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Basel Committee on Banking Supervision

Consultative Document

Identification and measurement of step-in risk

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BANK FOR INTERNATIONAL SETTLEMENTS

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Executive summary

1. The Basel Committee on Banking Supervision (hereafter the Committee) has undertaken a review of the scope of application of its prudential framework for banks and, as a first priority, proposes in this consultative document a conceptual framework that could form the basis of an approach for identifying, assessing and addressing step-in risk potentially embedded in banks' relationships with shadow banking entities mainly (although without limiting the proposals to them).

2. For the purposes of this document, step-in risk is the risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations, should the entity experience financial stress. To capture and address such risk, the focus is on identification of unconsolidated entities, to which a bank may nevertheless provide financial support, in order to protect itself from any adverse reputational risk stemming from its connection to the entities. These proposals only apply to unconsolidated entities, that is to say entities that, as of today, are out of the regulatory scope of consolidation.

3. Accordingly, the proposed conceptual framework aims at identifying unconsolidated entities that could entail significant step-in risk for banks. To this end, it comprises descriptions of the relationships and of the indicators that characterise such relationships between banks and shadow banking entities. Where one of the step-in indicators, which range from capital ties, sponsorship, provision of financial facilities, decision making and operational ties, is met under the framework there is the presumption that significant step-in risk exists. A bank could also argue as part of its own assessment of step-in risk that the risk towards a specific entity has been mitigated. The present document also includes a discussion of secondary indicators that could supplement the primary indicators, and that could be part of any discussions between supervisors and banks about the final assessment of step-in risk.

4. The proposed conceptual framework also includes potential approaches that could be used to reflect step-in risk in banks' prudential measures. The Committee considers either (i) the application of a conversion approach, under which the entity posing step-in risk would remain a third party to a bank (ie unconsolidated) but the potential step-in risk be captured using quantitative requirements or (ii) the regulatory consolidation of the entity identified. The consultative document contains proposals to match a relationship with a potential measure of the step-in exposure. The proposals herein are preliminary and the Committee has yet to decide how the proposals will fall within the regulatory framework, including whether they fall within Pillar 1 and/or Pillar 2.

5. There may be regulations that have addressed step-in risk locally. Therefore, the present document discusses collective rebuttals that could come into play to rebut the presumption as regards indicators (see part 5.2). The document also discusses in part 5 the specific cases of joint-ventures, asset managers and assets under management.

6. The Committee welcomes comments from the public on all aspects of the proposals described in this document by **17 March 2016** using the following link: www.bis.org/bcbs/commentupload.htm. All comments will be published on the Bank for International Settlements website unless a respondent specifically requests confidential treatment. In parallel, the Committee will conduct a Quantitative Impact Study (QIS) in the first half of 2016 to collect evidence on the nature and extent of step-in risk, so as to inform its deliberations on the final framework

7. This document and the complementary QIS are designed to elicit discussion and provide the Committee with empirical information. The Committee is interested in assessing the potential impacts of the proposals, particularly as to whether they would adequately capture entities posing potential step-in

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risk and whether they would result in unintended consequences, and is ready to modify its proposals as appropriate, based on comments received and information collected.

Part 1: Introduction – objectives of the review

1.1. Experience from the financial crisis

8. The global financial crisis was triggered by losses on US subprime mortgage loans which escalated into widespread financial stress. Reliance on credit intermediation in the shadow banking system, which includes but is not limited to non-bank lending entities and securitisation vehicles, were widely cited as triggers or factors contributing to the financial crisis, as they gave rise to the possibility of spillover to the banking system.

9. In addition, the supposed credit risk transfer to shadow banking turned out to be inefficacious in certain instances during the crisis. Banks had manoeuvred assets off-balance sheet and linked them to the capital markets via special purpose entities (SPEs), but needed to take them back onto their balance sheets when perceptions of risk changed abruptly in the market and had provided financial support to those vehicles beyond or in the absence of contractual obligations to do so.[1] That was particularly evident during the crisis, when banks preferred to support certain shadow banking entities in financial distress, rather than allowing them to fail and facing a loss of reputation, even though they had neither ownership interests in such entities nor any contractual obligations to support them

10. To this extent, the financial crisis provided evidence that banks sometimes have incentives beyond contractual obligation or equity ties to "step-in" to support entities to which they are connected but not included within the scope of regulatory consolidation. Prominent examples of such cases in which credit or liquidity support was given from banks have been observed during the crisis, in particular, in the following areas:

- Securitisation conduits

  During the financial crisis, the majority of the conduits that suffered problems were absorbed by their sponsoring banks which brought the conduit assets onto their own balance sheet and/or assumed all of the conduit's outstanding liabilities.

- Structured Investment Vehicles (SIVs)[2]

  The majority of the SIVs that suffered problems as a consequence of the financial crisis were supported by banks. In particular, in almost all cases, banks voluntarily provided liquidity where they were not committed to, ultimately leading in most cases to absorption of all the vehicles or bringing their assets onto the bank's balance sheet.

[1] In that regard, see: Thiemann, M. (2012) *Out of the Shadows? Accounting for Special Purpose Entities in European Banking Systems, Competition and Change* and Blundell-Wignall, A. & Atkinson, P. 2010 T*hinking Beyond Basel 3: Necessary Solutions for Capital and Liquidity*; OECD Working Paper.

[2] Structured investment vehicles (SIVs) are SPEs that invest in diversified portfolios of interest earning assets, generally funded through issues of commercial paper, medium-term notes and other senior debts to take advantage of the spread differentials between the assets in the SIV and the funding cost.

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- Money Market Funds (MMFs)

  During the financial crisis, some MMFs were supported by banks, including those sponsored by the asset management arms of banks. Those banks felt obliged to offer liquidity to their associated funds when fund holders redeemed their funds en masse and there was a concern that the fund's net asset value (NAV) would fall below par, due to the fire sales of assets as a result of significant concurrent withdrawals.[3]

1.2. Subsequent accounting and other developments since the financial crisis

1.2.1. Accounting developments

11. The 2007 financial crisis highlighted a lack of transparency about the risks to which banks were exposed from their investments in and involvement with "off-balance sheet vehicles" (such as securitisation vehicles), including those that they had set up or sponsored. As a consequence, the G20 leaders and the Financial Stability Board (FSB) asked for a review of the accounting and disclosure requirements for such off-balance sheet vehicles. More specifically, in 2009, the G20 issued a *Declaration on strengthening the financial system.*[4] The progress report included a range of reforms to be undertaken by regulators, credit rating agencies and standard-setters. In this context, the G20 leaders called on the accounting standard-setters to work with others to improve standards on valuation and provisioning and achieve a single set of high quality global accounting standards and, in particular, recommended to "*improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty*".

12. In order to address these concerns, both the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) issued new accounting standards, generally aligned in principle, designed to improve the accounting criteria for consolidation of SPEs and the related disclosure requirements.[5] Accounting standards generally trigger consolidation when there is control (ie substantive decision making rights to direct the activities most significant to an entity's economic performance and thereby affect the investor's returns from its involvement with the investee).[6] This control-based model may still exclude certain entities from the scope of accounting consolidation,

[3] In particular, according to the Moody ́s report "Manager support key to money market fund stability Global Credit Research", during the crisis at least 20 managers of prime funds in the US and Europe expended more than $12.1 billion dollars to preserve the net asset values of their constant net asset value (CNAV) funds due to credit losses, credit transitions or liquidity constraints. In addition, according to the aforementioned report, the vast majority of the fund managers did not have a legal or regulatory obligation to do so, but stepped in to protect their franchises and reputations.

