The Clearing House
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March 17, 2016

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

Re: Identification and Measurement of Step-in Risk – Consultative Document, dated December 2015.

Ladies and Gentlemen:

The Clearing House Association L.L.C.[1] welcomes the opportunity to respond to the Basel Committee on Banking Supervision's request for comment on its consultative document proposing a framework with respect to step-in risk (the "**Consultative Document**"). The Consultative Document broadly defines step-in risk as "the risk that a bank may provide financial support to any entity beyond or in the absence of contractual obligations, should the entity experience financial stress,"[2] and sets forth a proposed conceptual framework, primary and secondary indicators to be used in the identification of step-in risk, as well as examples of the application of such indicators of step-in risk and related matters, collectively intended to address such risk. Although we agree that step-in risk is an appropriate focus of banks and their supervisors, we respectfully urge the Basel Committee to fundamentally reconsider the approach described in the proposal.

It is undeniable that step-in risk manifested itself during the 2008 financial crisis, as certain bank holding companies and other nonbank entities provided financial support to securitization conduits, investment vehicles and money market mutual funds to prevent the negative consequences associated with their failure under the highly stressed conditions that

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1 The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C. owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly $2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

2 Consultative Document at para. 2. *See also* discussion in Section I.A.3 below.

existed at such time.[3] It is also the case that, as the Consultative Document clearly recognizes, appropriate reforms have already been implemented since the crisis in a number of jurisdictions, and in particular the United States, to ensure that step-in risk is considered and addressed. In the context of this substantial progress to date, we are concerned that the framework outlined in the Consultative Document does not provide an appropriately well-defined and tailored answer to whether and how any residual step-in risk that may yet exist in certain jurisdictions should be subject to further regulation.

We appreciate that the Consultative Document is designed to elicit further discussion on the topic and the Basel Committee's stated willingness to modify its proposals, as appropriate, based on comments received.[4] In that vein, we respectfully urge the Basel Committee to reconsider and revise the approach to step-in risk described in the Consultative Document. Once the many post-crisis reforms are taken into account, we question whether a binding international framework of the scope and breadth presented in the Consultative Document is ultimately warranted as an analytical or policy matter. Instead, we believe that a proper step-in risk framework should not start from scratch, without regard to mitigants to step-in risk that already exist. If an overall international framework is still desired, it should identify potential areas of step-in risk that national supervisors would use to compare against their own accounting standards, legislation, regulations and supervisory methods of identifying such off-balance sheet risks to determine what, if any, residual risk might actually exist that has not already been addressed in a manner sufficiently flexible to accommodate the characteristics of each jurisdiction and the specific nature of the entities that may pose such step-in risk. Only once the actual residual risk not previously addressed is identified, would national regulators implement the portions of the international framework relevant to such residual risks.

I. The Consultative Document's framework suffers from serious flaws that would render it imprecise and impractical in application. In particular, the proposed approach would (i) take a one-size fits all approach to identifying step-in risks by defining broad indicators, by presuming step-in risk when an indicator is present, and incorporating ill-defined and inconsistent definitions of step-in risk, (ii) result in an inappropriate and over-inclusive approach that would have significant negative consequences for certain bank holding company activities that are important to the broader economy, and (iii) not take into account the full range of existing mechanisms and post-crisis reforms that sufficiently mitigate step-in risk in most if not all instances in the United States.

The Basel Committee's proposed framework has a number of fundamental flaws that would outweigh the incremental benefits that would result from addressing residual step-in risks

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3 Consultative Document at paras. 8-10.

4 Consultative Document at para. 7.

in the manner set forth in the proposal. The Consultative Document sets out as Principle 3 that the framework "should be conservative, risk-sensitive and proportional" and that it should not be "so conservative/prudent that it addresses residual risk in an unjustifiably disproportionate or non-risk-sensitive manner."[5] We believe the proposed framework fails this principle in two crucial respects. First, the framework directly conflicts with Principle 3's stated aim that it should not be "unjustifiably disproportionate," in that the framework provides a mechanical, overly-inclusive approach that presumes step-in risk exists if an indicator is present, as well as the framework's unduly harsh treatment of asset management activities. Second, the proposed framework is not risk-sensitive because it is not limited to only "residual risks" but also because it fails to take account properly of existing mechanisms and reforms that mitigate step-in risk.

