FORDHAM
UNIVERSITY

The Jesuit University of New York

Gabelli School of Business

May 16, 2016

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Comment on consultative document: *Identification and Measurement of Step-in Risk*

Dear Sir or Madam:

Below please find comments on *Identification and Measurement of Step-in Risk* as researched, written, and assembled by a group of students in the Regulatory Outreach for Student Education (ROSE) Program at Fordham University.

This program brings together students from across the university to study our financial system, how it impacts society, and, specifically, current issues in financial regulation. This year's group included both graduate and undergraduate students in Economics, Finance, Accounting, Management, and Law, bringing a diverse range of perspectives and skills to the task. The consultative document, with its breadth and depth, offered an excellent opportunity for them to comment.

Five student teams studied the consultative document, researched the issue, and wrote comment documents. This document consolidates this work. First, in Appendix A, we include the full letter from the team that a group of judges selected as the most outstanding letter. Second, Appendix B contains the key ideas from each of the other four teams. We are submitting this document as an addendum to the comment you received, dated March 17th, from the Center for the Study of Financial Market Evolution.

We are grateful for the opportunity to comment on your document. It is our hope and belief that these students' work will constitute a productive part of your consultative review.

With sincere thanks and regards,

Chris R. Meyer
Clinical Assistant Professor
Gabelli School of Business
Fordham University
New York, NY

Appendix A

April 20, 2016

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Via: http://www.bis.org/bcbs/commentupload.htm

RE: Consultative Document: *Identification and Measurement of Step-in Risk*

Ladies and Gentlemen:

We are Fordham University students writing to respond to the Consultative Document referenced above, as released for public comment by the Basel Committee on Banking Supervision ("BCBS") and published by the Bank for International Settlements ("BIS") in December 2015.[1] We understand the currently proposed Step-In Risk Framework ("the proposed Framework") to be a commendable effort by the BCBS to minimize the potential for economic damage from future occurrences of global banking panics.

To achieve this, the proposed Framework seeks to identify and implement better standards for the control and mitigation of step-in risk. However, we believe that a closer look should be taken at the proposed Framework, as it could put additional pressure on banks and might hinder their success during a recovery from financial crises.

As students, we are eager to work in the financial sector, and by understanding financial regulation such as this we have a greater appreciation for and understanding of the global economy. Therefore, we will discuss our views on the following aspects of the proposed Framework, focused in these areas:

1. Overlap with Basel II and Credit Rating Agencies
2. Overlap with Basel III and Other Regulations/Frameworks

We believe that the Consultative Document presents relevant considerations for the financial system and step-in risk. However, because step-in risk is considered in previous regulatory frameworks and guidelines, there is little necessity for a universal regulation for step-in risk in its current form.

Through Basel II, Basel III, credit ratings, MMFs reforms, and additional market considerations, we seek to show that the measures proposed in this Consultative Document would be unnecessary and even harmful to the health and continued prosperity of the financial system. However, we believe that the BIS can work to create a more universal application of step-in risk identification, measurement and minimization.

[1] Conflicts with our university calendar prevented submission by the 17 March target date. However, our paper was presaged as an additional submission by the Center for the Study of Financial Market Evolution in its own timely comment letter.

Overlap with Basel II & Credit Rating Agencies

Because of the ambiguous wording and broad nature of many elements of the Proposal, we do not feel that it is essential that its measures are enacted. Furthermore, there are existing processes in place that already address many of the triggers and circumstances of step-in risk. Shadow banking and the associated step-in risk have been serious issues in the financial world for a number of years.

Basel II was implemented to revise international standards regarding how much capital banks need to possess to protect against the financial and operational risks they face. In particular, Pillar 2 provides a framework for dealing with residual risk. Residual risk is a risk that remains after all efforts have been made to mitigate risks associated with a business. The rationale behind the implementation of this Pillar was to encourage banks to utilize the best possible risk management strategies and assure that those banks have the necessary capital to support all risks.

For example, supervisors require banks to have appropriate written credit risk mitigation policies and procedures in place in order to control residual risks. These supervisors will review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. They will also take appropriate supervisory action if they are not satisfied with the result of this process.

Through this process, each bank is expected to have its own process for assessing its overall capital adequacy in relation to its risk profile as well as a strategy for maintaining its capital levels. The reasoning behind this recommendation was that there is no single best strategy when it comes to capital reserve requirements that are going to work for all banks.[2] If a policy is put into place that forces banks to adopt certain capital requirements in relation to step-in risk, it will directly contradict the idea that there is no "one-size-fits-all policy" that works for all banks.

If the U.S. banks that are subject to risk-based capital rules under Basel II are not holding sufficient capital to protect against off-balance sheet risks, such as step-in risk, supervisors can require them to treat the exposure to this risk as if it were consolidated on the balance sheet. Due to this requirement, there are already incentives for banks to appropriately allocate capital to address step-in risk. If separate measures are put in place to address step-in risk before there is sufficient time for the effects of the implementation of the Basel II accord to be assessed, there is a risk that the two separate sets of rules will lead to double counting and general confusion.

One of the other factors that these banks must take into consideration when determining their capital levels are the expectations of credit rating agencies. Some of the parameters that are used by these ratings agencies are "branding, entity sponsorship, liquidity provision and the ability to influence management."[3] All of these are identified by the BCBS as key potential step-in risk triggers. The use of these factors to determine credit ratings shows that step-in risk is already taken seriously by major organizations in the business world. As noted in the Consultative Document, external credit ratings are one of the Primary Indicators for step-in risk. Fitch specifically states that it "already considers potential step-in risks as part of its rating process."[4] Rating agencies will consider the probability that an entity will receive financial support from a bank in their analysis of said entity, and it is common for rating agencies to examine whether the bank is able to provide support to the entity. This means that if the rating of an unconsolidated entity is adjusted because of the likelihood that it will be supported by a bank, it is potentially a strong indicator of likely support in a situation of stress.