[4] G20 Leaders, *London Summit – Leaders' Statement, 2 April 2009*, accessible at http://www.financialstabilityboard.org/wp-content/uploads/london_summit_declaration_on_str_financial_system.pdf.

[5] See Financial Accounting Statements No. 166, *Accounting for transfers of financial assets*, and No. 167, Amendments to FASB Interpretation No. 46(R), issued by FASB, and IFRS 10 *Consolidated financial statements* and IFRS 12 *Disclosure of interests in other entities* issued by the IASB.

[6] For instance, according to IFRS 10, an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Thus, an investor controls an investee if and only if the investor has: (a) power over the investee; (b) exposure, or rights, to variable returns from its involvement with the investee; and (c) the ability to use its power over the investee to affect the amount of the investor's returns. In turn, an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, ie the activities that significantly affect the investee's returns.

despite them exposing a bank to risks. A prominent example is the situation where a structured entity exposes a bank to reputational risk. Indeed, under the relevant accounting framework reputational risk is part of an investor's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. For that reason, while it represents a factor to take into consideration when assessing control, along with other facts and circumstances, it is not an indicator of power in its own right and therefore would not in itself require a bank to consolidate a structured entity, even in cases where step-in risk exists.[7]

13. In addition, applying the relevant consolidation accounting framework inherently requires a high degree of judgement, which may lead to inconsistencies across jurisdictions and could result in the exclusion of some vehicles from the accounting scope of consolidation. For instance, vehicles considered to have no decision-making activity, but operating substantially in the interests of a banking group (which is exposed to the risks and benefits stemming from the vehicle) may be scoped out of the scope of accounting consolidation under stringent interpretations of the accounting requirements.

1.2.2. The Basel Committee reforms

14. Various regulatory reforms undertaken by the Committee have provided elements of response to the issues related to reputational step-in risk. To this extent, it is worth noting that:

- In July 2009, the Committee issued *Enhancements to the Basel II framework* which included Pillar 2 guidance on reputational risk and implicit support. This supplemental Pillar 2 guidance focuses on weaknesses in banks' risk management processes that were revealed during the recent financial crisis. One of the "risk management topics" covered in the guidance is reputational risk, notably the type of reputational risk that leads banks to provide implicit support to certain transactions/vehicles/activities that they might sponsor or originate.
- The final framework for the *Liquidity Coverage Ratio*, issued in 2011, explicitly refers to the need for national supervisors to determine the liquidity impact of: "contingent funding obligations [that] may be either contractual or non-contractual and are not lending commitments...[these] include associations with, sponsorship of, products sold or services provided that may require the support or extension of funds in the future under stressed conditions".
- In December 2014, the Committee issued the *Revised securitisation framework,* that addresses two of the main causes of step-in risk on the prudential level, by (1) specifying that significant risk transfer (SRT) cannot be recognised for structures securitising revolving credit facilities (such as credit card securitisations) with early amortisation features - where risks returning to the originator increase if the early amortisation is triggered, and (2) requiring that the undrawn portion of all liquidity facilities be converted at a credit conversion factor of 100%, thereby eliminating any preferential treatment for ABCP liquidity facilities.

15. The proposals in this document would supplement these reforms and might impact current practices.

[7] In particular, according to IFRS 10 BC 39: "[...] reputational risk is part of an investor's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. For that reason, the Board concluded that when assessing control, reputational risk is a factor to consider along with other facts and circumstances. It is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor power over an investee".

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1.2.3. Other reforms

16. The impact of step-in risk has been tackled by various authorities following the financial crisis. These initiatives include:

- *UK ring-fencing:* The UK has passed legislation to structurally separate ("ring-fence") banks with retail and small and medium-sized entities' deposits (greater than £25 billion) from investment banking activities and the risks arising from broader financial markets. Under this legislation, a ring-fenced bank (RFB)[8] is only permitted to have exposures to or relationships with special purpose vehicles (SPVs) in very limited circumstances, which include securitisation of its own assets or establishment of its own conduits. The RFB could still however step-in in a stress to support entities that it is permitted to have exposures to. In addition, the "non-ringfenced" part of the group that is not subject to restrictions on its exposures could also step-in to support any entities that it has a relationship with during a stress. This means that some broader reputational risk will continue to exist for the RFB as it will remain part of a wider group with non-ringfenced entities. So, whilst the RFB will still be exposed to some level of step-in risk, the ring-fencing legislation should reduce step-in risk significantly for the RFB.
- *US Volcker rule:* Under the Volcker Rule, which forms part of the Dodd-Frank Act, a bank generally is not allowed to provide support to covered funds, including hedge funds or private equity firms where it directly or indirectly serves as an investment manager, investment advisor or sponsor, but it excludes money market funds. The banking entity and its affiliates are not allowed to directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the covered funds. Thus, the prohibition could provide a great deal of mitigation against step-in risk.
- *US Securities and Exchanges Commission (SEC) reform on money market funds (MMFs):* On 23 July 2014, the SEC issued final rules to the regulatory regime for US MMFs whose purpose is to mitigate step-in risk. There are two principal amendments in the new MMF reforms. First, "prime" and "municipal" institutional MMFs will be required to float their net asset values (NAV) instead of the previous practice of maintaining a stable NAV of $1 per share through the use of amortised cost accounting. A floating NAV fund attracts less "step-in" risk than a stable NAV fund, because there is less implied safety in the invested principal. This may reduce the motivation for MMF shareholders to withdraw en masse in a crisis, as there are reduced benefits associated with early exit. Second, these funds will be allowed to impose liquidity fees and/or redemption gates if their liquid assets fall below certain thresholds, subject to the discretion of a fund's board of directors. This provision is also designed to reduce "run risk" during times of stress, which generally exacerbate losses in a fund and the resulting need for a sponsoring bank to step in with support. For retail MMFs, the potential for a sponsor to step in remains as it was pre-financial crisis; however, historical data suggest that retail investors are less likely to withdraw en masse from a MMF during a stress scenario and hence require support.
- *Proposed SEC rule on liquidity risk management for mutual funds and exchange-traded funds (ETFs):* On 22 September 2015, the SEC issued a proposal to enhance effective liquidity risk management by open-end funds, including mutual funds and exchange-traded funds (ETFs). Under the proposed reforms, mutual funds and ETFs would be required to implement liquidity

8 "Ring-fenced bank" is the common terminology for a "Ring-fenced body" which is defined in section 417 of the UK *Financial Services and Markets Act 2000*, as amended by the *Financial Services (Banking Reform) Act 2013*.

risk management programs and enhance disclosure regarding fund liquidity and redemption practices. The proposal is designed to better ensure investors can redeem their shares and receive their assets in a timely manner.

- *EU regulatory initatives*

The European Commission has proposed the following two draft regulations covering similar matters:

(i) the regulation on structural measures improving the resilience of EU credit institutions; and

(ii) the regulation on money market funds.

These regulations, which are still under discussion, include requirements intended to enhance the prudential resilience of the entity concerned thereby reducing or excluding the possibility of it encountering serious financial difficulties and, in turn, step-in risk.

1.3. The continuing need for a prudential approach

17. Following the financial crisis, the G20 at its Cannes Summit in November 2011 requested the FSB to develop policy measures to address the risks incurred during the crisis, extending the regulatory perimeter where needed to protect financial stability as new regulations on banks would be expected to lead to a shift of certain activities to shadow banking entities. To this end, the FSB has adopted a two-pronged strategy. First, it has created a monitoring framework to enhance national authorities' ability to track developments in the shadow banking system, which it has defined as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system", in order to identify the build-up of systemic risks and take corrective actions where necessary. Second, the FSB has coordinated the development of policies in five areas where oversight and regulation needs to be strengthened to reduce systemic risks:

(i) mitigating risks in banks' interactions with shadow banking entities;

(ii) reducing the risk of "runs" to affect money market funds (MMFs);

(iii) improving transparency and aligning incentives in securitisation;

(iv) dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending; and

(v) assessing and mitigating financial stability risks posed by other shadow banking entities and activities.

