

**MEMO# 29778**

March 21, 2016

# ICI Global Submits Response to Basel Committee Consultation on "Step-In Risk"

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TO: ICI GLOBAL REGULATED FUNDS COMMITTEE No. 20-16  
ICI GLOBAL STEERING COMMITTEE No. 9-16  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 6-16  
SEC RULES COMMITTEE No. 13-16 RE: ICI GLOBAL SUBMITS RESPONSE TO BASEL COMMITTEE CONSULTATION ON "STEP-IN RISK"

As you know, the Basel Committee on Banking Supervision (BCBS) published a consultative document in December 2015 on the identification and measurement of "step-in risk"—the risk that a banking organization would "step in" to provide financial support to off-balance sheet entities in the absence of a contractual obligation to do so (e.g., for reputational reasons). [\*] The proposal specifically highlights the potential for investment funds and asset managers to present step-in risk. The BCBS is not yet suggesting specific regulatory measures for addressing such risk, nor has it decided whether any such measures would be supervisory in nature or would relate to bank capital requirements. Instead, the BCBS is first seeking feedback on a "conceptual framework and its underlying elements" relating to the identification and measurement of step-in risk.

ICI Global submitted the attached comment letter responding to the consultation on behalf of regulated funds in jurisdictions worldwide. The letter explains the many reasons why regulated funds sponsored by bank affiliates—both regulated money market funds and regulated stock and bond funds—are unlikely to present step-in risk and therefore should lie outside the scope of the proposed framework, which is designed to focus on sources of significant step-in risk for banks. The letter also discusses why a bank regulatory capital charge to address presumed step-in risk from a regulated fund would be inappropriate and conflict with US law. Set forth below is a more detailed summary of ICI Global's comments to the BCBS.

## Summary of Comments

Regulated funds sponsored by banks or bank affiliates are unlikely to experience "weakness or failure" that would have any related negative impact on the bank and

therefore should lie outside the scope of the Committee's proposed framework for identifying and measuring step-in risk. There are several reasons for this. First are the key regulatory and structural characteristics of regulated funds that bear directly on the nature of the relationship between a regulated fund and its bank-affiliated sponsor and that also mitigate the risk of material stress for the regulated fund. By way of illustration, these characteristics include:

- Separation between a regulated fund and its bank-affiliated sponsor, which sharply limits any incentive for the bank to absorb fund losses
- Provisions to mitigate conflicts of interest between a regulated fund and its bank-affiliated sponsor, which in the US effectively prohibit or limit most forms of sponsor support
- Regulated fund governance, which includes strong independent oversight of regulated fund management and operations
- Prospectus and other disclosure to investors, which makes clear that regulated fund investors bear the risks of their investment
- "Substitutability" of regulated funds and lack of "critical functions", which make it highly unlikely that a bank-affiliated sponsor would take measures to "safeguard" any one fund

Additionally, since the global financial crisis, the US Securities and Exchange Commission (SEC) has adopted two packages of significant reforms that sufficiently mitigate step-in risk associated with regulated US money market funds. Post-crisis measures also have made regulated European money market funds more resilient, and a pending legislative proposal would make further reforms, possibly including a prohibition on sponsor support.

Regulated stock and bond funds also are unlikely to present step-in risk. Fund investors understand that any gains or losses belong to them and accordingly have no expectation of sponsor support. These funds, moreover, do not experience "financial distress" of the sort that might occasion sponsor support. In the US, for example, ICI data show only modest redemptions by regulated stock and bond fund investors, even during periods of severe market stress.

To measure step-in risk, the BCBS proposes approaches that would increase a bank's regulatory capital—a proposition that underscores why regulated funds should remain outside the proposed framework. Fund investors retain, and should expect to retain, all risks of their investment. Any suggestion to the contrary would introduce clear moral hazards, potentially making investors less careful in their choice of regulated funds and bank sponsors less disciplined in managing a fund's investments. And, as applied to regulated US funds, the Committee's proposed approaches conflict with the letter and spirit of a law that generally prohibits the US Federal Reserve Board from taking into account affiliated regulated fund activities when setting capital requirements for bank holding companies.

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## [Attachment](#)

### **endnotes**

[\*] Basel Committee on Banking Supervision, Consultative Document, Identification and measurement of step-in risk (Dec. 2015), available at <https://www.bis.org/bcbs/publ/d349.pdf>.

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