---

[2] Simon Topping, Basel II Pillar 2 Supervisory Review Process.
[3] Fitch: Banks May Need More Capital to Cover Basel Step-In Risk, Fitchratings.com (2015).
[4] Ibid.

The fact that the banks and nonbanking entities' ratings are already adjusted for possible step-in risk means that they are already being impacted for their decision to take part in a shadow banking relationship. They know the risks and possible downsides before they become involved. It does not seem necessary to us that they face even more regulation for their decisions.

Overlap with Basel III & Other Regulations/Frameworks

In addition to Basel II, the Basel III regulatory framework also dealt with risk and capital requirements. The Basel III framework specifically sought to alleviate pressures and avoid further fallout following the financial crisis of 2007-2008. This framework provided countries the guidelines and structure for individual regulation, while mandating key components such as capital standards and risk coverage. This document became the central guidance for further regulatory configuration. However, it appears to conflict with this Consultative Document on step-in risk.

Key ratios and monitoring tools were important elements of Basel III and through the capital reserve requirements set out in the framework countries and central banks changed sector structures and better accounted for systemic risk and other important risk factors. By understanding these tools and ratios, we can identify how they conflict and overlap with the Consultative Document on step-in risk, and also help us to identify ways to better formulate the step-in risk framework.

Discussion of NSFR & LCR

Liquidity Coverage Ratio:
The key liquidity coverage ratio (LCR) recommended in Basel III seeks "to promote the short-term resilience of the liquidity risk profile of banks."[5] By setting an LCR, countries, and thus banks, can better utilize their capital and protect against future crises. The liquidity coverage ratio ensures that companies have enough unencumbered high quality liquid assets (HQLA) to convert easily to cash in a scenario in which liquidity is needed for 30 calendar days. Not only does this capital liquidity requirement seek to stabilize and protect companies from systemic risk, but it also puts pressure on banks to focus their investment strategies. In an increasingly volatile financial market still recovering from the financial crisis, long-term investing has become slow. Every year until January 2019, the LCR minimum standard will increase 10% to reach 100% liquidity coverage by 2019. This is meant to enable firms to slowly ease into having enough capital reserves to protect against liquidity risk, but by 2019, an LCR of 100% is an expensive and daunting requirement for some banks.

Net Stable Funding Ratio:
The Net Stable Funding Ratio was implemented as part of Basel III as well, in an effort to enhance a more sustainable funding structure. This ratio, in addition to the LCR, is one tool firms can use to mitigate systemic risk. The Basel III document states that the ratio, and resulting funding structure "is intended to reduce the likelihood that disruptions to a bank's regular sources of funding will erode its liquidity position in a way that would increase the risk of its failure and potentially lead to broader systemic stress."[6] While the Net Stable Funding Ratio (NSFR) will come into effect only as early as January 1, 2018, Deloitte has said that "its future compliance seems to entail far more business challenges than the

---

[5] "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools."*Basel Committee on Banking Supervision*. Bank for International Settlements, Jan. 2013. Web. 19 Apr. 2016.
[6] "Basel III: The Net Stable Funding Ratio." *Basel Committee on Banking Supervision*. Bank for International Settlements, Oct. 2014. Web. 19 Apr. 2016.

LCR."[7] The NSFR attempts to encourage banks and companies to use longer term funding sources, in order to minimize maturity transformation risk. Again, it is similar to the costs of the LCR, with Deloitte pointing out that "this will automatically translate into higher funding costs and reduced interest margins."[8] This added liquidity requirement will force companies to once again change their capital structure and investment decisions.

As these ratios come into full effect in the next few years, the capital requirements will only grow, causing concern for companies world-wide, particularly if an additional standard is implemented to cover the costs of step-in risk.

Measurement of Profitability

By requiring companies to provide additional capital for liquidity when taking on step-in risk, profitability is further hindered. The ratios set forth by Basel III have already made an impact on the bottom lines of banks around the world, and with three years remaining until the LCR and NSFR are fully enacted, it is evident that it will be a challenge for banks to meet these requirements and remain profitable.

The profitability measured following the implementation of Basel III has seen this happen already, and one can only assume will continue if additional capital is required to protect against step-in risk. McKinsey & Company has stated that "the pretax ROE of European banks would decrease by between 3.7 and 4.3 percentage points from the pre-crisis level of 15 percent," following the completed NSFR application in 2019.[9] KPMG has also said that "these regulations reduce the interest rate margin and increase the operational costs which results in a deteriorated net income after tax. This is then combined with a profit retention policy, which increases the shareholder's equity and negatively impacts the ROE."[10] With higher levels of reserved capital, banks also have a reduced lending capacity. Given the current market, with the limited appetite of term debt and low-yielding assets, this will continue to challenge firms as they work to maintain the proper ratios.

If banks are already struggling to maintain return on equity with the LCR and NSFR, it will be even more challenging to maintain additional capital reserves for step-in risk coverage. We feel that these two ratios and the monitoring tool set forth by Basel III are adequate in ensuring that companies fully allocate the money necessary to protect against many types of risks, including step-in risk.

