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Step-In Risk: A New Reputational Risk

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This Client Alert discusses the Basel Committee's proposal to require banks to identify and measure the "step-in" risk from related "shadow banks."

On December 17, 2015, the Basel Committee on Banking Supervision ("Basel Committee") issued a consultative document on a conceptual framework for identifying and measuring "step-in" risk arising from "related" nonbank financial companies ("Step-In Proposal").[1] Step-in risk is defined as the risk that a bank may provide financial support to a related entity, beyond, or in the absence of, any contractual obligation to do so, should the entity experience financial stress. Implementation of measures that limit the ability, or at least willingness, of banks to provide credit intermediation to any sector raises far-reaching questions about the primary functions of banks, especially at the onset of a liquidity crisis. It also draws into question whether national banking supervisors believe that the substantial new capital requirements and buffers and related enhanced prudential standards imposed on banks since the latest global financial crisis would prove insufficient to stem the potential for "shadow banks" to pose a systemic risk to the banking system in the next crisis.

The Step-In Proposal is based on the Basel Committee's presumption that in a crisis, a banking organization has a reputational incentive to "step-in" to support an entity with which it has a connection even though the banking organization does not control the entity and is not contractually obligated to support it. That step-in could take the form of enhancing the terms and lending limits of an existing credit or liquidity facility, or providing financial support where there was no ex-ante facility in place. The Step-In Proposal seeks to establish a framework that would require a banking organization to measure that potential future support and to show to the satisfaction of its banking supervisor that it would be able to provide that support in a future crisis without compromising its capital position. The Basel Committee falls short of proposing a specific capital requirement for step-in risk, but does propose two approaches to the banking organization's treatment of related entities for capital purposes that would have the same effect.

When liquidity is tight, should a bank continue to favor financial services or other firms with whom it has an existing relationship?

In prior liquidity crises, banks continued to lend to funds and other nonbank financial firms with which they had binding commitments. A bank today must measure its exposure at default ("EAD") under such binding commitments and reflect that credit risk by risk-weighting each loan commitment based on its EAD value for Basel II purposes.[2] EAD is the best estimate of the gross exposure under a facility upon default of an obligor.[3]

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1 Basel Committee, Consultative Document on Identification and Measurement of Step-In Risk (Dec. 2015), available at http://www.bis.org/bcbs/publ/d349.pdf.

2 Under Basel II, EAD applies to banking organizations using internal-based approaches to measure credit risk. Basel Committee, International Convergence of Capital Measurement and Capital Standards (Jun. 2006) ("Basel II") at ¶211 et seq.

3 In the United States, banks report unfunded commitments on Schedule RC on their quarterly report of condition (CALL) report).

The EAD concept recognizes the tendency for lenders to increase lending to a borrower as it approaches default.

A step-in capital requirement, however, would go well beyond measuring the EAD of an existing funding commitment. It presumes that even absent any actual commitment to do so, a bank in a crisis will provide funding to the collective investment and funding vehicles, asset managers and critical service providers with which it has a sponsor or other relationship. That may be. The Basel Committee notes that it has been so in prior crises. That would seem the hoped—for outcome—that is, that banks are willing to continue to lend in a crisis. The Basel Committee's historical focus on capital adequacy is premised on the ultimate goal of ensuring that banks, if financially stable, would continue to lend in a crisis to enable businesses, consumers and economies to find their way out of the crisis. Basel III's significant addition of risk-based capital and leveraged minimums, capital buffers and standalone liquidity measures would all seem aimed at that goal. The Step-In Proposal would indicate a fundamental shift in the Basel Committee's approach for ensuring that banks have sufficient capital to continue to provide credit intermediation in a crisis to directing how and to whom they would lend.

Will central banks provide credit that may be used for step-in funding?

With the exception of the recent severe liquidity crisis, when funds have become tight, as, for example, may occur when the debt markets are not operating in their usual manner, banking organizations have increased their funding to companies, in particular, financial firms, with which they had a relationship. And where banking organizations in the United States themselves had difficulties in obtaining market funding to finance those lending activities, they called on their Federal Reserve Bank discount windows for credit. Historically, central banks would open their discount windows wide, as the Federal Reserve Banks did in 1970, to address the "run" on the commercial paper market following the bankruptcy of Penn Central, then one of the largest issuers in the market. Window borrowings were made available with the intent to support bank on-lending to other commercial paper issuers. Central banks also have been known to flood the market with liquidity through their open-market operations, as the Federal Reserve and other central banks did in the wake of the 2008 global crisis and the ensuing sovereign debt crisis. Is the Step-In Proposal a signal that the past involvement of central banks will not be repeated in a future liquidity crisis, at least, insofar as banks providing liquidity to related entities?

If the Basel Committee and banking authorities are successful causing banks to limit funding to shadow banks during a liquidity crisis, will central banks open their lender of last resort facilities to shadow banks?

How real is reputational risk and does it lead to step-in risk?

The Basel Committee believes that step-in risk flows from reputational risk. The Basel Committee defines reputational risk as the risk arising from the negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or to establish new, business relationships and to continue to access sources of funding (e.g., interbank or securitization market).

