follows that the provision of financial support to third parties without or beyond a contractual commitment to do so is primarily a measure taken by management to reduce reputational risk. As the Basel Committee correctly points out, step-in risk is a consequence of reputational risk. But this means step-in risk is only an aspect of managing reputational risk – an aspect which should not, in our view, be seen as a risk category in its own right and, above all, should not be dealt with independently of reputational risk management. There is otherwise a danger of creating a new risk silo which cannot be sensibly integrated into banks' overall risk management. It is unfortunate, moreover, that the consultative document makes no mention of the positive contribution step-in risk can make to the level of a bank's reputational risk and thus to its overall risk profile.

All in all, the definition of step-in risk set out in the consultative document is highly diffuse; the same goes for the line of demarcation between step-in and reputational risk. We therefore do not consider the proposed treatment of step-in risk appropriate and would urge the Basel Committee not to pursue the presented approaches further. The aspects addressed are essentially downstream reputational risks, in our view. It is primarily other types of risk which will materialise first. We continue to regard Pillar 2 as a suitable instrument for dealing with multidimensional risks, such as reputational risk, in an effective manner.

We would also question the empirical relevance of the issue. What cases have actually been identified of step-in risk posing a significant threat and how serious was the economic impact of such cases? We suggest carrying out thorough empirical analyses before proceeding any further with this discussion. These analyses should be an integral element of the consultation and the findings should be shared with the industry. The potential quantitative impact of introducing "step-in" capital requirements could be substantial and out of all proportion to the questionable relevance of the actual risk.

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Most importantly, we would ask the Basel Committee to recognise the fundamental difference between "classic" risks (e.g. credit risk) and step-in risk. The former are realised in the form of losses (triggered by a borrower's default, for example) which the bank has to assume. When it comes to the latter, by contrast, it is up to the bank to decide whether or not it wishes to assume the losses associated with "stepping in". A bank would never step in if it could not afford to, so step-ins pose no threat to the financial stability of banks. Consequently, there is no need to set aside capital.

The consultative document mentions various examples of entities which the Basel Committee considers particularly relevant in the context of step-in risk (cf. para 28).

Insurance companies and other companies currently excluded from the regulatory scope of consolidation and subject to a specific prudential treatment do not need to be considered. This means that the range of companies which do need to be considered is extremely broad and open to interpretation. This raises serious practical problems, since virtually all entities outside the scope of consolidation with which a bank has or has had business relations would need to be analysed. It is also unclear why securitisation vehicles should need to be considered given the regulation already in place in this area. As pointed out in para 14, the rules on providing implicit support in this area have already been revised. Securitisation companies in the form of special purpose vehicles are, moreover, often consolidated for accounting, though not for regulatory purposes. Regulatory non-consolidation is the precondition for capital relief on the basis of a significant and effective transfer of risk because the exposure effectively transferred to the SPV would otherwise have to be included in the scope of regulatory consolidation. A significant and effective risk transfer and the associated capital relief should not be nullified by requirements concerning step-in risk such as a possible need for additional regulatory consolidation or the application of credit conversion factors. With this in mind, we believe securitisation vehicles should be explicitly excluded from the scope of relevant shadow banking entities.

On top of that, the activities mentioned as being relevant to step-in risk also cover investment funds. On the other hand, however, entities already attracting a specific prudential treatment are to be excluded. It would make good sense to spell out in more detail exactly which types of entities are covered. Since companies already attracting dedicated prudential treatment include the following, in our view, it should be made clear that these do not fall within the scope of the consultative document:

- asset managers subject to sector-specific regulation (UCITS and AIF managers)
- regulated funds (UCITS)
- regulated investment firms
- payment services providers
- central counterparties
- entities included in the scope of consolidation of another bank or an insurance or reinsurance company

In summary, we believe that it will be difficult to adequately define and consistently quantify step-in risk. We also see overlaps with other areas of regulation (accounting, Pillar 1

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requirements for securitisations). The Basel Committee largely defines exemptions on the basis of national rules and regulations, particularly the US Volcker Rule and US Securities and Exchanges Commission (SEC) reform on money market funds (MMFs). It is argued that these adequately limit step-in risk. This gives the impression that US institutions will be virtually exempt from the requirements. The Basel Committee needs to dispel this notion. Otherwise, there is a danger of serious competitive disadvantages for banks in the EU, where the consultative document's proposals could generate a far wider scope and much higher capital requirements as a result. The proposed approach does not lend itself to Pillar 1 treatment.

Notwithstanding our fundamental concerns outlined above, we would like to raise the following points concerning the consultative document.

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Detailed comments

As a general point, a materiality threshold should be established for assessing step-in risk. The threshold should be designed to relate to possible individual cases on the one hand and the aggregate risk of all possible cases on the other.

