



March 17, 2016

Basel Committee on Banking Supervision
Attn: Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Consultative Document "Identification and measurement of step-in risk," December 2015

Ladies and Gentlemen:

Better Markets¹ appreciates the opportunity to comment on the above-captioned consultative document ("Consultative Document") issued by the Basel Committee on Banking Supervision ("BCBS"). The Consultative Document proposes a conceptual framework that would allow financial regulators to identify, assess, and address the risk that a regulated financial institution might be called upon to support an affiliated entity even if the regulated financial institution is under no contractual obligation to do so.

INTRODUCTION AND SUMMARY OF CONTENTS

As the Consultative Document points out, the global financial crisis was worsened when regulated financial institutions stepped in to rescue their affiliates. As a result, credit risk that many believed would be contained in the so-called shadow-banking sector migrated back to regulated banks and broker-dealers, threatening to bring down the entire global financial system. Rather than transferring risk from the regulated financial system, the informal, loosely-regulated relationships between the regulated financial system and the shadow banks masked that risk from regulators and investors while allowing the creditors

¹ Better Markets, Inc. is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street and make our financial system work for all Americans again. Better Markets works with allies- including many in finance - to promote pro-market, pro-business and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements and more.

and counterparties of these shadow banks to rely on the implicit support of the regulated banks standing behind these lightly-regulated institutions. When these lightly-regulated institutions found themselves suffering unexpected losses and demands for liquidity, the regulated financial institutions that had sponsored them supported them rather than allowing them to fail.

As a result, the regulated financial institutions found themselves facing capital and liquidity shortfalls as well. The informal, loosely-regulated relationships between regulated financial institutions and the shadow banks that they sponsored thus meant that there was insufficient capital in the global financial system to bear the losses that arose in the shadow banking system that were ultimately backstopped by regulated financial institutions. These relationships did not transfer credit risk from regulated financial institutions; instead, these relationships effectively increased the leverage of these financial institutions to unsafe and unsustainable levels.

The Consultative Document highlights three examples in which regulated financial institutions stepped in to support affiliates for which they had no contractual obligations: securitization conduits, structured investment vehicles,² and money market funds. In each case, the regulated financial institution that sponsored the non-bank financial institution either provided capital and liquidity support or brought the non-bank financial institution on to its balance sheet to reassure panicked creditors, avoid larger losses, prevent runs on the sponsoring bank, and protect the regulated financial institution's reputation.

Among other things, the Consultative Document sets forth a conceptual framework that will help regulators identify and measure the risk that regulated financial institutions will step in and support affiliates for which they have no capital or contractual obligations. While the Consultative Document does not set capital requirements to account for step-in risk, it nonetheless represents an important preliminary step in defining, identifying, and measuring step-in risk. Better Markets therefore endorses the Consultative Document as a necessary stage in increasing the resilience and transparency of the global financial system. However, the Consultative Document—as important as it is—is only a preliminary step in mitigating the threat to the global financial system posed by step-in risk.

After the BCBS completes its conceptual framework, it must both incorporate step-in risk into its calibration of capital requirements and direct national financial regulators to

² In particular, Citigroup's disastrous experience in sponsoring structured investment vehicles shows the risk that non-bank affiliates can pose to regulated financial institutions. In 2007, to avoid failure of the SIVs that it had sponsored, Citigroup brought \$49 billion of SIV assets onto its balance sheet. Because market participants did not distinguish between Citigroup and its non-guaranteed subsidiaries, Citigroup knew that to allow its non-guaranteed affiliates to fail would have so damaged Citigroup's reputation that Citigroup would have failed. For that reason, Citigroup brought its SIV's assets onto its balance sheet, even though it had no legal obligation to do so. Other transnational banks—including Barclays, HSBC, Dresdner, and the Bank of Montreal—similarly moved SIV assets onto their balance sheets to avoid reputational damage. *See generally* Better Markets Comment Letter on "Proposed Interpretive Guidance and Policy Statement: Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act" (Aug. 27, 2012), available at <https://www.bettermarkets.com/sites/default/files/CFTC-%20CL-%20Cross%20Border%20Application%20of%20swaps%20provisions%208-27-12.pdf>.

subject the arrangements that result in step-in risk to enhanced supervisory review. And Better Markets believes that rather than seeking to identify and measure step-in risk, global financial regulators should instead seek to eliminate it either by requiring parents to fully capitalize the contingent liabilities represented by their subsidiaries' reputational claims against them or by requiring parents and affiliates to publicly disavow that parents will provide any support to their affiliates other than in the ordinary course of business.

COMMENTS

Question 1

The Consultative Document sets out four principles that guided the BCBS in developing its conceptual framework:

- The framework should anticipate the situation after a step-in;
- The framework should be simple and foster consistent implementation;
- The framework should be conservative, risk-sensitive, and proportional; and
- The framework should be readily operational.

The first question posed by the Consultative Document solicits commenters' views on these four principles.

Better Markets strongly endorses these four principles. Of these, the most important is the first for the reasons set forth by the BCBS: By assuming that a regulated financial institution will step in to rescue a faltering subsidiary, Consultative Document can “help ensure that the banking system has adequate resources in advance of a stress” such that regulated financial institutions are not weakened to the point that their distress poses “systemic implications.”

In other words, the failure of an affiliate poses a substantial risk of contagion to the regulated financial institution that steps in to provide credit support, which in turn poses a risk that that contagion could be transferred to the broader financial system. The global financial crisis demonstrates that this kind of risk is not hypothetical—in fact, the existence of these kinds of relationships between regulated financial institutions and their affiliates accelerated the panic that crippled the financial system in 2008, which in turn resulted in government bailouts and the worst economy since the Great Depression.