18. In connection with its efforts related to risks posed by shadow banking entities, and in particular with point (i) above, the FSB requested that the Committee study the current scope of consolidation to which prudential regulations are applied and, to the extent entities are excluded from this perimeter, develop a framework for their potential inclusion. Such a framework should ensure that all relevant banks' activities are captured within the prudential regime, and limit regulatory arbitrage opportunities to the extent possible.

19. 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. In particular entities for which banks have potential step-in risks might not be included within the accounting scope. Therefore, the Committee established that additional work in this area is warranted. In

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summary, whilst the reforms undertaken appear adequately set out and the accounting frameworks are harmonised in principle, they may not be sufficient to bring all entities and risks adequately under prudential control.

20. The Committee recognises that there are other reform initiatives currently underway, in addition to the enhancements to the accounting frameworks. These initiatives would include but are not limited to the aforementioned "other reforms" (see section 1.2.3 above), which alone or combined may limit or prohibit the extent of banks' exposure to step-in risk.

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Part 2: Proposed conceptual framework: overview

2.1. Principles for the review

21. This section provides a brief description of the overarching principles that guided the Committee in the development of the conceptual framework proposed in this document.

Principle 1: the framework should anticipate the situation after a step-in.

The proposed framework should be geared around the purpose and design of a bank's link to an unconsolidated entity, aiming to replicate the bank's situation assuming that a step-in has occurred. This will help ensure the banking system has adequate resources in advance of a stress and thus minimises the procyclicality of such a stress. The objective is to avoid that unanticipated support provided by banks weakens their situation – possibly to the point of having systemic implications. There are, however, limits to the application of this principle. For example, the Committee does not envisage supervisors being asked to judge whether support of a vehicle is for liquidity reasons only and is not (or could not turn into being) solvency support.

Principle 2: the framework should be simple and should foster consistent implementation.

In accordance with the strategic direction adopted by the Committee, the conceptual framework should be as simple as possible. It should also be stipulated so as to foster consistent implementation across jurisdictions, banks and prudential metrics, where relevant.

Principle 3: the framework should be conservative, risk-sensitive and proportional.

As in all Basel requirements, the framework should be sensitive to residual risk (after consideration of possible mitigants), with a bias of conservatism which is inherent to the focus on capturing implicit commitments not appropriately captured by the existing regulatory and accounting frameworks. That said, it should not be so conservative/prudent that it addresses residual risk in an unjustifiably disproportionate or non-risk-sensitive manner.

Principle 4: the framework should be readily operational.

Making sure the proposals are operationalisable by banks and supervisors is another guiding principle. In particular, it would imply that the framework properly identifies the step-in risk situations and allows the drawing of straigtforward conclusions, to the extent possible. It should also ensure that the specific features of a particular case can be considered as an idiosyncratic, one-off assessment based on the supervisor's judgment as to the bank's demonstration of the facts and details of the case.

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

2.2. Terms used in this document

Reputational risk

22. The Committee defined in 2009[9] reputational risk as "*the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (eg through the interbank or securitisation markets).*"

23. In this document, the focus is on the reputational risk[10] that arises when a bank considers that the weakness or failure of an entity is likely to have a negative impact on the bank itself. It should be noted that operational risk is considered separately within the Basel framework and its definition explicitly excludes reputational risk "*Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.*"[11]

Step-in risk

24. "Step–in risk" is the risk that banks would provide financial support to certain shadow banking or other non-bank financial entities in times of market stress, beyond or in the absence of any contractual obligations[12] to do so. The main reason for step-in risk is found in different aspects of reputational risk. Indeed, as discussed above, the financial crisis provided evidence that a bank might sometimes have incentives beyond contractual obligation or equity ties to "step-in" to support unconsolidated entities to which it is connected. In developing its proposal, the Committee considered whether there are identifiable upfront triggers that indicate that a step-in might occur, ie there is a significant step-in risk. A description of such "step-in indicators" is provided in Part 3 of this document.

25. Banks may provide financial support to entities that they do not own, but sponsor, at a time when those entities are in financial stress. Listed below are three circumstances of support that banks might provide:

(a) "Full" financial support that was contractually agreed in advance (eg programme-wide credit enhancement and liquidity facilities), but where the "full" use of these arrangements was unanticipated in prudential metrics.

(b) Financial support beyond that contractually agreed in advance. For example, if partial credit enhancement or liquidity facilities are agreed up front, but a bank provides support in excess of the amount that was contractually agreed.

9 See BCBS, July 2009, Enhancements to the Basel II framework, paragraph 47.

10 In the Basel II Accord issued in 2004, the Basel Committee stated (paragraph 742) that: "Although the Committee recognises that 'other' risks, such as reputational and strategic risk, are not easily measurable, it expects industry to further develop techniques for managing all aspects of these risks."

11 See BCBS, June 2011, *Principles for the Sound Management of Operational Risk*.

12 If a bank has a contractual obligation to support an entity, this commitment should already be subject to prudential consideration according to the existing framework. Banks' contractual commitments provided to third parties are subject to capital and liquidity charges.

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(c) Financial support that is provided where there is no ex-ante arrangement. This may arise, for example, where a bank manages a vehicle but does not provide contractual credit enhancement or a liquidity facility.

26. So, given the potential for banks to step in to provide financial support, an overarching principle (see principle 1 above) is that the prudential approach should reflect upfront the position a bank would find itself after it has provided financial support.

Shadow banking entities

27. The FSB defined the "shadow banking system" as "*credit intermediation involving entities and activities (fully or partially) outside the regular banking system.*" However, since there is no commonly established definition or a comprehensive list of entities under this term, for the purposes of its proposal, the Committee concluded that it would be more efficient to focus on the situations that give rise to step-in risk, rather than trying to provide a definition of a category of entities that should be considered.

28. Nevertheless, the types of entities that banks have a relationship with that may lead them to provide financial support when that entity is in financial stress are likely to include, but are not limited to, the following:

(a) mortgage or finance companies;

(b) funding vehicles

(c) securitisation vehicles;

(d) money market funds and other investment funds;

(e) asset management companies (asset managers); and

(f) commercial entities that provide critical services exclusively to the bank.

29. Insurers and commercial entities that are currently specifically excluded from the regulatory scope of consolidation while attracting a specific prudential treatment are presumed not to be included within the types of entities considered here.

Scope of accounting consolidation

30. The scope of accounting consolidation includes all the entities that are consolidated according to the relevant accounting frameworks and reflected in the consolidated financial statements of the group. From an accounting standpoint, consolidation is currently based on the notion of control. For example, an entity is consolidated when the parent company has a control relationship over it, as defined by the relevant accounting standards.

Scope of regulatory consolidation

31. The scope of regulatory consolidation includes all banking and relevant financial entities consolidated according to the Basel framework as set out in Part I (Scope of Application) of Basel II. In many cases, this scope of regulatory consolidation differs from the accounting scope of consolidation. The difference may result from (i) a difference in the list of entities entering within each of the scope and (ii) a difference in the method of consolidation.

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Sponsorship

32. According to the Basel framework,[13] "a bank would generally be considered a sponsor and, in turn, an originator if it, in fact or in substance, manages or advises the programme, places securities into the market, or provides liquidity and/or credit enhancements." This definition was introduced in the Basel framework for securitisation purposes and is used in this document in the broader context of shadow banking entities.

