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Guidelines on identification and management of step-in risk

Basel Committee on Banking Supervision (BCBS)

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List of abbreviations

Abbreviations	Meaning
BCBS	Basel Committee on Banking Supervision
CDO	Collateralised Debt Obligation
CLO	Collateralised Loan Obligation
CMBS	Commercial Mortgage-Backed Securities
LCR	Liquidity Coverage Ratio
RMBS	Residential Mortgage-Backed Securities
SIV	Structured Investment Vehicle
TOB	Tender Option Bond

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Introduction

In October 2017, the BCBS published Guidelines on the identification and management of step-in risk[1], establishing a conceptual framework for identifying and managing step-in risk potentially embedded in bank's relationships with unconsolidated entities

Introduction

The recent global financial crisis showed that banks sometimes have incentives beyond contractual obligation to support unconsolidated entities to which they are connected. In some cases, banks preferred to support certain shadow banking entities in financial distress, rather than allow them to fail and face a loss of reputation, even though they had neither ownership interests in such entities nor any contractual obligations to support them

- In this context, following the two consultation papers published in December 2015 and March 2017, the BCBS published **Guidelines on the identification and management of step-in risk**.
- The BCBS aims to mitigate potential spillover effects from the **shadow banking system** through the application of more generic lessons about risk related to banks' connections with unconsolidated entities, and, as such, to identify situations where step-in risk exists and needs to be anticipated.
- To this end, these Guidelines entail no automatic Pillar 1 capital or liquidity charge additional to the existing Basel standards. Rather, they provide banks and supervisors with a method for identifying step-in risk and with a list of possible responses that leverage existing prudential tools by informing or supplementing them.

This **Technical Note** includes an analysis of the content of these Guidelines.

(1) Step-in risk is defined as the risk that a bank decides to provide financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support

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Executive summary

This conceptual framework, which is intended to enter into force no later than 2020, specifies the role of banks and supervisors for the identification and management of step-in risk

Executive summary

Scope of application	Regulatory context	Next steps
• Banks subject to the **Basel framework**.	• Among others, these **publications by the BCBS**[1]: i) enhancements to the Basel II framework, ii) revised securitisation framework; iii) LCR; and iv) capital requirements for equity investment in funds.	• The Guidelines should enter into force **no later than 2020.**

Main content

Role of banks

- Banks should regularly assess step-in risk taking the **following steps**:
    1. Definition of entities to be evaluated for potential step-in risk (i.e. unconsolidated entities that maintain one of the 3 types of relationships specified by the BCBS).
    2. Exclusion of entities immaterial or subject to collective rebuttals
    3. Assessment of the remaining entities against indicators (e.g. nature and degree of the sponsorship, degree of influence, implicit support, etc.).
    4. Determination of the estimation method and appropriate actions (e.g. inclusion of an entity in the regulatory scope of consolidation, conversion approach).
    5. Reporting of the self-assessment, using the templates provided by the BCBS.
- In addition to the regular self-assessment, banks must establish **policies and procedures** that describe the processes used to identify entities that are unconsolidated and the associated step-in risks.

Role of supervisors

- Supervisors should review banks' **policies and procedures** and their regular **step-in risk self-assessments**.
- Supervisors should have the authority to **ask banks to remedy any deficiencies** in their risk management approach.

(1) The step-in risk framework is intended to complement the existing provisions.

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Detail

Overview of the framework

Banks' self-assessment of step-in risk should be conducted following a five-stage procedure. In addition to this assessment, banks must establish policies in this regard. Both the self-assessments and the step-in risk policies should be reviewed by supervisors