Additional Market Considerations

In addition to Basel III, step-in risk coverage is also evident in the SEC's final ruling on Money Market Funds from July 2014. Though these reforms have not been fully implemented, it is clear that their impact will challenge money market funds and also protect against step-in risk. As stated in the step-in risk Consultative Document, the BIS acknowledges that a floating NAV can signify a safer invested principal when compared to a stable NAV fund. However, it will be critically important to understand and investigate the impact of the changes that result from these reforms. KPMG observes that "there's a major concern that the changes, particularly with respect to calculating the floating NAV for institutional funds,

---

[7] Basel III Framework: The Butterfly Effect." *Deloitte*. Deloitte Southeast Asia, 2015. Web. 19 Apr. 2016.
[8] Ibid.
[9] *Basel III and European Banking: Its Impact, How Banks Might Respond, and the Challenges of Implementation*. Working paper no. 26. McKinsey & Company, Nov. 2010. Web. 19 Apr. 2016.
[10] "The Cumulative Impact of Regulation." *KPMG*. KPMG Belgium, June 2013. Web. 19 Apr. 2016.

will require significant changes to the way funds operate."[11] While this won't directly impact the value or success of an MMF, it will certainly impact daily operations and expenses. Additional capital requirements might further restrict money market funds.

These reforms are necessary and important, as some of the previous regulation was unclear or had gaps. However, if governments and regulatory bodies continue to regulate, and in particular pass regulation that has been implemented in another form, companies will begin to doubt the authority and necessity of such regulation. While financial regulation is necessary, given the financial environment and slow recovery from the financial crisis, over-regulating can hinder business to the extent that it reverses the growth that has come out of the crisis and further hold banks back from progressing into a safe, healthy state.

Finally, long-term investment will continue to play a role in the sustainability of capital standard requirements for banks across the globe. The outlook on long-term investments remains skeptical. The Organization for Economic Co-Operation and Development (OECD) has cited the "short termism increasingly pervasive in capital markets,"[12] as one source of the attitude related to longer term investments. With this short-termism, banks will find it increasingly difficult to sustain capital reserves and liquidity, as short-term investments increase maturity transformation risk. As we have indicated above, the Net Stable Funding Ratio relies greatly on longer term investments, and this will continue to be the case with a form of capital reserves framework for step-in risk as well.

Recommendations to the Consultative Document

As we have indicated, the Consultative Document set forth by Basel has clear redundancies and risks associated with the framework. We believe step-in risk does pose a risk for the financial system as a whole. However, we also believe that an additional framework is not necessary in its current form. We recommend that Basel reconsider its approach to step-in risk mitigation, by first reconsidering the current regulatory efforts for step-in risk around the world. In the United States, UK and international ratings agencies, step-in risk is being considered and is certainly a concern for financial systems around the world. With further consideration of the current protocols and procedures, Basel will be able to then implement a more concrete, universal application for step-in risk mitigation, through the support of the regulations already in place. As indicated in the Consultative Document, UK ring-fencing reforms, the US Volcker Rule, the SEC reform on MMFs, and EU regulatory initiatives, are already in place to better regulate step-in risk. We recommend that the BIS further assess these regulations, and their success in mitigation, before implementing a whole new framework. By doing so, the BIS can work together with these countries and others around the world, to create a regulation that can be utilized without redundancies or overlap.

In addition, we recommend that, before any step-in risk frameworks are truly considered, the BIS wait until the Basel III requirements are fully implemented. It is important that banks and the industry have time to assess its impact on profitability, but also be able to tell how it is impacting risk mitigation in general, and specifically through the lens of step-in risk. If there are additional redundancies, they will be easier to identify once Basel III standards have gone into full effect. Through these two recommendations, we believe that the BIS will be able to better assess the need and the procedure through which to approach step-in risk. If the current regulations do succeed in their mitigation of step-in risk, then a more universal regulation could be put into place, using the existing regulations as a guide.

---

[11] "SEC's Money Market Reform Will Have Big Impact on Money Funds." *KPMG*. KPMG, LLP., 2013. Web. 19 Apr. 2016.
[12] *Institutional Investors and Long-term Investment*. Rep. Organization for Economic Cooperation and Development, May 2014. Web. 19 Apr. 2016.

Finally, we believe it is crucial for countries worldwide to guard against step-in risk. This Consultative Document reminds national regulators to consider step-in risk and how they are dealing with its mitigation. That said, it is important that all countries have the same unified understanding of, and tools to mitigate, step-in risk. A framework to do so needs to be specific enough that there are no gaps in its implementation around the world, and also ensures that step-in risk truly is mitigated.

Final Thoughts

We believe that additional regulation is not necessary to address the issue of step-in risk at this point in time. Given our recommendations, if the Committee finds it necessary at a later time to implement further regulation of step-in risk, we are confident that the BIS can do so without redundancies and with the full support of its member central banks. As students preparing to join in tomorrow's workforce, we have confidence in the BIS and their implementation of a framework that will find the best balance of what currently exists and what else can help the future of the global economy.

We thank you for your consideration of our comments.

Sincerely,
Kristen Lyons, GSB Class of 2017
Donatus Olumhense, GSB Class of 2016
Hanna Read, GSB Class of 2016

Appendix B

Group 2:

Implied Commitment to Support

Passage of the recommendations in the Consultative Document would imply to shadow banking entities that it could be expected that their traditional banking counterparts will step-in for them during times of stress. This is problematic in the sense that, as explained in the CSFME's comments, there are rarely explicit contractual obligations between banks and their sponsored shadow banking entities binding the banks to step-in. Step-in is contemplated by banks on a case-by-case basis and often involves many nuances that the Consultative Document does not capture. Furthermore, during the financial crisis, there were a number of instances where shadow banking entities that would be forced onto banks' balance sheets under the proposed Consultative Document were never absorbed by their sponsoring financial institutions.

