

Ministry of Finance

BRIEFING DOCUMENT

To: Athana Mentzelopoulos
Deputy Minister

Date Requested: September 30, 2016
Date Required: October 4, 2016

Initiated by: Frank Cholette
Director, Risk & Performance

Date Prepared: October 3, 2016

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Cliff #: 353437

TITLE: Level of operational impact to the Province of BC due to exposure in the capital markets from the potential litigation costs imposed on Deutsche Bank.

PURPOSE:

(X) FOR INFORMATION

For the purposes of understanding the Province of BC's level of risk exposure in the event of a capital markets disruption as a result of a Deutsche Bank default.

COMMENTS:

As part of its ongoing risk mitigation practices, the Debt Management Branch monitors capital markets activity on a daily basis, and places a strong focus on risk parameters and governance that assist in limiting the impact of contagion type scenarios in the event of capital markets disruption.

The Province of BC has limited direct risk exposure to Deutsche Bank in the event of a default.

Executive Director approval: _____

ADM approval: 

DATE PREPARED: October 3, 2016

TITLE: Level of operational impact to the Province of BC due to exposure in the capital markets from the potential litigation costs imposed on Deutsche Bank.

ISSUE:

- Settlements of complex capital markets litigation are difficult to predict, as is the resulting contagion effect on other capital markets players.
- Deutsche Bank is one of the 7 most global systemically important banks, according to the Basel Committee on Banking Supervision, and is the one financial institution that offers the highest risk at this point for a capital markets disruption.
- Customer engagement and counterparty confidence remain important elements of Deutsche Bank's fundamental creditworthiness. As such, a sudden or extended decline in these factors could lead to franchise or liquidity erosion.
- The ultimate risk to the global financial system is unknown. It is unclear what would happen if Deutsche Bank collapsed, either to our domestic financial institutions or the financial system in general.
- A capital markets disruption will likely impact the Province of BC's access to the market, result in a competitive pricing environment, and increase volatility of credit exposure and counterparty risk.

BACKGROUND:

- On September 15, 2016, Deutsche Bank announced that it had started negotiations with the US Department of Justice (DoJ), aiming to settle civil claims stemming from some of its underwriting and issuance of residential mortgage backed securities and related securitization activities between 2005 and 2007.
- Specifically, Deutsche Bank confirmed that it had received an initial settlement proposal from the DoJ of \$14 billion.
- Deutsche Bank has no intent to settle anywhere near the DoJ's proposed amount, and expects negotiations will lead to an outcome similar to those of peer banks, which have settled at materially lower amounts.
- Deutsche Bank has reported upwards of 7.2 billion euros in litigation reserves and unreserved contingent liabilities.
- It is important to note that this is a settlement negotiation related to the DoJ's civil claims. If the two sides do not come to an agreement, then the next step would be for the DOJ to file a lawsuit in US federal court. Deutsche Bank cannot be compelled to make a payment to the DoJ against its wishes until there has been a trial, a guilty verdict, and a determination of damages by a federal court.
- Such an outcome is not certain and could take years to progress through the courts. Both sides have an incentive to avoid the time, expense and uncertainty of a complex lawsuit.
- Deutsche Bank retains considerable control over the timing of any settlement with the DoJ. We do not expect that management will settle for an amount that would jeopardize its ability to meet its contractual coupon payments, the next of which are due in April 2017.

DISCUSSION:

