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Bank for International Settlements
CH-4002 Basel
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Dear Sirs,

Identification and management of step-in risk - second consultative document

HSBC welcomes the opportunity to respond to the Basel Committee on Banking Supervision's ('the Committee') second consultative document regarding the 'Identification and management of step-in risk', which proposes mechanisms to capitalise the risk that non-contractual support could be provided to entities in stress which are currently beyond the scope of regulatory consolidation.

General Comments

We responded to the first consultation paper regarding step-in risk expressing detailed concerns regarding the proposals. We are disappointed that in large part our concerns, and those of the industry, appear not to have been reflected in the second consultation document. We view this as particularly concerning given that the Committee views this second proposal as 'near final'.

As we stated in our first response, and as the Committee itself now notes in the consultation, step-in risk is to a great extent already addressed, or is in the process of being addressed, by other regulatory or legislative measures, for examples those regarding securitisations or money market funds. It therefore remains unclear how these developments have been factored into the Committee's revised step-in risk proposal. We consider that a further review of the effectiveness of these existing measures would be more appropriate rather than progressing to a finalised incremental step-in risk framework. In the first instance, we would recommend that the Committee remove these proposals from the Committee's current two year work programme and wait until the existing programme of regulation is completed and embedded before assessing whether any residual risk remains and considering if there is a need for any further prudential redress.

While we welcome the Committee's commitment that the revised proposals should entail no automatic Pillar 1 charge above the existing Basel standards, this paper still allows the application of the regime to Pillar 1 at a national supervisor's discretion. If applied in this manner, it will result in a lack of comparability of capital bases between banks that the Committee itself has been seeking to achieve.

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In order to preserve comparability, any residual step-in risk that a firm faces following the completion of the legislative reforms should be addressed solely through harmonised Pillar 2 standards rather than by giving national supervisory discretion to the form of the regulatory response. The use of Pillar 2 has already been envisaged within your paper '*Enhancements to the Basel Framework*' ('Basel 2.5') from July 2009, where reputational risk was covered. It is therefore unclear why the Committee considers there to be a need for additional legislation. Instead, we think that the Committee should consider revising its existing Pillar 2 guidance, if necessary. This is appropriate given the evaluation of implicit support for securitisation transactions is now part of the Supervisory Review and Evaluation Process ('SREP'), which specifically mandates supervisors to assess material risks in relation to non-consolidated entities as part of a Pillar 2 SREP assessment. A similar approach has also been taken in the EU for the purposes of assessing exposures to 'shadow banking' entities, whereby supervisors will assess firms' own monitoring and management of exposures to such entities, as part of the SREP.

We are also concerned that the proposal's scope remains unclear and could be excessively broad. This will result in an increased operational burden on banks that is not proportionate to any increased risk. The Committee notes that there is no prescribed list of entity types that should be subject to the identification and assessment process. At a minimum, banks are instructed to scrutinise securitisation vehicles, investment funds and other entities. However, the scope is far-wider, as the requirement involves consideration of all contractual and non-contractual arrangements which may result in a bank being obliged to step in. This would result in its assessment covering any interaction it has, but where no step-in risk may actually exist. In particular, it extends significantly beyond the scope of shadow banking which the Committee is being asked to address.

The extent of indicators that banks are to use to identify step-in risk, and the wide ranging measures available to address such risk, result in material uncertainty relating to the possible impacts of the proposals. We strongly recommend that the scope be significantly tightened and made more prescriptive to allow for a more reliable assessment of potential impacts and ensure convergence between supervisors in its application.

This uncertainty is further compounded by the lack of specificity in the methodologies offered for calculating step-in risk capital charges, particularly in relation to the conversion approach. It is unclear how national supervisors will consistently assess the adequacy of each firm's approach to the identification of step-in risk which could lead to a number of undesirable outcomes, such as a decrease in comparability. In our view, it is necessary for the guidelines to provide further granularity in their application.

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We are also concerned that the scope of collective rebuttals is unnecessarily limited to instances where there is legislation or regulation preventing step-in in place. In particular, the paper recognises that a public disclosure that a bank does not intend to step-in is a remedy for step-in; however we see that the existence of such a disclosure at the outset as being a rebuttal for the need to even consider whether an entity falls within the scope of the assessment. Similarly, where a bank's potential step-in exposure is already covered in full by capital, for example where the bank is a sponsor of a commercial paper conduit and provides 100% of the liquidity facility (subject to a 100% credit conversion factor), then this is also a valid rebuttal from the need for any additional assessment.

Conclusion

Overall, we continue to believe that step-in risk is already materially addressed in the manner outlined and therefore, any additional requirement for step-in risk is not required. We recommend the Committee focus on expanding the existing guidance to national supervisors in assessing residual step-in risks within the existing Pillar 2 framework. If the Committee decides that step-in risk should be addressed as proposed, further clarity on the methodologies and calibration is required before any such framework can be implemented.

