March 17, 2016

Submitted electronically

Basel Committee on Banking Supervision
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Identification and measurement of step-in risk

The Global Financial Markets Association, the CRE Finance Council, CREFC Europe and the Real Estate Roundtable1 ("We") write in response to the Basel Committee on Banking Supervision’s ("Basel Committee") request for comments on the consultative document "Identification and measurement of step-in risk" ("Consultation") that was published on December 17, 2015.2

We appreciate that the Basel Committee has published this Consultation at an early stage so as to maximize the ability of the Committee to receive industry guidance and input. We understand and agree with the Basel Committee’s desire that banks' interactions with off-balance sheet entities should not give rise to unexpected and unmanageable transitions of large amounts of assets back on-balance sheet. These are critical concerns for financial stability and market resilience.

However, we have significant concerns regarding what is proposed.

Firstly, we believe that the regulatory response to the financial crisis has already largely addressed what the Basel Committee seeks to address in this rulemaking – in particular for securitizations. We agree with the Basel Committee’s desire that banks’ interactions with off-balance sheet entities should not give rise to unexpected and unmanageable transitions of large amounts of assets back on-balance sheet. Therefore, we believe that an expansive new rulemaking such as that proposed in the Consultation paper is unnecessary.

Changes to accounting standards, regulatory capital rules, imposition of new requirements for liquidity management and other rules have either imposed new requirements on banks to consider implicit risks in bank activities, or simply prevented banks from performing those activities that were problematic before the crisis. Therefore, we believe that an expansive new rulemaking such as that proposed in the Consultation paper is unnecessary.

Further, the Consultation itself states that the proposals “…only apply to unconsolidated entities that, as of today, are out of the regulatory scope of consolidation.” Following the extensive regulation put in place post-crisis, we are not aware that such unconsolidated entities exist today to an extent that could pose a

1 Please see p14 for information regarding signatories.
2 http://www.bis.org/bcbs/publ/d349.htm
material and systemic risk to the financial system. We therefore urge the Basel Committee not to proceed with the proposals at all.

Secondly, should the Basel Committee disagree, and decide to proceed with new rules, we urge the Basel Committee not to follow the blunt, risk-insensitive, and pre-emptive approach set out in the Consultation by subjecting banks to capital requirements for actions that they may have no intention of taking. The proposal states that where any “one of the step-in indicators, which range from capital ties, sponsorship, provision of financial facilities, decision making and operational ties, is met under the framework, there is the presumption that significant step-in risk exists.”

To properly analyze this kind of risk, one must consider specific factors including bank, counterparty and market expectations of the probability of a step-in for a given structure, as well as the potential size of a step-in and the risk it might create. The proposal, due to its blunt approach, vastly overestimates the scale of this risk and does not appropriately provide the opportunity to analyze transaction-specific factors. We believe that the proposed indicators can be read to scope in almost any unconsolidated entity with which a bank interacts. We also note that it is not always the case that non-consolidation equals less regulatory capital -- the regulatory capital that a bank holds in relation to an unconsolidated entity can be equal to or greater than the regulatory capital that it would hold if the unconsolidated entity were consolidated. This is another aspect where a more nuanced approach is needed. In any case, history has shown that the risk of banks supporting these entities is remote and given the extent of reforms in the last nine years, likely to be even more remote than historical evidence would predict.

In the case of securitizations, the proposed rules would nullify the careful construction of the revised securitization framework’s implicit support rules. This means that it would replace a risk sensitive and considered approach with a blunt tool. The revised securitization framework provides that support to a securitisation that is not contractual is prohibited if a transaction seeks a non-regulatory consolidated treatment. The framework is specifically designed to address various securitization structures, referencing such features as ‘clean up calls’ and ‘revolving exposures’. The Consultation takes a blunt and non-tailored approach to these issues.

The securitization framework recognizes that some support might be added to a transaction, and that this must be explicit or contractual. Where there is explicit support, an exact assessment of that particular risk is considered for capital purposes. This is superior to a blanket inclusion of capital against potentially all of the underlying assets just in case a bank might (or might not) take the action of going further and stepping in. It is important to note that off-balance sheet securitizations are usually undertaken at least in part specifically for their capital benefit and the securitisation framework is designed with this objective in mind. The securitization framework would become meaningless if step-in risk rules require that further capital should be added through the consolidation of the underlying assets. Given the overly broad nature of the Consultation, we are concerned this may be a result.

Thirdly, should the Basel Committee continue to disagree and proceed with the pre-emptive approach outlined in the Consultation, we believe it is essential to address the lack of clarity in the proposal as to the bounds of which exposures (not currently capitalized) will need to be capitalized under the step-in risk regime. One could read the proposal quite broadly, or if one were so inclined, more narrowly. Indeed, regarding the Basel Committee’s QIS exercise, some of our members have taken a very inclusive view of the off-balance sheet entities for which there is step-in risk (i.e. that nearly everything is in scope), while others have taken a far more narrow view (that very little is in scope), while yet others remain simply unclear on how to assess this risk according to the standards laid out in this consultation. We believe the QIS would be more valuable to the Basel Committee if it were postponed until such time there was more clarity with respect to the scope of the proposed rules – e.g., if FAQ documents were issued, the proposal reconsidered and republished, or otherwise.

In any case, clarity will be the key to a consistent global application of any final rules by national regulators. If clarity is not achieved, the same criteria may be applied in different ways, and with different

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3 BCBS 303, paragraph 98 and elsewhere
effects, in different markets. This would undermine the rationale for criteria being set out at a global level by the Basel Committee. At the same time it is imperative that all criteria be articulated in a principles-based manner so as to be sensibly applicable to a variety of jurisdictions, market participants and asset classes.

We appreciate the opportunity to provide these comments to the Basel Committee and hope they are found to be constructive and helpful. Please do not hesitate to contact Chris Killian (ckillian@sifma.org) or Richard Hopkin (richard.hopkin@afme.eu) for additional information, clarification, or further discussions.

