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Mr. Stefan Walter
Secretary General of the Basel Committee
On Banking Supervision
Bank for International Settlements
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Dear Mr Walter

Deutsche Bank (DB) welcomes the opportunity to respond to the Basel Committee's Consultative Document 164 on the Committee's comprehensive reform proposals to strengthen the standards for global capital. The crisis exposed a number of shortcomings in the Basel II framework and it is clear that weaknesses in the methodologies for calculating capital requirements need to be addressed. Financial stability in the long-term will be underpinned by more and higher quality capital in the financial system. Flaws in the framework for market risk have been addressed and are now at the regional implementation phase. It is important to consider the other elements, particularly the issues around balancing risk sensitivity and procyclicality.

Although we are responding to CD 164 and CD 165 separately, the proposals need to be considered together, as there are strong correlations in their impact.

Macro-economic impact: The Committee's work in delivering on the commitments of the G20 and Financial Stability Board (FSB) in such a short time-frame is commendable. However, the speed of the revisions has made it difficult to ensure that the cumulative effects of the full package are fully analysed. It would have been preferable for the QIS 5 results to be available before the response date to the consultation. Further increases in capital and liquidity requirements must be viewed in the context of their impact on the wider economy.

The current implementation timetable would require firms to vastly increase common equity in an extremely short period. This cannot be done through future profits alone and thus implies a material scaling back of existing business. In order to increase their capital levels, financial institutions will have to raise fresh capital from the markets. This will only be possible if the sector remains attractive to investors.

It is unrealistic to expect such significant capital raising to occur without a significant impact on lending, businesses and ultimately growth and employment.

Time is needed to ensure the framework is effective from a technical perspective. It is important to reflect on whether or not the use test continues to be an objective of the Basel



Committee. It is not clear whether the models needed to comply with the proposals are designed for supervisory monitoring purposes, or are expected to be used for risk management purposes. In addition, careful consideration of the implementation timetable, including phasing in and grandfathering will be needed. Latest industry data compiled by the Association of Financial Markets in Europe (AFME) shows that the increase in market risk capital alone following the trading book amendments will be between 8 and 20 times current levels depending on the interpretation of the securitisation rules.

International level playing field: Basel Committee membership was recently extended to all of the G20 countries. With its extensive geographical footprint, DB is very supportive of a broader implementation of the international framework. However, despite the engagement and commitment of a number of Emerging Market countries, the United States continues to influence the Basel process but, in effect, treat the guidelines as optional. It is not clear to us what the US implementation timeline is for Basel II, the Trading Book amendments, or Basel III. While the US has its own process and the Basel Committee cannot influence that, DB believes that no other Basel Committee members should move ahead with implementation until there is a clear timetable from the US. The competitive distortions resulting from differing timetables and approaches would be particularly damaging to European firms.

Appropriateness of proposed rules: DB has concerns about the granularity and conservatism of many parts of the Basel proposals, and about the direction the proposals have taken:

- There is an isolated focus on banks without regard to the shadow banking system or the impact on securitisation markets.
- The objective of simplistic metrics such as the leverage ratio is unclear. Such formulae will not contribute to stabilisation of the financial system.
- There is an over-emphasis on liability side regulatory measures (e.g. equity buffers).
- The Basel Accord is intended to be risk-based. However a number of the proposals, most notably the leverage ratio and the deduction of DTAs, are completely contrary to this basic principle.

Although we support standardisation of international rules, the framework must continue to allow for an appropriate level of flexibility. Firms should be allowed to develop their risk management frameworks according to their specific profile and strategy. Not all banks made the same mistakes prior to the crisis. Overly prescriptive and detailed requirements at a global level will ultimately lead to a herd mentality in the industry, reducing innovation and resulting in greater concentrations of risk. If every institution is forced to take exactly the same actions at the same time this will result in decreased financial stability through increased volatility.

Procyclicality: While the Committee's proposals tackle the procyclicality of the existing framework through the dynamic provisioning proposals (although we do not favour the specific model proposed we generally support the concept), other elements of the paper may contribute to procyclicality. DB is especially concerned about the range of deductions to Tier 1 capital including the full deduction of Deferred Tax Assets (DTA). For Tier 1 capital purposes conservative rules of projecting future taxable income and the avoidance of a procyclical effect of an overly conservative approach should be considered.



The current Tier 1 capital treatment for DTAs reduces the volatility of Tier 1 capital over the economic cycle. Capital consumption from losses is reduced by DTA recognition, capital contribution from profits is reduced by DTA releases. As a result, the recognition of DTAs dampens the pro-cyclicality of Tier 1 capital.

Accounting vs prudential rules: Generally, conformity between accounting and regulatory treatment is to be preferred. Exceptions should be clearly justified. There is a tendency in the proposals to take an a la carte approach to choosing between the regulatory or accounting treatment of particular issues. This is seen clearly in the leverage ratio proposals where the regulatory definition of netting is ignored. However it also comes through in elements of the risk control framework where concepts are introduced without sufficient regard a) for the international accounting treatment under IFRS; or b) the fact that this framework applies to banks operating across diverse jurisdictions with their own accounting treatment of various concepts.

Alternative proposals: The Basel Committee's proposals have focused entirely on liability side restraints. DB believes that there are a range of alternative measures that have not been fully considered on the regulatory side:

- Reform is underway but there needs to be a comprehensive program to ensure the sufficiency and substantive consistency of regulatory powers and laws governing the rescue and insolvency of failing and failed banks.
- High level asset side constraints such as product/portfolio large exposure rules and standards for contingent capital should be reviewed.

