MORTGAGE BANKERS ASSOCIATION

March 16, 2016

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Basel, Switzerland

Reference: Consultative Document – *Identification and Measurement of Step-in Risk*

Dear Mr. Ingves:

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) Consultative Document titled *Identification and Measurement of Step-in Risk* (Consultative Document). The following is background information for the benefit of MBA's members and other readers of this letter.

Background

The Basel Committee defines "step-in risk" as "the risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations, should the entity experience financial stress."[2] Step-in risk applies specifically to off-balance sheet entities (shadow banking entities) that the bank does business with such as securitizations it sponsors or services or for asset-backed commercial paper (ABCP) that are done through Special Purpose Entities (SPEs) and not accounted for as on-balance sheet under existing accounting rules.

The Consultative Document states that certain indicators such as capital ties, sponsorship, providing financing facilities to an entity, decision making, and operational

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mba.org.

[2] Basel Committee, *Identification and Measurement of Step-in Risk*, December 2015, page 1.

ties create a presumption that significant step-in risk exists.[3] Secondary indicators of step-in risk include:

- branding (the SPE is branded in the same name as the bank),
- purpose of the entity is for regulatory arbitrage,
- economic dependence of the SPE on the bank,
- originator incentives such as whether the originator has the ability or obligation to repurchase the underlying assets,
- bank enjoys or assumes the majority of risks and rewards of the SPE,
- bank has implicit recourse if underlying assets go bad,
- investors' ability to bear loss on their investments, and
- investors' ability to freely dispose of their financial instrument.[4]

The presumption is that a bank under the circumstances enumerated above may repurchase or support the SPE because of "reputation risk" defined as the risk "that arises when a bank considers the weakness or failure of an entity is likely to have a negative impact on the bank itself."

In addition to SPEs, the Consultative Document enumerates the following situations where a bank may have step-in risk:

> Nevertheless, the types of entities that banks have a relationship with that may lead them to provide financial support when that entity is in financial stress are likely to include, but are not limited to, the following:
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> (a) mortgage or finance companies;
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> (b) funding vehicles;
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> (c) securitization vehicles;
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> (d) money market funds and other investment funds;
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> (e) asset management companies (asset managers); and
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> (f) commercial entities that provide critical services exclusively to the bank.[5]

As noted above, "sponsorship" is one of the primary indicators of step-in risk. The Consultative Document defines "sponsorship" as containing three elements: decision-making, operations (e.g. placing securities into the market), and financial support.[6]

The Consultative Document talks about three approaches to measure the magnitude of the step-in risk in risk-based capital[7]:

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[3] Ibid, page 1.
[4] Ibid, pages 16-18.
[5] Ibid, page 10, paragraph 28.
[6] Ibid, page 13, paragraph 46.
[7] Ibid, pages 20 and 21.

1. When the unconsolidated entity undertakes bank-like activities with risks that would get appropriate risk-based capital treatments if they were consolidated, the answer would be to consolidate the entity for regulatory reporting purposes.
2. The Basel Committee is also considering a "proportionate consolidation approach" as being the most appropriate when step-in risk is shared by two or more banks for the same unconsolidated entity.
3. Finally, the Basel Committee is considering using a "credit conversion factor" (CCF) like banks in the United States use in Basel III risk-based capital for off-balance sheet risks for items like unfunded loan commitments.

Step-in risk is presumed, but that is a rebuttable presumption. However, the Consultative Document is short on information about what constitutes compelling and persuasive evidence to successfully rebut the step-in risk presumption.

Following, please find MBA's General Comments followed by our response to certain questions in the Consultative Document.

General Comments

Proposal Is Based Upon Flawed Assumptions

Page 2, paragraph 9 of the Consultative Document states, "Banks had maneuvered assets off-balance sheet and linked them to the capital markets via special purpose entities (SPEs), but needed to take them back onto their balance sheets when perceptions of risk changed abruptly in the market and had provided financial support to those vehicles beyond or in the absence of contractual obligations to do so.[8]" The footnote reference at the end of the quote is to a research paper about the asset-backed commercial paper (ABCP) market in France, Germany and Spain – whereby the banks ended up buying much of the commercial paper back during the financial crisis that commenced in 2008. Page 41 of that article states that the adverse turn in the use of ABCP is when banks started securitizing long-term assets with short-term commercial paper in what was called securities arbitrage conduits. When underlying assets began to go delinquent, the sponsoring banks could not refinance those assets in the capital markets, and the banks had to take those assets back on their balance sheets.

