Deutsche Bank

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Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
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Deutsche Bank's response to the Basel Committee on Banking Supervision consultative document on the identification and measurement of step-in risk

Dear Mr Coen,

Deutsche Bank welcomes the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS') consultation on the identification and measurement of step-in risk.

Banks are required by regulation and accounting rules to adequately provision against the failure of unconsolidated entities whose failure would result in them providing financial support. We agree with the BCBS desire to create an additional safety net for those unconsolidated entities that may not be adequately provisioned for and which could present a material risk in terms of magnitude of impact and likelihood of occurrence. However, as noted in the consultative document, existing accounting and prudential rules, as well as several major reforms – either in place or being finalised – make unprovisioned step-in much less probable.

Despite mentioning existing rules, the consultative document does not fully consider the overall impact of existing rules whether from general corporate law or from bank-specific prudential or structural regulation. The BCBS needs to ensure the framework avoids duplicating risks already dealt with[1].

For example, the Liquidity Coverage Ratio (LCR) already takes into account liquidity risks that may arise under stressed scenarios from non-contractual contingent funding obligations to sponsored entities where non-contractual obligations may be embedded in financial products

[1] Please refer to the cover letter of the Global Financial Markets Association (GFMA) comment letter on Step-in Risk, which states that, "…should the Basel Committee disagree [with the GFMA request to not proceed with the Step-in Risk proposal], and decide to proceed with new rules, we urge the Basel Committee not follow the blunt, risk-insensitive, and pre-emptive approach set out in the Consultation by subjecting banks to capital requirements for actions that they may have no intention of taking."

and instruments sold. Additionally, the internal capital adequacy assessment process (ICAAP) already takes into account reputational risks and concomitant step-in risks and requires banks cover these risks by holding additional capital.

As a consequence, the remaining gaps, and therefore the need for step-in risk framework, should be revisited once the full regulatory landscape is realised and understood. The focus of the BCBS' work should be to identify only those risks that are not already provisioned against, and would result in a material financial commitment.

Any potential step-in needs to conform to existing corporate law restrictions on cross-stream guarantees and regulations on related party transactions. Another consideration is that step-in is extremely rare, as it would only occur where there was material reputational risk and all internal sign off processes had been completed. Additionally, there may be extremely small entities that a bank could theoretically be called on to support, but would not be appropriate to capture as part of a proportionately calibrated step-in risk assessment.

For financial risks not covered under existing regulations, the BCBS should take a risk-based approach with a clear materiality threshold which will allow it to accurately capture bank-specific risk. It would be helpful if BCBS could provide examples of where significant step-in cases have occurred in the past to allow the industry to better understand the proposals.

Deutsche Bank believes that supervisory authorities should monitor bank risk management systems relative to step-in risk under Pillar 2. Given the very specific and fluid nature of these types of risks, and the need to take existing risk mitigants into account, a Pillar 1 capital add-on is less appropriate. Any additional capital requirements should be based on supervisory assessment of how the bank monitors, escalates and mitigates step-in risk and be taken into account under Pillar 2.

Yours sincerely,

Daniel Trinder

Daniel Trinder
Global Head of Regulatory Policy

Annex I: Deutsche Bank detailed comments on the proposed framework

Q1. What are commenters' views on the four overarching principles? Are there any others that should be included?

Principle 1: the framework should anticipate the situation after a step-in:
We agree that the framework should be designed to anticipate the situation after a step-in. Howevever, the principle needs to recognise the likelihood as well as the impact of step-in risk. This could be based on the bank's existing regulatory constraints and internal governance framework. There should also be a clear prudential recognition of the fundamental difference between step-in risk and classic risks (for example, credit or market risk). The latter materialise in losses the bank has to assume once they occur. With respect to the former, the bank decides whether it wants to assume the losses once they occur.

