May 15, 2017

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Consultative Document – Guidelines: Identification and measurement of step-in risk

Dear Mr. Coen:

The Institute of International Finance (IIF), the International Banking Federation (IBFed), the Global Financial Markets Association (GFMA), the CRE Finance Council (CRE CF) and the Commercial Real Estate Finance Council (CREFC) Europe[1] (together "the Associations" or "the Industry") are pleased to provide comments on the Basel Committee's (the "Committee" or "BCBS") Consultative Document "Guidelines: Identification and measurement of step-in risk", published March 15, 2017. This letter has been produced under the guidance of the IIF's Shadow Banking Advisory Group. In offering these comments, we believe it is important to reiterate the Industry's support for targeted and proportionate regulatory measures designed to make the global financial system more stable while facilitating economic growth.

The Industry appreciates the willingness of the Committee to consult with the Industry and to take our concerns into consideration. The hearing hosted by the BCBS in April 2016 was important to foster mutual understanding around the development of this new approach. Based on the hearing and against the backdrop of the explanations by senior members of the Working Group we have developed the following understanding of the Committee's policy intentions:

[1] For further information on the IIF, IBFed, GFMA, CRE FC and CREFC Europe please refer to the Appendix.

- The Guidelines could serve as a forward-looking safety net in those Basel member countries where step-in risk has already been addressed by the implementation of relevant regulatory reforms, specifically, but not limited to, the Basel capital requirements. In these jurisdictions, the Guidelines can help to identify step-in risk under existing regulations.

- The Guidelines could serve as a comprehensive backstop only in those jurisdictions where the implementation of the international accounting and regulatory frameworks is incomplete.

Against this background, we commend the Committee for the significant changes that have been made to the proposed framework.

Most importantly, we appreciate the change in the overall regulatory approach. Replacing the previously conceived automatic Pillar 1 capital or liquidity surcharges with a tailored approach that relies on a bank's self-assessment in conjunction with supervisory analysis is an important step in the right direction. We acknowledge the Committee's intentions to create a framework that is designed "*to act as a safety net for the situation where step-in risk may remain, emerge or re-emerge.*"

Nevertheless, the Industry is concerned about introducing another regulatory framework that is forward looking in nature with an overly broad mandate. The proposed Guidelines could impose significant operational burdens on banks, be mostly redundant in the context of other regulatory frameworks, and ultimately be difficult to apply consistently, even among banks within the same jurisdiction. We are aware of the Committee's intentions to finalize the step-in risk Guidelines as part of its 2017-2018 policy development program[2]. However, given the secondary nature of this proposal and its function as a safety net we strongly recommend postponing finalization of this framework until the Committee's own assessment of the effectiveness of their post-crisis reforms has been conducted and evaluated. A postponement would also enable policy-makers to recognize the results of the European Commission's Call for Evidence[3], the outcome of the analysis currently conducted by the U.S. Department of the Treasury as mandated by President Trump's recent Executive Order[4], as well as the envisaged post-implementation evaluation of the effects of the G20 Financial Regulatory Reforms to be conducted by the Financial Stability Board (FSB).[5] If these analyses should confirm the need for an enhanced emphasis on step-in risk this should be addressed through revisions to the Committee's existing standards rather than the development of an incremental step-in risk framework.

---

[2] See *BCBS*, The Basel Committee's work programme (update 25 April 2017); (http://www.bis.org/bcbs/bcbs_work.htm).
[3] *European Commission*, Call for Evidence – EU Regulatory Framework for Financial Services; (http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document_en.pdf).
[4] Core Principles for Regulating the United States Financial System, Presidential Executive Order No. 13772 (February 8, 2017), 82 FR 9965.
[5] *Financial Stability Board*, Proposed Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms - Consultation document on main elements, 11 April 2017; (http://www.fsb.org/wp-content/uploads/Framework-for-the-post-implementation-evaluation-of-the-G20-financial-regulatory-reforms.pdf).

1333 H Street NW Suite 800E • Washington, D.C. 20005 • www.iif.com • @IIF

Should the Committee nevertheless decide to proceed with the finalization of the step-in risk Guidelines despite our concerns, then in a spirit of constructive engagement we would like to propose a number of recommendations that would further improve the clarity and focus of the proposed Guidelines and reduce to some degree the scope of coverage and operational burden for jurisdictions that have already implemented the Basel framework.

Instances where step-in risks "*remain*" can only relate to jurisdictions where the Basel framework is not yet implemented. As the Committee explains in paragraph 72 of the current Consultative Document, including entities prone to step-in into the regulatory scope of consolidation could be considered as a backstop to address the incomplete implementation of existing accounting and regulatory frameworks. As such, we believe the Guidelines would not be useful in jurisdictions that have already addressed step-in risk. Jurisdictions where familiar manifestations of step-in risk are already covered by a variety of existing regulations could instead focus on situations in which new forms of step-in risk may "*emerge*" or "*re-emerge*". However, such analyses are already conducted under existing accounting and regulatory requirements on an ongoing basis. The analysis must be refreshed on a recurring basis as new manifestations of step-in risk arise – either as structured entities do not perform as expected or as new structures are developed.

