May 15, 2017

Basel Committee on Banking Supervision
c/o Bank For International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Re: Comments on Guidelines re: Identification and management of step-in risk

The Structured Finance Industry Group ("**SFIG**")[1] appreciates the opportunity to offer some general comments on the March 2017 Consultative Document: Guidelines – Identification and Management of Step-In Risk (the "**Guidelines**") of the Basel Committee on Banking Supervision (the "**Committee**") that seeks to help the industry and regulators develop an approach for identifying, assessing and addressing step-in risk potentially embedded in bank[2] relationships with "shadow banking" entities (such approach, the "**Framework**"). The comments of this letter build upon the comment letter SFIG sent to the Committee on March 17, 2016 in response to the questions raised by the December 2015 Consultative Document – Identification and Measurement of Step-in Risk (the "**2015 Consultative Document**") of the Committee.

SFIG acknowledges the efforts of the Committee in producing the Guidelines and thanks the Committee for their efforts to clarify and build an implementable framework from the ideas set forth in the 2015 Consultative Document.[3]

I. Introduction

We applaud the Committee on the work it has done thus far in addressing step-in risk and recognize its efforts to implement the comments it received on the 2015 Consultative Document. In particular, we believe that the Guidelines properly place the Framework into Pillar II of the Basel III reforms.

Nevertheless, we continue to have concerns about the Framework as proposed. While recognizing that the Committee sees the Framework as important, we recommend the Committee postpone finalizing the Framework until the Committee conducts an evaluation of the effectiveness of all related post-crisis reforms by itself and all other relevant regulators and other parties. This would also allow for a further assessment and development of regulatory reviews underway in the U.S. and the European Union, and aligns with the recently announced evaluation of the effects of the G20 Financial Regulatory Reforms to be conducted by the Financial Stability Board (FSB).

Should the Committee nevertheless decide to proceed with the finalization of Framework, we would like to propose a few points to clarify further the proposed Framework.

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[1] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization markets. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

[2] For purposes of this letter, "bank" refers to any regulated bank or other financial institution, or affiliates of the same, that are subject to or that may become subject to the Framework.

[3] Unless otherwise specified, abbreviations defined in the Guidelines have the same meaning in this letter.

Overall, we remain concerned about the scope of the Framework and the significant operational burden its implementation would place on banks and the redundancy the Framework would have in the context of other existing regulatory frameworks. Specifically, our concerns center on the breadth of the terms "sponsor" and "other contractual and non-contractual involvement" as they relate to the entities for which step-in risk information would need to be compiled and reported. We also believe an exception should be created for non-consolidated entities when a bank opts to holds regulatory capital in an amount and quality equal or greater than to the regulatory capital it would be required to hold if the entity were consolidated. Further, we believe that requiring public disclosure of potential step-in risks would create market expectations that a bank would step-in, which could, should the occasion arise, result in added pressure on a bank to step-in despite the lack of a contractual requirement. Finally, we continue to assert that the Framework is unnecessary given other regulatory developments, but should the Committee nevertheless determine to proceed with the Framework, we believe that jurisdictions should have the option to opt out of the Framework, entirely or in part, if they determine their regulatory framework otherwise adequately addresses step-in risk concerns. We address each of these concerns, in turn, below.

II. Scope of the Definition of Sponsor

We remain concerned about the broad scope of the definition of "sponsor" and its extension to entities that would not normally be included in such concept. The successful implementation of the Framework will require definitions that clearly delineate the scope of and limit the types of entities and transactions intended to be covered. To eliminate any ambiguity and uncertainty, the definition of "sponsor" should be more clearly defined and limited.

As presented in the Guidelines in Paragraph 24 (first bullet point), a bank would be required to evaluate all entities with which it has a relationship. Included in this list is what Paragraph 24 defines as "Sponsor," which would encompass all scenarios in which the bank manages or advises the entity, places the entity's securities into the market, or provides liquidity and/or credit enhancement to the entity. We disagree that all such scenarios would present step-in risk and we would request that the Committee adopt a more narrowly tailored definition of "sponsor." Were the Committee to leave the definition as is, the breadth of its scope would place an outsized operational burden on banks to identify and assess on an ongoing basis all these entities, many of which present no step-in risk.