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

The consultative document considers the degree of sponsorship the key criterion for assessing step-in risk. Sponsorship is defined in the same way as in the Basel Committee's revised securitisation framework, namely on the basis of three indicators:

- decision-making – management and/or advice
- operations – placing securities in the market
- financial support – provision of liquidity facilities or credit enhancement

The decision-making indicator is not defined further in the consultative document. A clear, detailed definition is essential, however, if the Committee's proposals are to be properly assessed. Footnote 17 states that the role of a bank in selecting assets in the capacity of an agent would require further analysis. Significant influence in the selection of assets in the context of asset management activities does not, in our view, automatically lead to step-in risk.

The Committee takes the view that the more "upfront facilities" the bank has already provided to an entity, the stronger the sponsorship and the greater the likelihood of furnishing additional financial support in the event of a crisis. A distinction is made between

- full upfront facilities – full provision of credit and liquidity, and
- partial upfront facilities – provision of credit and liquidity up to a certain amount.

These indicators are combined in different ways to give eleven different categories of sponsorship, which subsequently trigger different consequences. We believe classifying relationships into, and distinguishing between, these categories would be a highly complex exercise. Given the need to base these assessments on indicators which are defined only in rudimentary terms and are primarily qualitative in nature, it would, moreover, often prove very difficult to do so objectively.

If one of the eleven primary indicators is met, there is to be a refutable assumption that step-in risk exists with respect to an unconsolidated entity.

When establishing and defining the indicators, it should be borne in mind that these might have implications for various national company-law regimes. The Basel Committee does not appear to have thoroughly analysed these implications. One example of the need to do so is the seventh primary indicator, "dominant influence". According to this indicator, step-in risk exists if the bank can appoint or remove members of the governing body or exert a dominant influence although it has no capital ties to the entity.

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The dominant risk indicator would frequently prove problematic in the context of asset management activities. Please see our reply to Q7.

This indicator could also have serious ramifications for commercial real estate financing. Clients in this segment usually hold the property in separate, real estate holding companies. In some countries banks require collateral to be furnished in the form of the right to appoint the board of the holding company, or banks pledge holdings in real estate holding companies. The sole purpose is to enable the bank to swiftly liquidate the property in the event of problems with the loan. In other countries, contractual arrangements of this kind are not necessary because the lending bank is permitted by law to appoint a receiver.

It should therefore be made clear in the definition of "dominant influence" that it is not an indicator of step-in risk if a bank has a contractual or statutory right to assume control of a property holding company in the event that a loan becomes non-performing so that real estate collateral can be realised.

Indicator 10, "external credit rating based on a bank's own rating", should be dropped. While rating agencies may assess the likelihood of a bank providing support to an entity, third-party assessments of this kind are highly speculative and should on no account form the basis of a prudential requirement.

Indicator 11, "exclusive critical services provider", should also be dropped. Banks already have contingency (business continuity) plans in place to prevent problems in this area. On top of that, resolution regimes already cover economy-wide contingency issues from a regulatory perspective. Additional capital requirements would be redundant and damaging.

This point notwithstanding, the definition of "exclusive critical services provider" is too vague. Some service providers supply customised services to banks, for instance. Would such services render the provider "exclusive" within the meaning of the consultative document?

As a general point, we are not totally clear on the Basel Committee's objectives or its observations concerning the relationship with regulatory and accounting consolidation. If a bank provides upfront facilities, this leads to consolidation, as the consultative document points out. The associated risks are then identified by the bank and managed accordingly. The picture is basically no different (from a risk management angle) when a "regular" loan is granted. There is always a basic risk of default, which the bank covers – if the risk is considered high – by establishing loan loss provisions. In other words, these risks are captured. On top of that, banks establish provisions, the aim of which is to prevent or mitigate the realisation of reputational risk. Banks are aware of these risks, manage and recognise them. It is not clear where an increased risk within the meaning of the consultative document is supposed to exist which has not already been identified and covered.

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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?

In addition to the primary indicators, a set of secondary indicators is listed. Their definition is also extremely broad.