Overall, the proposed policies and procedures for identifying and managing step-in risk seem to be overly complex and onerous for banks that have already accomplished these objectives under the primary Basel framework. In our view, it would be inefficient for national jurisdictions to require banks – and supervisors – to conduct an additional regular exercise that will in most cases yield a null set. The Industry is concerned that the Committee regards the Guidelines as "*near final*". To strengthen the subsidiary role of the proposed framework ("*safety net*", "*backstop*") some important changes should be considered.

Against this background of these deliberations the Associations are offering the following Key Recommendations:

Key Recommendations:

- The Industry strongly recommends postponing finalization of the Guidelines until the Committee's own assessment of the effectiveness of their post-crisis reforms has been conducted and evaluated. In the same vein the Committee should wait for the European Commission, the U.S. Department of the Treasury and the Financial Stability Board (FSB) to finish their respective assessments.

- If these analyses should confirm the need for an enhanced emphasis on step-in risk this should be addressed through revisions to the Committee's existing standards rather than the development of an incremental step-in risk framework.

- If the Committee nevertheless should decide to go ahead with its proposed Guidelines it should clarify that, as always, implementation will be left up to national discretion. Such clarification would need to be reinforced, for example, by language in paragraph 3 that explains in more detail that:

  (a) the Guidelines could serve as a forward-looking safety net in those Basel member countries where step-in risk has already been addressed by the implementation of relevant regulatory reforms, specifically, but not limited to, the Basel capital requirements. To assist national regulators who choose to adopt the Guidelines, the Guidelines should explicitly address how the scope of coverage and requirements are reduced for such countries and what remaining parts of the step-in risk framework would apply.

  (b) the Guidelines could serve as a comprehensive backstop only in those jurisdictions where the implementation of the international accounting and regulatory frameworks are incomplete.

- The Committee should limit the scope of the Guidelines to include only shadow-banking entities as defined by the FSB.

- The Industry suggests changing the qualification of "Regulatory restrictions and mitigants". In the Industry's view "*regulations that restrict (…) a bank's ability and/or propensity to support an entity on terms that are unfavorable to the bank*" should not serve as indicators for step-in risk but should qualify as collective rebuttals.

- In jurisdictions that have already addressed step-in risk, the reporting requirements should be more thematic in nature and not suggest lists of entities. Using reporting templates that support risk-related discussions between banks and regulators is more appropriate and will reach better outcomes than reporting templates that favor data dumps that can be both distractions and can lead to false conclusions.

- Given the secondary nature of the proposed Guidelines it seems to be appropriate to delay their implementation until the overall Basel III package came into force and has proven its effectiveness. Against this backdrop a staged approach seems to be most appropriate with a suggested time lag between the implementation of the primary and secondary regulations of at least one year. At the very least the implementation of the proposed Guidelines should be synchronized with the implementation of the overall Basel III package.

As the Committee is not asking specific questions we will comment on the various sections of the proposed Guidelines in chronological order:

Objective

The Industry in general acknowledges the objective of the Committee's work, i.e. to mitigate potential spillover effects from the shadow banking system to banks. However, we would like to reiterate our view that the ties between prudentially regulated banks and shadow banks have already been severed to such an extent that it is highly unlikely for banks to provide uncommitted liquidity support to a failing entity from the shadow banking sector. Most jurisdictions have implemented Basel, accounting and other reforms that greatly reduce the potential for banks bailing out entities from the shadow banking system. Indeed, most – if not all – examples of step-in were triggered by short term funding needs (e.g. Structured Investment Vehicles (SIVs), Asset Backed Commercial Paper (ABCP) conduits) whereas today, most of the remaining shadow banking vehicles are longer-duration instruments. In the same vein the amount of riskier, short-term funding has declined. While certain crisis-era shadow banking entities continue to exist today, post crisis regulatory reform in many cases now requires full capitalization of potential exposure to these entities. For example, a Credit Conversion Factor (CCF) of 100% applies to liquidity facilities extended to SIVs and ABCP conduits by regulated banks.[6]

Further, it should be recognized that a bank may decide to support an unconsolidated entity for various reasons. Reputational risk is only one potential reason amongst others and not always the driving force. For example, it might be sensible for a bank to make an additional investment to preserve the value of its existing stake, or because the bank views it as a good opportunity. However, banks could hesitate to provide financial support to a client in difficulty, out of concern that this could be perceived as a step-in for reputational purposes. In general, the proposed framework creates incentives for a pro-cyclical avoidance of providing financing to clients in a cyclical downturn.

Existing provisions

We commend the Committee for highlighting the significant regulatory reforms that were implemented in many jurisdictions in the aftermath of the 2008 financial crisis[7]. As the Committee acknowledges "*implicit support and reputational risks are included in the different building blocks of the Basel framework*". In our view the Committee has not sufficiently explained why it deems these requirements insufficient in dealing with step-in risk in the first place.

---

[6] *BCBS*, International Convergence of Capital Measurement and Capital Standards - A Revised Framework, Comprehensive Version, June 2006 (BCBS 128), No. 557 (p. 128); (http://www.bis.org/publ/bcbs128.pdf).