Ironically, as much of the proposed Consultative Document aims to address the reputational risks banks consider when deciding to step-in, it could actually force banks into reputation-damaging situations. In the eyes of shadow bank entities, the proposed Consultative Document would objectify the status of their relationships with sponsoring banks. With divergence between the understood step-in arrangement, or lack thereof, and what is made explicit in the proposed Consultative Document, banks will be exposed to further reputational risk in the event they consider to terminate their relationship with a shadow banking entity. Complicating the situation, the implied commitment to support created by the proposed Consultative Document would become a source of moral hazard as shadow banks will be incentivized to take excessive risk knowing that they will essentially be bailed out.

Macroeconomic Considerations

One cannot be certain how banks will react to increased capital requirements, nor how their reactions will affect the broader economy. Many U.S. bank stocks are already trading below their book value and increased capital requirements could make it difficult for them to raise capital from long-term investors. Overall, there are several potential macroeconomic consequences that may be the unintended result of the proposed Consultative Document that could cause ground to be lost in the quest for the stability of the financial system. The first can be illustrated through the historically inverse relationship between banks' capital requirements and credit accessibility for borrowers, even during an economic upswing. For instance, in the United Kingdom, 1990 to 1991 was a time of relatively low economic output that immediately followed the introduction of the Basel I framework in 1988. In addition, from 2000 to 2007, bank capital requirements were steadily decreased as lending expanded in the buildup to the financial crisis. This inverse relationship has further continued after the financial crisis as the lending of credit has tightened with the rise of required capital ratios. [13]

Specifically, in the long-run, "an increase of 15 basis points in aggregate leverage-based capital ratios of banks operating in the UK is associated with a median reduction of around 1.4% in the level of lending after 16 quarters."[14] Although the causality behind this relationship is difficult to isolate, the strong correlation's potential broader economic impact cannot be ignored.

[13] Noss, Joseph, and Priscilla Toffano. "Estimating the Impact of Changes in Aggregate Bank Capital Requirements on Lending and Growth during an Upswing." *The Journal of Banking & Finance*, October 7, 2014, 15-27. Accessed April 11, 2016.
[14] Ibid.

In a worst-case scenario, the increased capital requirements may not give investors full confidence in the decreased risk of bank entities, therefore not fully offsetting banks' increased funding costs. In this scenario, "banks are likely to pass this on to borrowers by raising interest rates on loans or decreasing the quantity of credit they extend by foregoing otherwise profitable lending opportunities."[15] Ultimately, this would lead to a decrease in the profitability and return on equity of banks. Furthermore, there is a less significant inverse correlation between bank capital requirements and GDP growth.

Perhaps most important, though, because GDP is not tied to changes in capital requirements nearly as much as lending is, corporations must be turning to other sources of financial debt when banks are not lending. In other words, when banks stop lending, that does not mean companies stop seeking sources of funds – they instead seek capital from shadow banking entities, increasing the capital controlled by non-bank financial institutions. Ultimately, consumers of credit may pull traditional banking activities into the shadows when banks face increased capital requirements.

Regulatory Arbitrage

Further exacerbating the growth of shadow banking, "If regulation is inefficiently tight… it induces banks to offload more risk than necessary in the shadow banking sector to bypass excessive capital requirements."[16] Historically, banks have done whatever it takes to utilize regulatory arbitrage and avoid any capital requirements that would cause financial drag. For instance, shadow banking saw its first major uptick in size in the aftermath of the 1988 Basel I Accord which required a capital requirement of 8% of risk-weighted capital/asset ratios. To avoid setting aside this capital, banks engaged in historically high amounts of financial innovation by expanding their over the counter (OTC) securitization efforts.[17]

By inducing banks into regulatory arbitrage, not only would the proposed Consultative Document expand the shadow banking industry through banks' relatively disproportional ability to lend, but also by inclining banks to move as many operations as possible into the shadows. With this in mind, we believe that the proposed Consultative Document may force history to repeat itself. In fact, we would argue that it could be favorable to limit capital requirements, as research shows that this would dry up liquidity in shadow banking, and move more traditional banking activities back into the realm of regulated financial institutions.[18]

Alternative to the Consultative Document

We believe that it may be beneficial for the Committee to consider regulation aimed at shadow banks themselves. The proposed Consultative Document could cause even more regulatory arbitrage than what banks have historically responded to increased capital requirements with. "The higher solvency of the traditional banking system then may be more than offset by such growth in shadow banking."[19] Further exploration needs to be done into potential methods for directly regulating shadow banking entities and encouraging the movement of more financial activities into the regulated realm of traditional banking.

Ian Cairns
Xavier Del Rosario
Matthew Farrell
Soorya Ramanj

---

[15] Ibid.
[16] Plantin, Guillaume. "Shadow Banking and Bank Capital Regulation." Oxford University Press, August 12, 2014.
[17] Prates, Daniela, and Maryse Farhi. "The Shadow Banking System and the New Phase of the Money Manager Capitalism." The Journal of Post Keynesian Economics. Accessed August 13, 2015.
[18] Plantin, Guillaume. "Shadow Banking and Bank Capital Regulation." Oxford University Press, August 12, 2014.
[19] Ibid.

Group 3:

1. The Proposal's Capital Charges Impose Ongoing Costs on The Financial Sector

First, we are concerned that the Consultative Document's approach increases the cost that step-in risk imposes on the financial sector. The Document's proposals would require banks to set aside capital so that banks can respond effectively when they decide to step in.[20] This is a respectable goal, but it transforms step-in from a question of *if* step-in will occur to a question of *when* it will occur.

A. Capital Charges Create Unnecessary Opportunity Costs

Any proposal to increase bank capital requirements carries a high opportunity cost to banks. If a bank is required to set aside capital to cover possible step-in costs, the bank is unable to employ that capital in money-making activities. Thus, any regulation that increases capital requirements must do so only to the minimum level required to achieve critical objectives. Additionally, this proposal's capital requirements are particularly costly because they must be held as Tier 1 capital, and increasing the level of Tier 1 capital raises the firm's Weighted Average Cost of Capital. This is because Tier 1 capital must come from common stock and retained earnings, and does not enjoy the tax-privileged status of debt. This may incentivize firms to engage in riskier activities in order to seek out higher returns to cover this higher cost.