As proposed, the indicators have the potential to scope in nearly any unconsolidated entity with which a bank holding company transacts, while bank holding companies' support of these entities due to reputational concerns is historically remote and, in many cases, unprecedented in the wake of post-crisis reforms. A one-size-fits-all approach to step-in risk and resulting capital charges would have broad implications for market liquidity, which is already restricted in part due to the post-crisis regulatory reform overhaul. For example, the proposed framework could considerably restrict bank holding companies' ability to sponsor securitizations, even in an agency capacity, further impeding issuances or liquidity for that market broadly. Because of the potential consequences, it is critical that the full suite of regulatory reforms be assessed to ensure that any measure the Basel Committee ultimately may determine to take is properly designed to mitigate only any remaining residual risk.

A. The Consultative Document's one-size-fits-all approach to identifying step-in risk results in an inappropriate and over-inclusive definition of step-in risk that would have significant negative consequences and fails to account for the full range of mitigants.

1. The step-in risk indicators are too broad.

We do not believe it is possible to capture true step-in risk accurately through a mechanical, rules-based approach. Most importantly, attempting to define indicators of step-in risk through rigid and overly broad rules embodied by the Consultative Document's indicators will inadvertently scope in numerous entities that were not intended to be covered, potentially causing severe unintended consequences and potentially very large, unwarranted capital increases. For example, the Basel Committee identified the notion of "sponsorship" as a driving primary indicator of step-in risk and then defined sponsorship as containing three alternative elements: (i) decision-making (management and/or advice); (ii) operations (placing securities into the market); or (iii) financial support (provision of liquidity facilities or credit enhancement). However, determining who has "decision-making" authority is exceedingly difficult and unclear

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[5] Consultative Document at para. 21.

given the obvious breadth of "management" and "advice." Furthermore, there is no distinction drawn between having decision-making authority in a principal capacity versus an agency capacity. Assuming step-in risk where a bank holding company is merely acting as an agent would be a strange outcome, but in some cases, agency decision-making authority could be far greater than in those cases in which a bank holding company acts as a principal. In addition, the breadth of the terms "management" and "advice" would almost certainly lead to over-inclusion and inconsistent implementation. The sweeping definitions of indicators are made worse by the framework's presumption of step-in risk when primary indicators are merely present, subject to the ability of a bank holding company to rebut the presumption to a supervisor's satisfaction based on prescribed secondary indicators.[6] In addition, due to the fact that the presence of any one indicator would trigger the presumption of step-in risk, multiple bank holding companies would be treated as having step-in risk related to a single transaction.

We are deeply concerned that the proposed framework's inherent ambiguities would effectively lead bank holding companies and regulators to a mechanical and overly conservative application of these broad concepts, thereby finding step-in risk resulting in capital increases where actual step-in risk does not actually exist. This would also result in highly distorted allocations of capital in the broader economy – effectively requiring that bank holding companies hold capital far in excess of the underlying risks and, in turn, restricting the ability of bank holding companies to deploy such capital for other important purposes, including lending to the broader economy and other vital credit intermediation functions. Finally, we believe that the indicators set forth in the Consultative Document are so unworkable in practice that the results of the quantitative impact study exercise associated with the proposal are, unfortunately, unlikely to produce consistent results within or across jurisdictions, impeding the Basel Committee's efforts to develop a uniform step-in risk framework grounded in empirical analysis. Simply stated, there is significant confusion over how to apply the broadly worded indicators and high-level definitions, particularly because the indicators have not been aligned with existing applicable accounting standards that impose far more specific tests and analyses for making consolidation determinations based on implicit support.

2. A presumption of step-in risk if an indicator is present in all entities at all times is contrary to empirical evidence

Even assuming that an appropriate indicator regime could be defined in an unambiguous manner that accurately identifies entities and relationships as to which step-in risk actually exists, it would nevertheless almost certainly lead to unwarranted higher capital requirements far in excess of the actual risks posed. It is simply inconceivable that any bank holding company would in fact step in with respect to each and every unconsolidated entity identified through the presence of a set of primary indicators. The experience of the 2008 financial crisis provides clear evidence that step-in risk, even before the important reforms discussed in Section I.C below,

6 Consultative Document at para. 47.

occurred only in specific, limited instances; it was not a wide-spread phenomenon for all financial institutions with respect to all instances where step-in risk was in some way remotely conceivable, as measured by the proposed framework's indicators.

3. The Consultative Document includes two inconsistent definitions of step-in risk, which makes the scope of step-in risk that the Consultative Document intends to address unclear.

The Consultative Document also appears to contain two different definitions of step-in risk. Initially, as set forth above, step-in risk is defined as "the risk that a bank may provide financial support to any entity beyond or in the absence of contractual obligations, *should the entity experience financial stress* [emphasis added]."[7] Later in the document, however, step-in risk is defined as "the risk that banks would provide financial support to certain shadow banking or other non-bank financial entities *in times of market stress* . . . [emphasis added]."[8] It is therefore unclear exactly which version of step-in risk the Consultative Document is attempting to capture as an analytical matter. We believe the variation in the two definitions represents a critical distinction. In the absence of market stress, a bank holding company could very well make the decision to support an entity that is experiencing financial stress based on a business judgment that doing so would be a good financial investment, and separate from any and all reputational concerns, it would then hold capital against the asset as would be the case with any other investment. Simply put, investing in an entity that is in distress is often a routine business strategy that does not pose systemic financial risk and is quite divorced from times of market stress. However, nowhere in the Consultative Document's step-in framework itself—primary indicators, secondary indicators, measurement methodologies – is market stress, or even financial stress at the unconsolidated entity, considered or reflected. Thus, the Consultative Document would cause bank holding companies to hold capital against circumstances well beyond market stress where the bank holding company may make an investment in an entity in the ordinary course of business due to the distress of the entity in question. This turns the entire Basel regulatory capital framework on its head—banking organizations should not be required to hold capital against investments they may or may not make in the future in the ordinary course of business, unless and until they actually make the investment. We respectfully request that these starkly different definitions of step-in risk be clarified before any further consideration of any international framework for addressing step-in risk.

B. The Consultative Document takes an over-inclusive and insufficiently risk-sensitive approach to asset management activities.

The Consultative Document's overly expansive view of the scope of step-in risk is inappropriate and over-inclusive with respect to a number of traditional bank holding company

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7 Consultative Document at para. 2.

8 Consultative Document at para. 24.

activities that are beneficial to the broader economy. The proposed sweeping framework for asset management activities is a prime illustration of this approach with the potential for serious negative consequences. Specifically, the notion of "sponsorship" in the Consultative Document would effectively impose a uniform presumption of step-in risk onto any and all fund sponsorship structures. The framework also fails to take account of the extensive regulatory regime that asset management activities are already subject to in certain jurisdictions, including the United States, that protect against step-in risk and, together with the designs of funds themselves, help establish investor expectations regarding the role of sponsor. The Consultative Document does not provide evidence of a regulatory gap in the asset management activities of bank holding companies that would warrant the imposition of a new regulatory capital framework. Yet a framework of this scope would subject trillions of dollars of assets under management by bank holding companies to regulatory capital requirements, making this business difficult for a bank holding company to remain in as a practical matter, especially given the competitive distortion when compared with non-bank holding companies. This cannot be the intended result—insofar as no investor or other market participant would actually expect bank holding companies who engage in fund-related activities to be the insurer of last resort for market crises, and no rational bank holding company would serve that role in a broad-based way.

"Sponsorship" in the proposed framework is defined to include the provision by a bank holding company of "management and/or advice" to an unconsolidated entity.[9] Fund sponsorship structures would be identified as creating step-in risk for bank holding companies solely because of the existence of sponsorship, as defined in the Consultative Document, even though in the vast majority of cases, the role of a fund sponsor would pose no risk that the applicable bank holding company would actually provide financial support to the relevant fund. By including "management and/or advice," the sponsorship definition would include merely acting as an investment adviser for an otherwise unaffiliated U.S. mutual fund, European Union undertakings for collective investment in transferable securities and other similar national fund structures. The Consultative Document's definition of "sponsorship" would, notably, scope in to the step-in risk framework index funds where a bank holding company acts as a sponsor. It is almost inconceivable for a bank holding company to have reputational concerns regarding a market downturn which results in losses to an index fund which is by definition designed to track the performance of a specified set of assets. In that context, it would be nonsensical for a bank holding company's investor adviser affiliate to step in to provide financial support to an index fund.[10]

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9 Consultative Document at 13.

10 Similarly, mutual fund investors can redeem fund shares by selling them at net asset value, which provides a mechanism for investors to exit the investment without the need for intervention. In the United States, the U.S. Securities and Exchange Commission's (the "**SEC**") recent proposal regarding liquidity risk management requirements for open-end funds should help ensure that funds will be able to meet such redemption obligations. *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-

Moreover, the presumption of step-in risk is not supported by historical evidence. The Consultative Document does not refer to any examples of bank holding companies, or other financial institutions, providing financial support to funds that they sponsor in times of financial stress outside of the context of money market mutual funds, and we are not aware of any examples, either. A presumption that a sponsorship relationship, which could involve merely acting as an investment adviser for an unaffiliated fund, creates step-in risk is vastly over-inclusive and unjustifiably disproportionate. Investor expectations with respect to stable net asset value ("**NAV**") funds are unique and any assessment of step-in risk must be limited to funds where investor expectations might actually lead to step-in risk, to the extent that the risks are not otherwise addressed through regulatory or other means. Unlike money market mutual funds, other investment funds have variable NAVs and thus do not have a concept of an implicit floor, and making up the difference between the actual NAV and such a "floor" was the primary rationale for fund sponsor support of money market mutual funds.

The proposed framework also fails to take into account the extensive regulatory framework that asset management activities may already be subject to, and provides no mechanism for jurisdictions to do so. For example, in the United States, mutual funds are regulated under the Investment Company Act of 1940 (the "**1940 Act**") and investment advisers are subject to the Investment Advisers Act of 1940, each of which includes a comprehensive regulatory framework. Mutual fund investment advisers are also required to register with the SEC and are subject to SEC regulation. The regulatory framework already in place in the United States includes many requirements designed to separate mutual funds and their managers, including the 1940 Act's requirements that funds each have their own board of directors independent from the fund's investment adviser.[11] Asset management vehicles are designed in light of these regulatory requirements.

In addition to complying with regulatory requirements, the design and legal framework for asset management structures is meant to take account of and shape investor expectations, including with respect to the relationship between a bank holding company and its sponsored funds. In considering potential implications of a step-in framework, the Basel Committee should be mindful that such framework not change investor expectations in ways that may paradoxically increase step-in risk. If a bank holding company is required to hold capital against step-in risk, it could create an expectation in the market that the bank holding company would in fact step in if the fund in question were experiencing financial stress. This result would obviously be the polar opposite of what the Consultative Document is attempting to achieve as an overarching policy matter.

Opening of Comment Period for Investment Company Reporting Modernization Release (80 FR 62274 – October 15, 2015).

[11] *See* 15 U.S.C. § 80a-10 *et seq.*

C. The framework does not sufficiently take into account the full range of mechanisms and post-crisis reforms in jurisdictions such as the United States that effectively eliminate step-in risk.

The Consultative Document recognizes that some jurisdictions already have implemented effective legislative, regulatory and accounting-related reforms to significantly ameliorate step-in risk.[12] We believe that if the full range of post-crisis reforms in the United States is properly considered, however, the residual risk, if any, does not warrant a binding international framework of the scope and breadth presented in the Consultative Document, and certainly not a framework that would require the imposition of potentially significant, unwarranted regulatory capital increases.

We appreciate that the Consultative Document anticipates that supervisors could make determinations of whether there is existing law (or regulation) that prohibits a significant portion of bank holding companies or other market participants from providing non-contractual support to off-balance sheet entities through a collective rebuttal process.[13] We also agree that, if a significantly revised international step-in framework is finalized, each jurisdiction should have the ability to exclude unconsolidated entities from the application of this framework if the relevant supervisor is satisfied that the potential step-in risk from such entities is mitigated. A collective rebuttal approach, however, is too narrow and fails to give appropriate weight not only to the significant reforms enacted since the financial crisis, but also to the full range of ways in which step-in risk may be mitigated in a particular jurisdiction. In particular, by focusing on laws or regulations that *prohibit* providing support to off-balance sheet entities and by requiring that such laws or regulations be based on the nature of activities,[14] the Consultative Document ignores a range of other real mitigants to step-in risk that are already present in jurisdictions such as the United States, more specifically:

- **Accounting requirements.** The Consultative Document seeks to superimpose a step-in framework on existing accounting requirements and would not permit accounting requirements to be the basis of a collective rebuttal. The primary indicators, in many cases, overlap with the very same considerations that companies, including bank holding companies, must take into account in considering whether an entity should be consolidated. U.S. generally accepted accounting principles ("**GAAP**") consolidation requirements, as addressed by the Financial Accounting

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12 Consultative Document at paras. 14-16.

13 Consultative Document at para. 80.

14 *See* Consultative Document at para. 80 ("The supervisors in deciding upon collective rebuttals in their jurisdiction should ensure that there is existing law (or regulation) that prohibits a significant portion of banks or other market participants from providing non-contractual support to off-balance-sheet entities.").

Standards Board (the "**FASB**"), provide guidance on whether an entity holds an implicit variable interest in a variable interest entity. An implicit variable interest may exist if a reporting entity can be required to protect an investor in a legal entity from absorbing losses incurred by that legal entity. A reporting entity is required to consider whether it has an implicit variable interest in a legal entity, in determining whether it is required to consolidate that legal entity.[15] The result of the Basel Committee's proposed framework would be at best duplicative of and at worst conflicting with GAAP, thereby potentially creating an unnecessary gap between accounting consolidation and regulatory consolidation, a gap that the United States deliberately eliminated.

- **Existing legal mechanisms.** The Consultative Document does not acknowledge the interplay of step-in risk assessments on existing contractual frameworks. Typical contractual arrangements outline the protocol and unwind mechanisms for an entity in a bankruptcy scenario, and bank holding companies have governance processes to consider and limit the potential for implicit obligations outside of contractual arrangements. A regulatory presumption of support based on the proposed indicators could disrupt these relationships and potentially cause confusion for investors, as well as increase legal and operational risks. For example, a regulatory capital requirement aimed at a relationship with a specific third-party entity could raise the possibility that a bankruptcy court could determine that the bank holding company in question should be liable for that support to creditors.

- **Other approaches for addressing off-balance sheet risks.** The Consultative Document also does not give any weight to the fact that the United States has also developed a framework for ensuring that off-balance sheet risks are considered and identified by bank holding companies. The Board of Governors of the Federal Reserve System (the "**Federal Reserve**") has put in place the Comprehensive Capital Analysis and Review ("**CCAR**") process, which functions in connection with the related supervisory and company-run stress testing requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the regulations promulgated thereunder.[16] In the CCAR process, bank holding companies are required to identify and assess risks to their institution, which assessment should include, among

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15 ASC 810-10-25-50 to -54.

16 *See* 12 C.F.R. § 225.8; 12 C.F.R., subparts B, E and F to part 252.

other items, off-balance sheet exposures and "risks that only materialize or become apparent under stressful conditions."[17] The Federal Reserve has also developed and implemented form FR Y-14A, which includes a number of schedules that bank holding companies are required to complete annually and requires reporting a number of off-balance sheet items.[18] The identification and assessment of risks in the CCAR process and the requirement that subject bank holding companies hold appropriate amounts of capital against these and other risks under a variety of adverse stress scenarios, including a severely adverse scenario, addresses many of the concerns identified in the Consultative Document. Again, however, it is not clear how, if at all, the CCAR process would be considered a mitigant within the Consultative Document's framework.

- **Regulatory reforms.** The Consultative Document does acknowledge and recognize the mitigation potential of certain regulatory reforms, such as Section 619 of the Dodd-Frank Act, the so-called "Volcker Rule."[19] The Consultative Document would give no weight, however, to other regulatory reforms that mitigate step-in risk because they are not *prohibition*s on providing support. For example, the Liquidity Coverage Ratio ("**LCR**"),[20] which the Consultative Document itself acknowledges,[21] requires national supervisors to determine the liquidity impact of "contingent funding obligations that may be either contractual or non-contractual and are not lending commitments ... including associations with, sponsorship of, products sold or services provided that may require the support or extension of funds in the future under stressed conditions."[22] Although the LCR includes provisions designed to address

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17 *See* Federal Reserve, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms,* SR 15-18 (Dec. 18, 2015).

18 *See* Instructions for the Capital Assessments and Stress Testing information collection (Reporting Form FR Y-14A) (version as of March 1, 2016), *available at* http://www.federalreserve.gov/reportforms/forms/FR_Y-14A20151231_i.pdf.

19 Dodd-Frank Act § 619. The Volcker Rule was implemented through a final rule jointly issued by U.S. regulators. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds,* 79 Fed. Reg. 5536 (Jan. 31, 2014).

20 Basel Committee, The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013 (BCBS 238) (http://www.bis.org/publ/bcbs238.pdf).

21 Consultative Document at para. 14.

22 *Id.*, at 135.

step-in risk directly, the proposed framework does not take it into account. In addition, although the Consultative Document acknowledges that the SEC has finalized rules to alleviate step-in risk at U.S. money market mutual funds through rules designed to eliminate the run risk of money market mutual funds by, among other items, implementing a floating NAV, as opposed to a stable $1 per share NAV, and by imposing liquidity fees,[23] the Consultative Document's acknowledgment does not translate in any discernible way into a mitigant within the proposed framework. Similarly, the SEC's proposed rule on liquidity risk management for mutual funds and exchange-traded funds ("**ETFs**") would, if final, mitigate step-in risk at mutual funds and ETFs, but would not be recognized by the Consultative Document as an actual mitigant for collective rebuttal purposes.[24]

In light of the foregoing, if a substantially revised international step-in risk framework is nonetheless considered further by the Basel Committee, recognition of the reforms that have already been undertaken must be translated into real mitigants so that accounting, legislative and regulatory reforms that effectively eliminate step-in risk through other means are properly taken into account. An important illustrative example of this can be found in the United States where "the ability of banks to provide support to structured investment vehicles has been substantially curtailed through both restrictions on the accounting treatment of formerly off-balance-sheet exposures and more stringent capital requirements,"[25] and further, the "(c)hanges in capital, accounting, and other regulatory standards make these arrangements very unlikely to reappear."[26] Structured investment vehicles are, of course, identified in the Consultative Document as one of the principal areas where step-in risk manifested itself during the 2008 financial crisis.[27]

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23 SEC, *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 157 (Aug. 14, 2014).

24 SEC, *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release; Proposed Rule*, 80 Fed. Reg. 62274 (Oct. 15, 2015).

25 Vice Chairman Stanley Fischer, Speech at the "Financial Stability: Policy Analysis and Data Needs" 2015 Financial Stability Conference, "Financial Stability and Shadow Banks: What We Don't Know Could Hurt Us" (Dec. 3, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/fischer20151203a.htm.

26 Governor Daniel K. Tarullo, Speech at the Brookings Institution, "Thinking Critically about Nonbank Financial Intermediation" (Nov. 17, 2015), *available at* http://www.federalreserve.gov /newsevents/speech/tarullo20151117a.htm.

27 Consultative Document at para. 10.

II. If the Basel Committee nonetheless decides to implement a substantially revised step-in risk framework, any such framework should be designed to allow national supervisors to recognize the step-in risk mitigants present in their respective jurisdiction.