[7] However, regulatory reforms that contain potential step-in risk are not limited to those mentioned in Section 1.2 of the Consultative Document. As the IIF and IBFed have explained in more detail in their earlier submission bank structural reforms, revised securitization frameworks, money market fund reforms and increased conduct requirements all had a significant impact on further curtailing potential step-in risk.

a) Capital Requirements

In its proposed Guidelines, the Committee mentions its own "Revisions to the securitizations framework"[8] as well as the "Capital requirements for banks' equity investment in funds"[9]. However, these provisions are not the main rules covering step-in risk. In fact, "implicit support" and "reputational risk" have been an important focus area of the Committee's work for a long time. Indeed, the Committee had recognized the reflection of step-in risk in the Basel capital framework in the first Consultative Document but surprisingly fails to mention these provisions in the current document.

"Implicit support", defined as "support to a securitisation in excess of predetermined contractual obligation(s)" became part of the Basel capital framework in June 2006.[10] As a basic standard, the framework requires a bank that provides implicit support to a securitization, to hold capital against all of the exposures associated with the securitization transaction as if they had not been securitized.[11]

Furthermore, and in order to discourage banks from providing implicit support the framework also mandates sanctions in case a bank has indeed extended such support to a securitization. In such case, the bank will be required to hold capital against all of the underlying exposures associated with the structure as if they had not been securitized. The bank will also be required to disclose publicly that it was found to have provided non-contractual support, as well as the resulting increase in the capital charge.[12] If a bank is found to have provided implicit support on more than one occasion, the bank will be required to disclose its transgression publicly. National supervisors will take appropriate action that may include the requirement to hold capital against all securitized assets.[13] Sanctions will be aimed at changing the bank's behavior and to correct market perception as to the willingness of the bank to provide future support beyond contractual obligations.[14]

This "implicit support" concept was refined in the aftermath of the recent financial crisis to extend beyond securitizations. "Reputational risk and implicit support" became part of the "Supplemental Pillar 2 Guidance" within the Enhancements to the Basel II framework[15]. As a result, and as the Committee correctly observed in its first Consultative Document, its own framework already explicitly and comprehensively covers reputational risk. The framework obliges banks to "identify potential sources of reputational risk to which it is exposed"[16] and explicitly mentions reputational risk arising from "a bank's sponsorship of securitisation structures such as ABCP conduits and SIVs, as well as from the sale of credit exposures

---

[8] *BCBS*, Basel III Document - Revisions to the securitisation framework - Amended to include the alternative capital treatment for "simple, transparent and comparable" securitisations, 11 December 2014 (rev. July 2016) (BCBS 374); (http://www.bis.org/bcbs/publ/d374.pdf).
[9] *BCBS*, Capital requirements for banks' equity investments in funds, December 2013 (BCBS 266); (http://www.bis.org/publ/bcbs266.pdf).
[10] *BCBS*, *supra* (note 7) No. 551 (p. 122).
[11] *Id*, No. 564 (p. 126).
[12] *Id*, No. 792 (p. 221).
[13] *Id*, No. 793 (p. 222).
[14] Id, No. 794 (p. 222).
[15] *BCBS*, Enhancements to the Basel II framework, July 2009 (BCBS 157); (http://www.bis.org/publ/bcbs157.pdf#page=5&zoom=auto,-96,321).
[16] *Id*, at 48 (p. 19).

to securitisation trusts. It may also arise from a bank's involvement in asset or funds management, particularly when financial instruments are issued by owned or sponsored entities and are distributed to the customers of the sponsoring bank. (…) Reputational risk also arises when a bank sponsors activities such as money market mutual funds, in-house hedge funds and real estate investment trusts (REITs). In these cases, a bank may decide to support the value of shares/units held by investors even though is not contractually required to provide the support."[17]

In the United States this framework was implemented in 2013 in accordance with longstanding interagency guidance on the treatment of implicit support.[18] In the European Union, the evaluation of implicit support is now part of the Supervisory Review and Evaluation Process (SREP) pursuant to Section III of the "CRD IV"[19]. The latter is supported by guidelines provided by the European Banking Authority (EBA) which, inter alia, specifically mandate competent authorities to assess whether at the consolidated level group risk management covers all material risks including entities not subject to consolidation (special-purpose vehicles (SPVs), special-purpose entities (SPEs)).[20]

Reputational risks and any concomitant step-in risks are thus already covered by the Committee's Pillar 2 approach, have been identified by the comprehensive Internal Capital Adequacy Assessment Process (ICAAP) and been covered by an appropriate level of additional capital for isolated cases based on detailed supervisory assessment. Pillar 2 – correctly applied – guarantees that "all risks of a bank – both on- and off-balance sheet – are adequately covered, particularly those related to complex capital market activities."[21]

In April 2014, the Committee's risk-based capital standard was further strengthened by its large exposures framework.[22] This framework is designed to complement the capital standard as the latter is not suited to protect banks from large losses resulting from the sudden default of a single counterparty. Therefore, the capital standards were supplemented with a large exposures framework to protect banks from traumatic losses caused by the sudden default of an individual counterparty or group of connected counterparties. Specifically, the Committee sees this framework "as a useful tool to contribute to strengthening the oversight and regulation of the shadow banking system in relation to large exposures. In particular,

---

[17] *Id*, at 50 (p. 19).
[18] See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule, 78 FR 62018 (October 11, 2013); 12 CFR 217.42(e).
[19] See Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, L 176/338 (27.6.2013); (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN).
[20] See *EBA*, Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), December 19, 2014, No 110e (p. 54); (https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+%28Guidelines+on+SREP+methodologies+and+processes%29.pdf).
[21] *BCBS*, *supra* (note 15), at 5 (p. 10)
[22] See *BCBS*, Supervisory framework for measuring and controlling large exposures, April 2014 (BCBS 283); (http://www.bis.org/publ/bcbs283.pdf).