If the Committee proceeds, we recommend a staged implementation approach requiring firms to conduct an analysis of the capital implications within an adequate timeframe, given the wide-reaching and imprecise scope. Following this, discussions should take place at a national level to establish final standards. Consequently, we would consider a 2019 implementation timetable to be inappropriate.

We have provided more technical commentary in the appendices to this letter. Our comments relate to the broader framework in addition to the specific areas of reporting templates that the Committee has requested comments on.

We would be pleased to discuss any of these comments further, if this would be helpful to you and your colleagues.

Yours faithfully,

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Appendix I

Definitions and Scope

The Committee defines 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*' and is related to reputational risk. While we recognise that the potential scope of reputational risk is difficult to define, we consider that the scope of the proposed framework is not precise enough and potentially wide-reaching.

The scope of entities that a bank is asked to consider includes where a bank is a sponsor, an important equity or debt investor, or other instances where there is contractual or non-contractual involvement. Without further prescription, this will lead to a disparity of application between regulators which, in turn, will undermine the Committee's own work on simplicity, transparency and comparability, particularly given the possibility of requiring a Pillar 1 based charge. The current proposed framework would result in a wide variability in how different firms and supervisors may interpret and implement the framework. A non-exhaustive list of examples includes the following:

- Banks are required to evaluate entities where the bank is an "*important*" investor in their debt of equity instruments, however, importance is not defined;
- For securitisation entities, step-in risk might remain "*under specific circumstances*" after passing significant risk transfer ('SRT'), however, these circumstances are not identified;
- An entity may be excluded from the step-in risk analysis if stepping in to support that entity would not be "material" to the bank's liquidity and/or capital positions, however, materiality is not discussed further;
- Similarly, the proposal states that the purpose of the step-in risk analysis is to identify instances where stepping in would "*significantly impact*" the bank's liquidity and/or capital positions, however, there is no additional guidance as to the interpretation of a significant impact;
- Entities whose performance depends on an "*illiquid benchmark*" are also highlighted, however the concept of illiquidity is not further discussed;
- Entities whose activities "*do not sufficiently match the risk profiles of their clients/investors with those of the risk exposures of the entity*" are to be considered, however it is unclear what constitutes sufficiency for the purposes of this test.

The wide scope also means that at the outset, a bank is obliged to consider any entity with which it has an interaction, irrespective of whether the analysis would result in any material entities to be reported. It is recommended that the described indicators could be further simplified by merging them into one of the relationships subject to consideration. For example, the '*nature and degree of sponsorship*' risk indicator could be mapped to '*sponsorship*' as one of the four types of relationships prompting inclusion in the initial set of entities.

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While the proposal suggests that banks' policies and procedures for identifying and managing step-in risk should provide greater clarity regarding some of these items and should (upon request) be available for supervisory review, the lack of specificity in the proposal makes it unlikely that the framework will be implemented with any degree of consistency across firms.

As the proposals stand, the types of relationships that banks would need to consider are broadly defined and the definition of sponsorship, debt, or equity investment would extend the scope of entities beyond shadow banking. As such, these definitions are currently not aligned to the FSB guidelines[1] on shadow banking entities, according to which non-banking credit intermediation sits at the core of the definition. It seems remiss that the Committee's proposals are failing to make any strong link to these definitions, instead referencing any type of sponsorship, debt or equity investments, or any other contractual/non-contractual elements which could extend to corporate relationships. The proposed scope of step-in risk, therefore, could lead to potential overlaps with frameworks already in place, which we do not believe was an intended outcome.

For example, when a bank participates in a securitisation as an agent, there is no presumption of reputational risk, despite the fact that some of the proposed indicators may have been triggered. That is because firms acting as agents would not support these securitisation vehicles and there is no investor expectation to do so. Furthermore, the proposals in their current form would potentially restrict institutions' ability to sponsor securitisations which seems counter to other regulatory proposals aiming to revive the securitisation market. If not handled sensitively, the introduction of these rules could have destabilising effects in the market.

We understand from the proposals that the '*present framework should enter into force as soon as possible and no later than end-2019*'. This would appear to give firms limited time to identify those relationships which fall within the requirements as proposed and establish a supervisory implementation strategy which will deliver the reporting mechanics envisaged. A precipitous timetable could result in a withdrawal of funding, particularly if it is based on incomplete data. If alternative sources of funding are not available (and it is not clear what those might be), we could see failures of these entities as they are forced to sell portfolios below their long term market value to address funding concerns, as was the case during the financial crisis.

With respect to collective rebuttals, we are strongly supportive of the Committee's proposal to exclude entities subject to legislative or regulatory rebuttals from further step-in risk analysis. That said, further calibrations to collective rebuttals are necessary to allow regulated firms to apply this exclusion appropriately.

