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March 17, 2016

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: Basel Committee on Banking Supervision Consultative Document – Identification and Measurement of Step-in Risk

Ladies and Gentlemen:

Wells Fargo & Company (“Wells Fargo” or “we”) is a diversified financial services company with over \$1.7 trillion in assets providing banking, insurance, trust and investments, mortgage banking, investment banking, retail banking, brokerage services and consumer and commercial financial services. We appreciate the opportunity to comment on the Basel Committee on Banking Supervision (“BCBS”) Consultative Document: Identification and Measurement of Step-in Risk (the “Proposal”).

We have worked closely with several trade organizations in reviewing the Proposal. We share the concerns identified in the comment letters filed by The Clearing House Association L.L.C. (“TCH”), American Bankers Association (“ABA”) and the Institute of International Finance (“IIF”).

Executive Summary

The Proposal introduces step-in risk as a new risk to the Basel framework. Step-in risk is defined as the risk a bank may provide non-contractual support to an off-balance sheet (“OBS”) vehicle to protect its reputation. This potential non-contractual exposure is also referred to as an implicit interest. While we do not disagree that in limited circumstances banks provided non-contractual support to certain OBS vehicles during the financial crisis of 2007-2009, we believe step-in risk has already been adequately addressed in the U.S. through post-crisis legislative, regulatory and accounting reforms. The Proposal correctly identifies many of these reforms, including the SEC’s Money Market Fund (“MMF”) reforms,¹ SEC’s proposed liquidity rules for mutual funds and ETFs,² the U.S. Volcker rule³ as well as accounting reforms, specifically, the Financial Accounting Standards Board (“FASB”) projects on consolidation.⁴ Beyond the reforms mentioned in the Proposal, risk retention requirements for certain securitization

¹ See Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166, July 23, 2014 (79 FR 47735 – August 14, 2014).

² See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (80 FR 62274 – October 15, 2015).

³ Dodd-Frank Act § 619. The Volcker Rule was implemented through a final rule jointly issued by U.S. regulators. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014).

⁴ See FASB Accounting Standards Update 2009-17 Consolidation (Topic 810) – *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, December 2009 and Accounting Standards Update 2015-02 *Amendments to the Consolidation Analysis*, February 2015

transactions will be effective later this year,⁵ and the U.S. has also included an assessment of step-in risk in the 2016 Comprehensive Capital Analysis and Review (“CCAR”) process. Collectively, these reforms have greatly reduced step-in risk for banks in the U.S.; therefore, we do not believe additional guidance from the BCBS that does not recognize such reforms and allows for appropriate national discretion is necessary to address this risk for banks in the U.S. at this time.

While the International Accounting Standards Board (“IASB”) and FASB did complete consolidation reforms jointly, it appears the BCBS only considered IFRS guidance on implicit interests. Under U.S. GAAP, implicit interests must be considered throughout the consolidation assessment including in determining which consolidation model applies, whether the bank has power over the most significant activities of the entity and whether the bank has a significant variable interest in the entity. If an implicit interest exists, regardless of the probability of occurrence, it may be a determining factor in the U.S. GAAP consolidation assessment. The Proposal proffers that step-in risk has not been fully addressed by accounting reforms because implicit interests are not determinative. However, because implicit interests can be determinative under U.S. GAAP,⁶ we believe U.S. GAAP may fully address this concern. Further, we believe any presumption of step-in risk for regulatory purposes could potentially suggest an implicit interest exists for accounting purposes. This would present significant risk that the regulatory determination of step-in would override the U.S. GAAP consolidation framework. We do not believe it would be appropriate for the BCBS to issue regulatory capital guidelines that potentially conflict with U.S. GAAP. Consequently, we recommend the BCBS separately consider U.S. GAAP guidance in determining how much jurisdictional flexibility is necessary prior to re-proposing this issue.