We look forward to continued dialogue on these issues in the coming months and remain at your disposal to respond to any questions on either of our response. Our detailed comments elaborating on the above points are given in the Attachment.

Yours sincerely,

Andrew Procter
Global Head of Government & Regulatory Affairs
Deutsche Bank AG



Detailed Comments on CP 164

1 Raising the quality, consistency and transparency of the capital base

The quality of capital is crucial for the prudential based supervision of the banking industry and DB supports the Committee's efforts to enhance the quality of bank capital. In a number of areas, however, the proposals are too conservative and do not meet the stated objectives.

Furthermore, these measures together with other prudential requirements discussed in current consultations will impose an extraordinary burden on the industry and may lead to stagnation and a lack of macroeconomic growth:

- The proposals will vastly increase the need for common equity. Some analysts are projecting pro-forma Core Tier 1 decreases of up to 50% for European banks.
- In conjunction with the ineligibility for hybrid capital as Core Tier 1, this will cause a) capital raisings to become more expensive and b) the destruction of the hybrid market (size approx. EUR 750bn for European banks). An attractive hybrid market will be essential if banks are to raise the necessary additional capital. Equity investment will not suffice.
- There will be increased volatility in Core Tier 1 capital because of deductions of all unrealised other comprehensive income gains and losses and DTA.

In our view the two areas of the proposals on the capital base which need most reconsideration are the deduction of investments in financial enterprises (look through index securities: de facto ban of netting long and short positions), and the deduction of DTAs. Both proposals would significantly increase volatility and reduce Core Tier 1 capital. Full DTA deduction would actually increase procyclicality in the financial sector as discussed below. We would strongly urge the Basel Committee to revisit these areas and to engage in full and focused dialogue on these elements.

We draw your attention also to the importance of contingent capital. Contingent capital has been shown during the crisis to have a real value as a loss absorber and DB used it to great effect. For this to work in practice, management had to be able to decide whether to trigger the conversion. As this flexibility has been shown to be beneficial, there is no reason, for example, to insist on the alternative form of contingent capital where there are hard objective triggers. Contingent capital has proven to be popular with investors over the years and risks associated with it are well understood. Given that banks will have to raise significantly more capital it makes no sense to exclude contingent capital from Tier 1 particularly given the likely lack of emphasis on Tier 2 in the future.

Common equity Tier 1 ("Equity Tier 1") capital deductions
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Investments in financial enterprises (incl. insurance entities) which are not in regulatory scope of consolidation (i.e. minority stakes)

- **Basel proposal:** The current consultation proposes that netting of long positions in these investments is only allowed with short positions which do not result in counterparty risk. Additionally, exposures to financial institutions embedded in index



security will be added to the deduction, which also applies to investments held in the trading book (page. 24-25, #101).

- **Market making:** Many banks actively trade physical equities and index securities as part of their market making activities, with such positions being managed on a delta neutral basis. **We believe it would be appropriate to allow an exemption for positions arising as a result of market-making managed in this way.**
- Without such an exemption there would be an inevitable reduction in market liquidity for bank shares and indices (either including bank equity or sub-debt).
- **Risk management:** It remains unclear what is to be considered “short positions without counterparty risk”, and how this could be operationally enforced. Furthermore, from a risk management perspective, the proposal reduces the incentive for banks to reduce the risk from any long position by a mitigating short position. **Consequently, we support allowing the netting of long and short positions wherever held.**
- **Look through index securities: Holding of index positions does not create regulatory capital in a financial institution which is represented in the index security. Hence, a capital deduction is not justified.** Furthermore, a capital deduction of certain portions of an index product, which are hedged by a corresponding short position, would result in an asymmetric risk position between the decomposed index product (capital deduction) and the hedge (RWA on that part of the hedge which refers to the capital deduction of the underlying asset). As a result, a fully hedged position would be treated with a capital deduction and RWAs. Without the capital deduction, the net RWA on the fully hedged position would be zero. Decomposition of index securities and baskets will be operationally burdensome and impose substantial additional reporting costs. Where such index securities and baskets are part of a broader overall trading strategy, we question whether the benefits from deducting indirectly held investments outweigh the additional reporting costs. **We propose that the focus of the deduction of investments in financial enterprises to be on directly held physical investments.**

Net Deferred Tax Assets (DTA)

Basel Proposal: The Committee is proposing deducting from Equity Tier 1 capital Deferred Tax Assets (DTA) which rely on future profitability to be realised, net of deferred tax liabilities (DTL) (page 24, para 99).

DB believes strongly that no deduction of DTA/DTL is needed. If a deduction is to be contemplated:

- **DTA/DTL timing differences should be carved out of the deduction requirements;**
- **There should be a capital charge for remaining DTA depending on their economic value in a stress scenario; and**



- **DTA which must be deducted should be deducted from Tier 2 first.**

In considering the position with respect to DTA, it is necessary to appreciate the following factual aspects:

1. The DTA balance comprises 3 distinct elements:
 - a. A timing difference between accounting and tax systems arising from income being recognised for tax purposes (e.g. prepaid interest) before it is recognised for accounting purposes. This can arise from external or intra group transactions. The DTA is in effect a prepayment to the tax authorities of a tax expense that will later be recognised for accounting purposes;
 - b. A timing difference between accounting and tax systems arising from expenses being recognised for accounting purposes (e.g. fair market value losses) before they are recognised for tax purposes. The position will automatically reverse through the passage of time. For example, in the case of fair market value losses, the position will reverse either upon the market value recovering or when the losses are crystallised for tax purposes;
 - c. A claim against tax authorities to reduce the tax on future profits due to net operating losses (NOL) or tax credits carried forward.