Clearly the culprit here relates not to the general use of SPEs but to the refinance risk created by securitizing long-term assets with short-term sources of funds. This is not the case when an SPE is created and the debt holders get paid off directly by the repayment of the underlying assets or by pool or individual asset insurers. Such is the case with mortgage-backed securities (MBS) backed by commercial and residential

[8] In that regard, see: Thiemann, M. (2012) *Out of the Shadows? Accounting for Special Purpose Entities in European Banking Systems, Competition and Change* and Blundell-Wignall, A. & Atkinson, P. 2010 T*hinking Beyond Basel 3: Necessary Solutions for Capital and Liquidity*; OECD Working Paper.

mortgages. Even though the financial crisis in 2008 began in this market, MBA is unaware of banks stepping in to assist the MBS that they sponsored.

MBA strongly recommends that the Basel Committee reconsider the underlying assumptions and resulting recommendations in the Consultative Document by looking at the actual cases where banks did step-in to determine the root causes. If the root causes are primarily related to the aforementioned securitization arbitrage or other specific factors, any change in regulatory capital requirements should be directed at those specific situations in a more precise fashion instead of the broad approach outlined in the Consultative Document.

Underlying Consolidation Accounting Rule Adequately Captures Step-in Risk

As discussed above, the Consultative Document defines "sponsorship" as containing three elements: decision-making, operations (e.g. placing securities into the market), and financial support. FAS 167 was issued in June of 2009 (soon after the Great Recession began) and specifies the circumstances under which an SPE must be consolidated in a reporting entity's balance sheet. Pages i and ii in the beginning of FAS 167 summarize the accounting:

> This analysis identifies the primary beneficiary of a variable interest entity as the enterprise that has both of the following characteristics:
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> a. The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance
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> b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.
>
> Additionally, an enterprise is **required to assess whether it has an implicit financial responsibility** to ensure that a variable interest entity operates as designed when determining whether it has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.
>
> This Statement amends Interpretation 46(R) to require **ongoing reassessments** of whether an enterprise is the primary beneficiary of a variable interest entity.[9] (emphasis added)

ASU 2015-02, Consolidation, was issued in February 2015 to amend and recodify FAS 167, and it provides the same guidance above. Thus, in determining whether a reporting entity must consolidate, the reporting entity must look to see if it has decision making and an implicit financial responsibility. Further, reporting entities are required to perform ongoing assessments to see if circumstances have changed. In the case of the European banks that did actually step-in on their ABCPs, if they didn't consolidate initially, the first reporting period when they suspected they might step-in, they clearly should have reconsidered and consolidated at that time – at least under U.S. GAAP.

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[9] Financial Accounting Standards Board (FASB), Statement Number 167 *Amendments to FASB Interpretation No. 46(R), June 2009, pages i and ii.*

MBA notes that both FASB and IASB put in place their respective new consolidation principles several years after the Great Recession. The Basel Committee should review those ABCP situations to see if those banks now consolidate the ABCPs where securities arbitrage is underlying the transaction.

Proposal Ignores Existing Regulatory Capital and Liquidity Coverage Rules

Risk-based Capital Rules in the U.S. Require Capital for Consolidated SPEs

Shortly after FAS 167 became effective, prudential U.S. bank regulators updated risk-based capital rules to require banks to maintain capital for assets consolidated under FAS 167. Thus, banks in the U.S. are already maintaining capital on these assets that are not owned by the bank and that are supported by liabilities that the banks do not owe. MBA continues to believe that banks should not be required to maintain capital on assets consolidated under FAS 167. Rather, we believe that risk-based capital should be maintained on only those interests a bank retains from the securitization.