this is the case for the proposals for the treatment of exposures to funds, securitisation structures and collective investment undertakings (CIU)."[23] The framework thus requires banks to apply a look-through approach and to assess possible additional risks that do not relate to the structure's underlying assets, but rather to the structure's specific features and to any third parties linked to the structure. In the European Union this framework has been further strengthened by specific guidelines on exposure limits to shadow banking entities which have become effective in January 2017.[24]

As a conclusion to this section we deem the regulatory framework as it stands as comprehensive and robust enough to reflect and contain any residual step-in risk, and that supervisors already have the power to require banks to hold more capital against a particular exposure if they deem that as warranted in a specific instance.

Against this backdrop, the proposed Guidelines can only have any beneficial effect in such jurisdictions where the Basel Capital requirements have not yet been implemented. We respectfully ask the Committee to clarify its intentions. The language in paragraph 3 should explain in more detail that:

- The Guidelines could serve as a forward-looking safety net in those Basel member countries where step-in risk has already been addressed by the implementation of relevant regulatory reforms, specifically, but not limited to the Basel capital requirements as described above. To assist national regulators who choose to adopt the Guidelines, the Guidelines should explicitly address how the scope of coverage and requirements are reduced for such countries and what remaining parts of the step-in risk framework would apply.

- The Guidelines could serve as a comprehensive backstop only in those jurisdictions where the implementation of the international accounting and regulatory frameworks is incomplete.

b) Liquidity Requirements

We commend the Committee for citing the Liquidity Coverage Ratio (LCR)[25], in particular paragraphs 125 and 135. In general, the LCR requires banks having structured financing facilities that include the issuance of short-term debt instruments, such as ABCP, to fully recognize the concomitant liquidity risks. These risks include the inability to refinance maturing debt and the existence of contractual obligations that would allow the "return" of assets, or that require the original asset transferor to provide liquidity, effectively ending the financing arrangement ("liquidity puts")[26]. Furthermore, the framework explicitly aims to identify and to cover liquidity risks originating in non-contractual contingent funding obligations

---

[23] *Id*, No. 6 (p. 2)
[24] See *EBA*, Limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 (2) of Regulation (EU) No 575/2013, EBA/GL/2015/20, 3 June 2016; (https://www.eba.europa.eu/documents/10180/1310259/EBA-GL-2015-20+GL+on+Shadow+Banking+Entities_EN.pdf).
[25] *BCBS*, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013, BCBS 238; (http://www.bis.org/publ/bcbs238.htm).
[26] *Id*, at 125.

that may arise under stressed market conditions and may be embedded in financial products and instruments sold, sponsored, or originated by a financial institution and can give rise to unplanned balance sheet growth arising from support given for reputational risk considerations.[27]

We are concerned that while the Committee correctly acknowledges these provisions it does not provide any reasoning why it deems this standard – which in our view covers the potential liquidity risks associated with providing support for reputational risk considerations – as not sufficiently addressing "step-in risk". Furthermore, we stress that the LCR standard establishes a minimum level of liquidity for internationally active banks. National authorities may require higher minimum levels of liquidity to capture specific market conditions or periods of stress. Supervisors are free to require additional levels of liquidity to be held, if they deem the LCR does not adequately reflect the liquidity risks that their banks face. Even if one would assume that the very specific wording of the LCR does not sufficiently cover step-in risk in all its potential occurrences the discretion of supervisors would be suited to provide sufficient remedy. In fact, in the European Union this is recognized by a combination of the ICAAP and the Internal Liquidity Adequacy Assessment Process (ILAAP) which have to be conducted as part of the SREP.[28]

As a consequence of the several requirements banks frequently hold further liquidity beyond the contractually required amounts. Thus, an additional and specific charge for step-in risk might effectively lead to double counting.

Definitions and Scope

As the Committee explains at the outset of its Consultative Document its "*work is part of the G20 initiative to strengthen the oversight and regulation of the shadow banking system to mitigate systemic risks, in particular, risks arising due to banks' interactions with shadow banking entities*." However, the entities the Committee lists as those that require evaluation for potential step-in risk reach far beyond the scope of shadow banking entities. According to the FSB "(t)he shadow banking system can be broadly defined as the system of credit intermediation that involves entities and activities outside the regular banking system".[29] Non-bank credit intermediation is thus at the core of the FSB's definition and concern. Credit intermediation on the other hand is characterized by four elements: (i) maturity transformation, (ii) liquidity

---

[27] *Id*, at 135. "These contingent funding obligations may be either contractual or non-contractual and are not lending commitments. Non-contractual contingent funding obligations *include associations with, or sponsorship of, products sold or services provided that may require the support or extension of funds in the future under stressed conditions.* Non-contractual obligations may be embedded in financial products and instruments sold, sponsored, or originated by the institution that can give rise to unplanned balance sheet growth arising from support given *for reputational risk considerations*. These include products and instruments for which the customer or holder has specific expectations regarding the liquidity and marketability of the product or instrument and for which failure to satisfy customer expectations in a commercially reasonable manner would likely cause *material reputational damage to the institution or otherwise impair ongoing viability*." (emphasis added).