In all 3 cases, for the DTA to be included in the balance sheet, the accounting recognition tests must first be met.

2. For a large global bank, the reported DTA balance is the consolidated amount of individual balances of every country in which the bank operates. Additionally, in some countries there may be state, local or city taxation, which contribute to the DTA balance. DB regularly operates in or has dealings with 72 countries and while not all of these will contribute to the DTA balance, the number does indicate that many different tax laws are involved and that the mere existence of a DTA (which may be only timing in nature or a consequence of a single bad year in a particular country) is not at all reflective of the bank globally having an impaired capital position.
3. Even where a DTA arises from a NOL carried forward, the DTA has independent value and is not solely dependent on future profits from existing operations to be monetised. For example, simple additional equity from a legal entity perspective can be transferred to the jurisdiction to earn out the NOL, and a number of jurisdictions permit the transfer of DTA along with the transfer of the business to a new owner.

DB believes for the following reasons that no deduction from Equity Tier 1 capital is necessary for DTA:

1. DTA arising from timing differences should not be subject to deduction. In these cases the DTA may represent a prepayment of a liability (category 1(a) above), and there is no apparent basis for requiring prepayments to be deducted from Equity Tier 1 capital. Alternatively, where the DTA arises from expenses for accounting



purposes being recognised before they are recognised for tax purposes (category 1(b) above), the DTA will automatically reverse over time as market values change or as expenses or losses are realised for tax as well as accounting.

2. Further, the design structure of the Basel proposals should be such as to minimise disincentives to take appropriate prudential actions. A significant driver of DTA for banks is the fact that many tax systems only permit a deduction for loan loss provisions upon actual realisation of those losses, whereas the deduction for accounting arises at the time the provision is made. Requiring an Equity Tier 1 deduction for DTA will create an undesirable negative feedback loop when institutions review and seek to determine appropriate provisioning levels, including also with respect to the proposed new EL provisions if DTA on temporary differences is to be deducted. The European Commission has recognised the importance of this point in paragraph 152 of its 26 February 2010 consultation on further changes to the Capital Requirements Directive (CRD 4).
3. The tests for IFRS recognition of DTA are robust and if they are met then it is appropriate to recognise the value of the DTA for Equity Tier 1 capital purposes, irrespective of whether the DTA originates from timing differences or NOLs. In particular, the accounting standard requires detailed profit projections to prove the ability to earn out the DTA, with this process being subject to audit review and verification. Compared to goodwill and intangibles, DTA depend less on future profitability. The projections are not infinite because the existence of unused tax losses is initially taken as strong evidence that future taxable profit may not be available. Therefore the underlying projections to determine that a DTA is recoverable must provide convincing evidence and in most instances, are only accepted for a 5 year time horizon.
4. DTA recognition has a positive impact on reducing pro-cyclicality: capital consumption from losses is reduced by DTA recognition; capital contribution from profits is reduced by DTA releases. As a result, the recognition of DTA dampens the pro-cyclicality of Tier 1 capital. Deducting net DTA from Equity Tier 1 capital would eliminate this smoothening effect and significantly amplify pro-cyclicality.
5. Subtraction of DTA from Equity Tier 1 capital will impose a deadweight cost on the funding of economic activity generally and act as an undue impediment on economic growth. As noted above, a large global bank will operate in many jurisdictions, each with its own DTA rules. The strong probability is that these DTA will reverse and be realised. The net result of a DTA subtraction will simply be to effect an increase in average Equity Tier 1 capital over and above the amount otherwise considered prudent in appropriately balancing capital requirements against risk.
6. From past experience, it is probable the revised Basel accords will not be fully adopted in all major jurisdictions, and in particular there is a concern that some major jurisdictions may wish to retain their current approach (or some variant of it) and not implement the onerous proposed DTA provisions. For example, the United States has over a long period of time and after extensive consultation developed rules which permit the global netting of DTA and DTL, assume all temporary differences reverse



at reporting date, and allow a 2 year carry back of any net DTA balance based on US tax law independently of whether such carry back can actually be achieved in a relevant foreign jurisdiction, with no deduction then being required for any residual DTA to the extent it does not exceed the lesser of 10% of Tier 1 and 12 months projected tax liability (after taking into account proposed tax planning strategies). Assuming European implementation of the new Basel proposals as finally agreed, the consequence of implementing the present proposals without modification would be to place European based banks at a comparative competitive disadvantage to banks in jurisdictions which do not fully implement them, and also, for example, make it relatively easier for such other banks to acquire European based banks.

7. Notwithstanding their normal countercyclical impact, it could be argued that DTA recognition does not always reduce pro-cyclicality. Where the financial outlook for the bank as a whole declines materially, there may be limited ability to turn the DTA into cash to support the going concern position of the bank. However, we think this argument inappropriately mixes liquidity issues (which are being separately addressed) with quality of capital. There are many assets which could not be readily turned into cash or which may reduce in value in stressed situations, but (apart from goodwill – as to which, see further below) it is not proposed these be subtracted in their entirety from Equity Tier 1 capital, and it is inappropriate to discriminate against DTA in this way.
8. The proposal to deduct goodwill from Equity Tier 1 capital does not create any precedent for DTA. Unlike goodwill, DTA is not an intangible, and a stressed situation does not mean that DTA ceases to have value. Additionally, part of the reason for subtracting goodwill is to ensure acquisitive banks do not have an advantage over organically grown banks, with this consideration not arising in the case of DTA. In this regard, goodwill is created as part of a purchase price allocation, whereas DTA comprises actual assets which can (and are expected to be) realised for full value in cash.