Principle 2: the framework should be simple and should foster consistent implementation:
We agree with this principle. However, given the nature of step-in risk is highly specific to a bank's relationships, risk profile and business model, a Pillar 2 approach would provide the needed flexibility in enforcement to ensure proportionality and effectiveness. Whilst this is a conceptual framework, it is important that the BCBS consider the areas that need clearer interpretation in order to ensure consistent treatment. In addition, wherever possible, the BCBS should explicitly align with existing definitions in globally agreed accounting and prudential frameworks (for example, definition of sponsorship under IFRS).

Principle 3: the framework should be conservative, risk-sensitive and proportional:
This principle is sensible. The framework should not be disproportionate or risk-insensitive. Based on the proposal, however, the presence of any indicator would result in the identification of step-in risk – no matter the probability of step-in occuring or how large or small the risk may be. Therefore, to further enhance the proportionality of the proposal, we suggest that the measurement of step-in risk factor in the level of materiality of both the impact and likelihood of crystalising, taking into account the external and internal constraints on step-in.

Principle 4: the framework should be readily operational:
We agree with this objective. However, the complex nature of the proposal does not lend itself well towards a readily operational framework. Developing clear definitions of the indicators would make it easier to envision how the framework would function in practice This could be accomplished by leveraging existing internationally recognised frameworks (for example, the International Financial Reporting Standards (IFRS) concept of sponsorship).

Q2. What are commenters' views on the proposed indicators for step-in risk? Are there any additional ones that the Committee should consider?

The framework could be improved through the provision of clear definitions that explicitly describe the indicators. The BCBS should require banks to develop a materiality assessment, based on BCBS guidelines for determining thresholds for determining step-in risk. As stated previously, the framework should only apply to those financial risks not already covered under prudential and other regulations. Additionally, as part of a proportionately calibrated step-in risk assessment, the framework should only consider financial risks where there would be a material impact on the bank from step-in, and where there is a material risk that step-in could occur, taking into account the general legal restrictions on banks doing so.

The inclusion of indicator 10, external credit rating based on a bank's own rating, is questionable. While rating agencies may assess the likelihood of a bank providing support to an entity, such third party assessment is highly speculative and should by no means be directly linked to prudential requirements.

The inclusion of indicator 11, exclusive critical services provider, is also questionable. Business continuity/contingency planning and resolution provisions are designed from a bank‘s perspective and already reflect these concerns from a regulatory perspective.

Q3. What are commenters' views on the proposed secondary indicators for step-in risk? Are there any additional ones that the Committee should consider? Should any of them be considered as primary indicators?

While we agree with the inclusion of a secondary set of indicators for step-in risk, the following indicators should be reconsidered:

Indicator (a) branding:

As it stands, the branding indicator is rather generic and may leave room for inconsistenmt interpretations across banks. In order for the step-in risk framework to be readily operational parameters around branding should be more specified.

Indicator (j) investor ability to bear losses on their investing instruments:

In the EU, this concept is already considered under the Markets in Financial Instruments Directive II (MiFID II). The Directive states that when providing investment advice or portfolio management services the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field. In particular, the Directive requires the investment firm to take into account the losses investors would bear on their investing instruments ("suitability and appropriateness assessment"[2].) In order to eliminate opportunities for double counting this indicator should be removed. Otherwise, where jurisdictional differences exist, the BCBS should allow for a Pillar 2 approach to account for step-in risk.

Q4. What are commenters' views on the different potential step-in risk assessment approaches? Are there any other approaches that the Committee should consider to account for step-in risks?

The equity method approach should be included as an alternative to the conversion approach. While the conversion approach application works well for very specialised assets (i.e. industrial plant construction), it can be difficult to operationalise for Money Market Funds (MMFs) and Special Purpose Vehicles (SPVs).

As a general rule, whereever significant influence is present, the equity method of accounting should be allowed to bring the entity into the perimeter of consolidation. This accounting method most appropriately reflects a Group's interest in an entity, which following the equity method approach would result in the entity no longer being considered purely unconsolidated. Initially, the investment should be recorded at cost and this will subsequently be adjusted to recognise a bank's share of profits or losses after the date of acquisition. The share of the investee's net income is included in the determination of net income by the bank.