[28] See *EBA*, Final Report - Guidelines on ICAAP and ILAAP information collected for SREP purposes (EBA/GL/2016/10), 03 November 2016; (https://www.eba.europa.eu/documents/10180/1645611/Final+report+on+Guidelines+on+ICAAP+ILAAP+%28EBA-GL-2016-10%29.pdf/6fa080b6-059d-4b41-95c7-9c5edb8cba81).

[29] *FSB*, Shadow Banking: Strengthening Oversight and Regulation, 27 October 2011, p. 3 (internal citation omitted); (http://www.fsb.org/wp-content/uploads/r_110412a.pdf).

transformation, (iii) credit risk transfer, and/or (iv) leverage.[30] This is in line with the definition recently applied by the EBA. "EBA defines shadow banking entities as entities that: a. carry out credit intermediation activities, defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities; and b. are neither within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU legislation (or equivalent third country legal frameworks)."[31]

According to the definitions of the FSB as applied by the EBA and other authorities[32] credit intermediation by non-bank entities is the constituting element of "shadow banking". The industry is concerned that the Committee mentions the FSB's definition in passing (paragraph 22) but henceforth completely ignores the constituting element of shadow banking and the criteria developed by the FSB. Instead, the Committee without any further reasoning refers to sponsorships, debt or equity investments or any other contractual or non-contractual involvement. As the Committee intends the proposed relationships to be broadly defined such an extensive scope not only seems to be overly broad but seemingly arbitrary and to some extend backward engineered. Vague definitions and an extremely wide scope also introduce the risk of material divergences in application of the Guidelines both across jurisdictions and between firms within the same jurisdiction. Against this backdrop the Committee should limit the scope of the Guidelines to include only shadow banking entities as defined by the FSB.

Sponsor: The Industry is deeply concerned that the scope of covered entities could be virtually limitless and extend to ordinary business relationships with corporate clients. If the definition of "sponsor" were indeed to apply to any advisory role or the placement of securities for any entity the Guidelines would basically cover the complete capital markets business (Equity Capital Markets / Debt Capital Markets) of banks on behalf of corporate issuers. It should be clarified that the scope of sponsorships is limited to interactions with securitizations or other shadow-banking entities (as indicated by the reference to the BCBS's Revisions to the securitization framework in footnote 11 of the Consultative Document).

Debt or equity investor: A broad understanding of a bank's role as "equity investor" would also extend to longstanding investments into the capital of listed or unlisted companies which can be rooted in many reasons (e.g. seed investments; industry joint-ventures; corporate restructurings). To expose each and every one of these relationships to an analysis for potential step-in risk seems to be unwarranted and extremely over-stretched. At the very least, the Committee should provide further guidance or reference what kind of debt or equity investments it would deem "important". Irrespective of these general reservations we would like to remind the Committee that equity exposures already have to be recognized (and in most cases fully covered) under the Minimum Capital Requirements (Pillar I) of the Basel capital standard.[33]

---

[30] *Id*, p. 7.
[31] *EBA*, Limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 (2) of Regulation (EU) No 575/2013, EBA/GL/2015/20, 14 December 2015, p. 7 at 7; (https://www.eba.europa.eu/documents/10180/1310259/EBA-GL-2015-20+GL+on+Limits+to+Exposures+to+Shadow+Banking+Entities.pdf/f7e7ce6b-7075-44b5-9547-5534c8c39a37).
[32] See for example *Deutsche Bundesbank*, The shadow banking system in the euro area: overview and monetary policy implications, Monthly Report, March 2014, p. 15 (p. 17 footnote 4); (https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2014/2014_03_shadow.pdf?__blob=publicationFile).
[33] See *BCBS*, *supra* (note 6), No. 340 – 358 (pp. 79-82).

While investments in debt instruments may in most cases be excluded from the scope of the Guidelines as they may qualify as regular business we want to reiterate our general apprehension that banks could hesitate to provide financial support to a client in difficulty, out of concern that this could be perceived as a step-in for reputational purposes. In general, the proposed framework creates incentives for a pro-cyclical avoidance of providing financing to clients in a cyclical downturn.

Securitizations: As we have explained above, the existing regulatory framework calls for specific sanctions in case a bank has extended support to a securitization. In such case, the bank would be required to hold capital against all the underlying exposures associated with the structure as if they had not been securitized. It would also be required to disclose publicly that it was found to have provided non-contractual support, as well as the resulting increase in the capital charge. If a bank is found to have provided implicit support on more than one occasion, the bank will be required to disclose its transgression publicly. National supervisors may take appropriate action that may include the requirement to hold capital against all securitized assets. Any sanctions will be aimed at changing the bank's behavior and to correct market perception as to the willingness of the bank to provide future support beyond contractual obligations. Against this backdrop, we do not share the Committee's conclusion that banks "*may ignore other risk factors considered in the step-in risk framework*".

We believe that the capital and liquidity requirements (as described above) and the revised securitization framework (as explained by the Committee) effectively identify and address any step-in risk that banks may have in relation to securitization vehicles. In fact, capital and liquidity requirements for such entities in some cases could be the same as if the entity was consolidated. We further believe that meeting the operational requirements for significant risk transfer should preclude additional capital requirements for securitization vehicles under the proposed Guidelines.