Overview of the framework

Banks' self-assessment of step-in risk, and policies and procedures

1	**Definition of entities to be evaluated**	Define the scope of all **entities to be evaluated for potential step-in risk**, taking into account their **relationship** with the bank (i.e. sponsorship, debt or equity investor, or other contractual and non-contractual involvement).
2	**Exclusion of entities immaterial or subject to collective rebuttals**	Identify entities that are **immaterial** or subject to **collective rebuttals** and exclude them from the initial set of entities to be evaluated.
3	**Assessment of the remaining entities against indicators**	Assess all remaining entities against the **step-in risk indicators** (e.g. nature and degree of sponsorship, degree of influence, implicit support, liquidity stress, etc.) including **potential mitigants**.
4	**Determination of the estimation method and appropriate actions**	For entities where **step-in risk is identified**, use the estimation **method** deemed appropriate to estimate the potential impact on liquidity and capital positions and determine the **appropriate internal risk management action**.
5	**Reporting of the self-assessment**	Each bank reports its self-assessment of step-in risk to its **supervisor**.

➕ Banks must establish **policies and procedures** that describe the processes used to identify entities that are unconsolidated and the associated step-in risks.

Supervisory response

After reviewing the bank's self-assessment analysis, where necessary supported by an analysis of the bank's policies and procedures, the national supervisor should decide whether there is a **need for additional supervisory response**.

Detail

Banks' self-assessment of step-in risk

The BCBS defines the entities that banks should consider for the purpose of step-in risk. The initial set of entities under scrutiny contains any unconsolidated entity whose relationship with the bank corresponds to the ones below

Definition of entities to be evaluated

Scope of application

- The initial set of entities under scrutiny contains any **unconsolidated entities**. For the purposes of this framework, an unconsolidated entity is defined as an entity not within the **scope of regulatory consolidation**[1].
- The BCBS **does not specify a prescribed list of entity types** that should be subject to the identification and assessment. Nonetheless, as a minimum, banks are expected to scrutinise securitisation vehicles, investment funds and other entities[2].

Specific cases

- **Insurance entities**, that are currently specifically excluded from the regulatory scope of consolidation are **presumed not to be included** within the scope of the framework (as they are already subject to specific prudential treatment).
- **Commercial entities** (i.e. non-financial) may in general be **excluded** from the step-in risk analysis. However, a commercial entity that provides critical operational service(s) to the bank and cannot be substituted in a timely fashion or without excessive costs, should be considered in the scope of the framework.

Relationships under scrutiny

- A bank is **not required to evaluate all entities** with which it has a relationship, but those where the bank has one or more of the following relationships with an entity:
  - <u>Sponsor</u>: the bank manages or advises the entity, places its securities into the market, or provides it with liquidity and/ or credit enhancements.
  - <u>Debt or equity investor</u>: the bank invests in the entity's debt or equity instruments. However, banks should exclude regular business (e.g. lending relationship to operating entities and investments that arise from market-making).
  - <u>Other contractual and non-contractual involvement</u>: the bank is exposed to the risks or to equity-like returns from the assets of the entity or related to its performance.

(1) Under the Basel framework, the scope of regulatory consolidation includes all banking and financial entities meeting regulatory criteria or threshold for triggering consolidation.
(2) For further information see Annex 1. This list provided by the BCBS is only for indicative purposes and is not comprehensive.

Detail

Banks' self-assessment of step-in risk

Banks should then exclude entities immaterial or subject to collective rebuttals, because a law or a regulation explicitly prohibit banks from stepping in to support those entities, from the initial set of entities to be evaluated

Exclusion of entities immaterial or subject to collective rebuttals

Entities immaterial

- An **entity may be excluded** from the step-in risk analysis if, given its the size, stepping in to support it would not significantly impact the bank's liquidity and/or capital position[1].
- This materiality policy should consider both the **liquidity and capital requirements** that would arise from stepping in to support the entity as well as the broader adverse consequences of not stepping in. In performing the materiality evaluation, similar entities should be evaluated in aggregate to consider the 'contagion' risk.
- Entities considered as **immaterial for step-in risk** purposes should still be subject to an **aggregate reporting** to the supervisor.