- It is prudent to note that this is not a direct comparable to the collapse of Lehman Brothers. Deutsche Bank is a capital and credit problem, not a funding and liquidity crisis.
- In terms of the systemic risk that Deutsche Bank poses, in an International Monetary Fund report in June, the agency said Deutsche Bank may be the biggest contributor to risk among so-called global systemically important banks.
- It is generally accepted that Deutsche Bank can largely cover a high-end settlement through sales of non-core subsidiaries and with profits for the year before litigation expense.
- The bank has gross notional derivatives exposure of 46 trillion euros, according to an Investor Relations presentation published this month.
- To give you a sense of notional exposure, that's around 12% of the total notional value of derivatives outstanding worldwide.
- In attempting to evaluate the contagion effect somewhat, after netting and collateral, the reported derivative trading assets fall to 41 billion euros.
- This can lead to an assumption that Deutsche Bank is significantly globally connected.
- Deutsche Bank credit ratings remain unaffected at this time. However, this may change in the future (*please see attachment*).
- In terms of determining counterparty exposure to Deutsche Bank, the Canadian banks have little disclosed exposure to Deutsche Bank or German banks in general. It is believed that these exposures are manageable.
- The Province has no derivative contracts with Deutsche Bank, and thus no direct risk exposure from a credit default.
- The Province has approximately CAD \$1.5 billion in derivative risk exposure with its counterparties, of which ^{s.17}
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- The Province has risk exposure limits in place with each of its counterparties that limit trading activity, when these levels are approached.
- The levels of these limits are driven in large part to the credit ratings of the counterparty. The limits are positively correlated to its credit rating. If a credit rating is downgraded, the allowable limit exposure will decrease. If a counterparty is put on negative watch, trade activity is monitored to ensure that current exposure is manageable, if there is a credit rating downgrade.
- The Debt Management Branch is an active participant in capital markets activity, and monitors tone through daily updates with their counterparty relationships, and ongoing monitoring.
- These are prudent measures that limit the extent of a capital markets impact on the Province of a contagion risk exposure, if Deutsche Bank were to collapse.

- It is also important to note that the Province has funded the majority of the fiscal year borrowing requirements, and for at least this fiscal year, it would not be forced to enter the capital markets in an unfavourable environment.
- The Debt Management Branch will continue to monitor the capital markets for evidence of any new developments that may cause concern. In the event of serious concern about Deutsche Bank, we will report back and may recommend accelerating borrowing and/or pre-borrowing some of next fiscal year's requirements.

Attachment

The 'Deutsche Bank Crisis'

Summary as at Oct 3 2016

Debt Management Branch – Risk & Performance Measurement

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- Additional \$257 million in fines associated with deliberate activity between 1999-2006 with countries under US sanctions (sanctions associated with widespread human rights abuses and Iran's nuclear program).

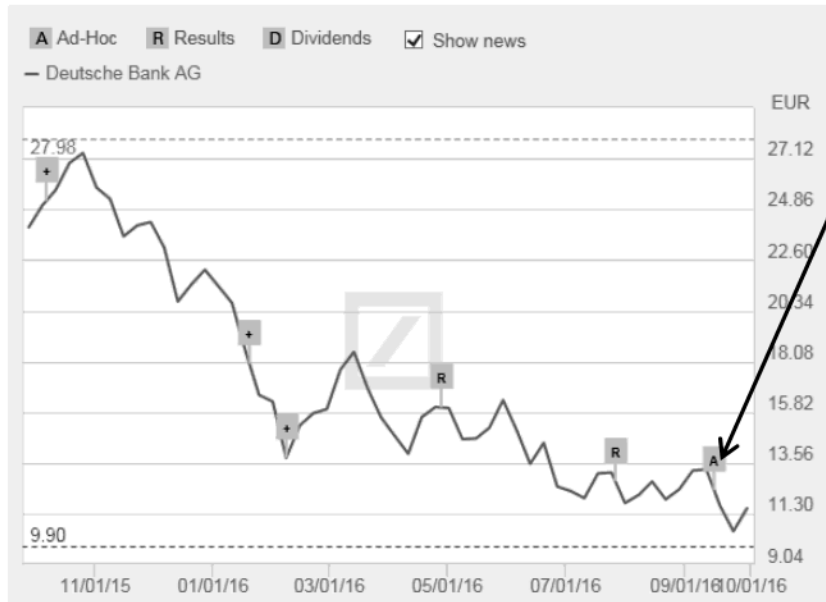
Net revenue continued to decline by 21% year-over-year in the first half of 2016.