Consolidation

33. The term consolidation usually describes the accounting procedure aggregating the components of financial statements (eg balance sheet items such as assets and liabilities) of different entities line by line, while eliminating any inter-entity balances and transactions in order to produce a group's single aggregate record, *as if* it were that of a single legal entity.[14] When used in the prudential context, the general features of the technique referred to as consolidation are the same as those used by reporting entities in preparing consolidated financial statements under their relevant accounting frameworks. As explained in the above entry *scope of regulatory consolidation*, differences between accounting and regulatory scopes of consolidation may still exist. For the purposes of this document, the equity method under the relevant accounting frameworks is not considered a consolidation technique.

Proportionate consolidation treatment

34. Proportionate consolidation, for the purposes of this document, is a method of consolidation whereby a parent company's share of each of the assets, liabilities, income and expenses of an entity is combined line by line with similar items in the parent company's consolidated financial statements. To this extent, the share of assets and liabilities proportionally consolidated is subject to the full set of the Basel standards.

Conversion approach

35. The conversion approach draws on the existing credit conversion factors (CCFs) used in the current framework for converting off-balance sheet items into credit exposure equivalents. The CCFs are used in the Basel credit risk framework to determine capital requirements corresponding to commitments. It is proposed to use the concept in the context of banks' step-in risk exposures to shadow banking entities, with the caveat that the commitments are implicit rather than contractual (or go beyond the contractual commitments).

[13] See BCBS, December 2014, *Revisions to the securitisation framework,* paragraph 7.

[14] In particular, according to IFRS 10 B.86, the typical consolidation procedures are those reported below:

"(a) combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.

(b) offset (eliminate) the carrying amounts of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (IFRS 3 explains how to account for any related goodwill).

(c) eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full)…"

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2.3. Overview

36. The present 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. The Committee deems it necessary to seek feedback on the conceptual framework and its underlying elements before it specifies the implementation modalities.

37. The entities that should be captured in the step-in risk assessment would include those entities not consolidated according to accounting and regulatory frameworks. Banks would conduct an assessment of the contractual and non-contractual relationships with these unconsolidated entities, in order to evaluate whether, in spite of the adopted accounting treatment, the bank is exposed to the relevant risks stemming from the activities of such entities and a significant "step-in risk" exists. To this end, banks would assess their relationships with those unconsolidated entities against the step-in indicators provided in Part 3 of this document.

38. The Committee also considered secondary indicators that might supplement the primary indicators of step-in risk and these indicators are presented in Part 3 as well.

39. Part 4 describes the possible measurement approaches once the entity is identified as presenting a significant step-in risk for the bank. Each of the relationships described for each primary indicator is mapped with the associated approach, as explained in Part 4.

40. Finally, Part 5 outlines specific circumstances or sectors that the Committee has identified as potentially requiring specific prudential responses.

41. The Committee seeks comments on all aspects of this conceptual framework and its elements, including the proposed indicators and potential approaches.

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Part 3: Identification of step-in risk

42. As discussed in Part 1, the financial crisis provided evidence that banks have incentives beyond contractual obligation or equity ties to step-in to support entities to which they are connected but not included within the scope of regulatory consolidation (and in many cases not included in the accounting consolidation either).

43. This section outlines the proposed approach that banks and supervisors should use to identify and assess the existence of potential step-in risk. In particular, it outlines some identifiable upfront indicators that banks may step in to provide financial support to an entity during a period when the entity is in stress.

44. The indicators below only apply to unconsolidated entities. The Committee expects that banks will first determine whether entities should be consolidated according to the applicable accounting and regulatory standards. After conducting this analysis and after applying any relevant regulatory adjustments (eg provisions applicable to insurance entities), the bank should assess whether any unconsolidated entity meets the indicators below.

3.1. Primary indicators

3.1.1 Use of the sponsorship concept

45. The notion of "sponsorship" is a key element in considering the risk that will lead to a bank steps in to provide financial support to an entity at a time of financial stress. This is because of a sponsor's close connections with the entity that it is sponsoring. The definition of a sponsor that we have used (extending it beyond securitisation entities only) is the one outlined in the Basel Committee's revised securitisation framework,[15] which states that:

"a bank would generally be considered a sponsor and, in turn, an originator if it, in fact or in substance, manages or advises the programme, places securities into the market, or provides liquidity and/or credit enhancements".

46. The definition of sponsor contains three elements of a sponsoring firm's relationship with the sponsored entity: decision-making (management and/or advice); operations (placing securities into the market); and financial support (provision of liquidity facilities or credit enhancement). In the present proposals, these elements form part of the non-exhaustive list of indicators below that banks will have to consider in undertaking a step-in risk assessment.

[15] Several similar definitions are used within the Basel framework.

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3.1.2. Table of primary indicators

<table>
<tr><th></th><th>Indicators</th><th>Comments</th></tr>
<tr><td>1</td><td>Full Sponsor
• full upfront facilities, and
• decision-making</td><td>Full upfront sponsorship provides a clear indication that a bank will provide financial support in a stress, as it is contractually obliged to provide full support and is involved in decision-making. This relationship between a bank and an entity that it does not own, but which it provides with "full" facilities, will in most cases to be fully consolidated within the accounting scope of consolidation.</td></tr>
<tr><td>2</td><td>Sponsor:
• Partial upfront facilities,
• decision-making, and
• majority, or only provider of facilities</td><td rowspan="4">Where a bank provides partial credit enhancement[16] and liquidity facilities there is an expectation that investors will take on some credit and liquidity risk. The combination of this partial support and a key role in the decision-making of the entity means that a bank has a contractual obligation to provide initial support and bears a significant franchise and reputational risk through its decision-making powers. These types of partial sponsorship relationship should be considered within a bank's step-in risk assessment unless the bank's has already fully consolidated them within the consolidated accounts.</td></tr>
<tr><td>3</td><td>Sponsor:
• Partial upfront facilities,
• decision-making, and
• where not majority or only provider of facilities.</td></tr>
<tr><td>4</td><td>Sponsor:
• Partial upfront facilities,
• no decision-making, and
• majority or only provider of facilities.</td></tr>
<tr><td>5</td><td>Sponsor:
• Partial upfront facilities,
• no decision-making, and
• where not majority or only provider of facilities.</td></tr>
<tr><td>6</td><td>Sponsor:
• Decision-maker,
• but no upfront facilities.</td><td>Where a bank has not provided any upfront contractual facilities, but retains decision-making powers over an entity there is a true test of reputational or franchise risk. Such a relationship could be reflected in a bank's consolidated accounts in some circumstances.[17] However, where it is not, such a relationship should be included within the bank's step-in risk assessment.</td></tr>
<tr><td>7</td><td>Dominant influence:
• Capital ties > 50%, or
• no capital ties but ability to remove and</td><td>The ability to appoint or remove the majority of members of the governing body is a strong indication that the bank effectively controls the entity. There</td></tr>
</table>

[16] By partial credit enhancement we are assuming here that the bank bears first-loss on the portfolio up to a certain amount.

[17] One consideration may be whether a bank has discretion over the assets that are on the entity's balance sheet, in particular by including assets that it has originated, or if it is subject to a strict mandate to follow specific investment guidelines. If it is clear to the entity investors that the bank is merely the "operator" of an entity that is investing in third-party assets rather than having discretion over the assets that are on the entity's balance sheet, including assets that the bank originated, then the bank is acting as an agent, and there may be room to discuss possible reputational risk and likelihood of step-in. In contrast, if there was more discretion over the assets on the balance sheet and, in particular, if some or all of those assets were originated from the bank's balance sheet, the bank may be acting as principal, and if so the entity should be consolidated.