Collective rebuttals

- National jurisdictions may **explicitly prohibit banks from stepping in** to support certain entities. In such cases, the banks are not required to analyse or report the step-in risk associated.
- Only a **law or a regulation** which is clearly enforceable, of general application and which explicitly prohibits the provision of support, can be considered as a collective rebuttal[2]. Thus, its rebuttal effect can only be recognised for those types of entity that are affected by these rules.
- The bank should specify in its **policies and procedures the types of entity excluded** due to a collective rebuttal and keep a list of such entities available on supervisory request.

(1) A bank should establish its own internal policy for determining materiality, subject to supervisory review.
(2) Contract law or industry standards are not be considered eligible for collective rebuttal.

Banks' self-assessment of step-in risk

Banks should assess all remaining entities against certain step-in risk indicators[1]. These indicators, which might be adapted for inclusion in the bank's policies and procedures for managing step-in risk, refer to nature of the sponsorship…

Assessment of the remaining entities against indicators (1/2)

Nature and degree of the sponsorship

- The bank may be exposed to a greater degree of step-in risk, such as when it provides:
  - **Full sponsor support** (via a guarantee or other credit enhancement).
  - Partial credit enhancements and liquidity facilities while playing a **role in decision-making**.

Degree of influence

- This indicator is not meant to be synonymous with the accounting notion of power/control that is a prerequisite for accounting consolidation, but rather **a lower threshold** (e.g. significant influence).

Examples: *Capital ties < 50% and power to exercise a significant influence over the management.*
Capital ties > 50% but no regulatory consolidation.
No capital ties but ability to remove and appoint board of directors.

Implicit support

- This indicator takes into account whether the bank is providing an **implicit guarantee** (e.g. the investor is accepting a lower rate of return on its investment relative to risk, potentially indicating that the investor expects the sponsoring bank to support the entity in a stress scenario).
- This indicator should also take into account the entity´s credit rating, whether assigned by a third-party rating agency or internally by the bank, and specifically the extent to which the entity's rating is dependent on the bank's credit rating.

Leveraged entities

- **Highly leverage entities** are more prone to step-in risk than adequately capitalised entities.

Examples: *Structured vehicles under IFRS and variable interest entities under US GAAP.*

Liquidity stress

- This indicator refers to entities with a **limited capacity to access liquidity** (e.g. long-term assets are funded with short-term liabilities) when facing an unanticipated increase in redemption requests and which would impact the bank's liquidity should it conclude that it must provide step-in support.

(1) The indicators provided by the BCBS should not be considered exhaustive. Generally, all these indicators need to be considered, although in certain cases one indicator alone may be sufficient to trigger the identification of step-in risk.

Detail

Banks' self-assessment of step-in risk

…degree of influence, implicit support, leverage, liquidity stress, risk transparency, accounting disclosures, investor risk alignment, reputational risk, historical dependence, and regulatory restrictions

Assessment of the remaining entities against indicators (2/2)

Risk transparency

- It refers to an entity's degree of transparency, and the extent to which investors are provided with **detailed information** that allows them to understand and assess its **risk-adjusted returns**.

Examples: *Entities where the risk in underlying investments is opaque, or that cannot be rated.*

Accounting disclosures

- Accounting disclosure requirements can provide **meaningful information to evaluate the nature and risks** of a bank's involvement with unconsolidated entities.

Examples: *Exposures towards unconsolidated entities disclosed under IFRS 12.*

Investor risk alignment

- This indicator refers to entities whose activities do not sufficiently match the **risk profiles of their clients/investors** with those of the **risk exposures of the entity**.

Reputational risk

- This indicator refers to the potential harm to a bank's reputation when an entity has **clients in common** with the bank and also carries the **bank's brand** (e.g. corporate name, logo)[1].
- The evaluation should also consider the degree to which **cross-selling** is part of the bank's **overall strategy**, as it increases reputational risk and incentives to provide step-in support.

Historical dependence

- This indicator refers to documented instances where **step-in support has been provided previously** to specific types of entity.

Examples: *Step-in risk support was provided to money market mutual funds during the crisis.*

Regulatory restrictions and mitigants

- This indicator refers to banking, securities, market and other financial regulations that **restrict**, without prohibiting, a bank's **ability and/or propensity to support an entity** on terms that are unfavourable to the bank.