Furthermore, IFRS 10 "Consolidated Financial Statements" and IFRS 12 "Disclosure of Interests in Other Entities" address the appropriate accounting treatment and disclosure requirements, respectively, for such vehicles. As such, identifying these entities again for the step-in risk framework appears unnecessary and does not result in the identification of any new entities not captured by accounting guidelines.

We believe that the current risk-based capital framework and international accounting standards provide a basis for excluding securitization vehicles from the scope of coverage. Where the relevant capital and accounting standards noted above are implemented, this should qualify as a collective rebuttal to exclude securitization vehicles from the scope of the proposed Guidelines.

Commercial Entities: We are concerned that the lack of focus will lead to an overlap between the proposed Guidelines and other regulatory work. While the Committee recognized the distinction between step-in risk and operational risk the proposed Guidelines may nevertheless overlap and potentially infringe with the Committee's own efforts to foster business resiliency and continuity or with other important initiatives like the FSB's Guidance on Arrangements to Support Operational Continuity in Resolution[34]. This concern is particularly relevant with regards to the providers of critical operational services

[34] See *FSB*, Guidance on Arrangements to Support Operational Continuity in Resolution, 18 August 2016; (http://www.fsb.org/wp-content/uploads/Guidance-on-Arrangements-to-Support-Operational-Continuity-in-Resolution1.pdf).

as mentioned in paragraph 27 of the Consultative Document. In compliance with the Committee's own "Principles for the Sound Management of Operational Risk"[35] banks have already identified critical business operations, key internal and external dependencies, and appropriate resilience levels. This obligation explicitly includes "the facilities, people and processes for delivering products and services or performing core activities, as well as technology systems and data. External dependencies include utilities, vendors and third-party service providers."[36]

Materiality: We appreciate the inclusion of a materiality qualifier in the Guidelines and suggest that the determination of materiality be made by individual banks with national regulators assessing and challenging the materiality determination as appropriate. We propose that the Committee establish a principle that the concept of materiality be applied at the consolidated balance sheet level where applicable.

We also recommend that the Committee make clear that the materiality threshold referred to in paragraph 28 of the consultative document refers to the 'incremental' capital requirements from applying the Guidelines beyond what is currently required to be held. We are concerned that the Committee fails to note that in other regulations (e.g. the LCR), banks are not only required to measure the amount of support that they might have to provide or the losses that they may incur, but they also have to set aside incremental financial resources to cover the measured amounts. It is very important that banks be allowed to reduce the amounts of capital that would be expected to be held in respect of step-in risk under the Guidelines by amounts already held pursuant to other regulations.

Collective Rebuttals: On the basis of information from each supervisor, the Committee should establish, maintain and publish annually a list of collective rebuttals in all jurisdictions with an explanation or/and a description of enforceable laws which constitute collective rebuttals. Examples and interpretation of laws will help banks to identify entities that are subject to collective rebuttals. Alternatively, to capture the many potential differences in laws across jurisdictions, each national supervisor could independently establish the set of laws within its jurisdiction that can be relied upon for exclusion via collective rebuttals.

Identification of step-in risk

In general, the indicators are so broadly written that they could lead to assessment of step-in risk indiscriminately and inconsistently across firms and jurisdictions. Instead, the Committee should seek to define indicators concretely enough that they support a meaningful dialogue between the industry and the regulators. We do not believe that certain proposed indicators of step-in risk add value and can be practically utilized by banks. An example is the indicator of "Implicit support". In particular, we do not understand how a bank would be expected to assess whether an investor is accepting a lower rate of return on their investment relative to the risk.

Most importantly, the Industry suggests changing the qualification of "Regulatory restrictions and mitigants". In the Industry's view "*regulations that restrict (…) a bank's ability and/or propensity to support an entity on terms that are unfavorable to the bank*" should not serve as indicators for step-in risk but

---

[35] *BCBS*, Principles for the Sound Management of Operational Risk, June 2011 (BCBS 193); (http://www.bis.org/publ/bcbs195.pdf).
[36] *Id*, p. 17; paragraph 58, footnotes 26 and 27.

1333 H Street NW Suite 800E • Washington, D.C. 20005 • www.iif.com • @IIF

should qualify as collective rebuttals. The presence of such regulations is a reliable indicator that the Basel framework has been implemented in the respective jurisdiction. In this case, it should be recognized that application of the step-in risk framework would not be useful. Under such circumstances it seems highly disproportionate to require banks to evaluate every entity within the scope of the framework as material or immaterial and to expose every material entity to the full range of step-in risk indicators. We are strongly convinced that the factor "regulatory restrictions and mitigants" will be dominant and yield a null set of covered entities. Elevating this factor to the level of a "collective rebuttal" would not only be in line with the policy intentions of the Committee but significantly increase the efficiency of the framework.

From a policy perspective, we would like to mention that the framework intends to "take a forward looking approach to possible step-in situations that are of a different nature to those seen in the past". Against this backdrop, we regard the proposed indicator "Historical dependence" as inconsistent with the policy intentions of the Committee. This indicator not only ignores the significant changes in the financial markets and in the regulatory framework but leads attention into the wrong direction. In particular, with regards to SIVs Federal Reserve Vice Chairman *Fischer* has recently observed that "the ability of banks to provide support to structured investment vehicles has been substantially curtailed through both restrictions on the accounting treatment of formerly off-balance-sheet exposures and more stringent capital requirements, including the supplementary leverage ratio applying to on-balance-sheet assets and off-balance-sheet exposures."[37] He was joined by Governor *Tarullo* who concluded that "(c)hanges in capital, accounting, and other regulatory standards make these arrangements very unlikely to reappear."[38] Against this backdrop we suggest this indicator be dropped.

