Step-in Risk: Consultation by the Basel Committee

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In December 2015, the Basel Committee on Banking Supervision (the Basel Committee) published a consultative document in relation to step-in risk (the Consultative Document).[1] Step-in risk is the risk that a bank may provide financial support to a "shadow bank" or other non-bank financial entity which is experiencing financial stress, where such a bank is not contractually obliged to do so but where it wishes to avoid damage to its reputation. The consultation period during which written comments could be submitted closed in March 2016.

Background

Following the financial crisis, in order to address issues identified in relation to the "shadow banking system",[2] the Financial Stability Board (the FSB) developed a strategy consisting of a monitoring framework and the development of policies to strengthen the oversight and regulation of this sector. The FSB requested the Basel Committee to consider the extent to which "shadow banking" entities remain outside the prudential regulatory regime and to develop a framework for the potential inclusion of any entities that are not included. Although it is acknowledged that the risk of step-in by a bank has been reduced as a result of the accounting and regulatory reforms that have taken place since the financial crisis, the Basel Committee believes that there remains some step-in risk.

The Consultative Document proposes a conceptual framework under which the risk of such a step-in could be identified, assessed and addressed.

Summary of the Consultative Document

In the Consultative Document, the Basel Committee notes that, during the financial crisis, banks provided financial support to certain entities, such as securitisation conduits, structured investment vehicles (SIVs) and money market funds, owing to concerns that the failure of such entities would damage the reputation of the relevant bank. Banks were incentivised to step-in even where they did not have any contractual obligations to do so and did not hold any ownership interests in such entities.

The Consultative Document focuses on the risk of step-in due to reputational concerns,[3] and the intention is not to cover operational risk, which is considered elsewhere in the Basel framework. The Basel Committee wanted to obtain feedback on the conceptual framework before determining whether the measures to be taken would fall within Pillar 1 (minimum capital requirements) or Pillar 2 (supervisory review process) of the Basel

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[1] Basel Committee on Banking Supervision, *Consultative Document: Identification and measurement of step-in risk* (December 2015), *http://www.bis.org/bcbs/publ/d349.pdf* [Accessed 15 June2016].

[2] Defined by the FSB in its publication *Strengthening Oversight and Regulation of Shadow Banking — An Overview of Policy Recommendations* (29 August 2013) as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system".

[3] The Basel Committee defined reputational risk in Basel Committee on Banking Supervision, *Enhancements to the Basel II Framework* (July 2009), p.19, *http://www.bis.org/publ/bcbs157.pdf* [Accessed 15 June 2016] 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 (e.g. through the interbank or securitisation markets)".

Framework. Banks have been particularly concerned by the potential prospect that they will be required to hold regulatory capital as protection against such reputational risk, in addition to the increased capital requirements resulting from various aspects of Basel III, and several market participants have expressed a preference for a supervisory approach, if it is indeed determined that it is necessary to put measures in place to address step-in risk.

The conceptual framework is based on four key principles. It should:

- anticipate the situation after a bank has stepped in, to avoid a detrimental effect on the banking system;
- be simple and foster consistent implementation;
- be conservative, risk-sensitive and proportional; and
- be readily operational.

The relevant entities with which a bank may have a relationship that may involve step-in risk would include (and would not be limited to) mortgage or finance companies, funding vehicles, securitisation vehicles, money market funds and other investment funds, asset management companies, and commercial entities that provide critical services exclusively to the bank.

Banks would be expected first of all to determine whether an entity should be consolidated according to the applicable accounting and regulatory standards. In the event that the entity is not consolidated with the bank, then the bank should consider whether certain indicators of step-in risk are present.

Primary indicators of step-in risk would include the following considerations:

- Is the bank a full or partial sponsor, i.e. does it provide credit enhancement and liquidity facilities to the entity and does it have decision-making powers in relation to the entity?
- Does it own share capital in the entity, or does it have the ability to appoint or remove the majority of the members of the governing body or exercise a dominant or significant influence over the management? [4]
- Does the entity have an external credit rating based on the bank's own rating?
- Does the entity provide critical services exclusively to the bank?