For example, the proposed definition may extend step-in risk assessments to transactions where an affiliate of a bank acted as underwriter for the securitization and would therefore be characterized as a "Sponsor." The purpose of an underwriter is to sell securities in the market, not to support existing transactions. The underwriter has a limited relationship with an issuer, as a result step-in risk is insignificant. Securities that are sold by a bank as underwriter do not affect its balance sheet other than as a result of any income earned by an underwriter in that role. Additionally, for those banks with affiliated broker-dealers that act as underwriter, performing the internal evaluation required by the Framework would be an onerous task.

As a result, we believe a more appropriate definition would be one that finds a "sponsor" to exist when the bank organizes and initiates a securitization. We believe this to be a more appropriate definition that would bring the definition of "sponsor" for the purpose for the Framework more in line with the standards of U.S. law. The definition of "sponsor" for purposes of Regulation AB and Risk Retention[4] in the United States reads: "[t]he person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[5] Whereas SFIG does not believe that Section 619 of the Dodd-Frank Wall Street Reform and

[4] Credit Risk Retention, SEC Rel. No. 34-73407, 79 Fed. Reg. 77604-77605 (Dec. 24, 2014) (Adopting Release).

[5] 17 CFR 229.1101(l).

Consumer Protection Act and the regulations implemented thereunder (collectively referred to as the "**Volcker Rule**") should apply to securitization structures, it does and as long as the rule continues to do so then under the "Super 23A" provisions, banks and their affiliates are prohibited from a range of transactions with a sponsored entity that is a related covered fund (including purchasing assets from, extending credit to, investing in, entering into certain derivatives or other transactions that would cause the banking entity to have credit exposure to such covered funds).[6] Therefore, these provisions eliminate any step-in risk with regard to those entities.

III. Scope of the Definition of Other Contractual and Non-Contractual Involvement

The proposed guidelines in Paragraph 24 (third bullet point) also propose that an analysis would be required for any entity for which a bank has a relationship which entails "other contractual and non-contractual involvement," defined to include involvement that exposes the entity to "the risks or to equity-like returns from the assets of the entity or related to its performance". This definition is extremely broad and has no further guidance as to what type of entities would be captured by such a definition. In addition, the concerns represented by "step-in risk" would not seem to apply where a bank held subordinate securities – in such a situation, as an investor, attempting to exercise its rights under the transaction documents to remedy a situation would be very typical and not extraordinary in any way. Investors in subordinate CMBS, for example, frequently have certain control rights over the commercial mortgage loans in the trust which are normal for investors in that type of security and the value of this right is already part of the value of the security. Regardless, as with the definition of "sponsor", were the Committee to leave the definition as drafted, there would be an undue operational burden on banks first to identify all the potential entities covered by this definition and then to assess on a routine basis step-in risk for all these entities unnecessarily.

We believe it more appropriate to remove "other contractual and non-contractual involvement" as a type of relationship subject to the Framework. However, were the Committee to decline to remove this broad category of relationships, we would recommend revising the definition to delete "the risks or to" so that it reads "[e]xposes an entity to equity-like returns from the assets of the entity or related to its performance" so as to limit step-in risk solely to those situations where the bank is acting as an investor in the first-loss subordinate securities of a securitization. By limiting it in such a way, this would considerably reduce the burden of compliance for banks to identify and assess these types of relationships.

IV. Unintended Consequences

The Committee should guard against taking actions that, by their nature, create perceptions or raise expectations that the bank is prepared to step-in or provide a backstop. In requiring banks to identify entities that may be prone to step-in risk, the Committee may be perversely encouraging step-in by banks. Once a bank has identified a particular vehicle or asset-class as a potential step-in risk, it may have created a market expectation and increased pressure to step in.