Sincerely,

David Strongin  
Executive Director  
Global Financial Markets Association

Stephen Renna  
President and CEO  
CRE Finance Council

Peter Cosmetatos  
CEO  
CREFC Europe

Jeffrey D. DeBoer  
President & Chief Executive Officer  
The Real Estate Roundtable
1. Layering of new rules for step-in risk on top of existing regulatory and prudential standards is unnecessary and backward-looking; Regulatory change since 2007 will prevent a recurrence of past problems

We agree that step-in risk was an issue for certain asset classes including SIVs, securities arbitrage conduits, money market mutual funds and credit card asset backed securities transactions as noted in the Consultation. However step-in risk was not an issue for the vast majority of other securitization asset classes or other bank sponsored activities. For example, there were not (to our knowledge) significant instances where banks stepped in to support issuances in the far larger securitization markets of RMBS, CMBS, or CLOs. We are likewise not aware of a significant number of step-ins with respect to traditional regulated mutual funds or other similar asset management products; where we are aware of their occurrence they tended be bespoke and occurred in the context of particular facts and circumstances. It is important to view step-in risk through this lens – it was a fairly narrow problem that was not spread across a significant multitude of asset classes or activities.

Since the onset of the financial crisis many new regulations have been implemented and many market practices have changed. As a result, today’s financial markets environment is very different from that of 2007. A very large number of previously off-balance sheet transactions have been brought back on balance sheet and capitalized accordingly. Consideration of implicit risk is required under accounting and other regulatory rules. Money market mutual funds (MMMFs) have new liquidity and other rules which should mitigate problems that occurred in the past. Other asset classes that are at the core of concerns driving this Consultation – e.g., SIVs and securities arbitrage conduits – do not exist anymore, and due to many post-crisis regulations (including the Volcker Rule, regulatory capital and other regulations) are highly unlikely to be formed anew in a way that would cause issues of the past to recur. Below we highlight, non-exhaustively, some of the key changes.

Accounting Standards - United States

In the U.S., the world's largest securitization market, revision of accounting consolidation standards resulted in very material changes to what could be held off-balance sheet, and regulatory capital treatment was generally aligned with this revised accounting treatment. As a result, a very large number of assets, including credit card master trusts, ABCP conduits, and other types of transactions that were at one time recipients of off-balance sheet treatment are now consolidated on banks’ balance sheets.

The Consultation clearly considers control and influence to be critical factors in whether or not step-in risk exists – these concepts appear as an element in each of primary indicators 1-9. Relevant U.S. accounting and regulatory consolidation standards not only already require a similar analysis of control and influence (in addition to risk of loss/receipt of benefits), but they also require an ongoing review of a bank’s relationship with the vehicle to ensure that the bank’s relationship to the vehicle does not change over time so as to require consolidation. Implicit support must similarly be considered. To illustrate our point:

- ASC 810-10-25-38A provides that a bank must analyze its relationship to a vehicle, inclusive of its related parties and agents: “A reporting entity [e.g., a bank]…shall assess whether the reporting entity has a controlling financial interest in [the vehicle]…This shall include an assessment of the characteristics of the reporting entity’s variable interest(s) and other involvements (including involvement of related parties and de facto agents)…”

- ASC 810-10-25-38A (a) and (b) provide that the bank will be deemed to have control if it has “the power to direct the activities of [the entity] that most significantly impact the [entity’s] economic performance” and “the obligation to absorb losses…or the right to receive benefits…that could potentially be significant to the [entity]…”

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4 As opposed to multi-seller ABCP conduits.
• ASC 810-10-25-38F provides that the reporting bank must also consider design and implicit support: “...if a sponsor has an explicit or implicit financial responsibility to ensure that the [entity] operates as designed, the sponsor may have established arrangements that result in the power to direct the activities that most significantly impact the economic performance of the [entity].”

• ASC 810-10-25-38G requires consideration of relative levels of control and benefits: “Consideration shall be given to situations in which a reporting entity’s economic interest in an entity, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of an entity that most significantly impact the entity’s economic performance.”

• ASC 810-10-35-4 requires a bank to reconsider its previous consolidation treatment if, among other things, “the legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity’s expected losses.”

• Furthermore, ASC 810’s revisions to consolidation standards specifically considered and included as examples discussions of the consolidation of SIVs and other securitized products. See, for example, ASC 810-10-55-122 through 810-10-55-133, which discussion includes reference to implicit obligations.

U.S. accounting standards and regulatory consolidation standards therefore already consider and address many of the concerns of this Consultation.

**Accounting Standards - International**

For companies reporting under International Financial Reporting Standards (“IFRS”), in May 2011 the International Accounting Standards Board (“IASB”) issued IFRS 10 - Consolidated Financial Statements, which replaced the previous consolidation guidance in International Accounting Standard 27, Consolidated and Separate Financial Statements, as well as the risk-and-rewards overlay for structured entities under Standing Interpretations Committee (SIC)-12, Consolidation – Special Purpose Entities. IFRS now includes a single consolidation model for all types of entities. Similar to US standards, IFRS 10 is based on control and both frameworks consider power and variable interests. The following extracts from IFRS 10 reflect how similar factors to those noted above in relation to US standards are considered:

• IFRS 10:5 requires an investor to determine whether it should consolidate an investee by assessing whether it controls this entity, “regardless of the nature of its involvement”. IFRS 10:B58 also requires an investor to determine “whether another entity with decision-making rights is acting as an agent for the investor”.

• IFRS 10:6 provides that an investor controls an investee “when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.”

• IFRS 10:B5 requires to consider “the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities” when assessing control.

• IFRS 10:B8 provides further guidance for structured entities: “An investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor’s consideration of the purpose and design of the investee shall also include consideration of the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks. Consideration of the risks includes not only the downside risk, but also the potential for upside.”

