KOREA FEDERATION OF BANKS

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KFB comments on Basel Committee' s Consultative Document on Guidelines for Identification and Management of Step-in risk

The Korea Federation of Banks (KFB) is a bankers' association that represents and promotes the interests of the Korean banking industry as a whole. Our membership comprises banks both domestic and international, operating in Korea.

The Korea Federation of Banks has collected, and hereby submits Korean banks' views on Basel Committee's Consultative document on Guidelines for Identification and Management of Step-in risk. This document points out some issues of the consultative document and suggests recommendations reflecting the current situation in Korea after consulting with Korean banks.

1. Concerning the scope of application

○ Revised framework issued for consultation

- Each bank is to include unconsolidated entities for step-in risk*2 assessment considering the relationship*1 between a bank and an entity. However, unconsolidated entities deemed as immaterial may be excluded from a bank's step-in risk assesment in line with the bank's own criteria of materiality*3. [1]

  *1 Sponsor(where the bank manages or advises the unconsolidated entity, places the entity's securities into the market, or provides liquidity/credit enhancements to the entity), Bank being debt/equity investor, and presence of other contractual and non-contractual involvement[2]

1) Refer to Section 2 of the Consultative Document

*2 A risk of making a decision 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[3)]

*3 Each bank should define the materiality criteria in its risk management policy while supervisors may elect to establish absolute and/or relative quantitative materiality thresholds and associated qualitative considerations.[4)]

○ Potential Issues

- Entities subject to step–in risk assessment are vague, and establishment and application of differing and arbitrary materiality criteria may lead to reduced comparability and regulatory arbitrage.

○ Our Comments

□ **Guidelines are required for the criteria of "materiality" so as to specify the scope of step–in risk assessment and to identify entities subject to such assessment.**

- The "shadow banking system" is required to have a commonly established definition through a global consensus then to assess the status of "shadow banking entities". Of such entities, it is then necessary to specify entities subject to assessment depending on the materiality of their relationship with the bank.

  • The introduction of the framework for the identification and management of step–in risk is to mitigate potential spillover effects from the shadow banking system to banks.[5)]

2) Refer to Paragraph 24 of the Consultative Document
3) Refer to Paragraph 14 of the Consultative Document
4) Refer to Paragraph 28 of the Consultative Document
5) Refer to Paragraph 1 of the Consultative Document

- As the Basel Committee on Banking Supervision mentioned in its consultative document, there is neither a commonly established definition nor a comprehensive list of entities in the category of "shadow banking system". 6)

– Guidelines by the Basel Committee are required to establish the criteria of materiality by country and by bank so as to ensure consistency in the regulatory scope.

2. Concerning the step-in risk indicators

o Revised framework issued for consultation

– In principle, 11 indicators are specified to be assessed against for the identification of step-in risk.7)

* ① nature and degree of a bank's sponsorship ② degree of a bank's influence ③ a bank's implicit support ④ whether falling under the category of structured entities and highly leveraged entities ⑤ likelihood of liquidity stress of entities, and existence of first-mover incentive ⑥ level of risk transparency for investors ⑦ level of disclosure depending on accounting disclosure requirements ⑧ level of investor risk alignment ⑨ reputational risk from branding and cross-selling ⑩ historical dependence ⑪ regulatory restrictions and mitigants

o Potential Issues

– Due to the absence of guidance on a holistic interpretation of the results from step-in risk assessment against each indicator for the purpose of determining the existence of such risk, the interpretation of the aforementioned indicators by country and by bank would inevitably deviate more from one another.

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6) Refer to Paragraph 22 of the Consultative Document
7) Refer to Section 3 of the Consultative Document

- Our Comments

☐ **Further guideline is required for utilizing the indicators including weight assignment by indicator.**

– Further guidelines* are required for utilizing the above indicators, for example by assigning weights to each indicator, so as to improve practicality and consistency of determining the existence of step–in risk.

* **(For instance)** In consideration of the definition given to step-in risk, "nature and degree of sponsorship" and "degree of influence" are deemed to be essential among all the other indicators. Therefore, these two indicators may integrate the rest then to establish quantitative and qualitative thresholds while assigning weights by indicator and threshold.

3. Concerning potential responses to identified step–in risk

- Revised framework issued for consultation

– Depending on the nature and degree of step–in risks identified, a bank can apply a range of potential risk measurement and management measures. [8)]

- Potential Issues

– It is unclear whether to include all the identified step–in risks, regardless of respective materiality, for risk measurement and management.

– When even an insignificant step–in risk is included for risk measurement and management, it is the case of excessive regulation.