Should the Committee nevertheless decide to move ahead with these deductions, the following clarifications would be helpful:

- (i) intention and effect of “rely on future profitability” qualification- it is not clear whether all DTA relating to temporary differences should not be subtracted or only DTA which will turn into a cash claim; and
- (ii) the extent to which DTL can be netted, particularly since the DTL and DTA may be in different jurisdictions.

The following items should be taken into consideration if the proposed deductions go ahead:

- **Deduction amount - Classes of DTA:** The current proposal requires the deduction to “rely on future profitability to be realised”. The “rely on future profitability” test should carve-out all DTA relating to temporary differences as these depend only on different computation rules between tax law and IFRS/GAAP rules, without any underlying economic driver, and in the case where taxable income precedes



accounting income the DTA is actually equivalent to a prepayment. On the same basis, all DTL should be netted against DTA. For that reason, we propose carving-out DTA resulting from timing differences with a full offset for all DTLs.

- **Deduction amount - Assumption of zero value:** Compared to DTL, DTA are only recognised to the extent that it is probable that sufficient taxable profit will be available against which those unused tax losses, unused tax credits and deductible temporary differences can be utilised [IAS 12.24, 12.34]. Even in a gone-concern scenario the value of DTA may be positive in the financial accounts. We propose to allow banks to recognise DTA in Equity Tier 1 capital up to a certain extent, preferably to the extent that it is allowed under IFRS, or to the extent that they can be utilised within a specified period (e.g. the 5 year period as set forth in German Commercial Code sec. 274 par (1)). Some overall cap may be warranted to deal with extreme outlier cases.
- **Deduction exclusively from Equity Tier 1 capital:** We do not consider this deduction to be consistent with the overall framework of Tier 1 as going-concern capital, and Tier 2 as gone-concern capital (page 17, para 85). There is no justification to assume that in the going-concern case, where the institution is expecting to continue its operations and return to profit, all DTA will be written off. As Tier 2 capital is dedicated to shielding creditors in case of insolvency, **we propose a deduction cascade: first deduction from Tier 2 capital; then any excess deduction would eat into Tier 1 Additional Going Concern capital; and any excess deduction left would be deducted from Equity Tier 1 capital.**
- As an **alternative to capital deduction**, we encourage the Committee to consider **risk-weighting DTA on unused losses**. This approach would recognise that DTA on unused losses always have a certain value.

Minority interest

- **Basel proposal:** Minority interest not eligible for inclusion in Equity Tier 1 capital. Reason: “Minority interest may represent an interest in a subsidiary with little or no risk.” (p. 23, #95)
- **Asymmetry with RWA treatment:** non-recognition of minorities and at the same time full recognition of RWA (as if owner of a 100% stake) is asymmetric and ignores the risk-bearing capacity of minorities in the entity. To achieve symmetry and address the Committee’s concerns around artificially high minority stakes in low risk subsidiaries, **we propose the recognition of full RWA, with minority interest being included in the appropriate class of regulatory capital up a ceiling based on (i) overall group capital ratio, or (ii) some pre-determined ratio set by the regulators. To the extent that the minority interest exceeded this threshold, the excess would not be available for regulatory capital recognition.**

Other comprehensive income (OCI; unrealised gains and losses)

- **Basel proposal:** Unrealised gains and losses (on equities, debt instruments, loans and receivables, own properties and investment properties) fully included in from Equity



Tier 1 capital (p. 23, #96)

- **Liquidity discount:** Proposal ignores that the valuation of assets with low market liquidity may suffer a steep discount in a stress scenario. This would be reflected in Equity Tier 1 ratio even if the management would not intend to realise the loss through a disposal of the asset. Correlation between stress scenario and increase of liquidity discount in asset valuations would also add to pro-cyclicality.

At a minimum, we propose to exclude unrealised gains and losses from government bonds and other bonds which are eligible for repos with the central bank.

Deduction of unrealised gains / losses:

- IFRS 9 needs to be finalised before any prudential adjustment can be decided upon. When considering such adjustments it needs to be taken into account that the valuation of assets with low market liquidity may suffer a steep discount in a stress scenario. Without a prudential filter, this would be reflected in the Core Tier 1 ratio even if the management did not intend to realise the loss through a disposal of the asset. In particular, for assets which are held for liquidity risk management purposes, there is no need to sell the asset as long as they are central bank eligible.
- The correlation between a stress scenario and an increase of liquidity discount in asset valuations would also add to procyclicality.

At a minimum, we propose to exclude unrealised gains and losses from securities which are eligible for repos with the central bank. For all other securities, we agree with the symmetrical proposal of the Basel Committee not to apply any prudential filter for unrealised gains and losses as the securities can be sold on the market to crystallise the value.

Investments in own shares (treasury stock)

- **Basel proposal:** Netting of treasury stock only with short positions not resulting in counterparty risk. Also own shares indirectly held via index securitites to be included in deduction. This also applies to shares held in the trading book. (p. 24, #100)
- **Cash-settled derivatives:** Cash-settled derivatives on own shares are subject to credit and market risk like any equivalent derivative on other shares. **We propose to continue following the accounting treatment and apply no new prudential filters as cash-settled derivatives do not change equity.**

IAS 32 establishes "...principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; ..." (IAS 32, para. 4)

The accounting standard differentiates in detail between equity instruments, which are directly reflected in equity, and instruments presented on the balance sheet as financial assets or liabilities, whose changes in value will be reflected in P&L or OCI.