Question 2

The Consultative Document sets forth 11 primary indicators for assessing the possibility that a regulated financial institution will step in to provide support to an affiliated institution. Among these indicators are the contractual arrangements between the sponsor and its affiliate, the facilities provided by the sponsor to its affiliate, the extent to which the

sponsor influences or controls the decision-making of its affiliate, and the sponsor's provision of critical services to its affiliate. The second question posed by the Consultative Document solicits commenters' views on these proposed indicators for step-in risk.

Better Markets agrees that these 11 indicators can help regulators identify step-in risk or predict the circumstances in which a regulated financial institution might step in to rescue a failing affiliate even when it is not contractually obligated to do so. However, notwithstanding the comprehensiveness of this list, these indicators do not fully specify all of the conditions in which a regulated financial institution might extend support to a failing affiliate. In addition to these indicators, the BCBS and regulators should also consider the "secondary indicators" set out by the BCBS. In many respects, the "secondary indicators" identified by the BCBS may prove to be even more reliable indicia of step-in risk than the primary indicators.

Question 3

The Consultative Document sets forth 13 "secondary indicators" to supplement the 11 primary indicators. These indicators are branding, entity structure, dependence on the sponsoring financial institution, sponsors' incentives, sponsors' share of the risks and rewards, the affiliate's implicit recourse to the sponsor, the sponsor's dependence on a particular funding source, investor expectations, composition of the investor base, investors' ability to bear losses, investors' ability to sell their holdings, IFRS-12 disclosure, and the affiliate's importance to the sponsor's critical functions. The third question posed by Consultative Document solicits commenters' views on these proposed secondary indicators, and asks whether the BCBS should consider other secondary indicators of step-in risk and whether any of these indicators should be considered as primary indicators rather than secondary.

Better Markets believes that these indicators are extremely important in identifying and measuring step-in risk. In fact, branding and the affiliate's dependence on the sponsoring financial institution are so important that they should be considered as primary indicators of step-in risk rather than secondary. So long as the affiliate's investors and creditors have reason to believe that the sponsoring financial institution and the affiliate share a corporate identity or that the sponsor may come to the affiliate's rescue, the affiliate's investors will underprice the risk of dealing with the affiliate. In turn, that underpricing of risk will result in the sponsor's either having to step in and provide support to the affiliate for reputational reasons—exactly as happened during the global financial crisis—or the sudden realization among the affiliate's creditors and counterparties that the support they imagined would be forthcoming in stressed economic circumstances was illusory will lead to panic as these creditors and counterparties attempt to flee from the faltering subsidiary.

Given that the counterparties and creditors of an affiliate will infer support from the parent in good times and demand it in bad, the Consultative Document is correct to look beyond the formal indicia of credit support to the criteria it lists as "secondary indicators." In fact, Better Markets believes that the presence of these "secondary indicators" should create a presumption that the sponsor will step in and provide support to its affiliate.

In the related context of de facto guaranteed foreign affiliates,³ Better Markets has pointed out that to credibly signal to regulators and the markets that a parent will *not* step in to support a failing affiliate, regulators should do the following:

1. Prohibit the affiliate from using, incorporating, or referring to the sponsor's name in its own name or documentation because references to the sponsor's name create the impression that the parent will support the affiliate as well as give rise to reputational risk arising from the use of the parent's name.
2. Require affiliates to explicitly state in all trade documentation that the sponsor will not provide resources or support of any kind to the affiliate, whether directly or indirectly, other than in the ordinary course of business.
3. Require the creditors and counterparties of the affiliate to explicitly waive claims against the sponsor.
4. Require the sponsor to publicly affirm that it will not provide resources or support of any kind to the affiliate, whether directly or indirectly, other than in the ordinary course of business.

In fact, these requirements suggest a preferable approach to step-in risk: rather than seek to identify and measure step-in risk, the regulators should seek to end it altogether. Either regulators should take steps to ensure that any possible liabilities represented by the affiliates' contingent claims are fully capitalized on the balance sheets of the parents, or regulators should require parents and affiliates to publicly disavow any support from parents to their affiliates. Even then, such a disavowal must be independently verified through the use of external credit ratings and, more importantly, market prices whenever possible.

CONCLUSION

Better Markets commends the BCBS for issuing its Consultative Document on identifying and measuring step-in risk. As the Consultative Document amply demonstrates, step-in risk permeated the financial system in the run up to the financial crisis and helped bring about the greatest economic crisis and worst economy since the Great Depression. The principles set forth in the Consultative Document as well as the primary and secondary indicators of step-in risk represent a promising first step for regulators in addressing the risk that affiliates pose to their parents and to the global financial system.

But as promising as that step is, the BCBS and global regulators must do more to mitigate and end step-in risk. The BCBS and global regulators must incorporate step-in risk into their calibration of capital requirements, and the BCBS must direct national financial

³ See Better Markets, "Cross-Border Factsheet: U.S. Banks are Again Trying to Evade the Financial Reform Law by Changing a Few Words in a Contract: this Time, it's Called 'De-Guaranteeing' Overseas Affiliates," available at [https://bettermarkets.com/sites/default/files/Cross-Border%20Guarantee%20Fact%20Sheet%206-19-14%20\(2\).pdf](https://bettermarkets.com/sites/default/files/Cross-Border%20Guarantee%20Fact%20Sheet%206-19-14%20(2).pdf).

regulators to subject the arrangements that result in step-in risk to enhanced supervisory review.

And Better Markets believes that global financial regulators should seek to minimize step-in risk either by requiring parents to fully capitalize the contingent liabilities represented by their subsidiaries' reputational claims against them or by requiring parents and affiliates to publicly disavow that parents will provide any support to their affiliates other than in the ordinary course of business.

Sincerely,



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