Examples*:* *Entities for which higher capital requirements are set to cover potential step-in situations.*

(1) Branding could strengthen the presumption of step-in support, especially if the brand is associated with a deposit-taking institution in the same banking group.

Banks' self-assessment of step-in risk

For entities where step-in risk is identified, banks should determine the appropriate risk management action. Responses may be comprehensive, such as the inclusion of entities in the regulatory scope of consolidation or the conversion approach…

Determination of the estimation method and appropriate actions (1/2)

Potential responses to step-in risk

- The **Basel II framework** already requires banks to measure the amount of support they might have to provide or the losses they might experience.
- A bank's approach to step-in risk management and measurement should be **sensitive to residual risk** (i.e. after taking into account of possible risk mitigants).
- When a bank identifies significant step-in risk to an entity, it can apply a range of potential risk **measurement and management measures**. Some of these measures have a more encompassing effect on banks than do others, while other measures might have a more targeted impact.

Regulatory scope of consolidation

- Where a bank already has **substantial contractual obligations to provide support** to another entity at a time of stress, inclusion of the entity in the regulatory scope of consolidation may be the most appropriate measure[1].
- Certain situations would generate a strong **presumption** that consolidation ought to be applied. (e.g. the entity appears to have been designed to avoid regulatory consolidation).
- This measure **does not require any further quantification** of the step-in risk because the risk is essentially addressed through the entity's consolidation.

Conversion approach

- When the step-in risk identification and assessment process concludes that **significant step-in risk exists** in relationships with certain unconsolidated entities, but that consolidation would not be appropriate, using a **conversion factor** to estimate the risk might be appropriate.
- This conversion factor would be applied to the entity's exposures (in accordance with the specifications provided by the BCBS) and will be used to determine a response in terms of **increased capital and/or liquidity requirements**. It would be specific, since a uniform 'one size fits all' conversion factor may not be sufficiently risk-sensitive.

(1) In particular where the entity's balance sheet structure and activities are amenable to banking regulations. Nonetheless, this measure might not be appropriate when consolidation would artificially improve capital or liquidity position of the bank.

Detail
Banks' self-assessment of step-in risk

…or targeted measures, such as the use of the liquidity standards, the inclusion of the entities in the stress testing framework, the use of an *ex post* capital charge, etc.

Determination of the estimation method and appropriate actions (2/2)

Liquidity requirements

- The **existing provisions in the liquidity standards** could be used to account for step-in risk.
- In particular, the **LCR** addresses the potential need for the bank to buy back debt non-contractual obligations in order to mitigate reputational risk; and the **NSFR** requires stable funding factors for off-balance sheet exposures, including for non-contractual obligations.

Stress testing

- Banks and supervisors may decide to **include in their stress-testing framework** entities that are not part of the regulatory scope of consolidation of the banking group.
- The results of such **stress testing** would be expected to help a bank **consider whether it needs additional capital or liquidity** in respect of these unconsolidated entities.

Provisioning

- Banks and supervisors might build upon the **accounting framework for provisioning**. For instance, this might take the form of estimating the potential cash outflows resulting from a step-in, assessing them against the expected fire sale value of the entity's assets[1].

Punitive *ex post* capital charges

- When a bank actually steps in to support an entity beyond its contractual obligations, supervisors might require either the **post-step-in exposure be risk-weighted** at a considerably higher level than under the default rules, or that the entity's total assets be **brought onto the bank's balance sheet** at the prevailing risk weight.

Large exposure-like internal limit

- This specific measure requires a bank to **apply an internal limit** to all of its contractual exposures and/or estimation of step-in risk to shadow banking entities.

Disclosure

- To mitigate step-in risk through market discipline, banks and supervisors might require public disclosures, such as the **number, size and nature of unconsolidated entities**, and of **banks' own risk assessment** and their management of such exposures[2].