• IFRS 10:B19 requires, when assessing whether an investor has power, to consider indications that “the investor has a special relationship with the investee, which suggests that the investor has more than a passive interest in the investee”, including situations where “the investor’s exposure, or rights, to returns from its involvement with the investee is disproportionately greater
than its voting or other similar rights. For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.”

- IFRS 10 requires an investor to perform a continuous assessment of control: IFRS 10:8 and IFRS 10:B80 provide that an investor “shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7.” Among other factors that should be considered, IFRS 10:B83 requires an investor to consider “changes affecting its exposure, or rights, to variable returns from its involvement with an investee.”

- IFRS 10 includes specific considerations and examples in relation to structured entities, see IFRS 10:B53 and application examples 11 and 12 in Appendix B. In addition, some paragraphs of the basis for conclusions that accompanies IFRS 10, such as 54, 78 and 80, also discuss entities with predetermined activities and securitisation vehicles.

It is clear that international consolidation standards also already contemplate many of the risks upon which the Consultation is focused – and we believe this further supports our view that moving forward with this Consultation to a rulemaking is unnecessary. Consolidation standards require consideration of control, risk, benefits, and implicit support along with requiring a re-evaluation of treatment for so long as the vehicle exists.” These standards were revised with the experience of the financial crisis in mind.

**Basel and national rules**

Furthermore, existing Basel and national rules provide for a mechanism to handle the risk of implicit support. See, for example:

- Basel II, paragraph 564.8 “When a bank provides implicit support to a securitisation, it must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. Additionally, banks would not be permitted to recognise in regulatory capital any gain-on-sale, as defined in paragraph 562. Furthermore, the bank is required to disclose publicly that (a) it has provided non-contractual support and (b) the capital impact of doing so.” The Basel II framework also acknowledges that these risks are not easily measureable. European regulatory capital rules generally incorporate this standard. We believe the proposal is very similar to existing Pillar 2 requirements in its consideration of reputational risk and implicit support, and in the scope of activities which it might capture – yet we are not clear as to why the Basel Committee believes the Pillar 2 approach is insufficient. Paragraph 98 of the revised securitization framework similarly addresses this concern.

- US banking agency regulatory guidance on implicit recourse guidelines on implicit recourse.9 U.S. regulators have published guidance stating: “As with contractual recourse, actions involving non-contractual post-sale credit enhancement generally result in the organization being required to hold risk-based capital against the entire outstanding amount of the securitized assets. Supervisors may require the organization to bring all assets in existing securitizations “back on the balance sheet” for risk-based capital purposes, and to increase its minimum capital ratios. They may also prevent an organization from removing assets from its risk-weighted asset base on future transactions until the organization demonstrates its intent and ability to transfer risk to the marketplace. Supervisors may also consider other actions to ensure that the risks associated with implicit recourse are adequately reflected in the capital ratios. For example, supervisors may require the banking organization to deduct residual interests from Tier 1 capital as well as hold risk-based capital on the underlying assets.”10

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7 We also note that even if, for example, an ABCP conduit were held off-balance sheet (e.g., one established in a jurisdiction where consolidation were not required), the sponsor bank would need to hold capital related to the liquidity it provides to the vehicle.
10 Supra note 3, at 4
Pillar II rules already require consideration of reputational risk, which is a large component of step-in risk as identified in the Consultation. If the Basel Committee believes that Pillar II does not currently address this issue sufficiently, we think that this assessment and evaluation could be performed in the ICAAP. Based on this assessment and evaluation, we consider that a Pillar 2 capital charge could be imposed, but only when risks are evident and after a thorough analysis of each relationship. Step-in risk is not easily measurable and depends on many variables and requires a very deep analysis of each relationship (e.g., type and degree of involvement with the unconsolidated entity, riskiness of the entity, composition of the client base and their ability to absorb losses). As such, it is important to consider both the probability of an incident of a step-in and the scale at which it would be provided. Full or partial consolidation and conversion factors are blunt solutions for a nuanced and bespoke risk. We note that assessing both the likelihood and extent of support would not only be a prudent and risk-sensitive approach, but also be consistent with the probability of default and loss given default methodology within the credit risk framework. It is not clear to us exactly where the existing Pillar II approach is deficient in terms of the ability of regulators to address these concerns today.

Other changes in regulation since the financial crisis

Many other regulatory changes have been made to bolster resilience, controls, liquidity, capital requirements, and financial stability. These changes have or will materially enhance the oversight and resilience of banks and funds they sponsor, and they will reduce the risk that banks will need to or be legally able to step-in. This is because banks will either not be allowed to step-in or their sponsored funds will be higher quality and therefore less likely to run into problems that might tempt a bank to step-in. They include:

- The U.S. Volcker Rule. This rule prohibits propriety trading and relationships with hedge funds, private equity funds, and other types of funds, and renders many activities that were performed by banks prior to its imposition impermissible. For example, a bank could not sponsor or support a SIV as it might have done in the mid-2000s.
- Revisions to U.S. MMMF standards and forthcoming mutual fund liquidity rules. The MMMF revisions, among other changes, require institutional money market funds to establish a floating net asset value (NAV), and provide new options to MMMF boards with redemption gates and liquidity fees. The mutual fund liquidity rules, when finalized, will require the creation of liquidity risk management programs and enhancements to disclosure. These rules aim to enhance the robustness and liquidity positions of MMMFs, mutual funds and ETFs, and make them less susceptible to runs (consequently, less likely to need a bank to step-in).
- Proposals to revise European MMMF rules. The European Commission proposal would enhance daily liquidity requirements and enhance disclosure, implement a capital cushion for stable NAV funds, and require internal credit risk assessments. Similar to the U.S. rules discussed above, this is an effort to reduce the risk of runs and reliance on sponsor capital for these funds.
- NSFR and LCR rules generally, and specifically with respect to ABCP conduits. Among other reforms, they assure that bank sponsors of conduits must have sufficient liquidity on hand to refinance maturing commercial paper, effectively mitigating the risk of sudden liquidity emergencies for a bank conduit sponsor. The LCR also specifies that off-balance sheet SPVs require reserves against outflows.