B. The Proposal Makes Step-In More Likely

Requiring banks to set aside capital for step-in will normalize the idea of step-in. Currently, the presumption rests against step-in: banks must make a subjective decision to provide financial support beyond or in the absence of any contractual obligation to do so, and banks only ever incur costs related to step-in if they choose to step in for some financial entity. The Proposal will fundamentally transform the cost of step-in from a one-time cost incurred only as the result of a voluntary decision, to an ongoing cost. If a bank must hold step-in related capital, investors in a sponsored SIV or MMF are more likely to expect the bank to step in during stress, increasing moral hazard. Bank executives will also be more likely to step in because they have capital set aside to do so. Step-in will be seen as a more acceptable tool to use in times of stress. The foregone profits from keeping that capital set aside will be seen as buying the firm the right to step in whenever it wants to do so. In the end, this imposes an ongoing cost to banks while increasing the systemic risk posed by step-in. Capital reserves should not be designed to encourage investors to believe that their investments will be bailed out by a bank sponsor.

2. The Proposal's Approach is Too Broad

The proposal presents a set of objective standards for determining the step-in risk posed by a certain financial entity. However, because the decision to step in is so subjective, even the most well thought out set of objective criteria will never be able to capture the full set of factors influencing a bank's decision to step in. Using the proposal's factors is particularly likely to result in an overestimation of step-in risk, and thus an overly restrictive capital charge on banks. A less formulaic approach will yield lower, more realistic, and less onerous capital requirements. Because of this, we suggest that BIS recommend regulation that bans entities from stepping in unless they have specifically designated an entity as one they will step in for, and set aside an appropriate amount of capital to do so. This would reduce the likelihood of step-in and reduce unnecessary costs to the financial sector.

---

[20] The Consultative Document provides a set of objective factors that are used to calculate the Credit Conversion Factor for a given off-balance sheet entity. The potential exposure multiplied by the Credit Conversion Factor is then added to the bank's pool of risk-weighted assets used in existing calculations of capital requirements.

A. The Decision to Step-In is Inherently Highly Subjective

The executives who decide whether to step in will consider what, if any, representations they made regarding the safety of the vehicle; whether an explicit warning was made that the bank will not step in; the composition of that vehicle's client base as it relates to the firm's reputational risk; and the composition and risk profile of that vehicle. It is impossible to create a set of objective criteria that can accurately quantify the likelihood of a bank stepping in, and the potential size of the step-in exposure. Rather, we propose requiring banks to first come to their own determination of how much capital, if any, they will set aside for step-in, and second to disclose the factors that caused them to reach that conclusion to the public and all relevant regulatory bodies for approval.

B. The Proposal's Objective Formula is Likely to Result in an Overestimation of Step-In Risk

A bank's compliance department is in the best position to determine the step-in risk posed by a particular entity because it has access to the widest variety of information about that entity. They can anticipate the human factors and subjectivity inherent in a step-in decision much more effectively than a regulatory body can. A bank can rely on their credit risk data on counterparties to determine whether they are capable of supporting a joint step-in, which is much simpler than a regulator trying to infer the bank's attitude toward their counterparty.

Practically speaking, the total step-in risk faced by a given bank is lower than the sum of the step-in risk posed by each individual vehicle the bank sponsors, by means of diversification. However, under the Consultative Document's framework, a bank may be forced to set aside an unnecessarily excessive amount of capital relative to its actual risk exposure. For example, consider a bank which has constructed two SIVs to help its clients who wish to invest in interest rate swaps. One SIV holds a basket of fixed-floating interest rate swaps which will realize a profit if interest rates rise, and the other holds a basket which will realize a profit if interest rates fall. Under the Consultative Document's framework, the bank may be in a situation to step in if interest rates rise or fall rapidly, and the bank would have to set aside capital for both SIVs. However, interest rates cannot both skyrocket and plummet at the same time, and the bank would be forced to set aside twice as much capital as they need to protect them from step-in risk, at the cost of impeding their legitimate money-making operations. Banks ought to be able to make determinations such as this, as long as they disclose those choices and their reasons to the public and all relevant regulatory bodies.

3. Existing Regulations Addressing Step-In Risk Make the Proposal Unnecessary

Many jurisdictions have already implemented regulations to address step-in risk. Notably, these regulations aim to reduce step-in risk by severely limiting the circumstances where a bank may step in. This is fundamentally different from the Consultative Document, which assumes that a bank will step in, and tries to make the step-in process go smoothly. The following step-in regulations already exist:

- In the United States, the Volcker Rule functionally prevents step-in. It bars banks from providing financial support for covered funds. It also provides for extraterritorial application to banking groups that have any US banking operations.
- In Germany, the Investor Protection and Capital Markets Improvement Act and the Capital Investment Act provide some mitigation of step-in risk by limiting high short-term liquidity outflows and limiting when investors can withdraw money from certain funds.
- In the UK, ring-fencing policies provide a similar protection, preventing core banking units in a firm from providing support for non-ring-fenced activities such as SIVs and MMFs.

- In Japan, Article 39 of the Financial Instruments and Exchange Act goes further in preventing not just step-in, but indirect forms of step-in such as giving a customer preferential terms on a future transaction to compensate them for previous losses.

The following regulations are being considered to address step-in risk:

- Europe is considering regulations that ban MMFs from receiving external support. The regulations would also prevent global systemically important institutions from engaging in proprietary trading, holding shares in hedge funds, or holding shares in entities that do either of those activities.