(1) This method could be compared with the conversion approach but its practical implementation requires a deduction from CET1 rather than an increase in capital.
(2) As a potential downside, market participants could interpret them as implying that a requirement exists to step in, even where there is no contractual commitment to do so.

Banks' self-assessment of step-in risk

Finally, banks should report their self-assessments of step-in risk to its supervisor, using the reporting templates provided by the BCBS to this end

Reporting of the self-assessment

Reporting to the supervisor[1]

- Banks must regularly **report the results of their self-assessment** of step-in risk to their supervisor. The expectation is that this reporting becomes **mandatory** and should be submitted **annually**. The information contained in two templates is organised as follows[1]:
  - **Template 1** details the number and types of entity that were initially identified for review purposes (except those subject to collective rebuttals). These entities should be grouped under three categories: i) immaterial; ii) material but for which step-in risk is insignificant; and iii) material and for which step-in risk is significant.
  - **Template 2** details, for entities deemed material and with significant step-in risk, the nature of the step-in risk, and the action taken by the bank to limit, mitigate or recognise this risk.

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(1) The reporting templates as specified by the BCBS are included in Annex 2.

Detail

Banks' self-assessment of step-in risk

In addition to the regular self-assessment, banks must establish and maintain policies and procedures that describe the processes used to identify entities that are unconsolidated and the associated step-in risks

Policies and procedures

Banks' policies and procedures

- Banks must establish and maintain **policies and procedures** that describe the processes used to identify entities that are unconsolidated and the associated step-in risks, which should:
  - Clearly describe the **identification criteria** that banks use to identify the step-in, which should include, at a minimum, those specified before (step 3).
  - **Not be prescriptive** or geared towards any particular type of entity.
  - Clearly describe the specific provisions of the laws or regulations acting as **collective rebuttals** and list the **types of entities** covered by those laws or regulations.
  - Describe the **internal parties** responsible for identifying, monitoring, assessing, mitigating and managing the potential step-in risk.
  - Clearly describe the bank's own definition and **criteria of 'materiality'**, and their rationale.
  - Document the **process to obtain the necessary information** to conduct the self-assessment.
  - Be **reviewed regularly**, and whenever there is any **material change** in the types of entity or in the risk profile of entities[1].
  - Require the self-assessment to be included in the **internal risk management processes**, subject to **independent controls**, and to be discussed by the appropriate **risk committee**.
  - Be documented and **available for supervisory review** upon request.

(1) If there have been no material changes, they should be reviewed in accordance with the bank's own policy on frequency of review of policy documents, or at least every three years.

Supervisory response

Supervisors should review banks' policies and procedures and their regular step-in risk self-assessments, and should have the authority to ask banks to remedy any deficiencies in their risk management approach

Supervisory response

Review of policies and procedures

- At a frequency to be determined, supervisors may request a bank's step-in risk identification and assessment policies and procedures and assess banks on, among others, the following topics[1]:
  - Adequacy and **quality of policies** and processes with regard to the identification, assessment, management and control of step-in risk.
  - Adequacy on the internal policy to **determine materiality** and criteria used to this end.
  - Adequacy of **risk management and measurement system**.
  - Integrity of **management information systems**.
  - Conceptual soundness of **internal capital and liquidity assessment** and adequacy processes.
  - Soundness of **internal controls and internal audit**, and any findings of internal controls and internal audit with regard to step-in risk assessment.
  - **Previous provision of step-in support** to entities.
- Supervisors are expected to:
  - Ensure that banks have conducted appropriate self-assessments of the **eligible collective rebuttal presumptions**, including the appropriate interpretation and application of relevant laws.
  - Review the **materiality criteria** to ensure that they are reasonable.

Review of the self-assessments

- Regardless of the frequency, granularity or format of the reporting requirements, banks should **regularly assess step-in risk**. Supervisors will consider each particular case and its specific features.
  - In case the assessment reveals that significant residual step-in risks have not been appropriately estimated or mitigated, supervisors may use the **measures** that they determine appropriate in the circumstances, based on the **nature and extent of step-in risks**[2]. The types of response that supervisors may consider were outlined before (step 4).
  - **Reporting** is to be used by supervisors to assess the adequacy of the banks' self-assessment and the magnitude of residual step-in risk identified.
- Supervisors should have the **authority** to ask banks to **remedy any deficiencies** in their risk management approach.