If after overcoming the potential conflict with accounting rules the BCBS pursues a global regulatory capital standard addressing step-in risk, we strongly recommend the BCBS make significant revisions to address shortcomings in the conceptual framework, provide broad jurisdictional latitude to allow local regulators the ability to address step-in risk appropriately in their respective jurisdictions and re-propose in a second consultation prior to issuing final guidance. We also believe the BCBS should perform a more substantive QIS that appropriately recognizes all of the aforementioned legislative, regulatory and accounting reforms after modifying the proposed framework to then identify any remaining potential step-in risk. A summary of our concerns with the Proposal and recommended improvements to the conceptual framework, which are discussed in more detail below, are as follows:

- Step-in risk should not be addressed under Pillar 1;
- Significant changes to the proposed framework are needed to address step-in risk if the BCBS were to adopt a standard under Pillar 2;
- The definition of sponsor, including the primary indicator framework, needs significant improvement;
- The automatic and overly broad presumption of step-in risk should be removed; and
- Conducting a QIS based on the preliminary nature of the consultative document is unlikely to produce meaningful results.

Details Regarding Our Primary Concerns and Recommended Improvements

- Step-in risk should not be addressed under Pillar 1: Because non-contractual support generally arises from reputational risk and ultimately the failure to appropriately structure OBS vehicles to transfer risk under stressed conditions in accordance with the structure’s design and investor expectations, we believe the risk is best addressed through enhanced risk management as opposed to a general capital charge. Stressed conditions are a key element to an OBS entity’s design failure and consequently

⁵ See *Credit Risk Retention*, 79 Fed. Reg. 247, at 77602 (Dec. 24, 2014).

⁶ See FASB Accounting Standards Codification (ASC) 810-10-25-49 through 810-10-25-54

should be assumed in any attempt to identify step-in risk. A Pillar 1 approach would fail to address risk management as the root cause of the issue and instead unduly penalize a vast array of OBS vehicles under non-stressed conditions where no evidence of step-in risk exists.

We believe the impact of regulatory consolidation would be disproportionate to the risk presented, particularly because all of the assets subject to regulatory consolidation would be risk-weighted as if they were held by the bank directly without regard for the magnitude of step-in risk. While the consultative document mentions specific structure types that received non-contractual support from banks during the financial crisis, quantitative information regarding the amount of losses absorbed by the banks is not provided. Based upon our understanding and experience, losses absorbed by banks were limited to a subset OBS structure types and further limited to a subset of the OBS entities' exposures. Structure types that presented more material risks, such as securitization conduits and structured investment vehicles, are now generally consolidated for accounting purposes. As a result, reflecting all of the OBS entity's assets through full regulatory consolidation in cases that have not already been addressed by accounting reforms would significantly overstate the risk. This disproportionality is exacerbated by the overly broad definition of sponsor and presumption of step-in, which we discuss further below. Like the full regulatory consolidation, we also feel the proportionate consolidation method would be misrepresentative of the inherent risk. Under the equity method of accounting, the bank records in earnings its proportionate share of the entity's profits and losses with the offset reflected in the investment balance. In these cases, the Proposal suggests proportional regulatory consolidation would be appropriate. It is unclear how subjecting additional assets, beyond the bank's investment balance, to risk weighting would be more representative of the risk associated with the transaction or why the current risk weights applied to equity exposures are insufficient.

The U.S. effectively eliminated differences between regulatory and accounting consolidation decades ago. We believe re-introducing a significant reporting difference in the U.S. would create significant market confusion for investors and financial statement users. As previously described, we also believe there is a risk that requiring regulatory consolidation may potentially override the existing U.S. GAAP consolidation framework, which would render the Pillar 1 option moot. Even if the potential conflict with U.S. GAAP was overcome, it would be unjustifiably costly to perform the regulatory consolidation to create a second set of books and records in a timely manner to calculate capital and report results. As a result, we do not believe the Pillar 1 option is fit for this purpose.