Any final, internationally agreed, step-in risk framework should provide sufficient flexibility so that it can be properly tailored to the risk profile of a particular jurisdiction. The collective rebuttal approach reflected in the Consultative Document is an initial, if insufficient, start in this regard, but for the reasons described above it is inadequate, and is not consistent with the Consultative Document's Principle 3 because it would lead to national jurisdictions being required to address far more than just the "residual risk (after consideration of possible mitigants)."[28] Rather than a rebuttal approach, we would recommend a framework under which each jurisdiction first analyzes which step-in risks continue to actually be present in its jurisdiction, after taking into account those risks already addressed through other means, and then uses the Basel framework to develop appropriately tailored approaches to any remaining residual step-in risks.[29]

More specifically, an international framework could focus on three steps that each national jurisdiction should take to determine which, if any, step-in risks remain. The first step would be for the supervisors in a jurisdiction to assess whether the applicable accounting standards appropriately take into account reputational risk and provide for consolidation of implicit interests where appropriate. If accounting standards are in place and those standards achieve the desired goal, *i.e.*, that implicit interests are consolidated when appropriate, then those implicit risks addressed by the relevant accounting standards would be eliminated from consideration as step-in risks.

The second step would be considering whether existing legislative and regulatory reforms sufficiently address residual categories of step-in risk. The Consultative Document already would consider legal reforms implemented in the United States, such as the Volcker Rule, that include outright prohibitions, as an effective mitigant. Other regulations that effectively eliminate step-in risk but are not activity-specific prohibitions should also be considered as set forth above. To the extent such regulations effectively eliminate step-in risk, national supervisors should be able to evaluate whether or not it is appropriate to remove relevant entities from further consideration altogether.

The third step would provide for evaluation of other frameworks in a jurisdiction that are designed to ensure that other off-balance sheet items are appropriately considered and

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28 Consultative Document at para. 21.

29 The Basel Committee has heretofore adopted various approaches that leave certain aspects or specifics up to the discretion of a national jurisdiction. *See, e.g.*, Basel Committee, *Second Consultative Document: Revisions to the Standardised Approach for Credit Risk* (Dec. 2015).

internalized by bank holding companies, including potentially by ensuring bank holding companies maintain appropriate documentation to demonstrate adequate consideration of the relevant risks. For example, the CCAR capital planning and stress testing process in the United States includes, as one aspect, that off-balance sheet risks are appropriately considered by each applicable bank holding company under various adverse stress scenarios. Such a framework allows a national jurisdiction to address additional potential step-in risks that may not fall into clearly definable categories. Furthermore, such a supervisory approach is the only way to actually link step-in risk to reputational risk.

Any residual risks that may remain after application of this three-tiered assessment process would then be subject to any final step-in framework after the application of a cost-benefit analysis, to determine if the benefits of reducing the residual risks are greater than the costs, and if the manner of addressing the residual risks is proportionate (and not unjustifiably disproportionate) to the step-in risk actually posed. We anticipate that in a jurisdiction such as the United States, remaining residual risks may be few or perhaps even none. In developing a framework that could apply to these few residual risks, we urge the Basel Committee to take a flexible approach and avoid prescriptive measures of step-in risk that would mandate a regulatory capital requirement. Broadly defining different approaches that national supervisors could take may be beneficial, but any specific mandates are likely to have significant costs that may prove difficult to justify on a cost-benefit basis. It is important that local jurisdictions retain the flexibility to work with bank holding companies in understanding what step-in risks actually apply to them and the best methods to measure those risks and then internalize them so that they are properly captured.

After local jurisdictions identify residual risks and apply an internationally agreed-upon framework to those risks, a peer review process, of the type utilized in Basel III,[30] could be developed to ensure the consistent implementation of the step-in framework and that residual risks are appropriately identified and addressed. Peer reviews would have the added benefit of ensuring compliance with the Consultative Document's Principle 2, of fostering consistent implementation across jurisdictions.

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[30] *See* Basel Committee, Basel III Regulatory Consistency Assessment Programme (RCAP) (Oct. 2013).

If you have any questions or comments with respect to any of the matters discussed in this letter, please contact the undersigned at (212) 612-9883 (David.Wagner@theclearinghouse.org).

Respectfully submitted,

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