(1) In reviewing a bank's policies or procedures, supervisors may make use of its internal findings, including those from the bank's internal control or audit areas.
(2) Considering the probability and magnitude of step-in risk.

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Next steps
Calendar

The step-in risk framework should enter into force as soon as possible and no later than 2020. The BCBS intends to monitor jurisdictions' progress in implementing these guidelines

Next steps

- The step-in risk framework should enter into force as soon as possible and no later than 2020.

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Annex 1
Entity categories

Banks are expected to assess entities listed below. Nonetheless, this list is provided for indicative purposes and is not comprehensive

Entity categories

Categories of entities

- The entity categories specified by the BCBS are the following:
  - Entities issuing residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) or other assets (e.g. credit cards).
  - Entities issuing covered bonds.
  - Entities issuing collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs), including cash and synthetic CDOs.
  - Entities issuing tender option bonds (TOBs).
  - Entities issuing asset-backed commercial paper (ACBP).
  - Securities arbitrage conduits.
  - Structured investment vehicles (SIVs).
  - Repackaging vehicles.
  - Real estate investment trusts.
  - Mutual funds, including money market funds (and equivalent mutual funds in other jurisdictions), and exchange-traded funds.
  - Hedge funds.
  - Private equity funds.
  - Finance companies.
  - Securities firms.

Annex 2
Reporting templates

In template 1, banks should detail the number and types of entities that were initially identified for review purposes

Template 1

Entity types (choose from list in Annex 2 or include a meaningful entity category)	Number of entities	Total asset size of entities	Typical contractual exposures to the entities	Explanations of the assessment For (a), include explanations and criteria why the entities were not considered material.
(a) Entities were deemed immaterial (no assessment process conducted)				
...				
Total				
(b) Entities are material but step-in risk was estimated not significant				
...				
Total				
(c) Entities are material and step-in risk estimated as significant (to be reported in Template 2)				
...				
Total				

Annex 2

Reporting templates

In template 2, banks should detail for each material entity (or group of similar entities) for which step-in risk is estimated as significant the nature of the step-in risk…

Template 2 (1/2)

Entity name(s):

If multiple similar entities evaluated, total number of entities:

Entity type/category (choose from list in Annex 2 or include a meaningful entity category):

Purpose and design (include general description of assets, liabilities, key customers, investors and other stakeholders):

Estimation of the step-in risk potential impact:

Date: ___________	
(1) Entity / group of entities	
Asset size of the entity/entities	
Description of the methodology to estimate potential impact	
Type of support anticipated	
Size of support anticipated (nominal amount)	
Bank's assessment of step-in (difference between before and after materialisation of step-in support)	
Impact on CET1 ratio (percentage points)	
Impact on leverage ratio (percentage points)	
Liquidity position	
Impact on LCR ratio (in percentage points)	
Impact on NSFR ratio (in percentage points)	

Annex 2
Reporting templates

…as well as the action taken by the bank to limit, mitigate or recognise this risk

Template 2 (2/2)

Nature of bank's relationship with the entity (mark all that apply):

Yes/no	Attachment	Description
	Sponsor	
	Debt investor	
	Equity investor	
	Other contractual/non-contractual relationship	

Risk indicator analysis:

Indicator	Relevant to entity? (Y/N)	Discussion and analysis
Nature and degree of sponsorship		
Degree of influence		
Implicit support		
Capitalisation and reliance on leverage		
Liquidity stress/first-mover incentive		
Transparency and disclosure		
Investor disclosure		
Accounting disclosure		
Investor risk alignment		
Reputational risk from branding and cross-selling		
Historical dependence		
Regulatory restrictions		

Conclusion and risk management actions undertaken by the bank: