Consultative document on identification and measurement of step-in risk

Basel Committee on Banking Supervision

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Research and Development

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In December 2015, the BCBS published a consultation paper establishing a conceptual framework for identifying and assessing step-in risk potentially embedded in bank's relationships with unconsolidated entities

Introduction

- During the financial crisis, 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.
- In this regard, the BCBS has published a consultative document that could form the basis of an **approach for identifying, assessing and addressing step-in risk**, which is defined as the risk that banks would provide financial support to certain shadow banking entities or other non-bank financial entities in times of market stress, beyond or in the absence of any contractual obligations to do so.

- The proposed conceptual framework aims at **identifying unconsolidated entities** that could entail significant step-in risk through an assessment comprising the application of **primary and secondary indicators** (when necessary) and different **approaches** that could be used to reflect the step-in risk in banks' prudential measures.
- Moreover, there may be regulations that have addressed step-in risk locally. Therefore, the BCBS has considered the specific cases of joint-ventures, asset managers and assets under management where **collective rebuttals**[1] could come into play to rebut the presumptions regarding indicators.
- The proposals are **preliminary** and the BCBS has yet to decide how the proposals will fall within the regulatory framework, including whether they fall within Pillar 1 and/or Pillar 2.

This document analyses the conceptual framework proposed by the BCBS to address the step-in risks arising from the relationship between banks and shadow banking entities.

1. Rebuttals consist on the exclusion by the supervisor of the application of the relevant step-in risk assessment approaches for some unconsolidated entities, when the supervisor is satisfied that step-in risks are mitigated by existing public policy that is enforceable by law.

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Executive summary

The framework includes the steps to be followed in order to identify step-in risk, three approaches for measuring step-in risk and other considerations regarding joint ventures and asset managers

Executive summary

Scope of application

- **Unconsolidated entities**.
- Other **non-bank financial entities** which are supported by banks beyond or in the absence of any contractual obligation.

Regulatory context

- Enhancements to the **Basel II** framework[1] (BCBS, 2009)
- Revised **securitisation** framework[2] (BCBS, 2014)

Next steps

- The BCBS will carry in parallel a **Quantitative Impact Study** (QIS) and will consider its results together with the feedback received in order to establish a final framework.

Main points of the Consultative Document

Identification of step-in risk

- Banks will determine which **entities fall out of their consolidation scope**.
- Secondly, banks will apply **primary indicators** to **unconsolidated entities** in order to identify and assess the existence of potential step-in risk.
- Thirdly, banks will apply **secondary indicators** as a supplement of the primary indicators in those cases where as part of the step-in risk assessment, the risk towards an entity has been partially or fully mitigated.

Measurement of step-in risk

- Depending on the nature and extent of a bank's relationship with an unconsolidated entity three approaches can be applied:
  - **Full consolidation approach**
  - **Proportionate consolidation approach**
  - **Conversion approach**

Other matters and specific cases

- Supervisors possess the authority to make **case-specific judgement**, and to establish **collective rebuttals**.
- **Joint ventures** are usually approached with proportionate consolidation.
- The relationship between banks and **asset managers and asset under management** should also be considered.

1. One of the topics covered is the type of reputational risk that leads banks to provide implicit support to certain transactions/vehicles/activities that they might sponsor or originate.
2. It addresses two of the main causes of step-in risk on the prudential level.

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Identification of step-in risk

Banks should first identify unconsolidated entities, and then assess if such entities meet any of the primary or, if necessary, secondary indicators of step-in risk

Identification of step-in risk

1 Determining unconsolidated entities

- Banks will first determine whether **entities should be consolidated** according to the applicable accounting and regulatory standards.
- After conducting this analysis and applying any relevant regulatory adjustments, banks should assess whether any **unconsolidated entity meets** the prescribed **indicators**.

2 Application of primary indicators

- Banks would assess their relationships with the unconsolidated entities against the **primary indicators** (See annex 1 for further detail):
  - Full upfront sponsorship
  - Partial sponsorship
  - Decision-maker and no upfront facilities
  - Dominant influence
  - Significant influence
  - External credit rating
  - Exclusive services
- If one of these **indicators is met**, it would be presumed that significant **step-in risk exists**.

3 Application of secondary indicators[1]

- Supervisors will use them to **supplement the primary indicators** when a bank argues that a step-in risk indicator has been partially or fully mitigated. The indicators are (see annex 2 for further detail):
  - Overall design
  - Branding and dependency on a particular market
  - Risk's assumption and rewards
  - Originators incentives
  - Investor base's
  - IFRS 12 disclosure
  - Recovery and resolution plans

Binding | Not always binding

1. This step will only be applied if the step-in risk has been reduced or eliminated. Therefore, this step is not always necessary and might not be applied.

Details

Measurement of step-in risk

Three approaches are proposed (full consolidation, proportionate consolidation and conversion) to gauge the step-in risk considering the nature and extent of a bank's relationship with an unconsolidated entity

Three approaches for measuring step-in risk

1 Full consolidation approach

- This approach allows banks to have a **comprehensive view of the risks** posed by an entity when it undertakes bank-like activities with risks that would receive an appropriate regulatory treatment if they were included in the consolidation. This approach would:
  - prevent the **double counting of capital** within a group.
  - give better acknowledgement and understanding of the **risk of contagion** among entities within the same group.
  - avoid **regulatory capital arbitrage** among different subsets of the financial sector.
- However, it is **not appropriate** when the entity (i) is already consolidated by another banking group or; (ii) undertakes activities not appropriately tackled by the Basel framework.

2 Proportionate consolidation approach

- It represents the most **appropriate** method for addressing situations where a reputational risk of step-in is shared by two or more banks (**joint venture**).
- Nevertheless, it is **not appropriate** in cases of shadow banking entities different from joint ventures due to the difficulties of determining the percentage of consolidation.

3 Conversion approach

- It is the an **appropriate** approach when step-in is not expected to result in accounting consolidation once materialized, or when consolidation is not relevant or feasible.
- A bank would determine the amount of a potential commitment that could materialize using **credit conversion factors** (CCFs)[1]. Once the CCF is applied, the riskiness of the entity (using risk-weight under the SA for credit risk as a benchmark) could also be introduced to obtain the risk that banks should consider in their step-in risk assessment.

1. The consultative document does not include proposals for specific conversion rates for particular circumstances.

Details

Measurement of step-in risk

There is a mapping of primary indicators with possible measurement approaches to be applied …

Mapping of indicators with approaches (1/2)

<table>
<tr><th>Indicator</th><th>No</th><th>Description</th><th>Approaches</th></tr>
<tr><td>Full upfront sponsorship</td><td>1</td><td>▪ Full up-front facilities and
▪ decision-making</td><td>Full consolidation</td></tr>
<tr><td rowspan="4">Partial sponsorship</td><td>2</td><td>▪ Partial upfront facilities,
▪ decision-making and
▪ majority or only provider of facilities</td><td>Full consolidation</td></tr>
<tr><td>3</td><td>▪ Partial upfront facilities,
▪ decision-making and
▪ where not majority or only provider of facilities</td><td rowspan="3">Full consolidation or conversion approach</td></tr>
<tr><td>4</td><td>▪ Partial upfront facilities,
▪ no decision-making and
▪ majority or only provider of facilities</td></tr>
<tr><td>5</td><td>▪ Partial upfront facilities,
▪ no decision-making and
▪ where not majority or only provider of facilities</td></tr>
</table>

Details
Measurement of step-in risk

…which is assumed to apply to the cases where primary and secondary indicators show the existence of residual step-in risk

Mapping of indicators with approaches (2/2)

Indicator	No	Description	Approaches
Decision-maker and no upfront facilities	**6**	▪ Decision-making but ▪ no upfront facilities	**Full consolidation or conversion approach**
Dominant influence	**7**	▪ Capital ties >50% or ▪ no capital ties but a dominant influence	**Full consolidation**
Significant influence	**8**	▪ Capital ties >20% and <50%, or ▪ a dominant influence	**Conversion approach**
	9	▪ Capital ties <20% but ▪ dominant influence	
External credit rating	**10**	External credit rating based on bank's own rating	**Full consolidation**
Exclusive critical service provider	**11**	Exclusive provision of critical services to the bank	**Conversion approach**

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Details

Other issues and consideration for specific cases

The proposal also discusses collective rebuttals and includes provisions on the specific cases of joint-ventures, asset managers and assets under management

Specific cases

Collective rebuttals

- Supervisors have the power to exclude unconsolidated entities from the application of step-in risk assessment where **mitigants are present**.
- Banks where a supervisor has exercised its **ring-fencing powers** could comprise banks with a reasonable rebuttal of step-in risk.
- Supervisors should ensure that there is a law that regulates the **prohibition of providing non-contractual support** by banks to off-balance-sheet entities.

Joint ventures

- In the case of a **joint-venture between two banks** or when the other party is itself a regulated bank or another regulated entity, a proportionate consolidation (e.g. 50/50) should be applied.
- When the **joint venture includes a non-banking-like regulated entity**, it should be assessed whether full consolidation could be a more appropriate baseline treatment.