11 E.g., the Consultation states: “To capture and address such risk, the focus is on identification of unconsolidated entities, to which a bank may nevertheless provide financial support, in order to protect itself from any adverse reputational risk stemming from its connection to the entities.” See Consultation paragraph 2.
16 See http://www.bis.org/publ/bcbs271.pdf.
17 See http://www.bis.org/publ/bcbs238.pdf.
18 GFMA affiliate AFME’s analysis of liquidity draws for ABCP multi-seller conduits is attached. It shows that draws through the crisis were much less than might have been thought.
• Risk retention\textsuperscript{19} and other related standards. These are aimed at improving the alignment of interests among the participants in a securitization, with the goal being an improvement in oversight, controls, and ultimately the credit quality of securitization transactions.

• The Basel Committee’s efforts regarding simple, transparent, and comparable securitizations have similar goals to improve transparency, accountability, disclosure, and quality.\textsuperscript{20}

We conclude that step-in risk and implicit recourse are issues that have already been contemplated and incorporated in existing capital regulations, accounting standards, and other rules.

If the issue driving this Consultation is a concern that an excessive amount of stepping-in took place during the financial crisis, creating sudden demands on capital which harmed banks and damaged market stability, we disagree that this reflects a flaw in capital or regulatory consolidation rules. The root of the problem was that banks engaged in activities that led to these risks at a scale that proved harmful. This is exactly what the regulatory change we discuss in this letter have addressed. Banks are simply no longer permitted to undertake the types of activities that led to the kinds of step-ins that are of concern in this Consultation. While it may have proven useful in 2006, in today’s environment the proposed framework is unnecessary and may in fact be harmful, as we detail below.

\textit{Negative Impacts of the Proposed Rules}

If the Basel Committee proceeds with the pre-emptive approach outlined in the Consultation, we fear issues of clarity as well as unintended negative consequences may arise.

• On clarity, how will a bank be able to protect itself from pre-emptive capital charges? Financial transactions are based on contracts, and likely or associated activities which may or may not surround those contracts in a complex market. If regulation is instead to be based on non-contractual relationships, where will a bank be able to draw the line and determine with certainty that it has no step-in risk?

• Because of this uncertainty, banks may structure their activities so as to make it impossible for them to step-in and support transactions, even if to do so was in the best interest of liquidity, financial stability, or any other reason. This would reduce the ability of banks to take actions that might calm volatile markets, actions that might also be in the best interest of the institution as well as financial stability more broadly.\textsuperscript{21}

• The proposed approach may also impact how banks are able to interact with, or are treated in, insolvency and other proceedings that relate to a troubled entity because of a presumption that a bank has some kind of obligation to support an entity. A presumption that a bank will support an entity, based on a bank’s retention of capital for just that risk, could complicate unwind or other proceedings and potentially create additional legal and operational risk to the bank. Contractual arrangements (or law) outline the protocol and unwind mechanisms in an entity’s bankruptcy or other dissolution, and banks have governance processes to consider and limit the potential for implicit obligations outside of their contractual arrangements or expectations of the legal process. How would a bankruptcy judge react to the situation where a bank holds capital for the potential support of an insolvent entity, even if the bank had no intention of ever doing so? These proposed step-in rules could themselves create fact patterns that lead to outcomes that were not envisioned at the initiation of the transaction, and result in unexpected and possibly negative


\textsuperscript{20} See “Criteria for identifying simple, transparent and comparable securitisations” available at http://www.bis.org/bcbs/publ/d332.htm and “Capital treatment for “simple, transparent and comparable” securitisations - consultative document” available at http://www.bis.org/bcbs/publ/d343.htm.

\textsuperscript{21} Any extraordinary action a bank would take should be discussed with its supervisor, be done on an arms-length basis with market-standard pricing and other terms, and appropriately capitalized as per relevant regulation.
outcomes for banks. We note as well that the impact of this could be very different in different jurisdictions given the variation among insolvency laws.

- We believe the proposed rules may limit the ability of or reduce incentives for banks to engage in securitization, which would run contrary to regulatory efforts to enhance, make more robust, and expand high quality securitization issuance. For example, we are unaware of any instance of a bank-affiliated entity that served as a third-party underwriter in a securitization transaction stepping in to support a transaction. Furthermore, as we have discussed elsewhere, for the overwhelming majority of securitizations sponsored by banks or their affiliates, regardless of how poorly they performed, there were no step-ins and there was no expectation from investors or other counterparties that there would be. Indeed, investors in mortgage-backed securities suffered significant losses through the crisis with no support from bank sponsors. This proposal could both directly (by making securitization more expensive) or indirectly (though fear of compliance risk) reduce bank incentives and willingness to engage in securitization. This runs contrary to both regulatory imperative and economic need, particularly in Europe where a concerted regulatory and legislative effort to revive simple, transparent, and standardized securitization is well underway.

- We also believe that the proposal to require pre-emptive capital allocations would create competitive disadvantages for bank-affiliated businesses, such as asset managers, broker-dealers, and other entities. By operation of these rules they would experience a higher cost structure than their non-bank competitors.

- Finally, the fact that a bank is holding capital against an exposure could create a perception that there is an implicit guarantee from the bank as to the performance of the entity, even if the bank has no intention to and in fact would not support the entity. Implicit guarantees distort investor and issuer incentives, and creating further implicit guarantees should be avoided. There should never be a public direct link between capital charges and step-in risk because such a link could create the perception that there is an implicit guarantee of the performance of an entity. This means that there should be (i) no Pillar 1 charge, (ii) no supervisory guidance for the Pillar II with comprehensive details on the calculation of the charge.