[2] Article 25 (2) of directive 2014/65/EU

In the unlikely event that a bank would step-in to provide financial assistance to an entity, accounting policy requires banks to consider whether the new arrangement gives authority over the entity and if this authority results in control, significant influence, or neither. Significant influence relates to the power to participate in the financial and operating policy decisions of the investee, while not being considered in control or joint control over those policies.

An equity method investment is also adjusted to reflect a bank‘s share of other changes in the investee’s “Shareholders’ Equity” (such as the remeasurement of Available For Sale (AFS) investments or the recognition of the effective portion of cash flow hedging programs). Such adjustments are included in the determination of the various shareholders’ equity accounts.

Therefore, the equity method approach should be considered as an acceptable method of reflecting investors’ interest in entities it does not control but over which it has significant influence.

Q5. What are commenters’ views on the proposed mapping between the primary indicators and the potential approaches?

The proposed mapping between the primary indicators and the potential approaches is well designed. It would, however, be easier to envisage how a step-in risk framework would function in practice if the indicators were simplified.

Q6. What are commenters’ views on proportionate consolidation for joint-ventures?

When banks take part in join-ventures the equity method of accounting is generally applied.

DB does not generally agree with proportionate consolidation as we believe it is contrary to the spirit of the recognition criteria under the IFRS Conceptual Framework, where assets should only be recognised on an entity’s balance sheet when the entity has both control and experiences risks and rewards from that asset. A joint-venture relationship derives from a joint-control situation and therefore does not meet the recognition criteria in the Conceptual Framework.

In addition, proportionate consolidation for regulatory purposes is prohibited by the EU Capital Requirements Regulation (CRR).

Instead, accounting policies should allow for a process of asset recognition that is driven by the amount of authority the Group has over an asset. Under this method, when no significant influence can be exercised over an asset, the interest is recorded on the bank‘s balance sheet as a financial investment. Once significant influence is established, the equity method of accounting is applied to the bank‘s investment (this includes joint-venture arrangements). And when a bank controls an entity, then it should consolidate it and bring all its assets and liabilities onto the Group balance sheet. This, we feel is the appropriate way to reflect the type of influence/interest in the investee.

Q7. What are commenters’ views on risks stemming from banks’ relationships with asset management activities and funds and the appropriateness of the direction envisaged?

While we agree that risks stemming from banks‘ relationships with asset management activties and funds need to be taken into account in the prudential framework, it should be recognised that a significant amount of these risks have already been mitigated through the prudential and accounting regulatory frameworks. The BCBS should focus only on residual risks.

We question the BCBS‘ assessment of the risks stemming from banks’ relationships with asset management activities. The unconsolidated nature of funds is dictated by their structure and is well understood by the market. We do not believe there is a material additional risk of step-in by the asset manager parent company purely as a result of it being a bank. In contrast, we believe this relationship brings financial stability benefits by way of the diversification of revenue streams. The BCBS highlights MMFs as one of the financial instruments that banks supported during the financial crisis. However, it is important to note that this was only true for a specific kind of MMF – MMFs with a constant net asset value (CNAV). Even then, CNAV MMFs are only a part of MMFs, and should not be representative for the whole asset management industry.

It should be kept in mind that the industry calculates economic capital for guaranteed funds. US MMFs are included in the calculation although guarantees but there are no contractual guarantees. Hence, economic capital for US MMFs quantifies the risk that in a situation when the market value of a CNAV funds' shares declines below $1 per share (banks convert the implicit guarantees into explicit guarantees to avoid reputational damage and to maintain market confidence).