For example, the requirement that banks should specify in their policies and procedures the types of entities to be excluded due to collective rebuttal increases the risk of inconsistent application across firms. As an alternative, national supervisors should be required to

[1] Financial Stability Board: Shadow Banking: Strengthening Oversight and Regulation, 27 October 2011, p. 3

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provide guidance to firms regarding which regulations or other exclusions could be applied as collective rebuttals. While this may not mitigate variability in application across jurisdictions, it would certainly mitigate variability across firms within each jurisdiction. Furthermore, the requirement that banks keep a list of such entities available upon supervisory request seems to be of limited value and would represent an incremental ongoing administrative burden for institutions. Such an obligation would also seem to contradict the explicit instructions in Template 1 of Annex 1 to exclude entities subject to collective rebuttals. If the Committee is convinced that such a list be maintained, it should simply be integrated into item (a) of Template 1 of Annex 1 (which itself is of potentially limited value as discussed further in Appendix II of this document.)

The scope of entities and transactions that would be eligible for exclusion from the step-in risk framework via collective rebuttal could reasonably be expanded in some circumstances. For example, the fact that contract law on its own is not considered to be sufficient for collective rebuttal should be reconsidered. If a bank enters into a series of similar contracts with unconsolidated entities whereby it has 1) legally restricted itself via contractual agreement from providing specific types of support to the unconsolidated entity in the event that it experiences financial distress, and 2) released a public disclosure confirming that it will not step-in to support the entity, this should be sufficient to scope that entity out of the step-in risk framework, assuming the publically disclosed contractual restriction is clearly enforceable, of general application, and explicitly prohibits the provision of support.

Such an arrangement could be enforced by national supervisors via an approach similar to the existing implicit support framework in place for sponsors and originators of securitisations. For example, if a regulated bank is found to have stepped-in despite satisfying the two criteria laid out above, it would be subject to both punitive capital charges and other potential penalties, such as restrictions on continuing to engage in certain types of activity, at the discretion of the national supervisor. Notwithstanding such a breach, this type of publicly disclosed contractual restriction should be sufficient for exclusion from the step-in risk framework, even in the absence of a law or regulation that would independently prohibit the provision of support.

As mentioned above, we would also suggest that scenarios where the potential step-in exposure has been fully covered by regulatory capital be exempt from further assessment of step-in risk.

Identification of step-in risk and potential responses

The majority of entities that banks would need to scrutinise and include in their initial assessment should either be carved out on the basis of posing immaterial step-in risk or being subject to collective rebuttals that go beyond the legislative framework.

The framework intends to "*take a forward looking approach to possible step-in situations that are of a different nature to those seen in the past*". For the same reasons, we see the "*historical dependence*" indicator as inconsistent with the above direction.

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In the asset management business, as an example, principal risks are limited in terms of exposure and are subject to prudent risk limit approval processes that require regular monitoring and are re-assessed annually. These policies, coupled with pre-product launch stress testing, provide the necessary controls and guidance on all material activities required to launch a product or manage a fund. As asset management's primary function within HSBC is to act as an agent, the documentation of the risks associated with each product makes it clear to investors that the bank would not step-in other than to compensate for operational errors. This is explicit and now forms part of the fund's documentation. Any loss appetite resulting from operational errors is set according to risk policies.

The proposals assume that special purpose entities operated by regulated institutions would be included where the assets of the entity are not consolidated for prudential purposes. However, in certain circumstances there is full information available relating to the underlying exposures and assets and therefore the risks of the underlying assets are fully understood. The current regulation adequately addresses risks associated with exposures to securitisations and exposures in the form of units or shares in funds. As a result, we strongly recommend that funds and securitisations where the look through approach is utilised should not fall within the entity scope subject to initial analysis of step-in risk.

Regarding potential responses to step-in risk, we believe that the consolidation approach is not an appropriate mechanism. While we agree that entities that are regulated on an individual basis, such as investment firms or insurance entities, do not need to be assessed, we question why an assessment is needed for other types of entities. In particular, for regulatory purposes, entities are not required to be included within the scope of regulatory consolidation where it is assessed that neither control nor dominant influence exist. Furthermore, where there exists significant influence in an entity, there is flexibility for regulators to determine, whether and how, consolidation should be carried out. For example, in the UK the Prudential Regulation Authority recently produced a statement on the application of a "durable link" to determine whether an investment constitutes a participation and should be proportionately consolidated for regulatory purposes. We also note that for securitisation vehicles, there are requirements to positively demonstrate that significant risk transfer has been achieved before entities can be removed from regulatory consolidation. It is vital that these existing considerations are not overlooked or overwritten by the proposed step-in risk framework. Moreover, it is unclear how and whether consolidation would be considered where an entity is already being consolidated by another banking group.