If one of these indicators applies, there would be a presumption of significant step-in risk.

However, the Basel Committee considers that there may be circumstances in which banks would be able to argue that the risk of step-in has been reduced or eliminated. In such cases, supervisors could take certain supplemental secondary indicators into account, as follows:

- **Does the entity share branding with the bank?**

  It is considered to be more likely that a bank will support an entity which shares its brand (e.g. its name, symbols or related marketing communications), in order to avoid reputational damage.

- **What is the purpose and design of the entity?**

  If the entity was established with the intention of putting banking activities off balance sheet, a supervisor could assume that step-in might arise.

- **Is there economic dependence by the entity on the bank?**

  If there are no other major stakeholders who could provide financial support, the supervisor could assume that step-in risk had not been mitigated.

- **Are the originator's incentives not aligned with those of the investors?**

  If so, it is considered that there is an increased likelihood of step-in, for example, if the originator has the ability or obligation to repurchase the underlying assets.

- **Does the bank retain or assume the majority of the risks and rewards?**

  Even where the bank retains or assumes most of the risks and rewards, some entities could remain excluded from accounting consolidation, for example, if there is no clear indication who has control over the entity.

- **Is there implicit recourse to the bank?**

  The Basel Committee anticipates that investors could claim that the originator or arranger bank is responsible where an entity's assets become bad, but this could be mitigated by providing information about the entity's underlying assets to investors.

- **Does the bank depend on a particular market for funding?**

  If the bank depends on a particular market for funding it could be grounds for step-in.

[4] Where the bank has the ability to appoint or remove the majority of the members of the governing body, or otherwise exercises a dominant influence, it is likely that the entity would be required to be consolidated. We note that consolidated entities are outside the scope of the step-in requirements in any event.

- **Investor expectations of returns:**

  It is anticipated that step-in would be more likely if investors are provided with inadequate information on the investments or receive unclear messages about the likely returns, particularly where there is a market expectation that the principal amount is guaranteed.

- **Composition of the investor base:**

  It is expected that step-in would be more likely if the entity and its financial instruments have been tailored for certain customers with whom the bank has a close commercial relationship (although the type and diversity of investors are likely to be relevant here).

- **Can the investors bear losses on their investments?**

  It is considered to be likely that a bank would be forced to step in if the investors are unable to bear the losses on their investments.

- **Can the investors freely dispose of their investments?**

  Investors may expect the bank to step-in if the liquidity of their investments is limited.

- **IFRS 12 disclosure:**

  In assessing step-in risk, supervisors could look at the information disclosed under IFRS 12 in order to evaluate the involvement of a banking group with unconsolidated entities. If, for example, the bank had provided support in the past outside of any contractual obligation to do so, this could be an indicator of step-in risk.

The Consultative Document envisages three different approaches that could be used to deal with step-in risk. These are (1) full consolidation of the entity; (2) proportionate consolidation (e.g. in the event that the reputational risk is shared by more than one bank); or (3) a conversion approach (i.e. the application of a conversion factor to the potential exposure to the entity).

Some considerations

It is not surprising that some market participants have questioned whether this proposed conceptual framework for step-in risk is really necessary, given the numerous other measures that have already been taken, or are currently proposed, with the intention of strengthening the financial system. For example:

- Basel II.5 introduced a requirement that banks must identify potential sources of reputational risk and the potential adverse impact of providing implicit support[5];
- banks will be required to hold increased amounts of regulatory capital under the Basel reforms, such as under the liquidity coverage ratio and the net stable funding ratio, and pursuant to the revised Basel securitisation framework, under which securitisation exposures held in the banking book will be subject to increased risk weights[6];
- under the revised Basel securitisation framework, where a bank provides implicit support to a securitisation, it is required, at a minimum, to hold capital against all of the underlying exposures associated with the securitisation as if they had not been securitised.[7] The bank is also required to disclose that it has provided non-contractual support and the capital impact of doing so[8];
- there have been changes to accounting standards, which may require an entity to be consolidated where a variable interest has been retained by the reporting entity or where such reporting entity has "control" over that entity;
- a number of regulations have been put in place in relation to securitisation transactions, for example, in relation to risk retention and disclosure;
- banks which are subject to the US Volcker Rule are generally prohibited from providing support to "covered funds" (with some limited exceptions); and
- further amendments to the regulatory landscape are expected in the form of the new EU securitisation regulation, which will include criteria for simple, transparent

