March 17, 2016

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

Via: http://www.bis.org/bcbs/commentupload.htm

RE: Consultative Document: Identification and Measurement of Step-in Risk

Ladies and Gentlemen:

The Center for the Study of Financial Market Evolution\(^1\) (CSFME) welcomes the opportunity to comment on the consultative document published by the Basel Committee on Banking Supervision (Committee), Identification and Measurement of Step-in Risk (Consultation). We share the goals of the Committee to minimize the potential systemic implications resulting from situations where banks may choose to provide financial support during periods of financial stress to entities beyond or in the absence of any contractual obligations. As discussed below, we have some concerns and suggestions, however, regarding the approach taken by the Consultation. Furthermore, we believe that the nature of step-in risk may be one example of an acceptable, non-diversifiable exposure, given the potential positives for the economy at large. To illustrate this, we offer an example from the trade finance sector.

Discussion:

The Consultation’s proposed framework is an effort to identify relational characteristics among banks and sponsored entities to try to capture the likelihood (or risk) that a bank will use its capital to step in and assist a sponsored entity during a period of financial stress. In the end, however, the decision to support sponsored structured investment vehicles (SIV) or money market funds remains purely discretionary and almost wholly dependent on the individual circumstances of the vehicle, nature of the market stress, and a host of other variables. The Consultation correctly states that at times during the financial crisis, “banks preferred to support certain shadow banking entities in financial distress, rather than allowing them to fail and facing

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\(^1\) The Center for the Study of Financial Market Evolution is an independent, nonprofit organization whose mission is to improve transparency, reduce risks, support research, and promote sound regulation of financial markets. It does so by conducting data-driven analysis, providing investor education and outreach, and supporting regulatory reviews in otherwise opaque markets. It serves individual and institutional investors, banks, brokers, other financial market participants, academic institutions, and government regulatory agencies.
a loss of reputation, even though they had neither ownership interests in such entities nor any contractual obligations to support them.\(^2\)

These decisions to step in, however, were each highly individualized and based on the facts and circumstances particular to each instance. Assessing the likelihood that a bank will step in to assist a sponsored entity in the abstract as contemplated by the Consultation framework is, therefore, highly speculative. Nevertheless, we offer the following insights, based on our experience, that may help banks and their supervisors to anticipate, quantify and monitor the threat of step-in risks.\(^3\)

**Step-In Decisions Are Complex**

Principals of the Center have been retained to testify as independent experts in more than a dozen matters involving litigation related to the 2007 – 2008 financial crisis. Many of those cases involved allegations to the effect that banks had breached their fiduciary duties to customers in their response to the crisis. With particular relevance to the issues associated with this Consultation, several banks were accused of failing to provide financial support, or of providing inadequate support for the collateral cash pools of their securities lending customers.

We have found that the circumstances involved in any bank’s decision to step in are very complex, especially if the financial commitment would be significant to the bank. Three variables are almost always involved, along with separate functions within the bank:

1. the bank’s *business managers* must believe that the entity’s expectation for recompense, or that of its stakeholders, is consistent either with prevailing market practice, or with the reasonable interpretation of an implied or explicit commitment;
2. the bank’s *general counsel*, after being advised by its outside attorneys and their experts, must believe that the beneficiary’s claims, presented by the latter’s own attorneys as a potential plaintiff, would have a non-trivial probability of prevailing in court; and
3. the best-informed *senior executives* of the bank must be reasonably confident that the outcome of providing recompense is superior to other alternatives.

As a rule, these cases move to the litigation stage only if substantial disagreement exists between the beneficiary and the bank as to the interpretation of the liability clauses in the relevant financial services contract(s). If there is no disagreement, the dispute will usually be settled or abandoned after negotiation. However, these are not usually black-and-white distinctions. And just as often, there may also be disagreements not just as to the existence of a viable claim, but

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\(^2\) We would be very surprised if there were no contractual relationship at all between the bank and the shadow banking entity. Although there may be no explicit support obligation, other provisions may be interpreted by the entity’s counsel as entailing implicit commitments.

\(^3\) While it is true that bank sponsors stepped in to assist sponsored money market funds or SIVs on many occasions during that financial crisis, it was not universally so. Post-crisis litigation provides excellent illustrations of how step-in decisions were highly dependent on facts and circumstances, and highlights some of the problems presented by the more generalized framework proposed by the Consultation.
also as to the degree to which the bank’s potential financial obligation to one or more customers, has priority as compared with its obligations to all customers generally. This last point calls for clarification, as the circumstances may not readily be anticipated.

In reviewing the circumstances of a claim, a bank may find that certain entities (or their stakeholders) argue that the bank has failed in its obligation to them, relative to its support for other entities or customers. In other words, the bank has acted prejudicially. In turn, the bank may offer a response that, for example, by establishing redemption gates and protecting an investment pool against actions taken by certain customers (such as redeeming beneficiary participations at par when the pool is below par on a mark-to-market basis) it is more appropriately fulfilling its obligation to all of its customers, even though certain individual customers may be disadvantaged by the bank’s response. Even more complex would be the underlying consideration that the bank’s customers may themselves have conflicting interests which the bank, as a fiduciary to all customers, must balance against their collective interests. This is never straightforward, nor is it easy to anticipate in the abstract.