- Changes to the proposed framework are needed to address step-in risk under Pillar 2: The Proposal appears biased towards a Pillar 1 approach due to its focus on the regulatory consolidation methodologies and lack of guidance on how step-in risk would be addressed under Pillar 2. While we believe Pillar 2 would be favorable to Pillar 1, the Proposal does not provide an adequate vision of a Pillar 2 framework for us to assess. An enhanced Pillar 2 framework should, at a minimum, address preventative risk management practices, specifically, internal governance over the bank's involvement with OBS entities, entity design, investor expectations and alignment of interests between sponsors and investors. In addition to preventative measures, we would recommend significant changes to the proposed framework for detecting the presence of step-in risk. We believe the overly broad and automatic presumption of step-in risk should be removed and primary indicators

modified in order to create a workable Pillar 2 framework. Beyond these changes, we believe the framework should include a filtering mechanism, as opposed to a broad presumption of step-in and rebuttal process, to establish a subset of OBS entities subject to further analysis for the presence of step-in risk. The analysis of the smaller subset of entities should reflect how the bank expects its' relationship with those entities would behave under stress. Only after appropriate scoping and expected entity performance under assumed stress conditions should the bank determine step-in risk exists.

- The primary indicators of step-in risk need significant improvement: The Proposal provides three indicators of sponsorship: (1) decision-making (management and/or advice), (2) operations (placing securities into the market) and (3) financial support (provision of liquidity facilities or credit enhancement). If a single primary indicator of sponsorship is present, the Proposal presumes step-in risk exists and sets a high hurdle in order to rebut the presumption. We believe the primary indicators, as proposed, require significant additional development and definitional guidance. For example, the Proposal acknowledges the bank may be acting as an agent as opposed to principal with respect to an asset management role, but fails to draw definitive conclusions on agency relationships and suggests the bank would likely be a decision maker and consequently, sponsor. Control over an OBS through decision making, including distinguishing between principal and agent relationships, has been the subject of significant deliberation by the FASB and IASB in their joint project on consolidation. The decision making definition within the Proposal includes instances where a bank has significant influence, as opposed to control, which expands the scope of entities subject to the decision making criterion well beyond instances where the bank has control over decision making. We agree decision making is a relevant indicator; however, it does not appear full consideration was given to the work done by the FASB and IASB on this topic. We recommend the BCBS more explicitly consider whether it intends to align the definition of decision making in the Proposal to the concepts developed by the FASB and IASB and if not, provide sufficient guidance regarding expected differences and rationale for the deviations.

The operations (placing securities in the market) indicator is the only indicator that can be met solely through involvement in the upfront origination of the entity. Said differently, this indicator does not require continuing involvement with the OBS entity. We believe this is an inherent flaw in the operations indicator. Further, it is very common for multiple banks to participate in the underwriting and issuance of securities to the market for a given transaction and the Proposal would again potentially have multiple banks capture the same risk. We recommend the BCBS focus on indicators that include a form of continuing involvement with an OBS entity rather than instances where a bank's only involvement is in the formation and original issuance of securities.

Due to the post-crisis accounting reforms, a single party that is a decision maker and also provides liquidity or credit enhancement would generally consolidate the entity, which obviates the need to address step-in risk. If the party providing the credit enhancement or liquidity does not consolidate the entity, that party often does not design the OBS entity or transfer assets to the entity. A party providing credit enhancement that is not also involved in the upfront design of the entity is simply acting as an investor and is far less likely to have any reputational risk. Similar to the other primary

indicators, we do not believe the presence of this indicator on its own would be indicative of sponsorship or step-in risk.

The Proposal includes structure design and investor expectations as secondary indicators of sponsorship.⁷ We believe these factors should be more prominent in the assessment framework because reputational risk arises when the OBS entity's performance presents risks investors had not expected to absorb. Therefore, the bank must first identify the type and nature of the risks designed to be passed on to investors before identifying the risks that could result in step-in risk. The Proposal identifies MMFs as a structure type that was supported during the financial crisis and acknowledges the MMF reforms put in place post-crisis, but fails to recognize the primary cause of MMF support in the proposed indicators or definition of sponsor. MMF support was due in part to a key design feature, the \$1 NAV, which resulted in reputational risk for a bank sponsor of a fund that was at risk of "breaking the buck". Instead of identifying and addressing the design characteristic, the Proposal would scope in other types of bank sponsored investment funds, where there is no expectation of bank support or evidence that step-in risk exists.