Now, the Basel Committee proposes to have banks maintain additional capital for those SPEs that they sponsor even though the bank demonstrates that it is not the primary beneficiary – the bank does not have a potentially material significant variable interest and the bank does not direct those activities that most impact the economic results of the SPE. MBA believes that if banks in Europe have demonstrated a history of providing support to SPEs beyond their contractual obligation to do so, look to see what in particular is driving them to do that. If the phenomenon is limited to ABCP where there is a maturity mismatch, then develop a rule specific to that problem. And, accounting standard setters at the IASB should address how those situations escape consolidation under their equivalent of FAS 167.

Liquidity Coverage Ratio Already Deals With Off-Balance Sheet SPEs

The Liquidity Coverage Rule in the United States' regulatory reporting regime requires that contractual cash flows related to securitizations must be included in cash outflows used in the liquidity coverage ratio. This is true even for those SPEs that are deemed to be sales under FAS 166 and do not have to be included in a bank's consolidated financial statements under FAS 167. MBA continues to disagree with this and to believe that only potential cash outflows related to a liquidity facility or other legally binding funding agreement should be included in cash outflows for the liquidity coverage ratio calculation.

However, if the Basel Committee is looking for a mechanism to deal with step-in risk – it already exists in the liquidity coverage ratio regime.

Two of the Three Proposed Approaches to Measure Step-in Risk Are Contrary to U.S. Law

The Basel Committee proposes three potential approaches to ascertain and report the magnitude of step-in risk:

1. When the unconsolidated entity undertakes bank-like activities with risks that would get appropriate risk based capital treatments if they consolidate the entity, the answer is to consolidate the entity for regulatory reporting purposes.
2. A "proportionate consolidation approach" is being considered for the situation where step-in risk is shared by two or more banks.
3. A "credit conversion factor" is also being considered.

MBA finds that the first two options are not workable. United States law (Section 12 of the Code of Federal Regulations) requires banks and bank holding companies to file their regulatory reports on a U.S. GAAP basis. Options 1 and 2 would explicitly require variance from GAAP.

Capital Requirement for Step-in Risk Should be Proportionate to Probability of Risk Occurrence

MBA believes that all step-in risks are not equal in probability of occurrence. For MBS in the United States where debtholders are paid off only from the cash flows of underlying mortgages or from foreclosure and insurance proceeds, history has shown that even during the Great Recession banks did not step-in and support. In contrast, an ABCP transaction whereby the underlying assets are long-term and the commercial paper issued is short-term has a higher probability to be supported by the sponsor. If the market for the underlying collateral declines or if the commercial paper market generally becomes less liquid – refinancing an ABCP on maturity would be difficult and could pose reputation risk to the sponsor. MBA believes that the credit conversion factor (CCF) is the most efficient and effective way to operationalize a step-in regime that would allow sovereign regulators to set CCFs based upon probability of step-in or the lack thereof as is the case with MBS transactions.

Rule May Be Particularly Harmful to Ginnie Mae MBS

Approved issuers of Ginnie Mae MBS issue the securities, service the underlying loans, advance principal and interest to investors when borrowers become delinquent, take certain curtailment losses on interest and legal costs on defaulted loans, and have the option to buy loans out of the pool upon a loan becoming 90 days delinquent. Each of these duties is, in fact, contractual since they are enumerated in the Ginnie Mae seller/servicer guide or in the respective servicing guides/agreements with the loan level insurers/guarantors. In contrast, the role of Ginnie Mae is to place the government's full faith and credit behind the securities.

Page 11, paragraph 32 of the Consultative Document talks about the existing Basel framework and defines sponsorship, "… a bank would generally be considered a sponsor and, in turn, an originator, if it in fact or in substance, manages or advises the programme, places securities in the market, or provides liquidity and/or credit enhancements."

When FAS167 (now ASU 2015-02) originally came out, MBA took the issue to the United States Securities and Exchange Commission (SEC) of whether the issuer/servicer of Ginnie Mae MBS was deemed to be the primary beneficiary and would be required to include the principal of the underlying loans and debt instruments in its consolidated balance sheet – especially since the bank is the issuer of the MBS under Ginnie Mae's program. The SEC agreed with MBA that the issuer/servicer is not the primary beneficiary. MBA also notes that the issuers/servicers reserve for the costs associated with loan defaults, so that the curtailments for interest and legal costs have already been written off through profit and loss.