In addition, we believe that the idea that one indicator alone may be sufficient to trigger the identification of step-in risk (paragraph 35) goes against the tailored approach that the BCBS is trying to reach and could be perceived as a rigid self-assessment. It brings automatism and ignores the fact that each indicator could apply with varying degrees of importance. For example, would step-in risk be higher for an entity where only one indicator applies with a high degree of importance, or for an entity where several indicators separately apply, but each with a relatively low degree of importance. All indicators should be seen in combination to reach a conclusion.

Potential responses to step-in risk

We encourage the Committee to clarify its policy intentions in paragraph 66 of the Consultative Document. In jurisdictions where the *Enhancements to the Basel II framework* have been implemented the framework already explicitly speaks to how step-in risks should be handled. In such an environment the new Guidelines may inform banks and policymakers in their task of identifying new manifestations of step-in risk. The situation may be different in other jurisdictions where the Basel framework has not yet been implemented. This differentiation is important for policy reasons and should be clarified at the outset of this section.

---

[37] *Fischer, Stanley*, Financial Stability and Shadow Banks: What We Don't Know Could Hurt Us, Washington, D.C., December 3, 2015, p. 6; (http://www.federalreserve.gov/newsevents/speech/fischer20151203a.htm).
[38] *Tarullo, Daniel K.*, Thinking Critically about Nonbank Financial Intermediation, Washington, D.C., November 17, 2015, p. 1; (http://www.federalreserve.gov/newsevents/speech/tarullo20151117a.htm).

We agree with the Committee's concerns about potential ramifications of public disclosures. Proposing that national jurisdiction require banks to disclose number, size, and nature of unconsolidated entities in terms of step-in risk creates market expectations of support, resulting in "moral hazard" and distorted competitive dynamics. Where a bank organizes, manages or advises a fund or other unconsolidated vehicle and has no obligation to provide financial support to that vehicle, investors should not expect the bank to provide such support. Earmarking such vehicles as prone to step-in risk may create an expectation that banks have the willingness and ability to step in and thus creates moral hazard – expecting downside protection, investors will delink pricing decisions from risk fundamentals and performance. Moreover, the existence of such an expectation may pressure banks to step in where they otherwise would not and, perversely, may reinforce market expectations of loss protection by banks.

Against this backdrop, we suggest aligning the disclosure requirements in the Guidelines with those in the Basel capital framework. As we have mentioned above, a bank that has extended support to a securitization would be required to disclose publicly that it was found to have provided non-contractual support, as well as the resulting increase in the capital charge. If a bank is found to have provided implicit support on more than one occasion, the bank would be required to disclose its transgression publicly. We regard these ex post disclosure requirements as suited to influence a bank's behavior and to correct market perception whereas ex ante disclosures will be misleading and create moral hazard.

Role of banks

In general, the Industry appreciates the conceptual approach of a self-assessment. However, we also ask for a greater differentiation along the policy intentions of the Guidelines. It should be clarified that the role of banks may be different among jurisdictions. The policies and procedures to identify and assess step-in risk would not be useful in jurisdictions that have already addressed step-in risk. Their focus should be forward-looking and their main purpose should be to guide decision-makers in the assessment of entities that come into scope in the future or with regards to potential new manifestations of step-in risk. With the Basel framework already in place any double-checking for step-in risk on a regular basis (in particular annually) seems to be highly exaggerated and inefficient.

Role of supervisors

The process by which the supervisor (paragraph 101) is allowed to apply measures that it determines appropriate when it assesses that significant residual step-in risks has not been appropriately estimated or mitigated should be clarified. The financial entity should have the opportunity to design a plan to appropriately cover the residual step-in risk if it has been identified by the supervisor that it has not been appropriately estimated or mitigated. There should also be a dialogue between the supervisor and the entity. A specific timeline on a case by case basis should be set for the entity to accomplish the plan to cover the residual step-in risk.

Implementation date

Given the secondary nature of the proposed Guidelines it seems to be appropriate to delay their implementation until after the overall Basel III package came into force and has proven its effectiveness. Against this backdrop a staged approach seems to be most appropriate with a suggested time lag between the implementation of the primary and secondary regulations of at least one year. At the very least the implementation of the proposed Guidelines should be synchronized with the implementation of the overall Basel III package. This may in any case imply a delay beyond the envisaged suggested implementation before end-2019.

Given the very nature of the "Guidelines" it also should be clarified at this juncture that jurisdictions, as always, are not mandated to implement the framework. National regulators will have discretion to apply the Guidelines taking into consideration in particular the status of the implementation of the general Basel framework as they deem appropriate.

Annex 1

In line with our earlier comments we suggest to limit the applicability of Template 1 to jurisdictions where step-in risk has not yet been addressed.

In particular, the reporting requirements should be more thematic in nature and not require lists of entities. Using reporting templates that support risk-related discussions between banks and regulators are more appropriate and will reach better outcomes than reporting templates that favor data dumps that can be both distractions and can lead to false conclusions. National supervisors retain the discretion to use, not use, or revise the reporting templates as appropriate for each jurisdiction or regulated firm. At the very least, the templates should recognize already existing national reporting requirements and prevent duplication.