Equity instruments are defined as: *"A contract on an entity's own equity is an equity instrument if, and only if: a) it contains no contractual obligation to transfer cash or another financial asset, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; and (b) if the instrument will or may be settled in the entity's own equity instruments, it is either (i) a non-derivative that includes no contractual obligation for the entity to deliver a variable number of its own equity instruments, or (ii) a derivative that will be settled by the entity exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments."* (IAS 32, BC6)

Cash-settled derivatives are not equity instruments. Non-equity instruments bear the same type of risks as other assets and liabilities, which do not reference the institution's own shares and are consequently treated in line with them. For example cash-settled forward purchases bear market and credit risk similar to forwards referencing to a third party and will not reduce the number of externally held shares.

Equity instruments on the other hand will directly impact the equity of the institution in the IFRS accounts. They already reduce regulatory capital. IAS 32 also clarifies that treasury shares shall be deducted from equity. (IAS 32, para. 33)

Previously the Basel Committee has not considered it necessary to apply prudential filters to the way instruments referencing the institution's own equity are treated under IFRS. We encourage the Committee to continue to apply filters only in order to correct a prudentially unacceptable outcome of the accounting rules. We do not see such an outcome of IAS 32 in this respect.

- **Netting:** It remains unclear what is to be considered "short positions without counterparty risk". At worst, the rule would effectively disallow any netting. Such a rule would disadvantage stock listed banks over non-listed banks in terms of market making in the respective listed bank's own shares.

We propose to allow for netting of long and short positions of own shares.

- **Look through index securities:** Banks usually hold inventory of index securities for market making purposes. Thus, a capital deduction of own shares embedded in an index security would put index member banks at a disadvantage to banks not represented in an index. These own shares embedded in index securities do not reduce the risk-bearing capacity of the bank. As to the size held, banks do have an incentive to limit the size of inventory to limit the associated funding costs. It is highly questionable whether the benefit to the banking system from deducting indirectly held own shares outweighs the additional reporting costs.

We propose limiting the deduction to directly held own shares.

Net surplus of pension assets

- **Basel proposal:** On-balance sheet surplus of pension assets over liabilities to be deducted (p. 26, #107).
- **Increased underfunding risk:** A deduction would provide an incentive for banks to minimise the overfunding of pension funds or even accept underfunding, putting pensions at risk.



We propose waiving the deduction and continuing to comprehensively monitor pensions under Pillar II. Should the committee nonetheless believe a deduction is necessary, we would propose deduction from Tier 2 capital because the pension surplus would only need to be realised in a gone-concern scenario.

Role of hybrids in Equity Tier 1 and Tier 1 capital

- **Basel proposal:** Predominant form of Tier 1 capital must be common shares and retained earnings (p. 15, #73). Defined criteria for Equity Tier 1 capital must be met solely with common shares (p. 18, #87, 2nd sentence). No “innovative” features like step-ups to be included in Tier 1 capital instruments (p. 16, #77). If Additional Going Concern Capital is issued by an SPV, then the proceeds need to be available to the holding entity or an operating entity in a form which meets all criteria for Additional Going Concern Capital. (p. 21, #14).
- **Regulatory approval:** A bank can only exercise the call right in “innovative” hybrids after regulatory approval anyway.

We propose to allow “innovative” hybrids as Tier 1 capital instrument.

- **Investor base:** If the predominant form of Tier 1 capital is to be common shares (as defined in local law) and retained earnings, the need for Equity Tier 1 can only be met by equity issuance. The investor base for equity may not have sufficient appetite for bank shares. Banks do need instruments such as hybrids which attract investor groups other than equity investors. **We propose allowing a material position in hybrids of 35% of own funds (as proposed in the CEBS implementation guideline for hybrid capital instruments of 10 December 2009).**
- **Equity Tier 1 eligibility:** Instruments which fulfill the criteria for Equity Tier 1 capital as set out on pages 18-19 (#87) should qualify for Equity Tier 1 even if they are not common equity as defined in local law. This is also necessary to broaden the investor base.

We propose to remove the restriction to common equity as an eligible Equity Tier 1 capital instrument. Exceptions may not be limited to non-joint stock companies.

- **Use of SPVs:** In certain jurisdictions, hybrid capital instruments can be issued directly off the parent company’s balance sheet in a tax deductible format (e.g. France, Netherlands, Belgium, Scandinavian countries). However, in other locations (e.g. Germany, UK) this is not currently the case. Permitting the use of SPV structures in certain circumstances would support a level playing field for banks, without diluting the effectiveness of the capital instrument on a consolidated Group level.

We propose that firms are allowed to retain the flexibility to on-lend capital through a variety of structures within the group, provided the legal and economic is that the bank is in the same position from a going concern (deferral and result principal write-down) and gone concern (subordination) perspective as it would have been if it had issued the instruments directly.



- **Loss absorption:** A permanent write-down feature puts the holder of the capital instrument into a worse position than a shareholder. Common shares absorb losses but do have an earn-out optionality in a going-concern scenario. A permanent write-down feature would eliminate such upside. **Therefore a write-up feature, complementing the write-down feature should be allowed.**

Contingent Capital and Convertibles

- **Basel proposal:** Committee continues to review the role of contingent capital (p. 22, #92).
- **Role:** Contingent capital is one of the most important tools to quickly restore Equity Tier 1 capital and Additional Tier 1 capital in stressed situations, to mitigate procyclicality and ensure survival. The proposed capital conservation measures (limits on dividend, share buybacks and bonus) are limited in size and therefore, additional instruments like contingent capital are required. **In order to ensure a sizeable market for contingent capital instruments, banks will need some flexibility in tailoring instruments, including triggers which we believe should include some level of management discretion.** After testing the market, the Equity Tier 1 and Additional Tier 1 capital criteria may need to be adjusted to create sufficient investor demand.