Conclusion

The Consultative Document highlights the danger that step-in risk poses to the global economy. However, we are concerned that the Document's proposed solutions are targeted at a symptom of that danger, rather than the root of the problem itself. We recommend that the BIS instead adopt a set of regulations that aim to prevent, rather than prepare for, step-in. These preparations are costly to the banks, and they make the banks more likely to step in when times get tough, because they have capital set aside and a step-in plan.

As such, we recommend that the BIS adopt a regulatory structure that explicitly bans banks from stepping in unless a sponsor: (1) makes an ex-ante affirmative commitment to step-in for a particular vehicle, and (2) voluntarily sets aside capital reserves. We believe that this framework will achieve the stated goals of the Consultative Document while addressing the issues with the proposal's framework highlighted above. Further, it is more consistent with existing regulatory regimes and shifts the presumption against step-in for an entity, unless the bank has specifically declared an intention to do so for that one entity.

Joseph Gorman
Israel Munoz
Piero Olcese
Oren Rafii

Group 4:

Lack of Initiative in Implementing Previous Basel Proposals

When Basel III, an extension to the capital reserve and liquidity requirements as listed in Basel II, was first finalized for legislators and regulators to adopt, there was a significant delay in implementation from some countries. Most notably, in December 2014, the European Union was found to be "materially non-compliant with the minimum standards as prescribed under the Basel framework."[21] At the time, The European Union was the champion of global financial standards, yet it lagged far behind in the implementation of an urgent and impending document directly following the financial crisis. It would be difficult to say that even the European Union would swiftly be able to adopt another new regulation, especially one absent a clear integration with Basel III.

Basel's ninth progress report[22] highlights an additional seventeen sovereign countries that have yet to fully implement the Basel III framework[23] Amongst these nations, few have concrete plans to fully implement this framework in the near future. The United States is no exception; no rule regarding LCR disclosure requirements had been instituted by the preset date of January 2015. Similarly, China has altered its reserve requirements after adopting Basel III standards in reaction to a financial tightening based on their economic performance in 2015.[24] With such a delay among different countries with the implementations of Basel III when it was so clearly needed, it is unlikely that the implementation of Basel step-in risk regulation will go any more smoothly or quickly.

With the gradual implementation of Basel III, reserve requirements for banking entities has significantly increased since the financial crisis. In some countries, the reserve requirement ratio actually doubled[25] and there was no country that did not see a large percentage increase from previous levels. With this in mind, the proposed step-in risk regulation would again increase the reserve ratio due to the need to calculate step-in risk, which, as the Consultative Document notes, is not objectively defined. It would be wiser to observe the effects of the changes resulting from Basel III's reserve ratio requirements before pushing out another increase in capital requirements.

Capital Reserves

1) Redundancy to Existing Policy

Aside from Basel III's continued implementation, countries have undertaken initiatives to address the issue of shadow banking. The United States instituted the Volcker Rule in an attempt to prevent commercial banks from making speculative investments and performing proprietary trading. The Volcker Rule's reach extends far beyond just the US, as foreign banks seeking to operate in the US are also

---

[21] This line was quoted directly from Basel's own assessment of Basel III in the European Union (http://www.bis.org/bcbs/publ/d300.pdf).

[22] Basel's ninth progress report is the most current progress report available online to the public so some of this data may have changed by the time this comment letter is sent in (http://www.bis.org/bcbs/publ/d338.pdf).

[23] Each individual country in the European Union is accounted for in this number.

[24] In February of 2016, China's central bank lowered the reserve requirements for banks by 0.5% in response to a weakening economy and Yuan value.

[25] In some countries, the reserve requirement ratio doubled from 2% to 4%.

affected by the Volcker Rule. In effect, it governs most countries in the world by discouraging banks from partaking in the exact activities that may cause step-in risk.[26]

Lastly, in the United States, the Volcker Rule was passed within the remit of the Dodd Frank regulation. Dodd Frank's many stipulations include one that limits banks from "directly or indirectly hedging or otherwise transferring the retained credit risk."[27] Basel's step-in risk regulation will likely end up being repetitive and redundant by the time the regulation can be enacted.

2) Reduced Capital Efficiency

The Consultative Document or any proposal that attempts to increase capital requirements limits banks' ability to finance and extend credit to entrepreneurs and individuals. Banks are encouraged to fund structurally viable projects that are likely to succeed and ignore those that are unlikely to do so. With higher equity requirements comes a reduced ability for banks to fund any institution's given initiatives. Unfunded projects may seek alternative sources of funding; increasingly restrictive bank regulation could lead to an increase in the transfer of funding to unregulated shadow banking system entities. This would clearly be counter to the goals of the Consultative Document.

Structural Variability Across Shadow Banking Entities

The Consultative Document raises concerns on the scope and specificity of the off-balance sheet standards that the BIS would require of the various member nations involved. The Committee must take the unique political and economic climates of all member states into account when proposing consultative documents. Such a proposal will only prove effective if it consists of sufficient substance to address shadow banking in most, if not all of its member states.

In Australia, for example, off-balance sheet entities make up a much smaller percentage of the total market; prudentially regulated entities hold up to eighty percent of the market. These entities also serve different functions from those in the U.S. In the U.S., traditional banking entities account for nearly half the financial system. Australia's banking system is not as exposed to as much systemic risk, and there is little purpose for Australia to adopt the Consultative Document as proposed.

Taking another example, in India, HDFC Inc. has $3.44 billion in listed assets and is the country's largest Non-Banking Financial Company[28] (NBFC). HDFC Inc. segregates its shadow banking services from its core commercial bank. One of these shadow entities, Credila, a subsidiary of HDFC, offers student loan services. Credila provides these loans while holding itself accountable for all the transactions on its balance sheet. In the event of financial crises, given the off balance sheet relationship between the two entities, it is highly likely that HDFC would step in on Credila's behalf.

Attempts to regulate NBFCs could prove detrimental to economically disadvantaged stakeholders as well as India's continued economic development. These two cases of countries with varying types of

[26] The Volcker Rule has since been eased in its implementation with other countries since its initial implementation. However it still holds considerable influence over both domestic and foreign banks that should not be ignored.

[27] This is taken directly from a report detailing the effectiveness of Dodd Frank on shadow banking (https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr533.pdf)

[28] In India, off-balance sheet entities called NBFCs offer small scale loans to the thousands whom India's traditional financial system cannot reach.

shadow banking entities illustrate that off balance sheet issues cannot merely be addressed using a simple framework. In considering regulation that may be implemented in different regions, high levels of discretion are recommended. A framework with an excess of regulations could undermine the economic progress of some countries while an insufficient framework could fail to mitigate step-in risks in others. It will be difficult to assess the complete effect of the Consultative Document on such emerging markets, but it will no doubt be detrimental towards long term growth efforts there.

Complexity and Subjectivity Within Step-In Decisions

As the Committee notes, certain money market funds and other related entities received support from banking entities absent contractual obligations in the name of reputational risk. However, it is extremely difficult to objectively articulate this process as the circumstances involved in a bank's decision to step in are extremely complex, with varying internal and external factors. Externally, market conditions and regulatory pressures play key roles. Further exacerbating the issue, these factors cannot be predicted in advance. In the majority of cases, before step in can occur, the following internal groups must be in agreement:

1) Senior executives of the bank must concur with the sentiments of large shareholder groups that such action is the best alternative in the given circumstance.
2) Bank directors must assess the step-in proposal against standard industry practices in relationship to the bank's commitment obligations, both legal and discretionary.

In 2008, Dreyfus took a $425M charge from BNY Mellon to avoid 'breaking the buck' in the name of protecting investors and the industry at large from further reputational harm[29]. Despite the market conditions during this period, the vast majority of money funds, of course, did not. This highlights the subjectivity within each step in decision. Lastly, internal branches and lines of business within a bank may have varying levels of objectives and interest; senior leadership must weigh the sentiments of each and factor them into a final decision. The circumstances behind each bank's decision to step in are complex and unique to each individual case at hand.

Rodney Fung
Javier Ocampo
Rachel Yan
Bernard Zhang

[29]The value of assets had dropped to 97 cents for every dollar: (see http://www.crainsnewyork.com/article/20080924/FREE/809249991/bank-of-ny-mellon-takes-charge-on-funds)

Group 5:

This comment describes concerns surrounding the principles of the document and the principles of the generally accepted beneficial practices of the financial industry that could be breached upon implementation. Our arguments are particularly focused on the effects that proposed policy would have on moral hazard, regulatory arbitrage and relationships. While there is an appropriate focus on measurement and impact of step-in risk throughout the document, little or nothing is said in the guiding principles about the ethos and the diligence that should go hand in hand with the measurement of step in risk. Our objective herein is to highlight the implications of proposed regulation when they come into stark contrast with the intention of the regulation itself.

1. Discussion of the principles of step-in risk regulation[30]

1.1 Moral Hazard: The effects of giving carte blanche to shadow banking entities.

While a consultative process could potentially ameliorate the technical difficulties in the proposed regulation, no amount of public input can correct for the moral hazards that will arise from the implementation proposed capital requirements.[31] When shadow banking entities recognize that they have a safety net when things go wrong, market behavior and past examples, such as the 2008 financial crisis, have proven that greater risks are taken.[32] [33] By implicating a safety net in the form of capital reserves, firms are indicating to shadow entities that they will be bailed out in the event of collapse.

Step-in risk regulation in the form of capital controls, no matter how well intended, could cause a moral hazard that will increase market volatility and ultimately contradict the intention of proposed regulation. When this moral hazard is combined with the decrease in system liquidity that stems from keeping contingencies, we believe that this regulation will cause more market instability that stability. We find the moral hazard implications of the proposed capital requirements to be in contrast with principles three and four of the document which stipulate that regulation be risk-sensitive and readily operational.

1.2 The Principle of definitional certainty and factors indicating potential step-in risk.

Knowing what is being regulated should be cemented before regulation is proposed. Therefore, we assert that the lack of a standard definition for shadow banking violates an important but excluded principle. The Financial Stability Oversight Council, Financial Stability Board and the European Central Bank consider shadow banking entities outside of the banking system and have no central uniform agreed upon definition of what shadow banking is or how it should be regulated .[34] We believe that the proposed framework attempts to create a global solution for a problem that is codified differently in different jurisdictions due to of variation among legislation and definitions surrounding shadow banking.[35] We suggest that this attempt regulate shadow banking risk will fail because of inconsistencies surrounding what is meant by the term "shadow banking" across borders. This rules out the possibility for constant implementation of regulation and opens the door for costly uncertainties and inefficient regulatory

---

[30] This section could be seen as an answer to the first question of the BIS consultative document.

[31] Stiglitz, Hellmann and Murdock. Liberalization, moral hazard in banking, and prudential regulation: Are capital requirements enough? 2000.

[32] Investopedia. How did moral hazard contribute to the financial crisis of 2008? 2016.

[33] Masera. Taking the moral hazard out of banking: the next fundamental step in financial reform. 2011.

[34] Fein. The Shadow Banking Charade. 2013.