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	appoint board of directors or to exercise a dominant influence as a consequence of contractual, organisational or financial relations.	may be circumstances in which a bank may have a small or no ownership stake in an entity while still being in a position to appoint or remove the majority of members of an entity's governing body or to exercise other forms of dominant influence as a consequence of contractual, organisational or financial relations. Where such a relationship exists, the current accounting treatment would most likely be for the entity to be fully consolidated with the bank, as this power demonstrates the ability of the bank to control the entity.
8	Significant influence: • Capital ties >20% and < 50%, or • Has the power to exercise a significant influence over the management.	A bank can have significant influence over an entity. In the accounting frameworks, such as IFRS and US GAAP, one of the indicators to determine significant influence is when a bank owns 20% or more of an entity or has the power, pursuant to a contract or otherwise, to participate in the financial and operating policy decisions but not control them (please see Annex for further details). These indicators of significant influence are broader than those (ie control) used for "full" accounting consolidation under IFRS and US GAAP.
9	Significant influence: • Capital ties < 20%, but • Has the power to exercise a significant influence over the management.	
10	External credit rating based on a bank's own rating.	Rating agencies take into account the likelihood that an entity will receive financial support from a bank in their analysis of the entity. In fact, rating agencies will consider whether the bank is able to provide support to the entity where it is providing full credit enhancement and liquidity facilities. So, if an unconsolidated entity's rating is underpinned by the implicit support of a bank (for reputational or other reasons), it is potentially a strong indicator of likely support in a stress and would be considered as part of the assessment process as a market indicator of step-in.
11	Exclusive critical services provider.	Entities (other than those which are specifically scoped out from the Basel framework, eg commercial entities) that provide critical services exclusively to a bank may receive financial support from it during stress to the extent they are vital for business continuity. Examples of this definition would include third parties that provide operational services to the bank exclusively and where those exclusive services are critical to the bank's operations. These services are likely to be ancillary services that would be included within a bank's recovery and resolution plan. The presumption that a bank may support these entities when they are in financial stress is likely to be subject to the following criteria: (a) Dependence and substitutability: Where there is a high degree of dependence on the bank to support the ongoing operations of the entity providing services, and the bank would face either difficulty or high costs to substitute with an alternative provider, it may be presumed that step-in may occur. (b) Costs: If there is a substitute for the entity's services, but it would be highly costly or time-consuming to implement these new services, then it may be presumed that step-in may occur.

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		(c) Business cycle correlation: If the service provided by the exclusive entity has a strong business cycle correlation with banks' economic cycles, it may be argued that step-in would most likely occur during times of fragile financial situations for certain banks and hence would be much more risky. So, potential step-in should be presumed in such circumstances.

Q2. What are commenters' views on the proposed indicators for step-in risk? Are there any additional ones that the Committee should consider?

3.2. Secondary indicators

47. The Committee has identified a set of secondary indicators that could usefully supplement the primary indicators set out above. Where a bank's relationship with an entity meets one of the primary indicators, it would be presumed that significant step-in risk exists. However, there may be circumstances in which banks could argue as part of their assessment of step-in risk, that the risk towards an entity has been partially or fully mitigated (ie the risk of step-in has been reduced or eliminated). These secondary indicators could be used to assist supervisors in considering whether a bank's argument that a particular indicator of step-in risk has been mitigated is reasonable.

48. These indicators would mostly be relevant in considering the presumption of step-in. They should be considered holistically to assess each specific case and could serve to determine whether the risks of step-in are fully mitigated. For example, if a bank assesses that it would not step in to provide partial support beyond its contractual obligation but that the investors are all wholesale investors with a close commercial relationship with the bank, then the "composition of the investor base" criterion may support an existence of significant step-in risk.

(a) Branding

49. Branding can be a significant supporting indicator of step-in risk when considered in conjunction with other relationships between a bank and another entity. This is because it is likely to untoward to a bank's reputation not to provide financial support to an entity that carries its branding. Therefore, a supervisor would not accept an explanation as to the mitigation of step-in risk where an entity carries the bank's brand. In terms of definition (based on a review of academic literature in this area),[18] the existence of a bank's branding on an entity would be effective when one of the following is present:

50. Visual identity: A bank will share akin visual identity with another entity if a combination of two or more of the following criteria concerning visual elements on their buildings, vehicles, corporate clothing or stationery are similar:

- corporate name (for instance, if an institution "X Bank" exists alongside a fund with the name "X Commodity Strategy Fund");

[18] Abratt, Russell, Kleyn, Nicola (2011): *Corporate identity, corporate branding and corporate reputations, Reconciliation and integration*, in: European Journal of Marketing, London.

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- logotype;
- symbol;
- typography;
- colour.

51. Besides, a bank and another entity may share similar brand communication when there is related marketing communication in terms of supporting the sales of the organisation's products and services. For instance, if a bank advertises funds on its own website, the criterion of related brand communication is met.

(b) Purpose and the overall design of the entity structure

52. Supervisors will expect to be provided with information on the purpose and design of the entity when analysing any mitigations. In particular, they will consider whether part of the purpose of the entity is regulatory arbitrage. So, for example, if the entity's business model, portfolio and funding structure are virtually the same as that of conventional commercial banking and that the supervisor considers that the entity was established solely for the purpose of putting such banking activities off-balance sheet, it is likely that the supervisor will assume that step-in might arise.

(c) Major economic dependence of the entity on the bank

53. Where a bank is arguing for mitigation of step-in risk it should detail all the other arrangements and (direct or indirect) involvements that relate to the activities of the entity. For instance, it should indicate whether there are any other major stakeholders in the entity and whether they have any obligation to provide financial support to the entity in a stress situation. 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.

(d) Originator incentives

54. Where the originator's incentives are not aligned with those of the investors, there will be an increased likelihood of step-in risk due to the originator's unfulfilled responsibilities. For example, if the originator has the ability or obligation to repurchase the underlying assets.

(e) Whether the bank enjoys/assumes the majority of the risk and rewards

55. As a consequence of the high degree of judgement in assessing control required by the relevant accounting frameworks, some entities could remain excluded from accounting consolidation, even when the reporting entity retains or assumes most of the risks and rewards. This could be the case for instance of certain static vehicles, for which it may not be possible to identify a person who has formal control over such vehicles.

(f) Implicit recourse

56. If a portion of the underlying assets of an entity unexpectedly become bad assets, investors could claim the originator/arranger bank responsible. Banks should therefore provide information about the nature of the entity's underlying assets as part of any mitigation or rebuttal.

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(g) The extent of the bank's dependency on a particular market (funding source)

57. The recent financial crisis indicated that it took some years to build up a new and sustainable investor base. Therefore, dependence on a particular market for a significant portion of a bank's funding could be a good reason for step-in.

(h) Investor expectations of returns from their investments

58. Where investors are provided with inadequate information on the instruments (ceteris paribus) in which they are investing or where they receive unclear messages about the likely returns, step-in will be more likely. This will particularly be the case where there is a market expectation that the principal amount of financial instrument is guaranteed. Supervisors will have to understand the information that has been communicated to investors and the messages that they have received about the expected returns from their investment.

(i) Composition of the investor base

59. If an entity and its financial instruments have been tailored for certain customers with whom a bank has a close commercial relationship there will be an increased likelihood of step-in. (Whether the investor base consists of major corporates /sophisticated institutional investors or retail investors and the diversity of investors are likely to be relevant in considering this factor.)

(j) Investor ability to bear losses on their investing instruments

60. 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.