We propose that the Basel Committee monitors the market acceptance for contingent capital instruments. If the investor demand seems too small, we recommend adjustment of the Basel Committee's requirements for contingent capital. We would also emphasise the importance of existing contingent capital instruments and the subordinated debt market in the Committee's deliberations.

- **Triggers:** A full universe of triggers is needed to ensure investor demand and to avoid systemic risk by having only one universal trigger across all institutions.
 - Simple thresholds in capital ratios (e.g. minimum ratio +100bp) for mandatory conversion.
 - Discretion of management to convert above the mandatory conversion trigger could be an optionality in structuring. This should not be a standard as the risk of earlier conversion would increase the spread demanded by investors.
 - Management discretion exercisable where a trigger is hit only temporarily, for example, due to time lag between an acquisition and the necessary capital raise.
 - Sole discretion of management (also useful outside of this crisis, e.g. to restore capital after a mid-sized acquisition).



2 Risk coverage

A move to migrate away from bilateral standardised OTC arrangements towards central clearing, dynamic hedging and clarification on collateral is welcome. However, the scope of the changes to the treatment of counterparty credit risk is not justified by evidence from the crisis.

The proposed measures are only partially suited to improving the assessment of capital demand for credit risk and counterparty credit risk. We discuss these proposed measures below.

- **Calculation of EPE with stressed parameters;** We understand the supervisory desire to determine regulatory capital conditional on economic periods of stress, but changing the underlying parameters alone may cause undesired effects. First, the directionality of the effect of increasing volatilities and correlations on the overall exposure is highly dependent on the portfolio composition. In particular, the capital reduction effect due to short positions may be overly amplified if volatilities and correlations unsuited to the underlying risk drivers are used. Secondly, the ongoing design of new financial products will limit the availability of relevant historical data to estimate these parameters. This will decrease the quality of capital estimates as time passes from the last period of stress.
- **Capital add-on for CVA risk:** We cannot follow the reason for introducing an additional charge on derivatives exposure. This would introduce double-counting with the spread risk component for CVA positions captured within our VaR measure and the dependency of exposure and creditworthiness captured by means of the alpha factor. Moreover, given our actual loss experience, we cannot follow the need to capture a P&L risk for CVA which have been determined based on internal PDs rather than market-driven credit spreads.

The proposed metrics appear inadequate to capture the joint market and credit risks to which derivatives are subjected. This in particular concerns the standardised and – introduced as part of the related QIS – “stylised” VaR metrics, which can not reflect portfolio effects with respect to counterparty component. The more sophisticated “Bond-equivalent” measure suffers from a “one-size fits all” product valuation and an unrealistic upscaling of its VaR result to fit it to the (inappropriate) one year time horizon and an unjustified conservatism in its maturity setting.

We welcome the essential recognition of eligible hedges in the assessment of the CVA VaR as an appropriate incentive for dynamic hedging but we believe that its scope is too narrow as portfolio hedges will not be recognised. **The latter will in particular increase the costs of derivatives for MidCap counterparts, for which no market for single name CDS exists. As a consequence, banks will have no choice but to pass on the additional capital costs directly to these clients or exclude them from the OTC business altogether.**

- **Capital charge for wrong-way risk:** In compliance with the German Banking Act SolvV §224 (9), we already regularly identify exposures to (general and) specific wrong-way risk. In addition, we monitor and measure the total risk contained in these transactions by means of the calculation process to estimate our own alpha. The fact that the level of our own alpha estimates fall far below the regulatory floor of 1.2,



and we believe these measures are fully sufficient to assess the impact of wrong-way risk for risk management and capital purposes. An additional charge for wrong-way risk would double-count this risk and is therefore not justified.

- ***Multiplier for the asset value correlation for large / unregulated financial institutions:*** We disagree with the claim that the default and rating migration behavior of financial institutions exhibits a higher sector correlation than the corporate sectors. See, for instance, *Kalkbrener, M. and Onwunta, A. (2010). Validating structural credit portfolio models. In Model Risk - Challenges and Solution for Financial Risk Models, Risk Books.* Moreover, the committee needs to consider that the current Basel II framework already comparatively penalises business with large, well rated firms via the current asset correlation assignment. Given the overall conservatism of the Basel II IRBA framework and in view of its general disregard of diversification, we see a clear need for validation of the new proposed settings against default correlations observed during the crisis before increasing the segment's capital requirement. More generally, we consider this proposed measure a serious threat to the inter-bank market as it will divert substantial liquidity.
- ***Increasing the margin period of risk: The concept of a "margin period of risk" (MPR) is based on*** the assumption that, in the event of a counterparty default, its respective derivatives portfolio is separated and liquidated in isolation. This assumption is contrary to actual practice where the underlying are immediately transferred into the bank's trading portfolio and managed within it. It may well be that keeping a respective outright position is more beneficial to the bank than selling it. Hence a liquidation horizon in the sense of the MPR does not exist in a manner which could be validated. We believe that an increase in this parameter is just another mean for a capital increase but not supported by practical evidence. Finally, we believe that further tying this parameter setting to the number of disputes by netting set will impose a significant administrative burden on firms with questionable benefit.
- ***Revise the shortcut method for Effective EPE:*** We believe that the proposed modeling better approximates the economic risk of margin trading. However, the second approach proposed within the accompanying QIS appears to be slightly better suited than the formula shown in the original paper.
- ***Standard supervisory haircuts for securitisation collateral:*** The proposal does neither provide a reasoning for the magnitude of the haircut multiplier (of 2) for securitisation exposures (compared to Other issuers) nor does it deliver an explanation why re-securitisations are to be derecognised altogether.

