NOMURA

Nomura Holdings, Inc. 1-1-9, Nihonbashi, Chuo-ku, Tokyo, Japan

Basel Committee for Banking Supervision
c/o Bank for International Settlements
CH-4002
Basel, Switzerland
Submitted via web

March 17, 2016

RE: Consultative Document – Identification and measurement of step-in risk

We, Nomura Group, as a global investment banking group headquartered in Japan, hereby responds to the Basel Committee on Banking Supervision's ("Basel Committee") request for comments on the Consultative Document "Identification and measurement of step-in risk" published on December 17, 2015.

We concur with the Basel Committee as to its recognition of importance of learning lessons experienced during the financial crisis which should be addressed in an appropriate manner through various policy measures including prudential regulations. Although it would be a complex framework to be added to the existing regulatory capital standards, to mitigate potential spillover effects from the shadow banking system to banks, we appreciate the G20 initiative to strengthen the oversight and regulation of the shadow banking system to avoid the associated potential systemic risks.

In our response to the Basel Committee's consultation, we try to share our findings and thoughts with you to sensibly form the basis of an approach for identifying, assessing and addressing step-in risk potentially embedded in banks' relationships with shadow banking entities. We believe that, given the implicit nature of risk to be covered, for reflecting step-in risk in prudential measures in a practically acceptable manner both for the regulators and banks, clear scope and clarification of primary indicators under the concept of 'sponsorship' should be pursued for the purpose of identification of unconsolidated entities to which a bank may provide financial support regardless of contractual obligations. Therefore, our response below primarily focuses on how to define and set the scope of primary indicators through the concept of 'sponsorship' while we strongly encourage Pillar 2 approach if it is being implemented in future.

I. General View on Approach to Regulatory Framework

We understand that the Consultative Document intentionally does not address how the proposals would be incorporated into or would modify the current Basel framework, including whether they fall within Pillar 1 and/or Pillar 2, and agree to the approach which first focuses on the conceptual framework and its underlying elements. However, while looking into the detail of conceptual framework and its underlying elements, we are more inclined to have a general view that Pillar 2 approach should be taken when the proposed framework is really being implemented in future.

Although, based on experience from the financial crisis, it is well-established policy agenda today to apply certain prudential regulatory framework to shadow-banking system, or more specifically credit risk transfer activities through securitisation conduits, structured investment vehicles and other similar forms of entity, if a policy approach tries to capture the wider scope of risks preemptively, it is likely to cause some regulatory design defects or practical difficulties somewhere unintended or unaware at all. If the proposal aims to implement Pillar 1 approach to an area which is more suitable for Pillar 2 approach by its nature, we will be in a position to express our strong concern.

The risk profile of business dealings with such an entity differ wildly across transactions, institution types, and geographies/countries. The nature of step-in risk adds complexity to the attempt of hammering out clear guidelines which can be applied uniformly to the entire spectrum of business dealings. We believe key principles and concepts should be clarified and agreed globally and individual home supervisory authorities take responsibility of ensuring step-in risk be addressed appropriately in their respective jurisdictions, with actual risk profiles and accounting treatment taken into account.

II. Primary indicators: Use of the sponsorship concept

i. Element of decision-making (management and/or advice)

We have no particular objection to use the "sponsorship" concept based on the Basel Committee's revised securitisation framework as a starting point. However, among three elements of sponsorship, decision-making (management and/or advice) and operations (placing securities into the market) need to be carefully considered to establish a good concept. First we would like to discuss the element of decision-making to make a table of primary indicators without excessive regulatory complexities and costs.

Under the items No 1 through to No 6 in the 3.1.2. Table of primary indicators, these indicators are set largely based on upfront facilities and decision-making. In general, provision of upfront facilities is more about something resulting in the accounting consolidation. On the contrary, depending on the conditions to be established, decision-making could have a broader meaning beyond the relevant accounting standards and it might be irrelevant to the assessment of step-in risk which concerns the possibility of providing financial support during a stress.

In the context of the sponsorship concept, we come up with two basic types of decision-making or decision-maker, namely i) those stemmed from the status of so-called 'originator' of the assets in question and ii) those engaged through the status of so-called 'operator' (or agent) of the assets under management. In this respect, we strongly urge the Basel Committee to clearly distinguish the originator status and the operator status, when capturing the risk of step-in which is implicit in nature and is considered to be associated with reputational or franchise risk. More specifically, we refer to No 6, in the 3.1.2. Table of primary indicators, where sponsorship is recognised when a bank is a decision-maker but has not provided any upfront facilities.

This distinction between an originator and operator is already recognized in footnote 17 of page 14 of the Consultative Document as an originator versus operator comparison. We agree to the point that when a bank has discretion over the assets that are on the entity's balance sheet, in particular where the assets that it has originated are included, it may be more suggestive of relationship associated with step-in risk. On the contrary, we strongly believe that if a bank merely acts as the "operator" of an entity that is investing in third-party assets rather than having discretion over the assets, relevant parties would not expect the bank to step in. In other words, an originator is closer to a principal while an operator is closer or equivalent to an agent.

As an operator/agent, decisions are made in accordance with the pre-agreed investment mandates (or objective/criteria) and this situation should clearly be excluded from the step-in risk assessment. We strongly believe that this should not be regard as "decision-making." In addition, the situation where a bank structures and arranges transactions for its clients using trading book instruments sourced from the secondary market should also be excluded as it entails no or minimal step-in risk. Clients would likely have a very different expectation for an operator/agent than they might have in the case of an originator which moves its banking book exposures to an off balance sheet vehicle (SIV, etc.).