[35] Carney. American Bankers Association. Re: Comments on the BCBS consultative document: Identification and measurement of step-in risk. 2016.

arbitrage. We propose that the Committee supply a specific and clear definition for "shadow banking" and a comprehensive list of regulated entities.

The lack of definitional certainty has dangerous implications on the proposed identification tactics and steps. First, as there is non-conformity among the definitions and institutions regulated as "shadow entities," the proposed runs the risk of incentivizing institutions to leave the regulated financial services industry to minimize exposure to regulatory risk. Second, the lack of certainty may result in massive conglomerations of few firms that can afford the increased cost of capital and specialization in shadow banking entities. This will further promote "too big to fail" systemic risk and strikes a blow to the principle of free and equitable enterprise. Therefore, this framework risks substituting one form of systemic risk for another. Therefore, we find the lack of definitional certainly to be in contrast with all principles in the document.

In terms of the identification of step in risk, we see two points that we suggest for consideration as factors that could be indicative of step-in risk. First, shifts in personnel from the parent company to a shadow entity may be a clear indicator. Second, the location of the bank and a shadow entity, especially if housed in the same commercial real estate could also be a strong indicator. Should a parent company share offices with a shadow entity, it is arguable that a strong link exists.[36]

1.3 The principle of a proportionality and being reserved on the use of capital reserves.

It is widely agreed that required capital reserves are a tool that should be used in only a select set of circumstances given the implications that it has for the financial system and global markets.[37] Through Basel III, increased capital reserves were enacted approximately five years ago. This was the correct tool to use at the time because it was justified by data obtained from stress tests, was supported by political will and was necessitated by the dangers that emerged during the 2008 financial crisis.[38]

However, the current circumstances are very different from the situation directly after the 2008 crisis. If capital requirements are the correct tool for the regulation of shadow banking and step-in risk, it should be asked if this is the correct time to make use of this serious tool. Using this tool so soon after Basel III could create the perception that regulators use capital requirements too often and for too marginal a set of problems. The risk that regulators will continuously call for banks to hold more capital will then be priced into banking equity. This would likely lead to a situation where banks struggle to raise capital to the point where banking sectors in various countries become uncompetitive.[39]

A further implication of mandated capital reserves is that the price of credit becomes more expensive to those in the market for loans. As students who will soon need credit to finance housing and further education, this consequence of capital requirements hits home.

1.4 Supplementing Principles with Monitoring and Evaluation of Regulation

Another key principle that is missing in the document is the notion of monitoring.[40] We find that the proposed policy neglects to outline a monitoring system that achieves the goals of the first principle. There should be a system in place for the measurement, understanding and control of the effects of these recommendations and any ensuing regulatory arbitrage. Monitoring and evaluation is a core principle as it

[36] This was written in response to question two and three in the BIS consultative document.
[37] Haldane and May. Systemic risk in banking ecosystems. 2011.
[38] Michel and Ligon. Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem. 2014.
[39] Elliot. Higher Bank Capital Requirements Would Come at a Price. 2013.
[40] Coglianese. OECD. Measuring Regulatory Performance. 2012.

gives responsive regulators the tools to sound the alarms before a crisis hits. Follow-up procedures should include the measurement, understanding and correction of effects stemming from regulatory arbitrage.

1.5 The responsibility of regulators to justify benchmarks and capital requirements

In principle, all proposed regulations must be supported by quantitative and qualitative analyses to ensure net welfare maximization.[41] In the proposed regulation, there is insufficient justification for the proposed capital levels. We propose that the committee include research and supported quantitative or qualitative data in order to best support the legitimacy of proposed capital requirements. Proposed levels appear arbitrary until such time where economic rationale underpins them and will be met with contention should supported data and quantifications go undocumented. While banks are required to adhere to rules and regulations, the onus is on regulators to defend and justify these proposed capital levels. We propose that further research be conducted in order to establish appropriate capital levels before implementing them**.**[42]

1.6 Proposed Additional Principles

We believe that two core principles are missing from this document in order to implement a morally and structurally sound regulatory policy. Should the committee decide to go forward with the proposed policy, we believe that a principle on definitional certainty and a "do no harm" principle be included. We believe that a main objective of the Committee should be to work with regulatory agencies to come to an agreement on the definition of "shadow banking" and the precise entities being called into regulatory question. Second, as economists, we believe that policy intervention should have a net positive effect on the economy as a whole. A "do no harm" principle would require that regulation meet economic and financial criteria resulting in a net positive effect for financial markets.

2. **Step-in risk, relationships and the moral economy.**

The recommendations in the consultative document could not only be a source of a financial stress due to the decreased liquidity and moral hazard, but they could also increase the spillover of risk from shadow banking and other entities to banks. Implementing the proposed framework creates the perception that banks will step in and thus the framework ties together entities who would otherwise be more isolated against risk transfers. If shadow banking entities take on more leverage and risk through moral hazard, the proposed regulation will tie the fates of these risky entities to banks. In this way moral hazard is spread throughout the system and risk is transferred from risky shadow banking entities to the banking system. This will work against the overall goal of the proposed BIS framework.

Furthermore, relationships and step-in risks go hand-in-hand. Regulators should consider that the relationships, trust and accepted best practices that are an inherent part of these non-contractually bound relationships. Regulators should not alter the structure of these relationships without full study and comprehension of the effects of proposed regulation on the foundations of the market.

Given these arguments surrounding the protection of the moral economy, relationships and the minimization of risk transfers, we conclude that the proposed framework contains inconsistencies with its own principles of risk sensitivity, proportionality and is ultimately not readily operational.

Harrison Angus
Lodewikus Lombaard
Mary Frances Wines

[41] Coglianese. OECD. Measuring Regulatory Performance. 2012.
[42] This was written in response to question two in the BIS consultative document.