2. **Comments on the principles**

- **Principle 1: “The framework should anticipate the situation after a step-in”**

As discussed earlier we do not believe banks should be subject to pre-emptive capital charges for actions they may not take. We believe that regulators have already set forth regulatory consolidation guidelines that drive the capitalization, or not, of a given exposure. We do not believe layering on additional rules on top of the existing consolidation rules is the correct approach. We believe Pillar II already contemplates these risks and provides the ability for regulators to address their concerns. Nonetheless, any step-in risk framework has to be principles-based in order to accommodate the many different and idiosyncratic issues that may influence a decision to step-in.

- **Principle 2: “The framework should be simple and should foster consistent implementation”**

We agree with this goal. It goes to the clarity of the rules and consequent ability to achieve consistent global application. However, the scope of the rules is quite unclear in terms of which potential exposures are in or out of scope, and present myriad opportunities for interpretation and judgment by both banks and regulators that will likely lead to inconsistent treatment of similar potential exposures. The proposed primary indicators are in some cases not defined well, or even at all. Banks’ application of these indicators will necessarily be inconsistent and varied, and multiple entities could capture and capitalize for the same risks. Multiple banks may be forced to hold capital related to their relationships to the same
unconsolidated entities, for example, in a joint venture scenario, given that multiple indicators could lead to the scoping in of a joint venture.

The range of banks’ step-in risk assessments are likely to directly undermine the Basel Committee’s stated objectives of simplicity and comparability across banks’ risk weighted assets.

- **Principle 3: “The framework should be conservative, risk-sensitive and proportional”**

This principle contains laudable goals; however we believe this principle is not reflected in the text of the proposal. Instead the Principle 1 (anticipation of risk) seems to have dominated. As drafted, the framework is not at all sensitive or proportional to the reputational risk it aims to capture, given it assumes that “significant step-in risk exists” with the mere presence of any one of the indicators. This presumption, without consideration of bank, counterparty and market expectations of the probability and potential size of step-in risk vastly overestimates potential exposure.

At a very basic level it is unclear how to differentiate step-in risk from a bank engaging in transactions with unconsolidated entities motivated purely for economic reasons and not rooted in reputational risk. A bank may elect to extend a loan to a non-consolidated entity in which it has invested - on an arm’s length basis and with standard terms - to protect its investment or because the terms of the loan itself are expected to be profitable to the bank. This is no different from any transaction a bank may enter in its normal course of business, but only upon entering such a transaction would the bank be expected to capitalize for it. Under the proposed rules, would the bank need to capitalize the entire off-balance sheet entity? We do not think that is a proportionate outcome.

The proposal also has overlaps with other prudential rules that should be explored in much further depth. For example, in the case where an institution steps-in and takes on the liabilities of an unconsolidated SPE this could theoretically reduce litigation risk. Therefore, any step-in risk proposal should contemplate some reduction in the operational risk capital charge.

- **Principle 4: “The framework should be readily operational”**

Given the lack of clarity in the proposal, we believe much work must be done to clarify and narrow the intended scope of the proposal before it could be implemented by banks in practice.

Any proposal should not only focus on the step-in risk indicators but should also include criteria for how an entity can demonstrate that there is no step-in risk. The Consultation references this but does not provide details. For example, the proposal should specify that explicit contractual clauses (e.g. in a fund prospectus) which state that the financial institution does not provide any form of guarantee of the performance of the fund or any (bridge) liquidity support would be an effective means to mitigate the risk to step-in.

3. **Comments on primary and secondary indicators**

To the extent the Basel Committee desires to continue with a pre-emptive approach that requires capitalization of potential risks as set out in the consultative document, we believe that work is needed to clarify its operational standards. The proposal put forth in this Consultation is far too unclear and expansive to be implemented in a fashion that would not disrupt financial markets as it could be read to require massive amounts of new and unexpected capitalization by banks. Therefore we believe this section requires significant clarification as many of the proposed primary and secondary indicators could be interpreted in multiple ways or are simply unclear. Some examples follow.

- **Sponsorship as an indicator of step-in risk.**
  - We strongly urge the Basel Committee to clearly distinguish between the originator status and the operator status when capturing the implicit nature of reputational or franchise risk.
More specifically, we refer to item 6 in paragraph 3.1.2 where sponsorship is recognized when a bank is a decision-maker but has not provided any upfront facilities. The distinction between originator and operator is already recognized in footnote 17 of the Consultation.

We strongly believe that if a bank merely acts as the “operator” of an entity that is investing in third-party assets rather than having discretion over the assets, relevant parties would not expect the bank to step-in. As an operator/agent, decisions are made in accordance with the pre-agreed investment mandates (or objective/criteria) and this situation should clearly be excluded from the step-in risk assessment. We strongly believe that this should not be regarded as “decision-making”.

- In addition, where a bank structures and arranges transactions for its clients using trading book instruments sourced from the secondary market, this situation should also be excluded as it entails no or minimal step-in risk.
- The definition of sponsor includes if a bank “places securities into the market”; i.e. if a bank acts as an underwriter. We strongly disagree that this presents step-in risk – underwriters are not obliged, contractually or otherwise, to support transactions, and we are not aware that underwriters (whose involvement in the transaction was as underwriter only) have ever supported transactions in the manner Basel is concerned about. Furthermore, in many instances there are multiple underwriters for a given transaction. Which would hold the capital? One of them, or all of them?
- Table 3.1.2 does not appear to include sales of securities in its criteria. It is unclear if this means our concern in the preceding bullet point is unfounded.
- Would “decision-making” include servicing? If so, would banks be expected to capitalize all transactions for which they serve as servicer, master servicer, or in a similar role?
- The definition also includes a bank that “manages or advises the programme”. This is a very broad phrase, and again, we see no reason for a bank to be required to capitalize an entity simply because it provides advisory services. If the Basel Committee means a bank that serves as a collateral manager (e.g., in a CLO) or similar capacity, this should be specified.