On that basis, the Step-In Proposal appears an attempt to add a capital requirement to protect against reputational risk. This raises a broader issue—that is, is reputational risk overstated or overrated? While banks did provide financial assistance or bailout funding to unconsolidated, related entities during the recent credit crisis, over the years, some global insurers put their subsidiary insurers into run off. An insurer in runoff pays claims from its own assets until those assets are completely expended, without support from its insurance group. Can a bank, or a company that controls a bank, do the same by not continuing to provide funding to a financially troubled company that is associated with the banking organization? Insurance holding companies or insurers that wholly own an insurer seem to have no problem putting a troubled insurer subsidiary into runoff—no step-in, no bailout and no reputational risk, real or perceived. The surviving companies seem not to suffer any stigma from the runoff and ultimate closure of an insurer with a similar name or other publicly recognized connection. What differences between banking organizations and insurance companies support the view that reputational risk would be too high for a bank not to step-in to support a related fund or other nonbank financial company? Would the failure of a banking organization to support a "related" nonbank financial company suggest that the banking organization also is incurring financial difficulties? Should it?

The need for an upfront capital requirement to protect against future potential reputational risk should be limited to those relationships where the risk that a bank will step-in has been clearly identified and quantified. The Basel Committee proposes to look primarily to the type of relationship to the related entity, as, for instance, where the banking organization is a sponsor of a fund. Relationship indicia, such as sponsorship or sharing a name, however, are not quantifiable measures of the materiality of the relationship to the banking organization. They also ignore contractual clauses expressly limiting the sponsoring banking entity's support; regulatory limitations that would preclude a banking organization from stepping in, as, for instance, the Volcker Rule Super 23A provision that would prohibit certain banking organizations from providing financing to a sponsored fund; and required accounting treatment of the related entity that may well require consolidation.

What "related" entities are the focus of the Step-In Proposal?

The Financial Stability Board defines the "shadow banking system" as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system." The Basel Committee too focuses the Step-In Proposal on shadow banks. The Proposal focuses on relationships with the following types of entities:

- mortgage or finance companies;
- funding vehicles;
- securitization vehicles;
- money market funds and other investment funds;
- asset management companies (asset managers); and
- commercial entities that provide critical services exclusively to the bank.

The Basel Committee expressly excluded from its step-in presumption insurers and commercial entities that are excluded from regulatory consolidation, but are subject to a prudential regime. Step-in to protect a nonfinancial related entity, such as a merchant banking investment, also would not be covered by the Proposal.

How would a banking organization determine if the related company presents step-in risk?

The Step-In Proposal would assess step-in risk by categorizing "related" companies based on primary and secondary indicators. The primary indicators focus on entities "sponsored" by the banking organization, making clear the Basel Committee's focus on the relationships with "shadow banks." These include "step-in indicators" ranging from capital ties, sponsorship, provision of financial facilities, decision-making and operational ties. Sponsorship would include providing full or partial facilities and/or decision-making to a related company; holding a significant influence over the related company's management and/or a significant (20% or more) equity interest in the related company; or using the related company to provide a critical service. A related company also would be considered to be sponsored if its external credit rating is based on the bank's own credit rating.

The Basel Committee concludes that, if one of these relationships exists, there is a presumption that significant step-in risk exists. What would it take to rebut such a presumption? The Step-In Proposal does set out secondary indicators that banking supervisors could consider to determine the validity of a bank's argument that a step-in relationship does not exist. Secondary indicators would look to whether or not the banking organization's relationship with the shadow bank involves any one or more of the following and would allow banking supervisors to use the existence of any one of the following indicators to support a finding of step-in risk:

- Branding – As indicated by the Volcker Rule limitation on sponsoring covered funds, the bank supervisory agencies view branding—where the bank and entity have similar names, service marks and logos—as an indicia of reputational risk.
- Overall design of the entity – To take into account the potential that the related entity was designed to accomplish regulatory arbitrage and, therefore, properly presenting step-in risk.

- Major dependence – Presumes that where the related entity has no other major shareholder or source of funding, the bank's step-in risk is unmitigated.
- Originator incentives – Where the banking organization originating the related securitization or other vehicle has rights or obligations different from those of other investors in the vehicle, such as the right or obligation to repurchase assets, the vehicle would be seen as subject to step-in risk.
- Risk and Rewards—Even where the entity is not consolidated with the bank, the bank would be viewed as having step-in risk if it retains and assumes most of the risks and rewards from the related entity's operations.
- Implicit recourse – A banking organization would be deemed to have step-in risk to the extent that investors in a related entity could make claims against the bank as originator or arranger if assets transferred to the entity become less creditworthy.
- Dependency for funding – This could be viewed as creating step-in risk where a related entity is in a particular market that the bank relies on for funding.
- Investor expectations – In cases where investors do not have an adequate understanding of a bank product and its expected returns, the bank would be viewed as more likely to step-in.
- Composition of investors – Where the investor base for the related entity's financial instruments is made up of a single type of customer (e.g., qualified institutional investors) whose relationships are important to the bank, the bank would be deemed to have step-in risk.
- Investor inability to bear losses – Where there is no possibility that investors will bear the related entity's losses, the bank would be deemed likely to step-in to provide financial support to the entity.
- Investor inability to dispose of investment – Where an investor in an entity's financial instruments is unable to dispose of them freely, a high probability of step-in would be assessed to the bank.
- IFRS 12 disclosures – For banks subject to International Financial Reporting Standards (IFRS), the required disclosure on unconsolidated entities would be used to determine the bank's level of involvement, including evidence that the bank has supported the entity where it had no legal obligation to do so.
- Entity functions critical to a bank – The step-in risk of a related entity also should take into account whether the entity provides a critical function in respect of the bank's recovery or resolution planning.