John Cryan, Co-Chief Executive Officer said DB would be restructuring the commercial and private banking business throughout 2016. The restructuring includes consolidating 723 branches into 535 larger sites, investment in digital products and advisory services, intensifying business with mid-size commercial clients and private banking clients, and negotiating with labour unions to cut up to 2,500 positions.¹⁰

Deutsche Bank AG Share Prices
1-yr view from Oct 3 2015-Oct 3 2016



Set your individual time range*: 10/03/2015 to 10/03/2016



09/15/2016 announcement of negotiations between Deutsche Bank AG and the U.S. Department of Justice for RMBS infractions from 2005-2007.

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**PUBLIC SECTOR EMPLOYERS' COUNCIL SECRETARIAT
BRIEFING NOTE – FOR DECISION**

PREPARED FOR: Honourable Michael de Jong, Q.C.,
Minister responsible for the *Public Sector Employers Act*

TITLE: Proposed Compensation Plan Revisions

ISSUE:

In June 2015, government provided direction to public sector employers to incorporate common principles for making compensation decisions to establish a public sector compensation philosophy to ensure consistency. This direction was consistent with the recommendations of the 2014 Public Sector Compensation Review by Ernst & Young, which were generally accepted by government. In December 2015, changes to compensation philosophies were approved and in January 2016, the revised compensation philosophies were implemented.

Four Crown corporations and one research university have returned for approval of structural changes to their compensation plans consistent with the new public sector compensation philosophy. As required by the *Public Sector Employers Act* (the *Act*), these changes require the approval of the Minister responsible. No exceptions are being requested.

BACKGROUND:

Refreshed compensation plans were required to include common benchmarking methodology and process, with primary comparators for management and executive employees as the British Columbia public sector organizations first, followed by other provincial jurisdictions where relevant (excluding territories). The private sector can only be used as a benchmark when there are no other comparable roles in the public sector, in cases of talent in high demand, and when there is significant recruitment pressure from the private sector.

The four core principles that all public sector employers were directed to include in their compensation philosophies are:

- **Differentiation** – Differentiation of salary is supported where there are differences in the scope of the position within an organization, and/or due to superior individual team contributions.
- **Performance** – Compensation programs support and promote a performance-based (merit) organizational culture.
- **Transparency** – Compensation programs are designed, managed and communicated in a manner that ensures the program is clearly understood by employees and the public while protecting individual personal information.

- **Accountability** – Compensation decisions are objective and based upon a clear and well documented business rationale that demonstrates the appropriate expenditure of public funds.

Additionally, effective July 1, 2016, employers were permitted to submit to PSEC a business case to adjust both management salary ranges and executive salary ranges at the same annual rate as provided to unionized employee groups under the Economic Stability Mandate. Employers could submit a business case to provide modest adjustments within an approved salary range to executive employees based on performance, and to address compression or inversion. To ensure consistency with the common public sector compensation philosophy, business cases for executive-level employees are required to include a discussion of the benchmarking data and job rate to support submissions.

DISCUSSION:

BC Assessment Authority

BC Assessment (BCA) is seeking approval to align its executive salary ranges with comparators in the provincial public sector and consistent with the public sector compensation philosophy. BCA's relevant comparators are Assistant Deputy Minister (ADM) levels C& D in the Public Service and Vice Presidents (VP) in similar sized service delivery Crown corporations such as BC Transit, BC Housing Management Commission, Community Living BC, and, the BC Oil and Gas Commission.

Currently, BCA's ranges are \$127,900 to \$150,400. BCA is proposing to increase ranges to a

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Not all VP positions will be eligible to reach the top of the band. BCA is not seeking a change to the CEO compensation. The proposed compensation plan does not propose any further changes to its executive total compensation package.

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Movement through the salary range will be consistent with direction requiring modest within salary range increases based on performance.

Please see Appendix A for BC Assessment and comparator VP ranges.