**External credit rating based on a bank’s own rating**
- It is not clear to our members that this is an indicator of step-in risk. Where this may have been an issue – with ABCP conduits and similar vehicles – we believe this concern is ameliorated by the facts that (a) most conduits are now on-balance sheet for regulatory capital purposes and/or (b) those banks that have exposures to off balance sheet conduits must anyway now capitalize their exposures under existing regulatory capital rules.
- We do not believe the fact that the rating of a securitization transaction is conditioned in part upon the rating of a bank swap provider is a relevant indicator of step-in risk.
- We would be pleased to discuss with the Basel Committee situations which it believes give rise to this risk.

**Exclusive Critical Services Provider**
- We find this indicator especially unclear: what happens when two or more banks utilize the same services provider? Some service providers provide “customized” services to a bank, and may be considered “exclusive” due to the customization, but may also provide similar but different customized products to other banks.

**Originator Incentives**
- It is unclear to us when supervisors might determine that incentives are not aligned. For example, securitization by its nature transfers risk from one party to another, and

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22 In a typical securities issuance context – we are aware of obligations in special circumstances such as primary dealer relationships with sovereigns, agencies and central banks, but step-in risk is clearly not an issue there.
accordingly the risk of loss. Regulators have already implemented meaningful risk transfer and risk retention requirements to address these risks.

- **Implicit recourse as a secondary indicator**
  - We note that, as referenced in the Basel rules and US implicit recourse guidance above, findings of implicit recourse already result in effective reconsolidation of off-balance sheet exposures.

- **Composition of the investor base**
  - We believe this criterion is far too broad. In general, banks have clients with whom they regularly transact business, as building relationships and generating repeat business are keys to banking success.
  - Further, transactions such as securitizations and many other products are required to be consummated with sophisticated institutional counterparties.
  - Therefore a bank's normal course of business is to regularly conduct transactions with sophisticated institutional clients. Thousands of these transactions were consummated with banks' recurring institutional customers with no occurrences of step-in prior to, during, and after the crisis.
  - We believe the point of this criterion is that a bank might step-in to prevent a loss to a specific, important investor client, but we see no way to implement this requirement in practice given the nature of a bank's business being continuous engagement with institutional clients.

- **Investor expectations of returns from their investments; Investor ability to bear losses on their investing instruments; Investor ability to freely dispose of their financial instruments**
  - We do not agree with the premise of these indicators. Again, many transactions performed poorly in the crisis with no step-in. It is unclear to us how these factors could be related to step-in risk.
  - How would an investor's ability to bear a loss be defined? What would indicate that an investor could not bear a loss? Because their fund unwound, because their fund needed to sell assets, or some other indicator? In any case how would that event be tied to a particular transaction sold by a bank?
  - Banks do not have information regarding investor financial condition available to them which would allow them to rationally conclude whether an investor could or could not bear a given loss on a particular instrument (even if “not being able to bear a loss” were defined).
  - We note many if not most jurisdictions have suitability and/or other similar rules related to sales of securities designed to ensure that securities products are sold only to investors who are able to understand and manage them.
  - We also note that any securities market could become illiquid at a point in time – and many are illiquid all of the time -- this is not an appropriate indicator of step-in risk given that step-ins have not been a common occurrence in those markets.
  - These seem more like assumptions or hypotheses than factors based on historical experience. Accordingly, they are not suitable standards by which one should develop prudential regulation.

### 4. Guide to GFMA responses to the Consultation's questions

- **Q1. What are commenters’ views on the four overarching principles? Are there any others that should be included?**
  
  See section 2, page 9.

- **Q2. What are commenters’ views on the proposed indicators for step-in risk? Are there any additional ones that the Committee should consider?**
Q3. What are commenters’ views on the proposed secondary indicators for step-in risk? Are there any additional ones that the Committee should consider? Should any of them be considered as primary indicators?

See section 3, page 10.

Q4. What are commenters’ views on the different potential step-in risk assessment approaches? Are there any other approaches that the Committee should consider to account for step-in risks?

See discussion in section 1, page 8.

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

See discussion in section 1, page 8.

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

We discuss a concern with application to joint ventures briefly in section 2 on page 9.

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

We reference asset management activities in the discussion of rulemakings in section 1, page 7, and competitive concerns in section 1, page 9.
Signatories

- **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 and Brussels, 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](http://www.gfma.org).

- **The CRE Finance Council** is the collective voice of the entire $3.5 trillion commercial real estate finance market. Its members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities (“CMBS”) lenders; issuers of CMBS including banks, insurance companies, Government Sponsored Enterprises (GSEs), and private equity funds; loan and bond investors such as insurance companies, pension funds, specialty finance companies, Real Estate Investment Trusts (“REITs”), and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, shopping centers, hotels, and other types of commercial real estate that help form the backbone of the American economy. Our principal functions include setting market standards, facilitating the free and open flow of market information, and education at all levels. Securitization is one of the essential processes for the delivery of capital necessary for the health of commercial real estate markets and broader macro-economic growth. One of our core missions is to foster the efficient, transparent and sustainable operation of CMBS. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations.

- **CREFC Europe** is a trade association promoting a diversified, sustainable and successful commercial real estate (CRE) debt market in Europe. Our core membership includes commercial and investment banks, as well as other lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance. We seek constructive and effective dialogue not only with banks, but also with non-originating investors, borrowers and regulators in promoting CRE debt markets that support the real economy without compromising financial stability.

- **The Real Estate Roundtable** and its members lead an industry that generates more than 20 percent of America’s gross national product, employs more than 9 million people, and produces nearly two-thirds of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the U.S.’s leading income-producing real property owners, managers and investors; the elected heads of America’s leading real estate trade organizations; as well as the key executives of the major financial services companies involved in financing, securitizing, or investing in income-producing properties.
Appendix – AFME analysis of liquidity draws for ABCP multi-seller conduits
Data submission to European Commission:
historic liquidity funding for multi-seller ABCP Conduits

12th December 2012
• The strong liquidity performance of multi-seller asset-backed commercial paper conduits (“ABCP Conduits”), supported by the data in this document, warrants consideration for relief in the form of an adjusted calibration under Article 412 on:
  • undrawn liquidity supporting the *utilised portion* of total commitments funded by commercial paper (the “Utilised Portion”); and
  • undrawn liquidity supporting the *unutilised portion* of total commitments (the “Unutilised Portion”).