We have the following specific comments on these secondary indicators:

- The "branding" indicator is described in very broad terms and will be difficult to pin down. It covers virtually all aspects of visual similarity, such as typography, symbols, colour, etc. These are aspects which, if uncertainty exists, only specialists will be able to assess since banks or supervisors will not normally have sufficient expertise. We believe it would make good sense to limit this indicator to obvious cases since these will be the only circumstances in which it can be assumed that a risk to the bank's reputation exists and thus also a danger of the bank stepping in.
- There is a lot of overlap between the indicators "purpose and the overall design of the entity structure", "major economic dependence of the entity on the bank" and "whether the bank enjoys/assumes the majority of the risks and rewards" and the criteria for determining accounting consolidation. We would recommend clarifying the relationship with these criteria in the interests of consistency and to avoid overlaps. It would be highly illogical, in our view, to reach or be forced to reach very different conclusions on the basis of similar criteria when assessing the existence of step-in risk on the one hand and the scope of accounting consolidation on the other.
- We see a need to clarify the relationship between the "originator incentives" indicator and the securitisation framework. Restrictions on repurchasing assets and the provision of support by the originator are among the criteria that have to be considered before banks are allowed to apply reduced capital requirements for securitisation transactions. It would be unjustified and inconsistent, in our view, if banks which complied with these restrictions to obtain capital relief were then penalised in the form of capital requirements for step-in risk.
- The secondary indicators (e.g. investor expectations of returns from their investments) address some aspects which, in our view, are already covered by capital requirements for operational risk and conduct risk.

Overall, assessing the secondary indicators would require banks to have a great deal of reliable and up-to-date information about shadow banking and other non-bank financial entities outside the scope of consolidation. Owing to the broad definition of the indicators, it would be very difficult if not impossible to analyse business relationships with these entities in the necessary depth.

The task of collecting data, establishing processes to identify possible interdependencies between the bank and other entities and putting measures in place to deal with cases where interdependence could not be identified would be hugely complex and costly for the banks.

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We would basically recommend refraining from the application of these secondary indicators. Should the Basel Committee nevertheless conclude that they are necessary, we would ask for them to be adjusted along the lines outlined above.

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?

The Basel Committee's proposals for assessing step-in risk are based on methods which are part of the Pillar 1 toolbox, namely

- regulatory consolidation
- a conversion approach based on existing credit conversion factors (CCFs)
- risk weighting using the standardised approach for credit risk as a benchmark.

This will give rise to overlaps with existing regimes, in our view.

a) Overlap with accounting requirements

Para 13 is critical of the high degree of judgement required in the application of the accounting framework. We see no grounds for such criticism. On the contrary, appropriate assessments are only possible if all relevant aspects are weighed on a case-by-case basis. In addition, we consider risks to be adequately recognised in accounting. Accounting consolidation criteria (e.g. under IFRS 10) are now very broad and consolidation is mandatory on the basis of a presumption of control even if risks have only been assumed on a minor scale. If the Basel Committee has reservations about the adequacy and appropriateness of accounting consolidation, it should not respond by imposing additional regulatory requirements. It should be left to accounting standard-setters, such as the IASB, to make adjustments to accounting requirements.

Given that the indicators presented in the consultative document will sometimes be very difficult to assess objectively, the Committee's proposals would also require the involvement of a high degree of judgement when measuring step-in risk. We do not see how this could lead to a more consistent application of the requirements than that under the accounting regime, which is criticised as inadequate.

b) Overlap with other requirements

The proposals for measuring step-in risk would give rise to potentially higher capital requirements for risks which, in our view, overlap with other requirements, especially

- operational risk
- conduct risk
- additional capital requirements primarily under Pillar 2 which already take account of the bank's risk profile.

We do not agree with the Committee's view that the risks in question are not part of operational risk. It is true that they are not explicitly measured, particularly under the standardised approaches. But this is inherent in a method which is essentially based on earnings and expenses. A bank subject to step-in risk in its relationship with another entity will

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probably earn interest or commission income with this entity. This income will already be reflected in the interest and/or commission components of the capital charge for operational risk.

c) Consolidation

The proposals for a full or proportionate consolidation approach overlap and may be at odd with accounting and regulatory consolidation requirements. This is a matter of great concern to us both because of the threat to the consistency of regulatory requirements and because supervisors have no authority to set accounting standards. The relationship between the proposals in the consultative document and regulatory consolidation requirements needs to be clarified.

Irrespective of this point, overlaps between existing consolidation requirements and the requirements for measuring step-in risk may lead to further divergence between the regulatory and accounting scopes of consolidation. This would undermine the comprehensibility and ability to reconcile the two sets of figures.

d) Conversion factor

Under the conversion approach, a conversion factor calculated on the basis of a bank's specific circumstances would be applied to the total assets (including off-balance sheet exposures) of the entity posing the step-in risk.

Using total assets as an assessment base is a highly pessimistic approach since it implies that the entity's entire assets might have to be refinanced by the bank if the entity got into difficulties. It would, moreover, give rise to problems of interaction with large exposure requirements and make it difficult to comply with the large exposure limit.

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

The Basel Committee basically proposes three approaches to measuring step-in risk. In addition, it has drafted a mapping table specifying which approach should be used depending on which indicator of step-in risk has been identified.