With respect to entities that are not included within the accounting consolidation, we see no reason to assess whether those entities should be included in the regulatory consolidation. Specifically, accounting requirements under *IAS 28 'Investments in Associates and Joint Ventures'* and *IFRS 10 'Consolidated Financial Statements'* are sufficient for examining which entities should be included in the accounting consolidation. It is unclear why these are deemed insufficient or why the Committee sees additional assessment is necessary for step-in risk purposes.

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Moreover, consolidation for regulatory purposes is only intended to capture entities which are 'financial' in nature, given there is no added value nor clear rationale for consolidating entities which are not considered relevant or ancillary to a group's banking activities.

Finally, we would request that more direction is provided on whether it is banks or supervisors that determine the potential consolidation consequences of specific transactions. According to paragraph 78 of the proposal, *"A bank (or supervisor) would be able determine an appropriate conversion factor and apply it to a specific set of circumstances, since neither a uniform "one size fits all" conversion factor nor full consolidation may be sufficiently case/risk-sensitive."* This would, again, pose the risk of inconsistent application of the framework across jurisdictions, or even within jurisdictions where banks are left to make this determination on their own.

Currently, there is considerable divergence in the application of the prudential consolidation rules across jurisdictions and the proposed approach would only exacerbate this discrepancy further.

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Appendix II

Supervisory reporting templates (Annex 1) and Entity categories (Annex 2)

It is generally possible to identify whether entities are of a type to be at risk of stepping in. However, the final determination will require a detailed assessment. More importantly, unless this regulatory status is inherent in the sectoral code for the obligor (as it would be for insurers which are excluded from the scope of step-in risk assessment), this will potentially require data enrichment for the purposes of reporting. This would mean that if there is not a staged implementation, some firms are likely to misreport or underreport until they have managed to refine their datasets and achieved data remediation via investigation. The time needed to fully operationalise this measure is key to its workability.

Given the minimally prescriptive nature of many elements of the overall proposal and the degree of variability with which firms and their supervisors could reasonably be expected to implement the framework, it should follow that the reporting templates in the proposal should be used as guidelines and suggestions rather than as required reporting. National supervisors should retain the discretion to use, not use, or revise the reporting templates, as appropriate, for each jurisdiction or regulated firm. If the reporting templates are to be used as written without exception, supervisors and firms will essentially be required to document a highly customized step-in risk assessment process into a rigid, standardised reporting format.

With respect to item (a) of Template 1 of Annex 1, we see little value in disclosing a potentially extensive list of entities where stepping in to support that entity would not be deemed material to the bank's liquidity and/or capital positions given the size of the entity. Since no further assessment is to be performed on these entities apart from their identification, it would be prudent to either limit the applicability of this template to such jurisdictions where the Basel framework has not yet been implemented or eliminate item (a) from the template, and to instead begin the process by assembling a list of entities that are deemed to be material. From there, the material entities can be bifurcated into those where step-in risk is, and is not, deemed to be significant.

Certain other fields require additional clarification, for example:

- The field heading "*Typical contractual exposures to the entities*" in Template 1. Specifically, firms will need to understand whether this field should be populated quantitatively or qualitatively, e.g. "typical exposure to the entity is £100m" vs. "typical exposures to the entity will consist of loans and interest rate swaps."
- In Template 2, the concept of a '*group of entities*' is not explicitly defined; depending on each firm and / or supervisor's interpretation of this concept, the list of items disclosed in this template will vary.
- In Template 2, the bank's '*assessment of step-in*' (stated to be the difference between before and after materialisation of step-in support), should take into account only the residual risk remaining after the impact of existing regulations are considered. While this will inevitably vary across firms and jurisdictions, any other approach to

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assessing the step-in risk will potentially overstate the magnitude of the risk and could result in unnecessary double counts for capital and liquidity purposes.

- Finally, the '*Risk indicator analysis*' table in Template 2 should include an additional 'other' row for bespoke transactions given that the list of indicators described in the main body of the proposal is explicitly stated not to be exhaustive.

Contrary to the Committee's intentions, the proposed list of entity categories in Annex 2 is backward looking and is in some cases redundant. Some structures will also have become subject to separate targeted regulation (e.g. Money Market Funds, Hedge Funds, and Private Equity Funds).

Similarly, the entity type list in Annex 2 should include an additional "other" category to allow for the possibility that new types of shadow banking entities, outside of those explicitly listed, for which step-in risk may be relevant, could come into prominence in the future. While the proposal generally describes the shadow banking system as "*credit intermediation involving entities and activities (fully or partially) outside the regular banking system*", it also acknowledges that there is neither a commonly established definition nor a comprehensive list of entities in this category, and that step-in risk could potentially involve a variety of additional entity types as the banking system continues to evolve.

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