RECOMMENDATION:

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APPROVED / NOT APPROVED

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Community Living BC (CLBC)

Since the establishment of CLBC as a Crown corporation in 2005, the legacy salary ranges have not been updated. CLBC is seeking approval to update its salary ranges to more closely align with the five level structure the Public Service is currently implementing. All current employees fall within the proposed ranges, and CLBC is not proposing any structural changes for its executive salary ranges.

Please see Appendix B for details of CLBC's current and proposed salary ranges.

RECOMMENDATION:

Approve CLBC's proposal to restructure salary ranges as proposed.

APPROVED / NOT APPROVED

The Knowledge Network

The Knowledge Network has proposed a structural change to its compensation plan by reducing the number of management salary ranges from four to two. This will result in two wider ranges to accommodate all management positions in the Manager, Senior Manager, Associate Director, and Director levels. In this process, the Knowledge Network proposes to eliminate one development range (E7-M), as well as a top end range 10. The developmental range is no longer used and has become compressed with the union-equivalent positions below it. The new ranges will eliminate incremental step increases and permit the Knowledge Network to move to performance-based increases, consistent with the public sector compensation philosophy.

Please see Appendix C for details of the Knowledge Network's current and proposed salary ranges.

RECOMMENDATION:

Approve the Knowledge Network's proposed compensation range change to collapse four management ranges into two.

APPROVED / NOT APPROVED

University of Northern British Columbia

As a result of restructuring and realignment of responsibilities, UNBC is seeking approval to add two Assistant Vice President (AVP) positions to its compensation structure; the AVPs will report to two of the four vice presidents. UNBC has proposed the AVP salary range to be s.17

s.17 While UNBC does not have ranges for its VP positions, the current annualized salaries of VPs range from \$170,000 to s.17

UNBC is proposing to eliminate one director level position and one manager level position and have those accountabilities added to the two new AVP positions: AVP Financial Services and AVP People, Organizational Design, and Risk. UNBC proposes to promote two directors currently responsible for elements of the new roles; their current salaries are \$135,000 and \$140,000, respectively and fall within the proposed ranges. s.17

s.17 which will be phased in over time in a manner consistent with the broader public sector approach.

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RECOMMENDATION:

Approve UNBC's request to formally add two AVP positions that report to VPs to its compensation plan, with a range of s.17 . Approve a compensation increase for the two AVPs of s.17 from their previous Director-level salary to recognize the increase in responsibilities taken on in their capacity as AVP. This would be effective upon Minister's approval. The Ministry of Advanced Education has been consulted on this proposal and is supportive of PSEC's recommendation.

APPROVED / NOT APPROVED

As per changes noted.



Minister

Oct 13, 2016
Date

Appendices:

- Appendix A: BC Assessment and comparator VP ranges
- Appendix B: Community Living BC's current and proposed management ranges
- Appendix C: Knowledge Network's Current and Proposed Salary Ranges
- Appendix D: UNBC's AVP Proposal

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Appendix A: BC Assessment and Comparator VP ranges

Organization	Minimum	Maximum
BC Assessment (current)	\$127,900	s.17
BC Assessment (proposed)	s.17	
BC Public Service		
Band B	\$140,000	
Band C	\$160,000	
Band D	\$175,000	
BC Transit (two ranges of VPs)	\$165,000 \$175,000	
BC Housing (four ranges of VPs)	\$122,618 \$148,972 \$156,227 \$166,046	
Community Living BC	\$125,879	
BC Oil and Gas Commission (two ranges of VPs)	\$141,000 \$166,000	

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Appendix C: Knowledge Network's Current and Proposed Management Salary Ranges

Current Management Band Ranges

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Proposed Management Ranges (s.17)

Management Ranges			
	Min	Mid	s.17
E7-M	N/A	N/A	
E8	83,015	92,391	
E9	101,766	111,141	
E10	N/A	N/A	

E7-M to be eliminated
E8-E10 merged into E8 and E9

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Appendix D: UNBC's AVP Proposal

University	AVP Range
Royal Roads University	s.17
Thompson Rivers University	
University of Victoria	
UNBC proposed	

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