[5] Basel Committee on Banking Supervision, *Enhancements to the Basel II framework* (July 2009), *http://www.bis.org/publ/bcbs157.pdf* [Accessed 15 June 2016].
[6] Basel Committee on Banking Supervision, *Basel III Document: Revisions to the securitisation framework* (11 December 2014), *http://www.bis.org/bcbs/publ/d303.pdf* [Accessed 15 June 2016].
[7] In addition, the European Banking Authority published a Consultation Paper in January 2016 entitled "Draft Guidelines on implicit support under art.248(2) of Regulation 575/2013" (the EBA Consultation Paper). Comments were required to be provided by 20 April 2016. Under art.248, a credit institution or investment firm is not permitted, with respect to a securitisation where significant risk transfer has been achieved, to provide support to that securitisation beyond its contractual obligations with a view to reducing losses to investors, unless the relevant transaction is executed at arm's length and has been taken into account in the assessment of significant risk transfer. The purpose of the EBA Consultation Paper is to consider what constitutes implicit support.
[8] Basel Committee on Banking Supervision, *Basel III Document: Revisions to the securitisation framework* (11 December 2014), para.98, *http://www.bis.org/bcbs/publ/d303.pdf* [Accessed 15 June 2016].

> and standardised securitisation (STS) and which is currently making its way through the EU legislative process.[9]

Not only should the regulatory and accounting measures described above have the effect of strengthening the financial system, but in addition, in many cases a bank may already have addressed the risk relating to an entity, for example, by consolidating it (meaning that it would be outside the scope of step-in risk) or by holding regulatory capital with respect to a liquidity facility which it provides to a conduit, or a bank may be prevented from providing additional support to such an entity in any event.

The proposed conceptual framework is unclear in many places, in particular with respect to how certain indicators of step-in risk would be interpreted. The framework appears to be based on a strong presumption that a bank will provide support to the relevant entity. It is difficult to see how a bank could rebut that presumption, even where such bank did not provide financial support to any such entity in the financial crisis and does not intend to do so in the future. It is not clear why, for example, it should be assumed that a bank would step in if investors suffer loss or if their investments have limited liquidity. Furthermore, the framework could lead to an assumption by investors that the bank would step-in, which could be disadvantageous to the bank, investors and the financial system in general. In addition, the range of entities where step-in risk could be considered to apply is potentially very wide.

If the resulting framework for step-in risk means that the banks are required to hold more regulatory capital, this could have the detrimental effect of limiting the availability of securitisation as a funding source, which would be at odds with other recent initiatives, such as the European Commission's plans to restart high quality securitisation markets via STS securitisation, which form part of the Capital Markets Union action plan.[10]

The Basel Committee is also carrying out a Quantitative Impact Study (the QIS) in order to collect evidence on the type and extent of any step-in risk. Banks will certainly be keenly awaiting further developments, following the Basel Committee's review of the responses to the consultation and the QIS, in the hope that any new requirements which are brought in to address step-in risk will be proportionate and will not be unduly onerous.

[9] Proposal for a Regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65, 2009/138, 2011/61 and Regulations 1060/2009 and 648/2012, Third Presidency Compromise (30 November 2015), *http://data.consilium.europa.eu/doc/document/ST-14537-2015-INIT/en/pdf* [Accessed 15 June 2016].

[10] Commission, "Action Plan on Building a Capital Markets Union" (30 September 2015), *http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf* [Accessed 15 June 2016].