(k) Investor ability to freely dispose of their financial instruments

61. 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.

(l) Assessment of IFRS 12 disclosure

62. IFRS 12 disclosure requirements could provide supervisors with meaningful information to evaluate the nature and the amount of the involvement of a banking group with unconsolidated structured entities and the risks associated with those entities, including for instance the maximum exposure to losses related to an unconsolidated entity. This set of information could be used by supervisors to assess whether step-in risk is likely to occur, as a consequence of the magnitude of the involvement a banking group with an unconsolidated entity or because the bank in the past provided financial or other support to an unconsolidated structured entity without having a contractual obligation to do so.

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(m) Entity is subject to being safeguarded for its continuity of critical functions in accordance with the bank's recovery and/or resolution plans

63. A bank should assess whether or not an unconsolidated entity is subject to being safeguarded for its continuity of critical functions in accordance with the bank's recovery and/or resolution plans.

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?

3.3. Application and examples

64. Some examples are provided below for illustrative purposes.

Box 1

Example 1: Static Special Purpose Vehicle

In order to provide its clients with new investment opportunities, Bank A establishes a vehicle that invests in a specific package of high quality bonds. The vehicle is not actively managed and the vehicle's governing documents state that the bonds will be held until maturity and no further bonds will be purchased in the future. The bank is involved in the placement of the notes issued by the vehicle among its clients and poses its brand name on the vehicle, in order to enhance the confidence of the clients on the proposed investment. Bank A receives a fixed fee for its services. The amount of the fee is not linked to the bond's yield.

From an accounting standpoint, Bank A concludes that the vehicle has no relevant activities to have power over, since the vehicle is not actively managed and the sole "asset selection" does not provide Bank A itself with any rights that are sufficient to constitute power over the vehicle. Therefore, the vehicle is not consolidated by Bank A, since the latter does not control it according to the relevant accounting standards.

The sponsorship relationship between Bank A and the vehicle should be considered. To this extent, it is worth noting that, although the vehicle has been established so that there are no decisions to be made after initial set up, Bank A acts as a sponsor of the vehicle and it has full discretion on the selection of the assets that are on the entity's balance sheet. Moreover, the vehicle itself was designed with the aim of providing new investment opportunities to Bank A's customers who are the main investors of the vehicle. In addition, Bank A put its brand name on the vehicle in order to increase market confidence. Therefore, the vehicle should be included in the bank's risk assessment since the indicator of sponsorship (ie only decision-making but with no upfront credit enhancement or liquidity facilities) is met. Moreover, in such a case, the secondary indicators of branding and the same customer base are met (see section 3.2).

Box 2

Example 2: Significant influence

Bank A has a 5% equity stake in an SPV that was set up by another bank (Bank B) and that the latter already consolidates it for accounting purposes. Even though Bank B controls the SPV, the contractual arrangements between Bank A and Bank B gives the former the right to appoint some (but not the majority) of the members of the governing body of the SPV, particularly with the power to participate in the financial and operating policy decisions of the unconsolidated entity.

The relationship between Bank A and the SPV should be considered. In such a case, there is at least the presumption that Bank A can exercise a significant influence over the entity as a consequence of the contractual arrangements with Bank B. Therefore, the SPV should be included in the risk assessment.

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Part 4: Measurement approaches for step-in risk

4.1. The range of measurement approaches and their comparative advantages

65. Depending on the nature and extent of a bank's relationship with an unconsolidated entity that poses significant step-in risk, the Committee envisages different potential approaches to gauge the magnitude of step-in risk.

Full consolidation approach

66. When the entity under consideration undertakes bank -like activities with risks that would receive an appropriate regulatory treatment if they were included, full consolidation-like technique allows banks to have a comprehensive view of the risks posed by the entity itself and to better understand the overall structure of the banking group and all the material activities conducted by entities in the wider group, both domestic and cross-border. In addition, the consolidation would:

1. prevent the double counting of capital within a group;
2. give better acknowledgement and understanding of the risk of contagion among entities within the same group; and
3. avoid regulatory capital arbitrage among different subsets of the financial sector.

67. Furthermore, when from an assessment of the financial, contractual and non-contractual relationships with the entity, it could be concluded that step-in is likely to result *ex post* (ie after step-in actually occurred) in the consolidation of the entity for accounting purposes,[19] full consolidation represents the most likely prudential treatment to replicate *ex ante* the banking group situation.[20]

68. Nevertheless, full consolidation would not be appropriate when the entity is already consolidated by another banking group or when it undertakes activities not appropriately tackled by the Basel framework, since it could lead to an inappropriate measure of risks and capital. In addition, there might be circumstances where consolidation-like assessment could not be feasible, because the bank is not in the position to obtain, in a timely manner, the relevant information required to produce the consolidated financial measures and respective regulatory key metrics. However, the Committee expects that the cases where a bank cannot gather the necessary information from an entity, over which it is exposed to a relevant risk of step in, are not common in practice.

Proportionate consolidation approach

69. Proportionate consolidation presents similar advantages and limitations of full consolidation. Furthermore, in the case of a vehicle performing bank-like activities, proportionate consolidation generally represents the most appropriate method for addressing situations where a reputational risk of step-in is shared by two or more banks, because they jointly control the vehicle or they are jointly exposed to the majority of the risks and benefits stemming from its activities, in such a way that the

[19] This can occur, for instance, when the abovementioned assessment gives evidence that the bank is exposed to the major part of the risks stemming from the activities of the vehicle.

[20] This approach would be consistent with Principle 1 reported in Part 2.

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substance of the operation is deemed to be a joint venture. By contrast, in cases of shadow banking entities different from joint ventures, this approach might be not appropriate since it could be difficult to determine an appropriate percentage of consolidation, given that banking groups generally do not hold a material equity stake in the shadow banking entities.

Conversion approach

70. Consistent with the Principles reported in Part 2 a conversion approach can be considered appropriate when step-in is not expected to result in accounting consolidation once materialised. In addition, a conversion approach can be considered as an alternative approach where consolidation is not relevant or feasible, because, for instance, the entity under consideration does not perform bank-like activities or the bank itself is not in a position to gather all needed financial information on a timely basis.

71. The CCFs existing in the credit risk framework apply to ex ante contractual commitments to provide financial support, whereas step-in risk involves potential support in the absence of or beyond existing contractual commitments. Therefore, under the Committee's proposal, the adoption of a conversion approach involves determination of the amount of a potential commitment or exposure that could materialise. To this extent, the total assets of an unconsolidated entity (including its off-balance sheet exposures) would be considered as a single row figure, for the purpose of the application of the conversion approach.

72. To avoid any double-counting resulting from the application of the existing regulatory framework, such an amount would be adjusted by taking into account:

- the amount of the unconsolidated entity's assets towards the banking group (that would be eliminated on consolidation);
- the amount of the banking group's on- and off-balance sheet exposures (assets) towards the shadow banking entity that have already been given rise to a capital charge (through RWA calculation) or to a capital deduction for the banking group.

73. The discussion in this document does not include proposals for specific conversion rates for particular circumstances. The upper bound envisaged is 100% (which would be closest to the effect of full consolidation), but the factor applied will be set at a level that appropriately reflects the extent of step-in risk, based on a bank's assessment of specific circumstances.

74. Once the conversion factor is applied, the riskiness of the entity (potentially using risk-weight under the standardised approach for credit risk as a benchmark) could also be introduced to obtain the magnitude of risk that banks should consider in their step-in risk assessment.

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?