To the extent that a banking entity is able to show that its relationship with the entity does not involve any of the secondary indicators, it would be in a position to rebut the presumption of step-in risk and the requirement to comply with the step-in capital or other requirement established by its national banking supervisor. The Proposal leaves to national supervisors the ability to establish specific rebuttable indicators based on their nation's public policy that is enforceable by law. The expectation is that, in order to satisfy a rebuttal, existing law or regulation must prohibit a significant portion of banks or other market participants from providing non-contractual support to the entity in question.

How would step-in risk be measured?

The Step-In Proposal is purposefully silent on whether step-in risk would require an added capital charge or simply enhanced supervisory review. The Proposal does provide three alternative approaches that could be used by banks to gauge the step-in risk of a particular relationship with a related company. The first and the second involve full or partial consolidation. The third involves application of a so-called conversion approach under which the entity posing step-in risk would remain an unconsolidated third party and its step-in risk would be captured using quantitative requirements. This final approach raises a question as to whether the bank could be regarded as a creditor in control.

Full consolidation approach

This approach could be used where the entity is not consolidated with another group or where the activities are do not appropriately fit under the Basel Committee regime. The Basel Committee finds this approach to be appropriate where the entity engages in bank-like activities. This approach would permit a bank to take a comprehensive view of the entity's risks.

Proportionate consolidation approach

The Basel Committee proposes this approach for where two or more banks jointly control the entity or jointly exposed to the majority of risk and benefits from the entity's activities.

Conversion approach

This approach would be considered appropriate in a situation where step-in is not expected to result in accounting consolidation or where consolidation is not feasible or relevant. This approach involves a determination of the bank's potential commitment or exposure from the entity. National banking supervisors would be expected to develop a conversion rate to quantify the magnitude of the risk that the bank should consider in its step-in assessment. One cannot help but wonder what legal issues that will create for a bank using the conversion approach.

What other tools are available to banking supervisors to assess and monitor step-in risk?

The Basel Committee sets out examples of steps taken by authorities to address step-in risks. That listing is not a fully convincing one because it includes affiliated subsidiaries (UK ring-fencing of commercial and investment banks), the Volcker Rule prohibition of prohibiting banks from providing support to advised covered funds, imposition of a floating rate NAV on certain money market funds and allowing those funds to impose liquidity fees and/or redemption gates if liquid assets fall below certain levels. Proposed Securities and Exchange Commission and European Commission actions are mentioned. In the United States, some step-in measures are regulatory, such as limitations and collateral requirements on certain transactions with affiliates, such as transactions with a fund advised by a member bank or an affiliate and others are subject to supervisory guidance, such as those imposing limits on leveraged lending. Nonetheless, it is certainly possible to assist customers investing in funds offered by a bank or an affiliate where those funds are trapped in a money market mutual fund by providing credit to those customers.

What is the motivation for the Basel Committee's action?

Prudential authorities have encountered resistance to extension of prudential regulation to shadow banks. Imposing requirements on banks for their step-in risk may be one way for the banking authorities to accomplish that goal indirectly. While that may result in some circuitous indirect supervision of shadow banks, the Proposal's potential effect may be to increase the likelihood that shadow banks will have liquidity difficulties in a financial crisis where market liquidity is frozen. It would seem counterintuitive to protect against the potential financial instability that such difficulties may cause by limiting the availability of bank funding. One would think that it is a key role of banks to step-in in such a situation. That is one of the reasons for bank liquidity requirements. Capital buffers too are intended to be used by banks in credit market downturns. Banks typically are expected to be impartial arbiters of credit. Nonetheless, a bank typically will favor its regular customers with which it has long-standing relationships, be they shadow banks or commercial enterprises. There is a question as to whether the Basel Committee's purpose in proposing the Step-In Proposal is to alter that state of affairs or to seek a backdoor to regulate shadow banks. If the latter, limiting the ability of banks to provide credit support in a crisis would not seem a way to mitigate the potential systemic risk provided by shadow banks. If, on the other hand, the Basel Committee does not believe that shadow banks present systemic risk, there is a question as to why it would be necessary to impose a special risk measure and deterrent on permitting banks to continue to provide credit support to such entities, related or not.

The Basel Committee requests comments on the consultative paper by March 17, 2016.

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