• In this paper, we refer to the sum of the Utilised Portion and the Unutilised Portion as “Total Commitments”.

• The currently proposed calibrations have the unwarranted consequence of severely penalising ABCP Conduits which:
  • have a 30 year operating history
  • have exhibited strong liquidity performance even during times of stress
  • fund the real economy: trade receivables, auto and consumer loans with good performance
  • are supported by sponsor banks, and
  • are relied upon by customers as a significant source of working capital.

• The data we present in this paper show that, historically, neither type of liquidity has been susceptible to “runs”, even at the most stressful times through the crisis when, for example, liquidity supporting the Utilised Portion never funded more than 5.45% of the Utilised Portion of Total Commitments.

• In other words, through the crisis, ABCP Conduits continued to fund at least 94.55% of the Utilised Portion of their Total Commitments by issuing and selling commercial paper, as they were designed to do.
The Basel Committee’s proposed calibrations for Higher Outflows under Basel 3 for liquidity lines provided to SSPEs were designed to penalise discredited structures such as Structured Investment Vehicles (“SIVs”) and “arbitrage conduits”, which experienced severe liquidity stress during the financial crisis.

If the proposed calibrations are not adjusted to take into account the very different nature, and very strong – performance, of multi-seller ABCP Conduits, then they will:

- reduce access to capital markets financing for customers, when financial conditions call for precisely the opposite policy objective
- make remaining capital markets financing more expensive by forcing customers to pay twice: both on the yield demanded by the investor and on the cost of redundant liquidity required by sponsor banks to meet the Higher Outflow in the LCR framework
- encourage these “real economy” assets to weigh on alternative bank financing sources at a time of significant de-leveraging pressure on banks
Section 1

**Key Features of ABCP Conduits**
Funding of corporate receivables by ABCP Conduits is key for the real economy

• Multi-seller ABCP Conduits provide European corporates* with a sustainable and resilient funding alternative to borrowing directly from banks.

• At the end of 2011, the global market for multi-seller ABCP Conduits was just over €238 billion, of which a significant portion provided working capital funding to real economy assets in Europe.

• An incorrect calibration of the treatment under the LCR of liquidity lines to multi-seller ABCP Conduits will therefore have a material and adverse effect on funding of the real economy and cause these “real economy” assets to weigh on alternative bank financing sources at a time of significant de-leveraging pressure on banks.

* Some large European corporate groups, for example Volkswagen, choose to originate receivables through subsidiaries that are regulated banks. The arguments we made in this paper for “corporates” apply with the same force to them even though technically they are banks.
While both SIVs / arbitrage conduits and ABCP Conduits sought their funding primarily from the short-term commercial paper markets, the similarities end there

**Key differences between SIVs / arbitrage conduits and ABCP Conduits**

<table>
<thead>
<tr>
<th>SIVs and Arbitrage Conduits</th>
<th>ABCP Conduits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Held long term financial assets, such as bonds</td>
<td>Fund short term trade receivables which are typically less than 90 days in tenor (with the vast majority shorter than 30 days), as well as other shorter term borrowing such as auto or consumer loans.</td>
</tr>
<tr>
<td>Funding need (and liquidity risk) at or close to maximum utilization as most SIVs were fully “ramped up”; they were highly dependent on financial market conditions</td>
<td>Funding need dependent on day-to-day financing needs of customers, namely whether business is good and a high volume of receivables is generated, or business is poor and a low volume of receivables is generated. Not systemic financial risk.</td>
</tr>
<tr>
<td>Proved to be illiquid under stress: short-term funding dried up, assets returned to banks’ balance sheets or liquidity drawn, no market for sale of the underlying long term financial assets</td>
<td>Proved to be relatively liquid under stress: short term funding was less affected, some limited liquidity drawings, underlying assets were “real economy”, short term and self-liquidating</td>
</tr>
<tr>
<td>Liquidity backup was dependent on financial market conditions: if there was no market for the assets, then liquidity was drawn</td>
<td>ABCP can be issued and liquidity put at risk of drawing only if good quality receivables are presented to the ABCP Conduit for funding. No receivables = No liquidity drawings or issuance of ABCP</td>
</tr>
<tr>
<td>Underlying assets performed poorly in credit and market terms: US sub-prime RMBS, US home equity loans, CDOs</td>
<td>Underlying assets were from the “real economy”; have performed and continue to perform well and within tolerances</td>
</tr>
<tr>
<td>Mis-used SSPE technology to exacerbate leverage and concentration of risk within the financial system</td>
<td>Well-established traditional use of SSPE technology to complement bank funding and share risk with capital markets investors</td>
</tr>
<tr>
<td>No longer active: no investor appetite and new regulations prevent re-emergence</td>
<td>Struggling to cope with new liquidity rules: some conduits have been closed because of the new liquidity rules</td>
</tr>
</tbody>
</table>
ABCP Conduits are backed by liquidity provided by sponsor banks which are “committed”; however, the Total Commitments cannot be utilised, nor can liquidity be put at risk of drawing, unless specific conditions precedent are met.

The first and most important condition – which makes such liquidity very different from “ordinary” committed lines of credit provided to corporates - is that sufficient receivables of good quality (there are “asset quality” tests) must be available for financing by the ABCP Conduit.

The amount of such receivables will depend on the needs of the day-to-day business of the corporate seeking funding from the conduit, for example:

- whether business is good, and the corporate is selling high volumes of goods, or
- whether business is poor, and the corporate is selling low volumes of goods

Therefore, even if the “committed” amount of an ABCP Conduit and its supporting liquidity facility is €100, if only €71 of eligible good quality receivables are available for financing then no more than €71 of ABCP can be issued. The associated liquidity remains undrawn unless ABCP cannot be issued due, for example, to market disruption.
AFME has gathered data from 2005 to date, showing historic utilisation across the industry and through the crisis Jan-05 to Jun-12

- AFME received data from 12 sponsor members representing issuance from over 27 multi-seller, multi-asset ABCP Conduits issuing in the Euro, Sterling and USD ABCP markets.