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4.2 Mapping of primary indicators with measurement approaches

75. The following is a mapping of primary indicators with possible approaches. This mapping is assumed to apply to the cases where primary indicators along with secondary indicators are supposed to indicate the existence of residual step-in risk (ie, after consideration of possible mitigants). Furthermore, it should be noted that the committee is yet to decide whether these responses fall within Pillar 1 or Pillar 2.

<table>
<tr><th></th><th>Indicators</th><th>Approaches</th></tr>
<tr><td>1</td><td>Full Sponsor
• full upfront facilities, and
• decision-making</td><td>Full consolidation

(It is expected that this relationship will in most cases be fully consolidated according to accounting frameworks, but if that is not the case, a bank should include such an entity within its assessment.)</td></tr>
<tr><td>2</td><td>Sponsor:
• Partial upfront facilities,
• decision-making, and
• majority, or only provider of facilities</td><td>Full consolidation

(The proposed treatment for this indicator would be full consolidation where a bank is the majority or only provider of facilities and has decision making powers, as this would appropriately reflect the fact that the bank might step-in to provide support to an unconsolidated entity during financial stress due to the reputational risks involved in its relationships with the entity.)</td></tr>
<tr><td>3</td><td>Sponsor:
• Partial upfront facilities,
• decision-making, and
• where not majority or only provider of facilities.</td><td rowspan="3">Full consolidation or conversion approach

(In these circumstances, full consolidation or the use of conversion approach may be appropriate.)</td></tr>
<tr><td>4</td><td>Sponsor:
• Partial upfront facilities,
• no decision-making, and
• majority or only provider of facilities.</td></tr>
<tr><td>5</td><td>Sponsor:
• Partial upfront facilities,
• no decision-making, and
• where not majority or only provider of facilities.</td></tr>
<tr><td>6</td><td>Sponsor:
• Decision-maker,
• but no upfront facilities.</td><td>Full consolidation or conversion approach

(The proposed treatment under this indicator is full consolidation or conversion approach, which would reflect the possibility that the bank might step in to provide financial support in a time of stress.)</td></tr>
<tr><td>7</td><td>Dominant influence:
• Capital ties > 50%, or
• no capital ties but ability to remove and appoint board of directors or to exercise a dominant influence as a consequence of contractual, organisational or financial relations.</td><td>Full consolidation

(This relationship is expected to be caught by the accounting framework).</td></tr>
</table>

8	Significant influence: • Capital ties >20% and < 50%, or • Has the power to exercise a significant influence over the management.	Conversion approach (Where a bank has a significant influence relationship with an entity due to it owning 20% or more of the entity, the relationship should already be captured within the regulatory scope of consolidation. The prevailing treatment under the Basel scope of application is to apply a deduction of the bank's investment in the entity or proportionate consolidation where it has a holding of 20% to 50% and no control (although use of the equity method, which reflects the accounting treatment, is permitted in a number of jurisdictions). When one or more of the significant influence indicators are met, that entity should be included within the bank's assessment. This will allow the supervisor to consider whether the prevailing prudential treatment is appropriate where in particular the size of the bank's stake is not representative of the potential step-in risk and neither proportionate consolidation nor deduction would reflect the potential ex-post situation.
9	Significant influence: • Capital ties < 20%, but • Has the power to exercise a significant influence over the management.	
10	External credit rating based on bank's own rating	Full consolidation (Full consolidation should be the approach in this situation, as the entity's financial rating is underpinned by its relationship with the bank and so there is a strong market perception that the bank will fully support the entity at a time of financial stress.)
11	Exclusive provision of critical services to the bank	Conversion approach

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

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Part 5: Other matters, including consideration of specific cases

5.1. Inclusion of other cases based on supervisory judgement

76. Supervisors possess the authority to make a case-specific judgment, at the same time as but separate from considering the presence of the indicators as to whether step-in risk exists. Examples of cases where the supervisor might wish to do so include the case when establishment of a vehicle appears to have been motivated largely by regulatory arbitrage considerations, or that the scale of the entity is such that the supervisor considers that this in itself has created a franchise preservation step-in risk. Additional examples might be where a bank's recovery and/or resolution plans indicate that it would safeguard particular non-owned entities, or where a bank's IFRS 12 disclosure lists entities where it has the intention to provide contingent financial support.

5.2. Collective rebuttals

77. It may be that reasonable rebuttals would also apply on a jurisdictional basis, if the supervisor is satisfied that step-in risks are mitigated by existing public policy that is enforceable by law. This would mean that supervisors could exclude unconsolidated entities wholly or partly from the application of the relevant step-in risk assessment approaches where such mitigants are present.

78. Outlined below are some proposed criteria that would allow jurisdictions to establish country-wide rebuttals of the presumptions established according to the indicators without making case-by-case analysis necessary. The goal is to establish a set of internationally-agreed criteria will ensure consistent implementation across jurisdictions and to improve the comparability of regulatory metrics.

79. Basel Core Principle 11 states that supervisors must have: "*the power to take corrective actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related entities in matters that could impair the safety and soundness of the bank or the banking system*." The existence of those powers alone would not provide a collective rebuttal of step-in risk that a jurisdiction could implement upfront. However, if a supervisor has exercised its ring-fencing powers in respect of a bank or group of banks that might provide a bank or banks with a reasonable rebuttal of step-in risk depending on the provisions of the ring-fencing measure.

80. The supervisors in deciding upon collective rebuttals in their jurisdiction should ensure that there is existing law (or regulation) that prohibits a significant portion of banks or other market participants from providing non-contractual support to off-balance-sheet entities. Examples of prohibited activities might include: providing recourse for assets sold, reducing revenue to be earned from those entities, and reimbursing the entities for losses that banks are not contractually obligated to provide. The laws or regulations must be of general application, based on the nature of activities. Contract law or industry standards must not be considered eligible for collective rebuttal and the prohibition must not vary based on a bank's capital or liquidity position and planning process or risk management approach.

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Box 3

Examples of potential collective rebuttals

US Volcker rule – prohibition on sponsors providing financial support: Under the Volcker Rule, which forms part of the Dodd-Frank Act, a bank generally is not allowed to provide support to covered funds, including hedge funds or private equity firms where it directly or indirectly serves as an investment manager, investment advisor or sponsor, but excluding money market funds. The banking entity and its affiliates are not allowed, directly or indirectly, to guarantee, assume, or otherwise insure the obligations or performance of the covered funds. Thus, the prohibition is due to provide a great deal of mitigation against step-in risk.

Japanese Financial Instruments and Exchange Act, Article 39: Under this law, banks are prohibited to make an offer, promise, or provide property benefit to a 3rd party or customer with regard to sale and purchase or other transactions of securities or derivative transaction in order to compensate for the whole or part of a loss incurred by the customer or make an addition to the profit accrued to the customer. In cases where a representative person, agent or employee of a financial institution has committed such a violation, they shall be punished by imprisonment with work for not more than three years or a fine with no more than 3 million yen, or both. In case of institutions, in addition to the punishments (including criminal charges) of a representative person, agent or employee of institutions, a fine equal to the value of not more than 300 million yen will be imposed.

European regulation under discussion, particularly the proposed regulation on Money Market Funds (MMFs) which could ban VNAV and CNAV MMFs to receive external support (proposal under discussion and still to be finalised).

5.3. Joint-ventures and proportionate consolidation

81. Consolidation on a pro-rata basis could be an appropriate tool in the case of SPEs where two or more banks jointly control the SPE or are jointly exposed to the majority of the risks. If the joint-venture is between two banks, the baseline treatment should involve a proportionate consolidation (eg 50/50).[21] If the other parties in the joint venture include non-banking-like regulated entities, it should be assessed if the bank sustains the major risks of the SPE and as a consequence, whether full consolidation could be a more appropriate baseline treatment.

