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FRENCH BANKING FEDERATION RESPONSE TO BCBS CONSULTATIVE DOCUMENT ON IDENTIFICATION AND MANAGEMENT OF STEP-IN RISK

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

I. Key comments on the proposed framework

The FBF welcomes the opportunity to respond to the Basel Committee's second consultative document relative to guidelines on identification and management of step-in risk.

Following the comments received during the first consultation period on identification and measurement of step-in risk, the FBF appreciates the Committee's proposal to change the regulatory approach by replacing the automatic Pillar 1 capital or liquidity surcharges with a tailored approach. The latter relies on banks' self-assessment and responsibility for choosing the most appropriate response once step-in risk is identified, in conjunction with supervisory analysis. Moreover, the proposed framework shall be applied as a "safety net" by supplementing existing prudential standards, without creating any unnecessary additional charges or redundancy with the existing Basel framework.

Against this backdrop, we would like to propose some recommendations that would contribute to add clarity and more alignment with the above mentioned overall objectives of the framework. In a nutshell we would recommend:

- **To remove the potential disclosure requirement:** disclosures on step-in risk are redundant with the accounting information already provided. Moreover, they may create a moral hazard by letting investors expect that banks would step-in may an entity be in financial distress. The existence of such an expectation may perversely pressure banks to step-in where they otherwise would not.
- **To remove the template 2** "detailed reporting of material entities posing significant step-in risk" or a minima the removal of the sub-templates "Nature of bank's relationship with the entity (mark all that apply)" and "Risk indicator analysis", whose production involves non automated calculations and heavy process to collect the information (see detailed comments page 4).

- **To narrow the scope and definition of step-in risk** notably where the bank is a debt or equity investor as it would embark a number of entities that would be extremely large, including any entities where a bank has a basic advisory role or long-term investments into the capital of listed or unlisted companies.
- **To ensure a level playing-field** by making sure that starting from the implementation date all jurisdictions will commit to implement these guidelines at the same time.

II. Detailed Comments on the Guidelines

Definitions and scope

- Par. 16 (cf. also Par. 65): If step-in risk is related to covering an operational risk at the level of an unconsolidated entity, step-in risk should be taken into account in the operational risk framework. In this regard, we would also suggest to add two "**counterexamples"** in the following paragraphs:
  - § 3.3 on "Implicit support": entities for which the implicit support by the bank covers the fraud risk and is already taken into account in the operational risk framework of the bank ;
  - § 3.9 on "Reputational risk from branding and cross-selling": entities for which the marketing is handled by the bank and the risk of mis-selling is already taken into account in the operational risk framework of the bank.

- Par. 24: The proposed types of relationships between banks and entities are **too broadly defined** (sponsor, debt or equity investor, other contractual and non-contractual involvement…). This definition would embark a number of entities that would be extremely large, including any entities where a bank has a basic advisory role or long-term investments into the capital of listed or unlisted companies. **The scope should be narrowed.**
  - ***cf. also comments below on the reporting templates.***

- Moreover, **the articulation with the perimeter of shadow banking entities should be clarified**. This would probably facilitate the identification process of the entities.
  - ***cf. also comments below on the reporting templates.***

- Par. 29: We share the Basel Committee's view that national law should be taken into consideration when it prohibits a bank of supporting a defaulting entity or severely reduces the ability of the bank to step-in.
  In the European Union for instance, regulators should consider that European Regulation on Money Market Funds (MMF) will totally remove any possibility of sponsorship for MMFs. Moreover, the consequences of MMF Regulation should not only be taken into account in the field of step-in risk but also and urgently in terms of LCR where investment in MMFs should be considered as HQLA.

- Par. 30: We share the Basel Committee's view that only a law, which is clearly enforceable and explicitly prohibits the provision of support, can be considered as a collective rebuttal.

However we would commend that on the ground of information from each supervisor, **the Basel Committee should establish, maintain and publish annually a list of collective rebuttals in all jurisdictions** with an explanation or/and a description of enforceable laws which can constitute collective rebuttals. Examples and interpretation of laws will help banks to identify entities that are subject to collective rebuttals.

Besides we believe that, in addition to collective rebuttals**, individual case by case rebuttals should also be taken into account**. There are situations where the contract or the legal documentation will prohibit any step-in.

- ***cf. also comments below on the reporting templates*.**

<u>Identification of step-in risk</u>

- Par. 34: The criteria on which banks should focus on when performing the evaluation of step-in risk are exactly the same as those of **IFRS10** (accounting consolidation analysis), which have become much more risk sensitive. **Consequently, there is no need in our view to capture more entities in the prudential perimeter than in accounting.**
    - ***cf. also comments below on the reporting templates*.**

- Par. 38: On degree of influence, we suggest that a reference to asset management be included in the counterexample in par. 40 **to underline that banks have no say in the decision making on funds.**

- Par. 41: On implicit support, we believe that the first example in par. 42 reintroduces a disproportionate impact of external ratings on possible implicit support **and thus should be deleted.**

- Par. 65: Regarding regulatory mitigants, we believe that the example may be extended by mentioning the EU MMF Regulation, which intends to make the MMFs more resilient, especially during stressed market conditions, and limit to zero any step-in risk occurrence.

- Par. 52 : As regards accounting disclosures and connection with **IFRS 12**, **the most relevant information are already provided** in the Note to the annual consolidated financial statements on unconsolidated structured entities:
    - **maximum exposure to loss** of the bank towards the non-consolidated entities;
    - comments on whether the bank has provided any financial support to these entities outside of any binding contractual arrangement and if, as at the closing date, it has or not the intention to provide such support.
    - ***cf. also comments below on the reporting templates*.**

Finally we believe that, due to several existing regulations[1], traditional asset management activities and entities will be out of the scope of potential step-in risk. Except of some hedge funds and possibly a few mandates or funds where the commercial involvement of the promoter is exceptionally high and may justify stepping-in as a way to avoid reputational damage.

- ***cf. also comments below on the reporting templates*.**

<u>Potential responses to step-in risk</u>

- Based on the existing frameworks (accounting and regulatory), if correctly implemented, **some of the proposed step-in risk measures are redundant.**

- Par. 70: Consolidation is already implemented when an asset manager is part of a banking group and we think that it is a fair practice for pillar 2 issues related to operational risk in a broad sense. We believe however that this approach could be extended to other asset management groups and included in a specific framework for independent firms.

- Par. 71: We further consider that past comportments will not repeat themselves since mitigation measures have been introduced and justify an examination of the effective risk as of the day of assessment.

- Par. 78: Should asset management activities be included in the scope of step-in risk, conversion must be flexible to adapt to different circumstances as pointed out in the document. However the mention of the total balance sheet of an entity to which a conversion factor would apply is not appropriate for asset management. Indeed there is no relationship between size of assets under management and effective risk which depends on the quality of internal procedures and their effectiveness for all investment strategies developed. **Only very granular conversion factors could be appropriate and they should take consideration of the organization of the firm as well as the investment universe and the specific strategy of the portfolio.**

- Par. 89: In our view also, the proposed disclosures on step-in risk are redundant with the accounting information already provided (cf. above). Moreover, these disclosures on step-in risk may create a moral hazard by letting investors expect that banks would step-in may an entity be in financial distress. The existence of such an expectation may perversely pressure banks to step-in where they otherwise would not. **Consequently, we propose to remove this potential disclosure requirement.**

[1] In terms of risk transparency for investors, legal and marketing documentation for funds and mandates is designed to fully inform investors prior to their decision and regularly during the time they hold their position. The requirement for clear, true, complete and understandable information is of paramount importance in EU UCITS, AIFMD, PRIIPs or MIF legislations. MIF particularly requires further tests of appropriateness and suitability that prevent any “mis-selling” and misalignment with investor’s risk profile. It now extends to all categories of client investors.

<u>Role of banks</u>

With respect to reporting requirement (Title 5.3 and Annex 1), we consider the required information in both templates, excessively detailed, heavy, complex and onerous to produce.

- **<u>Template 1:</u>** *overview of the initial set of entities under scrutiny*

    - the relationships between the banks and the entities are much too broadly defined ("other contractual and non-contractual involvement" is too broad) (***cf. also comments above***);
    - the articulation with the perimeter of shadow banking entities should be clarified (**cf. also comments above**);
    - individual rebuttals should be taken into account in addition to collective ones (***cf. also comments above***);
    - one column is not clear (what are the *typical* contractual exposures to the entities ?).

  Provided that the scope of entities is better defined, the production of this template would be possible.

- **<u>Template 2</u>**: *detailed reporting of material entities posing significant step-in risk*

  We believe that this template, if not fully removed, should be simplified in order to reduce the operational workload.

    - indeed, the production of this template involves non automated calculations and a heavy process to collect the information;
    - as a consequence, we propose the following simplifications:
        - Sub-templates "Nature of bank's relationship with the entity (mark all that apply)" and "Risk indicator analysis" should be removed. It should be noted that the Sub-templates "Entity name(s)", "Estimation of the step-in risk potential impact" and "Conclusion and risk management actions undertaken by the bank" already provide numerous qualitative information regarding the entities.
        - Furthermore, identifying whether an entity presents step-in risk due to one criteria or due to the twelve criteria does not appear necessary, as long as impacts are calculated. Identifying the main criteria (to be added in the "Estimation of the step-in risk potential impact" sub-template) could instead appear sufficient.
    - there is some redundancy with the existing frameworks, especially the accounting one (IFRS10/12). (***cf. also comments above***);
    - many structures no longer exist or have become subject to targeted regulations (funds, ***cf. also comments above on traditional asset management activities***);
    - it does not seem very relevant to compile estimates on the impact of step-in risk assessment in a global template because all the entities would not require support at the same time and in the same conditions. Therefore, the global step-in risk does not necessarily correspond to the sum of all individual step-in risks.