Page 1, paragraph 2 of the Consultative Document states that step-in risk is the "risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations." That would appear to protect banks who are Ginnie Mae issuer/servicers from the proposed step-in regime since each of the obligations a bank has are in fact contractual. However, MBA is concerned that issuer/servicer banks could be drawn into the scope of the Consultative Document under the above definition of a sponsor and thus be required to maintain capital against the principal amount serviced. This could likely result in a mass exodus of banks from servicing these loans. Basel III already requires mortgage servicing assets (MSAs) in excess of 10 percent or an aggregate limit of 15 percent of the common equity component of capital to be deducted from capital. Any MSAs not deducted from capital due to the aforementioned 10 and 15 percent limits must be risk-weighted at 250 percent in the United States. Now, the Basel Committee proposes to have banks hold capital against the principal balance serviced as well? This would result in a bank maintaining capital far in excess of the MSR on the balance sheet. MBA believes that this result would be unfair to bank servicers and disruptive to the market for Ginnie Mae and MBS in general. MBA repeats that the proposed step-in regime in the Consultative Document needs to be tailored to those situations where step-in risk has a reasonable possibility of occurrence.

Possible Unintended Consequence on Consolidation of Variable Interest Entities

MBA is concerned that this guidance, which is intended to address the capital position of banks and bank holding companies, may be construed as having broader implications from an accounting standpoint, which we believe is unintended. MBA is concerned that the rebuttable presumption in the guidance regarding step-in risk could be construed to imply an implicit liquidity guarantee or credit enhancement. This could cause any sponsor who is a service provider (for example, a loan servicer for a securitization) to consider their fee to be a variable interest, which could lead to consolidation of the SPE – that otherwise would not be consolidated under U.S. GAAP.

This presumption of a step-in risk could lead to an accounting conclusion that would push more and more securitizations and similar activities outside the banking system.

Response to Specific Questions in the Consultative Document

Q1. What are commenters' views on the four overarching principles? Are there any others that should be included?

MBA's Response: MBA believes that the premise and assumptions underlying the Consultative Document are wrong. The genesis of the Consultative Document appears to be related to certain EU banks stepping-in and buying the assets out of ABCP deals they sponsored when those deals could not be refinanced especially when banks started securitizing long-term assets with short-term commercial paper in what was called securities arbitrage conduits. MBA believes the entire Consultative Document needs to be revised so that it specifically deals with situations where it is reasonably likely for a bank to step-in and not spread such a wide net to capture and improperly penalize SPE structures that do not carry step-in risk. See all of MBA's General Comments above.

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

MBA's Response: See MBA's General Comments above titled "Proposal Ignores the Underlying Accounting Rule – FAS 167" and **"**Proposal Ignores Existing Regulatory Capital and Liquidity Coverage Rules."

MBA believes that existing accounting rules coupled with regulatory capital and liquidity coverage rules are sufficient to deal with step-in risk.

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?

MBA's Response: See MBA's General Comments above titled "Proposal Ignores the Underlying Accounting Rule – FAS 167" and **"**Proposal Ignores Existing Regulatory Capital and Liquidity Coverage Rules."

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?

MBA's Response: See General Comments above titled "Capital Requirement for Step-in Risk Should be Proportionate to Probability of Risk Happening" and "Two of the Three Proposed Approaches to Measure Step-in Risk Are Contrary to U.S. Law."

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

MBA's Response: See MBA's response to the Basel Committee's question 4 above.

Q6. What are commenters' views on proportionate consolidation for joint-ventures?

MBA's Response: MBA points out that the same proportionate result could be achieved in a CCF regime. Also see General Comment above titled and "Two of the Three Proposed Approaches to Measure Step-in Risk Are Contrary to U.S. Law."

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

MBA's Response: N/A to the mortgage banking activities of MBA's members.

MBA appreciates the opportunity to share its observations with you. Any questions about the information provided herein should be directed to Jim Gross, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at jgross@mba.org.

Sincerely,

David H. Stevens, CMB
President and Chief Executive Officer
Mortgage Bankers Association