Asset management

- Where banking groups provide **relevant credit enhancement to a fund** or where it is the only or the major **liquidity provider** a bank may step-in to support unconsolidated funds and/or an unconsolidated asset management company.
- A step-in risk assessment should be done by a banking group that owns an **asset manager** to support unconsolidated funds under its management.
- In addition, the banking group that owns an asset manager should also assess whether it would **step-in to support unconsolidated funds** under its management as an exceptional measure.

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Next steps
Calendar

The BCBS will conduct a QIS in the first half of 2016 to collect evidence on the nature and extent of step-in risk before it will publish the final framework

Calendar

Dic.15

Consultative document published by BCBS

Comments to the proposed conceptual framework shall be submitted by **17 March 2016**.

First half of 2016

The BCBS Committee will conduct a QIS

In parallel to the feedback, a QIS will be done to **collect evidence on the nature and extent of step-in risk**

To be determined

Publication of the Final Framework

Once the comments are analyzed and the QIS is performed, **a final framework will be published**.

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Annex 1
Primary indicators

Primary indicators are used to assess the relationships of banks with those unconsolidated entities according to accounting and regulatory standards

List of primary indicators (1/2)

Full upfront sponsorship

- It is a clear indicator that **a bank will provide financial support in a stress** when the bank is contractually obliged to provide full support and is involved in decision-making.

Partial sponsorship

- The bank has a **key role in the decision-making** and provides a **partial credit enhancement and liquidity facilities**. This means that the bank has a contractual obligation to provide initial support and bears a significant franchise and reputational risk through its decision-making powers.

Decision-maker and no upfront facilities

- This situation is a true test for **reputational or franchise risk**. In some cases, this relationship could be reflected in a bank's consolidated accounts.

Dominant influence

- In this case the **capital ties are over 50%** or there are no capital ties but the bank owes the ability to **appoint or remove the majority of the members of the governing body** of the entity. This most likely means that the entity is fully consolidated with the bank.

Annex 1
Primary indicators

Primary indicators help to define how significant is the bank's influence on the entity in terms of decision-making, operations and providing financial support.

List of primary indicators (2/2)

Significant influence

- **Capital ties from 20% to 50% or significant over the management**. This means that the bank can participate in the financial and operating policy conditions of the entity but not control them.
- **Capital ties < 20% but there is a significant influence over the management**. As in the previous case, the bank has the power to participate in the operating of the entity.

External credit rating

- Rating agencies will consider if the bank is able to provide support to the entity where it is providing full credit enhancement and liquidity facilities. In such scenario, the bank could **underpin unconsolidated entity's ratings** due to reputational reasons among others.

Exclusive services

- This case would include third parties that provide **exclusive services** which are **critical to the bank's operations**. In particular, the criteria to determine whether a bank may support these entities when they are in financial stress is subject to:
  - **Dependence and substitutability**. There is a high degree of dependence between the entities and the bank faces difficulties or high cost to substitute it.
  - **Costs**. Regarding the high cost or time-consuming of implementing the new entity´s substitute services.
  - **Business cycle correlation**. If there is a strong correlation between the service provided by the exclusive entity and the bank´s economic cycles.

Annex 2

Secondary indicators

Supervisors will use secondary indicators to supplement the primary signs when a bank reasonably states that a particular step-in risk indicator has been mitigated

Secondary indicators

General aspects

- **Overall design**. The purpose, the design of the structure and the nature of the entity's underlying assets will be assessed. In particular, supervisors will consider if the purpose is regulatory arbitrage.
- **Branding and dependency on a particular market** (funding source). In this case an entity carries the bank´s brand (e.g. corporate name, logotype, etc.) or there is a dependence on a particular market for a significant portion of a bank´s funding.
- **Bank´s assumption of the majority of risks and rewards**. Some entities could remain excluded from accounting consolidation due to the high degree of judgement in assessing control. Moreover, a bank should detail all arrangements and direct or indirect involvements that relate to the activities of the entity when trying to mitigate step-in risk.

Investors aspects

- **Originator incentives**. There could be step-in risk if these incentives are not aligned with those of the investors.
- **Composition of the investor base**. Supervisors will have to review its composition and analyse the investor's expectations of returns from their investments, as well as, consider investor ability to:
  - Bear losses on their investing instruments (if not, step-in risk probably arises).
  - Freely dispose of their financial instruments (if not, step-in risk probably arises).

Others

- **IFRS 12 disclosure**. This additional information could be used to evaluate the step-in risk.
- **Recovery and resolution plans**. In this regard, a bank should address whether an unconsolidated entity is subject to being safeguarded for its continuity of critical functions.