With respect to the proposal's additional requirements on risk management practices and processes, we have the following comments

- ***Treatment of highly leveraged counterparts:*** It is not apparent from the proposal how a "highly leverage counterpart" is defined for the purpose of the additional requirements of its PD assessment. A clear distinction is necessary to identify the respective rating system in this context. Moreover, the comment



made above regarding the use of stressed volatilities for EPE applies here as well.

- **Central counterparts / alpha:** We welcome the committee's reinforcement of the incentive to trade OTC derivatives via CCPs and to maintain the current applicability of the alpha factor.
- **Stress testing:** While we generally consider the extended qualitative requirements for stress testing of counterparty credit risk to be in line with best industry practice, we disagree with the requirement to take into account reverse stress tests. Reverse stress test may be an effective group level management instrument but their use for these purposes would be overly simplistic and may lead to false conclusions.
- **Back-testing:** Paragraphs 42-45 meet our understanding of what would be industry best practice regarding the validation of EPE models. Paragraph 46 should be clarified to make clear that the "whole forecast distribution" relates only to the sample (but not the entire CCR) portfolio (defined in para 45) under investigation. Paragraph 46(i) uses the word "historical" in a way which may be misunderstood as suggesting that underlying models would have be run with (portfolio and parameter) data stored in the past. This is not a feasible approach as data formats change alongside the ongoing development of bank's risk engines. Instead, it is best practice to store all relevant input and output upon production and compare this historical output to current realised risk measures. In view of this practical constraint it is also evident that the sixth requirement under 46(i) on the alignment of back-testing horizons with trade maturity is impractical.

As a concluding remark on the overall changes proposed to the measurement and management of counterparty credit risk, we wish to stress that their implementation will require substantial and time consuming changes to many complex risk management systems.



3 Leverage Ratio

Concept and consequences: A leverage ratio is a very simplistic, non-risk sensitive, metric. Therefore, it should only function as a trigger for further discussion and analysis. Over-reliance on such a metric in connection with the highly artificial calculation proposal with a gross, one-sided approach would have alarming and damaging consequences. It will not provide a meaningful comparison across the industry given its different effect on different business models. It may provide useful information about a bank over time and it may therefore be relevant in a Pillar 2 context. To use the leverage ratio to compare banks will trigger uninformed and potentially harmful commentary. In addition, it will:

- Restrict future credit supply / increase price;
- Discourage prudent risk management and encourage inappropriate behaviour (substitution of lower risk with riskier, higher yielding assets; reduction in risk mitigation/hedging);
- Potentially distort the supervisory and market understanding of firms' risk profiles;
- Be volatile (and procyclical) with no reasonable means to manage such volatility; and
- Trigger uninformed comment or scare-mongering if leverage ratios appear high, regardless of their real significance.

We note that many of the other initiatives in respect of capital, liquidity and funding would in any case act as practical constraints on leverage in the system.

Given its significant conceptual weaknesses and practical shortfalls, the leverage ratio concept must remain a supervisory tool under Pillar 2.

To the extent that leverage is assessed under Pillar 2, we believe the inputs need to be internationally consistent in terms of their accounting treatment. There is a need to address the specific issues with the calculation methodology listed below. The resulting output could then form the basis of a more meaningful discussion between supervisors and firms which would assess leverage in the context of the broader risk position of the firm. Without this, firms could potentially be required to report up to 4 different measures of gross assets:

- US GAAP equivalent (incl. full US GAAP netting)
- IFRS equivalent (incl. IFRS allowable netting)
- Gross IFRS equivalent (fully gross basis)
- Gross IFRS equivalent including potential future exposure

This would simply create confusion while adding no meaningful additional risk information.



We would also encourage an adjustment in the leverage ratio for those positions which form part of the liquid asset buffer of the firm in order to avoid potential conflicts between prudent liquidity management and the leverage ratio.

Another adjustment should be the exclusion of trade finance products (e.g. import letters-of-credit or performance stand-by letters-of-credit) as these products require an underlying client transaction (e.g. shipped goods or infrastructure projects). Thus, they cannot contribute to an excessive “build-up of leverage” and nor do they contribute to “downward pressure of asset prices” as they are short-term in nature and liquidated by payment at maturity. A removal of trade finance products from the leverage ratio calculation would be in line with the objective of a leverage ratio to “constrain the build-up of leverage in the banking sector, helping avoid destabilising deleveraging processes” (p. 60, para 204) with “amplified downward pressure of asset prices” (p. 60, para 202).

We suggest that all available going concern capital i.e. full tier 1 (or alternatively: total shareholders’ equity, consistent with simplified balance sheet Basel approach) rather than core tier 1 should be available to support leverage.

We see the following significant specific flaws in the proposed calculation approach:

- **Dis-allowance of netting.** Disconnects from the essential attributes of how derivative business is executed and ignores the legal position upon insolvency. It also contradicts accepted accounting practice under US GAAP (based on which a leverage ratio regime has been operated in the US for a long period of time) and ignores regulatory determinations already made under Pillar I (regulatory netting). Grossing out a series of legally enforceable netting of exposures provides no meaningful information on the position of the institution as it artificially seeks to extract one-side of a potentially matched or hedged position. Depending on calibration, this could have a severely damaging impact on risk-mitigation opportunities and liquidity provided by derivative and repo markets. Taking the long only mark-to-market of derivative exposures would cause massive volatility in the total assets figure as market spreads change, with values peaking at times of market stress thus adding a highly pro-cyclical effect. Such volatility could not reasonably be managed, other than by recognising offsetting derivative exposures.