- Members submitted program commitment amounts, amounts of direct bank funding, ABCP outstanding, liquidity draw amounts, ABCP retained amounts, and the amount placed with government facilities on a month-end basis from January 2005 to June 2012.

- The timeline was chosen to incorporate different stages of the economic cycle.

- Our sample represents an average of 55% of the global ABCP market for the period, and since 2009 over 60%.

Sources: Moody's, Member Data
Note: Pre-2007 market data is shown quarterly
Our approach to analysing the liquidity risk

• Assuming a given size of the Utilised Portion in an ABCP Conduit, the first aspect consists in evaluating how much funding pressure can be created for the sponsoring bank when the market is no longer able to provide the funding in the form of ABCP. Our data demonstrates that funding pressure is limited – see Section 2.

• The second aspect consists in evaluating by how much the Utilised Portion can increase, which – potentially – could add further funding pressure on to the sponsoring bank at times of stress (as per Section 2). Again, our data demonstrates that such growth remains controlled – see Section 3.

• Therefore we have kept both analyses separate and sequential. Firstly, we evaluate the liquidity funding given a certain Utilised Portion; secondly, we go on to analyse the evolution of that Utilised Portion.
Section 2

**Historic Liquidity Funding**
**Supporting the Utilised Portion of Total Commitments**
Highest liquidity funding = 5.45%
Jan-05 to Jun-12

• We define “Liquidity Funding” to include (1) liquidity draws, (2) retaining ABCP on-balance sheet for non-investment purposes, and (3) accessing government funding relief programs.

• Liquidity Funding proved to be non-existent pre-July 2007.

• The majority of issuers experienced nil, or minor, Liquidity Funding in the post-2007 period.

• In total, Liquidity Funding peaked at c.$16bn, accounting for only 5.45% of total program funding requirements.

• On average, Liquidity Funding accounted for only c.$3.3bn of average funding requirements of over $200bn (1.6%) during the sample period.

Note 1: at least five ABCP conduits were or are in the process of being wound up during the sample period. This may skew the reported liquidity draw figure to the high side because at some point in the wind-up process, an issuer may not choose to, or may not be able to, market its ABCP.

Note 2: sponsors who are also dealers of ABCP will, as a matter of course, retain ABCP inventory for market-making purposes. Dealer members were asked to remove this inventory when reporting.

Note 3: liquidity draws primarily occur for two reasons:
1. a genuine market-disruption type event; or
2. as a funding preference where the cost of funding via LIBOR-based liquidity is more efficient than the current market price for ABCP.
Section 3

**Liquidity supporting the Unutilised Portion of Total Commitments**
ABCP issuance is constrained by the borrowing base of the assets of the seller; if good quality receivables are not available, ABCP cannot be issued and within a funding cycle there is no risk of the associated liquidity facilities being drawn.

Of course, ABCP will vary from month to month as the volume of eligible receivables changes. Over time, therefore, and across funding cycles, liquidity could be at risk of being drawn as the Unutilised Portion becomes utilised.

However, historical data shows that utilisation by sellers has averaged 68% for the sample period, with a standard deviation of 2.94%.

The Utilised and Unutilised Portion has therefore remained relatively stable throughout the sample period.
Number of observations: 2,403.

Month over month variations in the Utilised Portion at an aggregate and sponsor level were tracked to assess the correlation between market stress during the financial crisis and increased utilisation of Total Commitments.

Highest monthly change in Utilised Portion = 4.34%

Jan-05 to Jun-12

Low correlation was found during the sample period. This was because the borrowing base restricts increases to the underlying programs, and also because of reduced economic activity.

Note that the graph on the left reflects not only underlying changes in the Utilised Portion but also an arithmetical feature which tends to exaggerate volatility.

For example, assume Total Commitments of 100 of which 90 is utilised (and 10 unutilised) in Period 1. In Period 2 the Utilised Portion increases to 95. This is shown in the graph as a change of 5 / 10 = 50%. Yet the absolute amount of the extra Utilised Portion is relatively small.
Section 4

SUMMARY OF DATA, CONCLUSIONS AND REQUEST
The strong liquidity performance of ABCP Conduits, supported by the data in this document, warrants consideration for relief in the form of an adjusted calibration under Article 412 on:

- liquidity supporting the Utilised Portion; and
- liquidity supporting the Unutilised Portion.

For the Utilised Portion, Liquidity Funding was never more than 5.45% of the Utilised Portion of Total Commitments.

For the Unutilised Portion:

- at an aggregate level and as a percentage of Total Commitments, the monthly variation in the Utilised Portion never exceeded 4.34%;
- expressed as a percentage of the Unutilised Portion, this monthly variation never exceeded 13.72%;
- applying the same methodology but at the individual sponsor level, the data showed an average monthly variation in the Utilised Portion of 8.13%;
- using a percentile analysis to focus on the more likely scenarios, the 95th percentile in the monthly variations is no more than 16.62%.

Neither the Utilised nor Unutilised Portions are therefore susceptible to “runs”.

Yet the currently proposed calibrations have the unwarranted consequence of severely penalising multi-seller asset-backed commercial paper conduits (“ABCP Conduits”) which:

- have a 30 year operating history
- have exhibited strong liquidity performance even during times of stress
- fund the real economy: trade receivables, auto and consumer loans with good performance
- are supported by sponsor banks, and
- are relied upon by customers as a significant source of working capital
Given that the current proposed LCR calibration exceeds these levels of historical drawings by many multiples, AFME respectfully requests:

- further dialogue with the European Commission, the Basel Committee and other stakeholders to resolve these difficult technical issues; and

- in any event, a commitment to a review to be undertaken by the EBA of the proposed calibration during an agreed observation period.
The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

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