82. It is worth noting that while generally one would expect a regulatory treatment for step-in risk to go beyond contractual commitments, there may be an exception for joint ventures. This is because stakeholders might reasonably expect the bank only to provide any support in proportion with the other parties (eg 50%). On the other hand, there may be a case for a more conservative treatment in circumstances where the other party may be unable or unwilling to carry out its obligations. A provisional conclusion is that joint ventures where the other party is itself a regulated bank or another regulated entity would apply proportional consolidation.

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

[21] Or analogous proportions depending on the number of banks.

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5.4. Asset management activities and funds under management

83. The asset management industry plays an increasingly important role in the global financial system. During the financial crisis between 2007 and 2008, certain money market funds received support from their sponsor or sponsor's parent company when the sponsor or its parent was not legally obligated to do so. The presumption that a bank may be compelled to "step in" has led the Committee to consider how funds under management should be considered in the framework.

84. The Committee recognises the difficulty of designing an approach which fits its purpose in view of the diversity of funds and associated risks. The Committee also recognises that the asset management industry has been and continues to be subject to an evolving regulatory environment. The Committee's intention is not to duplicate or contradict existing standards or those under development. The Committee is focused exclusively on banks' relationships with asset management entities and funds, and the risks for banks that may result from these relationships. The role of a bank as a fund sponsor is of particular interest for the purpose of this framework.

85. Against this background, the objective would be to use the set of indicators presented in Part 3 above, possibly supplemented by additional indicators that are specifically relevant for a bank's relationship with asset management entities and funds as discussed below.

5.4.1. Additional indicators specific to asset management

86. Applying the indicators described in Part 3 above would contribute to identifying cases where a bank might step in to support an unconsolidated asset management company or unconsolidated funds or both. This holds true for cases where the banking group provides relevant credit enhancement to a fund or where it is the only or the major liquidity provider.

87. In addition, the banking group that owns (and therefore consolidates) an asset manager should also assess whether it would step-in to support unconsolidated funds under its management as an exceptional measure. The bank should consider in its assessment whether it has (directly or through an asset manager subsidiary):

- has provided the investors with guarantees on the performance of the fund or on its assets;
- has provided the investors with an explicit commitment to meet any shortfall in returns earned by the fund; or
- has a relevant interest in the fund other than its management fee (eg relevant investment in the fund or loans to the fund).

5.4.2. Specific approach to asset management entities and funds

88. Based on the above, the Committee seeks feedback on possible approaches which would include:

- Consolidate the unconsolidated asset management company because of capital ties or that its external credit rating is based on the bank's own rating;
- Based on the sponsoring indicators applicable to funds, applying a conversion approach to the assets under management (AUM). In which case, the conversion approach described above might apply to for example 1% of the total assets of the fund.
- Based on the sponsoring indicators outlined above (ie performance guarantees, explicit commitments to meet any shortfalls in returns or relevant interests in the fund other than its management fee), the banking group should consider its relationship with such funds. This

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would reflect the fact that the group is providing a guarantee of the value of the assets of the fund and so has the obligation to provide such support to the entity when the value of its assets falls. In which case, the conversion approach described above might apply to for example 1% AUM.

Q7. What are commenters' views on risks stemming from banks' relationships with asset management activities and funds and the appropriateness of the direction envisaged?

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Annex

Significant influence accounting

89. *IAS:* According to IAS 28.3 significant influence is the power to participate in the financial and operating policy decisions but not control them.

90. According to IAS 28.5, a holding of 20% or more of the voting power (directly or through subsidiaries) will indicate significant influence unless it can be clearly demonstrated otherwise. If the holding is less than 20%, the investor will be presumed not to have significant influence unless such influence can be clearly demonstrated.

91. According to IAS 28.6, the existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(i) representation on the board of directors or equivalent governing body of the investee participation in the policy-making process

(ii) material transactions between the investor and the investee

(iii) interchange of managerial personnel

(iv) provision of essential technical information

92. Finally, according to IAS 28.8, potential voting rights are a factor to be considered in deciding whether significant influence exists.

93. *EU regulatory treatment:* The concept of significant influence is discussed in the Guidelines for the prudential assessment of acquisitions and increases in holdings in the financial sector required by Directive 2007/44/EC, which were published jointly by the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) in 2008. As defined in Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC, a 'Qualifying holding" is a direct or indirect (via one or several controlled undertakings) holding in an undertaking which represents 10% or more of the capital or the voting rights of an undertaking or which makes it possible to exercise a significant influence over the management of the undertaking. According to the above mentioned guidelines, a proposed acquirer is considered to exercise a 'significant influence" when its shareholding, although below the 10% threshold, allows it to exercise a significant influence over the management of the institution, for example, via a representative on the board of directors. Holdings are subject to the full notification requirements if the Member State concerned demonstrates, on a case-by-case basis, that the ownership structure of the target financial institution and the concrete involvement of the acquirer in its management create a significant influence even at this low level.

94. *US GAAP:* The relevant accounting guidance on this topic resides in ASC810, Consolidation, and ASC 323 – Investments – Equity Method and Joint Ventures.

95. Generally, the quantitative common stock ownership level is considered a starting point in evaluating significant influence. For example, an ownership interest exceeding 20% may imply that bank has the ability to exercise significant influence. However, determining significant influence requires an evaluation of all the facts and circumstances relating to the investment. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

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96. Qualitative indicators of significant influence are set out in ASC 323-10. Paragraph 323-10-15-6 states that the ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

(i) Representation on the board of directors

(ii) Participation in policy-making processes

(iii) Material intra-entity transactions

(iv) Interchange of managerial personnel

(v) Technological dependency

(vi) Extent of ownership by an investor in relation to the concentration of other shareholdings (but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor).

97. Regarding potential voting rights, paragraph 323-10-15-9 states that:

(i) An investor's voting stock interest in an investee shall be based on those currently outstanding securities whose holders have present voting privileges.

(ii) Potential voting privileges that may become available to holders of securities of an investee shall be disregarded.

98. *US regulatory treatment:* In addition, US bank holding companies are subject to the Bank Holding Company Act (BHC Act), which provides for the supervision and regulation of companies that control a bank and the subsidiaries of such companies. Included in the BHC Act is the definition of subsidiary (12 USC 841 section 2(d)) for regulatory purposes. The definition of subsidiary for regulatory purposes does not dictate accounting treatment, but for practical purposes meeting the requirement for a subsidiary for regulatory purposes has an influence on accounting treatment.

99. The BHC Act provides that a company has control over another company (and thus is a subsidiary for regulatory purposes) if:

(i) the first company owns, controls, or has power to vote 25 percent or more of any class of voting securities of the second company;

(ii) the first company controls in any manner the election of a majority of the directors of the second company; or

(iii) the Board determines, after notice and opportunity for hearing, that the first company exercises a controlling influence over the management or policies of the second company.

100. In determining whether one company has a controlling influence over another, the US financial regulatory agencies consider all the facts and circumstances surrounding the relationship between the two companies, including:

(i) the historical relationship between the companies;

(ii) the size of the first company’s voting and total equity investment;

(iii) the first company’s rights to director representation and committee service;

(iv) the nature and scope of the business relationships between the companies;

(v) any management or director interlocks between the companies; and

(vi) any covenants or other agreements that allow the first company to influence or restrict management decisions of the second company.

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101. Although the definition of controlling influence is written slightly differently from significant influence as defined for accounting purposes, in practice they are interpreted similarly, such that an entity that has the ability to exercise controlling influence for BHC purposes would also generally have significant influence for accounting purposes. It should be noted that while only one entity can control another, several entities can exert significant influence over a single entity.