**Saudi Banks’ Comments on the Identification and measurement of step-in risk - Consultative Document**

**Overall comments on the consultation**

**Bank 1:** Step-in risk is a tail-risk and most of the real-world historical experiences with step-in risk were experienced during financial crisis. Therefore, the risk weights and charges recommended for step-in risk need to reflect the tail-end-low-probability nature of this risk. This should also cater for potential regulatory mitigating action, especially for the money market mutual fund industry where historically regulators have intervened to avoid money market mutual fund runs, which could destabilize the banking system.

**Bank 2:** One area raised which is of the bank’s concern is around money market and other mutual funds. The bank notes that the BCBS is cognisant that this area may require more careful treatment than with regard to other entities where there is a presumption of step-in risk and the bank fully endorses this point of view. In particular, the bank believes that any move to consolidate un-guaranteed, un-leveraged funds with a bank that directly or indirectly sponsors the risks being significantly disproportionate to the potential risk posed. Such risk maybe better considered through a Bank's stress testing programme.

More generally, the bank would urge caution in the expansion of prudential rules to cover the sort of contingent risk with which the paper is concerned. Many of the vehicles that gave rise to problems during the financial crisis and which are cited as the motivation for considering new prudential rules, were established precisely to avoid regulatory and accounting consolidation. It seems probable that these entities would be better dealt with by means of outright prohibition or capture by a less legalistic interpretation of current rules, rather than creating a new set of rules to deal with them - since they will likely cease to exist in their current format as soon as such rules are published.

**Question wise comments:**

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

**Bank 1:** In the bank’s opinion, these principles put down a chronological framework to deal with potential step-in situations and are envisaged to identify and assess the step-in risks. Moreover, keeping the approach simple and readily operational, ensures that the framework is applied consistently across banks and jurisdictions.

**Bank 2:** The principles appear reasonable, although the bank would suggest considering a principle that should differentiate between ‘direct’ step-in risk scenarios where the bank has its own vehicles and ‘indirect’ step-in risk scenarios where such risk arises from being part of a wider banking group.
Q2. What are commenters’ views on the proposed indicators for step-in risk? Are there any additional ones that the Committee should consider?

Bank 1: In the bank’s opinion, all of the identified primary indicators may influence a bank to step-in, and support a shadow banking or a similar entity. Furthermore, in the bank’s judgment, brand association, which is included in this consultation as a secondary indicator, is a primary indicator for step-in risk. It is because of the reputational repercussions for the bank’s brand name that the bank decides to step-in. Hence, the bank recommends that the committee consider including “Branding” as a primary indicator.

Bank 2: It may be worth considering differentiating unconsolidated entities based on the extent to which that entity itself is regulated.

Bank 3: In the specific indicator no. 8, the bank is required to consider the step-in risk if the Capital ties >20% and < 50%, or has the power to exercise a significant influence over the management. In the bank’s opinion, both conditions need to be met to indicate need for measuring the 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?

Bank 1: In addition to the primary indicators, secondary indicators are envisaged to play an important supplementary role in identifying situations and relationships that may lead the bank to step-in and provide financial support beyond contractual obligation. However, as discussed above, the committee may consider “Branding” as a primary indicator of step-in risk.

Bank 2:

i- Para 53 of the Consultative Document has referred Major Economic Dependence of an Entity on Bank as one of the secondary indicators of Step-in risk. It states that “In the absence of stakeholders who could also credibly intervene at a time of financial stress, the supervisor would not assume that any step-in risk has been mitigated.” In the bank’s opinion, the scope for the terms major economic dependence of the entity and absence of other stakeholders support should not be the only reasons for step-in support. Therefore, the said indicator may be removed.

ii- Para 58 of the Consultative Document has referred Investor inability to bear losses on investing instrument as one of the secondary indicators of Step-in risk. It states that: “Where there is no possibility of investors bearing losses on their investment, it is likely that a bank would be forced to step-in to provide financial support to the entity.” In the bank’s opinion, the investor’s inability to bear losses in the Bank’s instruments should not be considered as the step-in risk factor unless the investor was assured/guaranteed for specific return.
The investor is supposed to perform due diligence on his own while making investments in any of the instruments of the banks and the bank is not bound to provide financial support to its investors in case of their distress. Therefore, the said indicator may be removed.

iii- Para 60 of the Consultative Document also mentions Investor’s inability to freely dispose their financial instruments issued by bank as one of the secondary indicators of Step-in risk. It states that: “If investors are limited in the ways that they can sell the financial instruments that they hold in an entity or that they acquired from an entity, there is a high probability that at a time of financial stress they expect the bank to step-in in order to make good any losses.” In the bank’s opinion, the investor’s inability to dispose investments in the Bank’s instruments should not be considered as a step-in risk factor unless the investor was guaranteed for financial support in event of crisis. The investor is supposed to perform due diligence on his own while making investments in any of the instruments sponsored by the banks.

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?

Bank 1: The approaches proposed by the committee are considered to be proportionate given the specific circumstances and risks they are intended to address. Moreover, the bank requests that the committee include therein, illustrative examples of all the three proposed approaches, to address understanding differences that might arise between market participants and across jurisdictions.

Bank 2: These appear reasonable at a high level but would require further review and calibration through a QIS study once detailed proposals are known.

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

Bank 1: The bank agrees with the mapping proposed by the committee.

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

Bank 1: In the bank’s view, proportionate consolidation should only be used for joint ventures where the other party is also a regulated entity. This is for the reason that when the other party is not subject to the same level of regulation / supervision, the bank can be expected to step-in to provide financial support beyond its interest in the Joint venture.

Q7. What are commenters’ views on risks stemming from banks’ relationships with asset management activities and funds and the appropriateness of the direction envisaged?
Bank 1: In the bank’s opinion, Assets Under Management (AUM) size does not necessarily indicate step-in risk. This is especially the case where the AUM is in the form of third party funds under distribution, AUM managed by external hedge fund managers or private equity managed externally. Furthermore, the step-in risks for internally originated and distributed funds is different from externally originated funds. Internally originated and distributed funds have greater reputational risks. In addition, step in risk is also generally greater for money market funds as compared to Alternative Investment funds. The latter being sold to sophisticated investors who understand the underlying risk exposures. The bank therefore suggests that the Basel committee consider incorporating a distinction, when using AUM as a risk indicator. This distinction can be made as follows:

- Internal/ external funds, and
- Fund asset classes

Bank 2: It is not clear how these arrangements would apply to the markets where segregation takes place between asset management activities (owned and managed by separately regulated entities) and banks that may own or control the investment bank.

Whilst the reputational linkages are acknowledged for asset management activities, the likelihood of intervention for a conventional, unleveraged fund would be remote, especially when managed by a separately regulated entity.