If the suggested reporting concept is maintained certain fields would require additional clarification, for example the field heading "Typical contractual exposures to the entities" in Template 1. Specifically, firms will need to understand whether this field should be populated quantitatively or qualitatively.

In Template 2, the concept of a "group of entities" is not explicitly defined; depending on each firm and/or supervisor's interpretation of this concept, the list of items disclosed in this Template will vary.

In Template 2, the "Bank's assessment of step-in" will inevitably vary across firms and potentially overstate the magnitude of the risk and could result in unnecessary double counting for capital and liquidity purposes.

The "Risk indicator analysis" table in Template 2 should include an additional "other" row for bespoke transactions given that the list of indicators described in the main body of the proposal is explicitly stated not to be exhaustive.

1333 H Street NW Suite 800E • Washington, D.C. 20005 • www.iif.com • @IIF

Annex 2

Contrary to the Committee's intentions this list of entity categories is backward looking and is in most parts redundant. Many structures no longer exist (e.g. SIVs[39]) or have become subject to targeted regulation (e.g. Money Market Funds, Hedge Funds, Private Equity Funds).

For example, in the United States the Volcker Rule explicitly prohibits banking entities from, among other restrictions, acquiring or retaining any equity, partnership, or other ownership interest in or sponsor hedge funds or private equity funds, as well as certain commodity pools, securitization vehicles, covered bonds, non-U.S. funds and structured products (collectively, "covered funds"), subject to limited exclusions and exemptions. In December 2013 the three federal banking agencies as well as the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), approved a final rule[40] implementing the Volcker Rule.

Further, accounting consolidation standards in the United States were amended in the aftermath of the recent financial crisis[41] to significantly limit the type of structures that can be held off-balance sheet. Furthermore, regulatory capital treatment was generally aligned with this revised accounting treatment. Accordingly, many ABCP conduits and other types of vehicles that were once recipients of off-balance sheet treatment are now consolidated on banks' balance sheets. Current U.S. accounting and regulatory consolidation standards not only require an analysis of control and influence but also mandate an ongoing review of a bank's relationship to the respective vehicle to ensure that changes in the relationship have not occurred as to require consolidation of that entity, as well as a consideration of implicit support.[42]

In the interest of creating a forward-looking regime that is designed to detect the "unknown unknowns" this Annex should not be applicable in jurisdictions where these concerns have already been addressed.

***

[39] According to the statements of Vice Chairman *Fischer* and Governor *Tarullo*; notes 37 and 38 *supra*.
[40] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule, 71 FR 5536 (January 31, 2014).
[41] See *Financial Accounting Standards Board*, Consolidation (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities, December 2009; (http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820006385&blobheader=application/pdf).
[42] *Id*, 810-10-25-38A, 810-10-25-38F, 810-10-25-38G, 810-10-35-4.

Conclusion:

We hope these comments are useful as the Committee considers the enclosed recommendations in order to ensure the best outcomes of this regulatory exercise. Given the complexity of these issues, we believe direct dialogue with the industry is essential and welcome the Committee's willingness to engage in that dialogue. The Industry stands ready to provide additional views or clarifications.

Should you have any questions on the issues raised in this letter, please contact Martin Boer (mboer@iif.com), Thilo Schweizer (tschweizer@iif.com), Richard Hopkin (rhopkin@afme.eu), Hedwige Nuyens (hedwige.nuyens@ibfed.org), Chris Killian (ckillian@sifma.org), Christina Zausner (CZausner@crefc.org), or Peter Cosmetatos (PCosmetatos@crefceurope.org).

Very truly yours,

Martin Boer
Director
IIF

Hedwige Nuyens
Managing Director
IBFed

David Strongin
Executive Director
GFMA

Lisa Pendergast
Executive Director
CRE FC

Peter Cosmetatos
CEO
CREFC Europe

***

IIF

The Institute of International Finance is the global association of the financial industry, with close to 500 members from 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks. For more information visit: www.iif.com.

IBFed

The International Banking Federation was formed in March 2004 to represent the combined views of a group of national banking associations. The countries represented by the Federation collectively represent more than 18,000 banks with 275,000 branches, including around 700 of the world's top 1000 banks which alone manage worldwide assets of over $31 trillion. The Federation represents every major financial centre and its members' activities take place in every time zone. This worldwide reach enables the Federation to function as the key international forum for considering legislative, regulatory and other issues of interest to the global banking industry. For more information visit: www.ibfed.org/

GFMA

The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London, Brussels and Frankfurt, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit http://www.gfma.org.

CRE Finance Council

The CRE Finance Council is the global trade association for the commercial real estate finance industry. Its members are participants in all aspects of commercial and multifamily real estate finance, including balance-sheet and securitized (CMBS) lenders, loan and bond investors, private equity firms, servicers, rating agencies and others. The current U.S. commercial and multifamily real estate mortgage market is $3.8 trillion.

Commercial Real Estate Finance Council (CREFC) Europe

The Commercial Real Estate Finance Council (CREFC) Europe is the trade association for the commercial real estate (CRE) debt market in Europe. Our core membership includes banks, other lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms that need finance. We seek constructive and effective dialogue across the industry and with regulators to promote CRE debt markets that support the real economy without compromising financial stability.