In some rare cases during the financial crisis, banks also provided support to open-ended real estate funds. In the wake of the crisis though, regulators worldwide have enacted new laws to enhance the prudential resilience of asset managers and their funds under management. As a result of these provisions, the probability of a bank's intervention, as a last consequence to avoid reputational damage, is significantly diminished. This is on top of the existing low likelihood of step-in in asset management entities due to the well-understood structure and mandate of such entities and the enhanced corporate governance requirements under relevant laws on banks stepping-in and, or providing cross-stream guarantees or regulations on related party transactions. The risk of implicit guarantee was therefore already remote, and is becoming more so as new regulations are introduces and existing regulations are enhanced.

Please refer to Appendix I for a non-exhaustive overview of existing and forthcoming regulations relevant to banks' relationships with asset management activities and funds that should be taken into account by the BCBS.

The existing and ongoing legislative initiatives mitigate step-in risks not only for CNAV MMFs, but also for the asset managers and investment funds. As an example, retail investment funds in Germany are allowed to suspend redemptions of units in unusual circumstances in which a suspension appears necessary to protect the interests of investors (§98 para. 2 KAGB – Capital Investment Act). Additionally, regarding retail property funds in Germany, the Investor Protection and Capital Markets Improvement Act (AnsFuG - Bundesgesetzblatt Teil I Nr. 14/538) requires investors to hold their units at least one year and a cancellation period of twelve months. These regulations ultimately minimise the risk of a run occurring on the funds, which therefore, minimises step-in risk.

As a result of the Capital Investment Act, asset managers are also subject to strict standards of:

- Risk management including stress tests;
- Liquidity management (including liquidity stress tests for each individual investment fund); and
- Setting leverage limits

Finally, competent authorities must conduct an analysis of the risks of investment funds. The information about the risk profiles should be shared with other authorities in the EU, with the European Securities and Markets Authority (ESMA) and with the European Systemic Risk Board (ESRB) so as to facilitate a collective analysis of the impact of the risk profile (including leverage) of investment funds on the financial system in the Union, as well as a common response to potential risks.

Appendix I: Overview of existing and forthcoming regulations relevant to banks' relationships with asset management activities and funds (non-exaustive)

With special regards to (CNAV) MMFs:

- CESR's Guidelines on a common definition of European money market funds (CESR/10-049) (enhanced disclosure requirements to ensure that investors' understanding of any specific risks linked to the investment strategy of the funds);
- European Commission proposal of a new Regulation on Money Market Funds ((MMFR – COM (2013) 615 final, 2013/0306 (COD)) (The regulation currently under discussion aims to ensure that MMFs can better withstand redemption pressure in stressed market conditions by enhancing their liquidity profile and stability. Although the regulation has yet to be finalised, the proposal notably seeks to deal with "MMF's propensity to require sponsor support to stabilise redemptions at par," which would make step-in much less probable).

With special regards to retail property funds in Germany:

- Regarding the asset management industry, the regime ensuring the resilience of asset managers has been significantly improved since the financial crisis. The Alternative Investment Fund Managers Directive (AIFMD - Directive 2011/61/EU) significantly enhanced the transparency of the activities of Alternative Investment Funds Mangers and the funds they manage, introducing in particular minimum capital requirements, a liability regime for depositories, limits and information requirements on leverage, and transparency and reporting requirements;
- The UCITS V Directive of 2014 sets rules for which financial instruments UCITS funds are permitted to invest, and also limits the net exposure to a proportion of the NAV of a fund that may be invested in each asset type.

Regarding the US market, the US Securities and Exchange Commission (SEC) is currently discussing the following new rules which are in principle comparable with the EU requirements for investment funds:

- Enhanced data reporting initiative: Report about fund operations and portfolio holdings by open-end and closed-end registered investment companies;
- Adequate stress testing methodologies: For large asset managers that are mandated to implement stress tests by US law;

- Use of derivatives by registered investment companies and business development companies (including proposals for portfolio limitations and risk management programs for derivative transactions);
- Open-ended fund liquidity risk management programs; swing pricing; re-opening of comment period in May 2015 for modernising investment company reporting, which would enhance the data and reporting disclosures of information for mutual funds, exchange-traded funds, and investment companies and investment advisors.