We believe each of the primary indicators is underdeveloped and the framework flawed if each is considered independently with the presence of a single indicator resulting in sponsorship and a presumption of step-in risk.

- The automatic and overly broad presumption of step-in risk should be removed: The need for the presence of only one indicator of sponsorship and presumption of step-in risk, particularly when combined, create an extremely broad array of OBS entities where step-in is presumed. Instead of including a presumption of step-in risk, the primary indicators need to be just that, indications that the bank should consider its involvement with the entity further. By requiring presence of only one of the three primary indicators before presuming step-in risk exists, the proposed framework inherently presents the risk that more than one bank would be deemed sponsor and could result in double or triple counting certain OBS entities.

Just as the support provided to OBS vehicles by certain banks in some instances during the financial crisis provides evidence step-in risk exists, a lack of support in other instances through the financial crisis also provides evidence that the risk does not exist. The Proposal recognizes that legislative or regulatory reforms may overcome the presumption of step-in for structure types that were supported during the crisis, but presumes step-in risk exists for structure types that were never supported. For example, we originated numerous private residential and commercial mortgage backed securitizations prior to the financial crisis; these entities were never supported and remain outstanding. We often are the decision maker, initially placed securities into the market and continue to make markets in the securities issued by the securitization trusts. Consistent with current U.S. GAAP, these MBS trusts are not consolidated. Based on the proposed definition of sponsorship, we would be considered sponsor and step-in risk presumed to exist. We believe this relatively common transaction fact pattern highlights fatal flaws in the proposed framework. We would also note that we are not the residual interest holder in the aforementioned fact pattern, so another party, potentially another bank may also be considered sponsor under the Proposal due to the financial support indicator.

⁷ See secondary indicators h-k on page 18 of the consultative document

We could provide numerous similar examples, but instead would strongly recommend the BCBS more carefully consider how to narrow the focus on a bank's relationships with OBS entities that truly present some degree of step-in risk. At a minimum, the framework should remove the automatic presumption that step-in exists based on presence of a single indicator of sponsorship.

- Conducting a QIS based on the preliminary nature of the consultative document is unlikely to produce meaningful results: The BCBS included step-in risk in its Basel III Monitoring exercise due in April of 2016. Because of the preliminary nature of the Proposal, we believe it was premature to include step-in risk in the QIS and believe the results may not prove useful. Specific issues with the QIS data collection include:
 - We expect the lack of clear guidance regarding the definitions of the primary indicators is likely to result in inconsistent responses;
 - The scenarios included in the table of primary indicators and QIS template do not include all scenarios where a bank would be considered sponsor based on the primary indicators;
 - Due to the overly broad definition of sponsor, the Proposal incorrectly assumes the bank will have access to quantitative information regarding an OBS entity's balance sheet;
 - The qualitative information requested in the QIS is often entity or transaction specific and cannot be provided for multiple OBS entities on an aggregate basis; and
 - We do not know the accounting conclusions of unrelated third parties involved in the transactions included in the scope of the QIS.

* * * * *

In summary, we acknowledge prior instances of step-in; however, we believe step-in risk has been largely addressed in the U.S. already via post-crisis legislative, regulatory and accounting reforms. If the BCBS pursues this consultative document further, we believe it is imperative that the BCBS provide sufficient national discretion to reflect jurisdictional differences in post-crisis efforts to address step-in risk and consider our suggested modifications to the proposed framework. Irrespective of possible changes to the proposed framework, we do not believe step-in risk should be addressed through regulatory consolidation or a Pillar 1 capital charge.

We appreciate the opportunity to comment on the issues contained in the Proposal. If you have any questions, please contact me.

Sincerely,



Neal Blinde
Executive Vice President and Treasurer