V. Exception for Non-Consolidated Entities when a Bank holds Regulatory Capital

Should a bank opt to hold regulatory capital for a non-consolidated entity in an amount and quality equal to or greater than the regulatory capital it would be required to hold as if the entity were consolidated, and can demonstrate this fact, we believe that such an entity should not be included in the Framework. Simply put, in these instances, the non-consolidated entity does not present a step-in risk intended to be addressed by the Framework.

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[6] *See* 12 U.S.C. § 1851.

VI. Ability for Jurisdictions to Opt Out of the Framework

The U.S. and numerous other jurisdictions have adopted rules, such as new accounting, capital, liquidity, stress testing, and risk retention standards. For example, the U.S. Volcker Rule addresses and constrains step-in for certain entities. We assert that these changes have fully addressed step-in risk concerns in jurisdictions like the U.S. As such, we continue to believe that the Framework, or any additional regulation, may be unnecessary.

Prior to the financial crisis, accounting rules allowed for off-balance sheet treatment of sponsored transactions. These rules were subsequently amended to require that such transactions be consolidated when issuers possessed control and held a potentially significant economic interest in the entities.[7] These accounting rules, known as ASC 860 (FAS 166) and ASC 810 (FAS 167), although adopted post-crisis, were conceived of and proposed pre-crisis, and were designed around the goals of open recognition of transactions on the face of the balance sheet rather than taking account of the level of contractual risk that was transferred. Nevertheless, following the crisis, U.S regulatory agencies elected to link regulatory risk-based capital treatment (a risk transfer concept) to accounting-based consolidation (a recognition and disclosure concept) decisions. While acknowledging that the Committee does not determine the implementation of regulatory capital treatment in the U.S., we would like to take this opportunity to share these concerns regarding the linking of such treatment to accounting consolidation.

Should the Committee continue to move forward with the Framework, we strongly suggest that there should be a mechanism so that jurisdictions can opt out of the Framework, entirely or in part, if they determine that their regulatory framework adequately addresses step-in risk concerns. At a minimum, we ask the Committee to permit "collective rebuttals" within the Framework whereby a jurisdiction, such as the U.S., can determine that there is no step-in risk in a certain class of entities or circumstances due to the application of U.S. law, and further that once a jurisdiction makes such a determination, the Framework should not require banks to continue to track those entities.

VII. Conclusion

In summary, our responses to the Guidelines include, among others, the following key recommendations:

- We encourage the Committee to define "sponsor" to exist when the bank organizes and initiates a securitization. Such an approach would bring the definition of "sponsor" more in line with the standards of U.S. law and more appropriately tailor step-in risk assessments.

- We encourage you to not include "other contractual and non-contractual involvement" as a type of relationship subject to the Guidelines as it is overly broad.

- Were the Committee to still include "other contractual and non-contractual involvement" as a type of relationship subject to the Guidelines, we ask that you revise the definition so it only applies if the entity exposes the bank to equity-like returns.

[7] When making GAAP consolidation decisions, a sponsor must evaluate pursuant to ASC 810-10-25-38B which activities are deemed most significantly impacting the VIE's economic performance and determine whether it has the power to direct those activities. If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of ASC 810-10-25-38A, that reporting entity also is required to consolidate the VIE if it has the obligation to absorb losses that could potentially be significant to the VIE.

- Further, we believe that requiring public disclosure of potential step-in risks would create market expectations that a bank would step-in, which should the occasion arise could result in added pressure on a bank to step-in despite the absence of a contractual requirement.

- We strongly recommend that the Framework exclude entities for which a bank can demonstrate that they hold regulatory capital for a non-consolidated entity in an amount and quality equal to or greater than the regulatory capital such bank would be required to hold if the entity were consolidated.

- Finally, we encourage the Committee to include a mechanism so that jurisdictions can opt out of the Framework, entirely or in part, if they determine that their regulatory framework fully addresses step-in risk concerns.

We greatly appreciate your consideration of our members' comments and would welcome the opportunity to discuss with the Committee the concerns expressed herein and how our members may contribute to the more successful development of a stable risk management strategy. Please do not hesitate to contact the undersigned at +1 (202) 524-6301 or Richard.Johns@sfindustry.org should you have any questions in connection with this letter.

Very truly yours,

Richard Johns
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