Instead of this mapping, we would recommend allowing banks to choose which approach to apply. This is the only way to ensure the use of the approach best suited to the individual bank.

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

We basically understand that both asset management activities, which play a major role in the financial industry, and funds, as widely-used investment vehicles, have been included in the Basel Committee's deliberations. We do not, however, understand the reasons for concluding that there is a need for a new regime to address step-in risk (as a consequence of reputational risk) in this area. We do not share this conclusion.

Isolated incidents during the financial crisis (e.g. involving money market funds, see para 10, third bullet) should not be used to justify a general need to address step-in risk in the context of asset management and funds. Since the financial crisis, lawmakers have significantly developed and refined the frameworks governing asset managers and funds. As a result, the risks of possible financial stress which might justify the introduction of requirements to cover step-in risk vis-à-vis asset managers and funds have either been excluded or significantly reduced.

In the area of money market funds, for instance, CESR issued "Guidelines on a common definition of money market funds" (CESR/10-1049) and the European Commission has published a proposal for a Regulation on Money Market Funds (COM(2013) 615 final). For real estate funds for retail investors, German lawmakers introduced rules in the Investor Protection and Capital Markets Improvement Act and in the Capital Investment Code which have significantly improved liquidity management (especially by introducing minimum holding periods, a return agreement, dropping the exemption threshold). In both cases, possible step-in risk has been adequately addressed.

We would like to stress, in particular, that the circumstances mentioned in para 87 have no relevance in practice to step-in risk. It is not clear to us why granting a (temporary) guarantee should give rise to step-in risk. And the risks resulting from granting credit to a fund or investing in a fund are already addressed by corresponding capital requirements under the CRR. The market risk associated with providing a performance guarantee should be addressed separately in the context of the CRR, in our view. The final point, namely whether the bank "has a relevant interest in the fund other than its management fee", needs to be spelled out in more detail. It needs to be made clear, in particular, that this refers not to the basic interest in business relations with clients to whom products can be sold, but to specific other interests.

Irrespective of this point, European lawmakers have continuously developed and strengthened the framework governing asset management and funds (take UCITS IV and V, the AIFMD) and are currently working on legislation for money market funds. In addition, asset management and fund issues are increasingly being addressed at global level (e.g. IOSCO's 2015 Final Report on Liquidity Management Tools in Collective Investment Schemes and its 2013 Final Report on Principles of Suspension of Redemptions in Collective Investment Schemes).

Moreover, in the EU are suitable arrangements already in place for counteracting risks emanating from the shadow banking sector. The EBA, for example, has issued guidelines on

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limiting exposures to shadow banking entities (EBA/GL/2015/20). These require the establishment of internal management and monitoring processes and have introduced specific upper limits on exposures to shadow banks. The guidelines thus seek to limit exposure to the shadow banking sector by setting clear Pillar 2 requirements along the lines of the large exposure regime. There are also clear requirements governing securitisations and possible implicit support under Article 248 of the CRR. Issues with ABCP programmes and SIVs, which are highlighted in para 10 of the consultative document, have been addressed at least in Germany, which requires the programmes to be differently structured. Liquidity lines offer full support, so contractual arrangements with the sponsoring bank already protect investors from defaults in the portfolio. These liquidity lines are already adequately addressed in all relevant areas (e.g. EU securitisation framework, liquidity risk). A reputational risk going beyond the risks already covered does not exist. On top of that, there is already a legislative proposal at EU level for a regulation on money market funds, which will introduce further regulation of the shadow banking sector in the EU. The question also arises in connection with the liquidity requirements envisaged for step-in risk as to whether the need for liquidity in a stress situation is not already adequately covered by the implementation of the LCR. It would serve no useful purpose, in our view, to cover risks from exposure to shadow banks both by Pillar 1 requirements set by the Basel Committee and Pillar 2 requirements set by national supervisors. Such a situation needs to be avoided. Other jurisdictions have their own arrangements in place for step-in risk. The Basel Committee's proposals need to be reviewed for empirical relevance and with existing regulation and regulatory projects in mind.

We are firmly opposed to the measures for addressing possible step-in risk listed in para 88. They are incompatible with Principle 3 set out in para 21 of the consultative document, which states that the framework should be "conservative, risk-sensitive and proportional". This applies particularly to the proposed conversion approach, which does not take into account the special features of asset management and funds.

The proposals for identifying risks stemming from relationships with asset managers and funds should be re-examined with great care. It is especially important to give adequate recognition to legal and practical measures that banks have already put in place to exclude or reduce the risk of having to step in with financial support for a fund. These measures may include, for example, clarifications in prospectuses or extensive risk and liquidity management processes in the area of asset management.