8) Refer to Section 4 of the Consultative Document

- Our Comments

☐ **Criteria of materiality and supporting rationale are required to be established to exclude immaterial entities from the risk measurement and management by the bank.**

– Criteria of materiality and supporting rationale are required to be established to exclude step–in risk identified but with low significance* from risk measurement and management such as capital requirements and/or liquidity requirements, stress testing and provisioning.

* **(For instance)** In the case where the impact of identified step-in risk on the BIS capital adequacy ratio is less than 5 bp.

- Just as the materiality criteria applied to the identification of step–in risk for follow–up assessment, criteria of materiality is required to be established then to be applied so as to improve the consistency of the regulatory framework.

4. Concerning disclosure

- Revised framework issued for consultation

– Supervisors may require specific disclosures, such as the number, size and nature of unconsolidated entities in terms of the step–in risk, and of banks' own risk assessment and their management of such exposures.[9)]

- Potential Issues

– When disclosure is made regarding unconsolidated entities identified with the step–in risk, information users might be led to expect that the bank has the commitment and capabilities to step in to provide support to the unconsolidated entities even in the absence of actual step–in by the bank to provide support. This might cause moral hazard.

9) Refer to Paragraph 89 of the Consultative Document

- Our Comments

☐ **There is a need to omit the provision related to the disclosure of step–in risk.**

– As the information related to step–in risk might cause side effects including moral hazard among market participants, we propose to remove it out of the disclosure scope.

• Such removal would not limit supervision in any way as banks are required to regularly report to their supervisors the results of their self–assessment of the step–in risk.

5. Concerning reporting the results of self-assessment of step-in risk to supervisor

- Revised framework issued for consultation

– Banks are required to establish their own policies and procedures so as to identify and manage step–in risk while regularly reporting to their supervisors the results of their self–assessment.[10)]

- Potential Issues

– Since the capital and liquidity requirements under Basel III require the step–in risk to be considered when calculating regulatory capital ratios*, the application of the guidelines for identification and management of step–in risk is deemed to be redundant regulations.

10) Refer to Section 5 of the Consultative Document

* **(For instance)**

① Concerning capital requirements

- When a bank provides implicit support to securitisation(in excess of any contractual obligations to provide credit enhancements to securitisation), it must, at a minimum, hold capital against all the underlying exposures associated with the securitisation transaction as if they had not be securitised. Furthermore, the bank is required to disclose publicly that it has provided the implicit support and the capital impact of doing so.11)

- When a bank owns less than 10% of voting common shares of unconsolidated financial institutions (banks, insurance and other financial entities), then the amount in excess of 10% of the bank's common equity, of the total of all holdings of common shares and capital securities in such financial institutions, is to be deducted from the common equity.12)

② Concerning liquidity requirements

- When a bank is a main liquidity provider for "other contingent funding obligations", which is one of components consisting the cash outflows when calculating LCR, whether such obligations are either (1) non-contractual obligations; (2) in associations with, or sponsorship of, products sold or services provided that may require the support or extension of funds in the future under stressed conditions; and (3) joint ventures or minority investments in entities, which are not consolidated, then non-contractual other contingent funding obligations for such entity are included.13)

o Our Comments

☐ **In the case where countries have adopted the capital and liquidity requirements under Basel III to the full extent, banks located in such countries are exempt from managing step−in risk, establishing procedures thereof, conducing self−assessment and reporting to supervisors on a separate basis.**

11) Revisions to the securitisation framework(July 2016, BCBS), Paragraph 98
12) A global regulatory framework for more resilient banks and banking systems(December 2010, BCBS), Paragraph 81
13) Liquidity Coverage Ratio and Monitoring Tools(January 2013, BCBS), Paragraph 134~140

– In the case where countries have adopted the capital and liquidity requirements under Basel III to the full extent, banks located in such countries need to be exempt from managing step-in risk, establishing procedures thereof, conducing self-assessment and reporting to supervisors on a separate basis so as to avoid the application of redundant regulations.

  - Even in countries where the capital and liquidity requirements under Basel III are fully adopted, it is possible for the supervisory authorities to enhance the prevention of step-in risk at own discretion by including entities identified with step-in risk in the consolidation scope(or including in the scope of stress testing conducted by the supervisory authorities) and implementing measures such as provisioning or ex post capital charges as mentioned in the Consultative Document. [14]

Thank you for providing the opportunity to industry stakeholders to comment on BCBS's *"Guidelines for Identification and Management of Step-in risk"*. The KFB and its members shall continue to closely follow future developments regarding this work stream.

Yours sincerely,

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14) Refer to Section 4 of the Consultative Document