We propose to reflect legally enforceable netting and regulatory netting allowed under Pillar I.

- **Off balance sheet commitments and guarantees included at 100% credit conversion factor (CCF)** – Weighting undrawn commitments on the same basis as a funded loan will lead to a reduction in credit supply and will restrict opportunities (or increase cost) for borrowers who often seek such committed lines as a prudent backstop yet the actual incidence of utilisation often remains relatively small. This especially applies to trade-finance related exposures (e.g. import letters-of-credit with a Pillar I CCF of 20% or performance standby letters-of-credit with a Pillar I CCF of 50%). Here, the draw-down is not only contingent to the default of the borrower, but also to all other terms and conditions being met. If the CCF for trade-finance related products would be set at 100%, trade organisations like the International Chamber of Commerce



expect a significant dislocation of world trade – contrary to the G-20 London Summit agenda to promote trade as engine for renewed growth.

We propose to apply Pillar I credit conversion factors to the off-balance sheet commitments and guarantees.

- **Written credit protection included at full notional** – In particular for trading book positions, this would inevitably damage the CDS market as market making costs would become unreasonably punitive given that the vast majority of trades is off-set by corresponding bought protection trades. Also, the inappropriate increase in the leverage ratios of banks would occur irrespective of the ongoing transition to central clearing agents for a large portion of banks' CDSs.

We propose only to include the “net” written credit protection in the leverage ratio calculation, i.e. net of off-setting bought protection trades.

- **Add-on for potential future derivative exposure without recognition of risk mitigation** – The proposal mixes the balance sheet with predictions of future development without recognising contractually agreed off-sets through margin calls.

We propose not to include add-ons for potential future derivative exposure in the calculation of leverage ratios.

It should also be noted that the current proposals on the leverage ratio will be subject to change as accounting standards evolve and the BCBS should be mindful of ongoing accounting discussions in this regard.



4 Procyclicality

Forward looking provisioning:

The industry is working on alternative approaches to the current provisioning standards in order to allow a more timely recognition of loan losses and achieve greater convergence of practice. This work includes an active dialogue with the IASB and FASB through the Expert Advisory Panel and other forums. We believe that good progress is being made by moving towards an Expected Loss based approach to loan loss provisioning which removes the current constraints on early recognition under the incurred loss model.

Whilst we understand that both, the IASB and the BCBS, are fully supportive of an Expected Loss based model it is important to recognize that there are considerable practical hurdles for the implementation of such a provisioning model in an accounting context. Notably, the de-coupling of interest and credit components and the acceptance of an 'open pool' concept are important pre-requisites to a robust implementation of any future standard. Open pools are required as banks continuously extent new loans to customers and equally receive repayments on outstanding loans. In our judgment a continuous separation of old and new loans into cohorts over time (as required under the current IASB proposal) would for some banks lead to very significant technical challenges but for most to a complete inability to implement such standard at all.

We believe that a simplified provisioning model which requires timely recognition of losses identified on an individual loan basis as well as an appropriate amount of Expected Losses of up to 1 year for all loans held on a given reporting date would be a sound foundation for a future loan loss provisioning model. This basis should be complemented by additional charges taken for losses expected over the remaining lifetime of a bank's loan book, whereby any such forward looking loss estimates and changes thereto should be recorded over the life of the loan book.

Such a model would lead to earlier recognition of losses, allow for practical implementation, avoid negative allowances (which would be possible under the current IASB proposal) and allow banks to draw on allowances build over good times when the credit cycle turns.

Building buffers through capital conservation

Concept of capital buffers

The stated purpose of the capital buffers is to serve to moderate the otherwise procyclical nature of bank capital requirements.

We fundamentally disagree with the concept of capital buffers which include a mandatory restriction on distributions of any kind.

We believe that most market participants will assess bank capital irrespective of whether some portion is earmarked to a procyclical reserve or not. Thus, we see little value in establishing an explicit procyclical reserve

To establish a rigid buffer framework, with mandatory cutbacks in dividends or employee compensation, may in fact damage a bank's ability to raise capital, and exacerbate rather than diminish bank risk. In particular, these constraints could increase stock volatility, damage investor confidence and diminish the investor base. We also



believe any use of buffer reserves would be accompanied by unwelcome financial press, and could risk reputational damage.

Furthermore, this framework does not adequately incentivise management actions that may be taken to diminish risk exposure and increase capital stability, nor is any leeway given for longer term remediation measures, such as strategic divestments.

Within the ICAAP, regulators regularly review the capital adequacy for each bank individually, according to its specific circumstances. It would be a mistake to further constrain this process with additional restrictions which may not be suitable in every situation.

Counter-cyclical buffer addressing excessive credit growth

Extraordinary macroeconomic credit risks are reflected in increased countercyclical elements in the calculation of capital requirements (e.g. PDs, downturn LGDs, downward rating migration).

If that is not deemed sufficient, then it would be preferable to build an increase into the capital requirement. The approach proposed would result in double-counting with increased capital requirements while the minimum requirement is also raised.

In addition, counter-cyclical buffers, which are introduced when local regulators identify any potential for systemic stress, transform minimum capital ratios into moving targets. Forward looking capital planning and capital management would become impossible. The communication of capital adequacy to the public, to analysts and investors would become much more difficult. This would increase the risk of uninformed comment in the press and could result in unintended consequences.