Ultimately, we have found that decisions to step in and absorb a liability are highly fact-dependent. More than one business unit of the bank may be involved in significant cases. Over time, the circumstances may change. As such, the outcomes of these decisions are virtually impossible to predict in advance, notwithstanding the Consultation’s framework of proposed indicators to identify and anticipate such risks.

**Capital Reserves for Step-in Risk**

While the Consultation does not propose a specific capital requirement for step-in risk, it does propose two approaches to the capital treatment of related entities that essentially would have the same effect. Banks have long been required to measure their exposure at default for money market funds, SIVs, and other nonbank financial vehicles with which they have binding commitments. We believe that adding a capital reserve requirement for step-in contingencies as contemplated by the Consultation is problematic for several reasons.

1. **Theoretical Departure from Basel III.** Implementation of Basel III has added risk-based capital and leverage minimums, as well as capital buffers and standalone liquidity measures to help ensure that banks, if financially stable, would continue to operate during a financial crisis. The concept of a capital reserve for step-in contingencies appears to move away from the goal of capital sufficiency, more toward identifying how and to whom banks should lend during a financial crisis.

2. **Implied Commitment to Support.** The litigation experience described above indicates to us that requiring capital reserves for step-in contingencies may be seen by investors in sponsored entities as vicarious commitments by banks to step in during a crisis, despite the apparent absence of legal commitments on the part of the sponsoring banks to do so. As a result, the presence of a capital reserve for step-in risk may itself be an invitation to pursue a claim by plaintiffs’ attorneys, opening banks up to expensive litigation over their wholly discretionary actions with regard to step-in situations.
3. **Potential Double Counting.** The Consultation candidly admits that no attempt was made to harmonize the framework with Basel III standards. Under the Basel III framework, the Leverage Coverage Ratio (LCR) already requires banks to determine the liquidity effect of non-contractual contingent funding obligations. While step-in contingencies do admittedly go beyond the off-balance sheet liabilities included in the Basel III leverage calculations, there remains a potential element of double counting. We suggest that if the Committee moves forward with the Consultation’s approaches to the capital treatment of related entities, every effort should be made to harmonize new reserve requirements with the existing Basel III framework.

**Alternatives to the Consultation**

The Committee acknowledges that the U.S. and the U.K. already have taken steps to limit step-in risk through the Volcker Rule and ring-fencing regulations, respectively. The Consultation also cites new U.S. rules on money market mutual funds, and proposed liquidity risk management rules for mutual funds and ETFs, as well as draft regulations in the EU covering similar matters for money market funds and for bank structure reform.⁴ The Consultation states that these other efforts to limit step-in risk do not go far enough and faults them for failing to eliminate step-in risk: "For the purposes of the development of the aforementioned prudential approach, the Committee took into consideration the relevant accounting and regulatory reforms that had occurred since the financial crisis and assessed their implications for the prudential scope of consolidation. It concluded that these initiatives, in aggregate, have reduced the likelihood of a bank stepping in to provide financial support but that this step-in risk might not have been completely eliminated."

While the Committee does not specify where the regulatory efforts cited are deficient, we believe that these regulations and standards proposed or already in place, in aggregate, may achieve the stated objective of the Consultation: “to avoid that unanticipated support provided by banks weakens their situation, possibly to the point of having systemic implications.” We believe that existing efforts will yield similar, if not superior, outcomes to the Consultation’s proposed framework, and may do so without many of the difficulties we outline above.

**Macroeconomic Considerations**

Not all risks can be purged from the market system. Indeed, risk-taking must be balanced against the opportunity for fair return on investment. In that regard, we offer the following example in which elimination of step in risk may result in a degradation of development opportunities linked to international trade finance.

Non-banks often participate in trade finance projects along with leading global banks. In the aftermath of the credit crisis, banks sometimes provided liquidity to their non-bank partners by acquiring their project participations in advance of the stated termination. This is a prime

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example of step-in risk to the bank. However, many projects were completed on time and within budget, despite the withdrawal of financial support from the non-banks.

To the non-bank investors, the involvement of a global bank in a trade-finance project is a clear incentive to participate in syndications which provide support to global capital flows, especially for developing markets. To banks as investors, participation from non-banks creates an expanded, more diversified layer of economic actors in the syndication. And to developing markets, the combined support from banks and non-banks in trade finance projects improves the likelihood that critical investments will continue to raise living standards for their populations.

If step-in risks are eliminated through the creation of significant capital reserves, the impact on global trade finance will be difficult to estimate, but will no doubt be highly negative to the welfare of developing markets.

Additional Research

Our comments are presented in the context of our lengthy professional experience. However, we recognize that other reasonable views are possible, even from those with considerably less “time in grade.” Therefore, we have arranged for submission of papers on the topic of step-in risk from a group of economics and finance students at Fordham University in New York City. By scheduling necessity, relative to the school calendar, the students cannot present their papers within the March 17th deadline, so we hope that you will accept their comments on a slightly delayed basis.

Thank you for the opportunity to participate in the Consultation process. If our comments appear to be useful to the Secretariat, we would be pleased to discuss them further at your convenience.

Respectfully yours,

[Signature]

Edmon W. Blount

Executive Director