In certain circumstances or depending on jurisdictions, it might not be straight-forward to distinguish between an originator and operator/agent clearly. For instance, a bank may act as an operator/agent on its face but in substance it keeps more discretionary power over the assets or an entity in question. These situations require a more granular case-by-case analysis so that in terms of the Basel framework, Pillar 2 approach should be pursued to address such step-in risk if any.

In addition to the above, for the avoidance of doubt, business-as-usual decision making in respect of day-to-day transactions based on a pure economic rational and any other ancillary business operations should be clearly carved out because it is not necessarily linked to step-in risk. It might be worthwhile considering to set certain material thresholds to help identify relevant risk in a risk sensitive and proportionate manner as the proposed guiding Principle 3 (the framework should be conservative, risk-sensitive and proportional) discusses. For example, a bank as swap counterparty may exercise in-the-money call options against a special purpose vehicle set up for the repackaged note transactions. This exercise of call options should not be regarded as "decision-making," triggering step-in risk, because such exercise is done only due to a clear economic rational of in-the-money position rather than any discretional decision-making where no objective economic rational exists out of the decision-maker's internal assessment. Regular transfer of assets between a bank and a special purpose vehicle through repos and other securities financing transactions would be another example.

All in all, under the Consultative Document, the "decision-making" element seems to try to cover every situation where a bank involves some regardless of the nature of the relationship. We strongly urge that, as discussed above, the Basel Committee should exclude a situation which is not appropriate to be covered by the scope of step-in risk assessment, hopefully by taking into account the proposed four guiding principles.

ii. Element of significant influence

The proposed element of significant influence is a new criterion which is broader than the existing accounting standards. We believe that the scope of primary indicators should not be broader than what would trigger accounting consolidation (under US GAAP / IFRS) because it only brings unnecessary complexities into the framework. We do not see any convincing reason to go beyond the scope of control for the purpose of accounting consolidation, especially in light of recent changes to U.S. and international accounting standards.

iii. Element of external credit rating based on a bank's own rating

As discussed in No 10 in the 3.1.2. Table of primary indicators, we broadly agree that if the relevant credit rating provided to an entity is actually lifted up thanks to recognition of implicit support of a bank as a source of strength, it may be able to be considered as an indicator of step-in. However, there may be a case where no credit enhancement by a bank is expected but still its credit rating is referenced by rating agencies for other reasons.

For example, a rating agency may review the rating of a bank as a swap counterparty to an entity (such as special purpose vehicle) to ensure no imminent material counterparty risk posed to the entire structure. A swap counterparty merely provides economic flows to an entity in accordance with the pre-agreed commercial terms on an arms-length basis without providing any credit enhancement to an entity, a debt instrument and a structure as a whole. Under the circumstance, there is no intention to upgrade from a rating which would have been granted without considering the credit quality of the swap counterparty. This sort of situation should clearly be carved out from the scope of assessment of step-in risk.

iv. Element of exclusive critical services provider

We see the relationship between a bank and critical services provider as, by its nature, something different from the other relationships such as these with SIVs as discussed in the Consultative Document. It is not necessarily stemmed from risks associated with financial transactions or anything like exposures captured as risk-weighted-assets for the regulatory capital purposes. In other words, it is not like a risk absorbed by regulatory capital but more like a business continuity management where financial assistance may be required as expenses and funded by certain general cash reserves just as any other commercial business operations are dealing with. This also may have a close relevancy with one of the proposed secondary indicators which is "Entity is subject to being safeguarded for its continuity of critical functions in accordance with the bank's recovery and/or resolution plans". In this respect, we have a concern that, if any step-in risk requirements were imposed on continuity of critical functions, it may bring disincentives with the banks to improve resolvability as required by the regulators. In any event, as the Consultative Document only provides very short analysis and rational on these points, we would like to ask the Basel Committee to consider this element separately with more analysis and until then we would like to reserve our definitive opinion on this matter.

v. Element of operations (placing securities into the market)

Based on the definition of a sponsor as outlined in the Basel Committee's revised securitisation framework, the element of operations (placing securities into the market) is included for the sponsorship concept. This simply means, as we interpret, the so-called "underwriter" of securities issuance which is one of the primary businesses carried out by a broker-dealer or investment bank along with its traditional market trading activities. However, we have a strong view that it is not necessary to assess or anticipate any step-in risk as a risk to be forced or in any way obligated to provide financial assistance to transactions on the part of the underwriter.

An underwriter assumes the risk of holding securities underwritten as inventory in its proprietary account until distributing these out to the market but assumes no risk to provide any financial assistance to the issuer of securities in question. The underwriter has already purchased the issued securities at an agreed price. Because of the risk assumed by the underwriter, underwriting activities are often carried out by multiple banks in the form of syndication which is a mechanism to diversify underwriting risks among banks.

We understand that certain risks associated with underwriting activities are already covered under the operational risk framework. We also understand that, among the risks covered under the operational risk framework, reputational risk is excluded. However, to capture all such reputational risk preemptively if any, it is required to assess through Pillar 2 approach with more substantive consideration.

Historically we, Nomura Group, have never experienced any step-in situation and, to our best knowledge, there has been no market precedent as to step-in by underwriters across the industry. The element of operations (placing securities into the market) should clearly be carved out from the scope of assessment of step-in risk.

****

We appreciate the opportunity to share our views on this Consultative Document issued by the Basel Committee. Should you wish to discuss any of the above, we are very glad to provide any further responses and in any way we expect our input to be useful for the Basel Committee to establish a sensible framework in relation to step-in risk.

Yours sincerely,

Yuji Nakata
Deputy CRO
Nomura Holdings, Inc.