Lufthansa

Response to the

- **Consultative Document „Strengthening the resilience of the banking sector“ of the Basel Committee on Banking Supervision**
- **The Commission Services Staff Working Document on “Possible further changes to the capital requirements directive”**

Based on the invitation to express our views on further possible changes to Directives 2006/48/EC and 2006/49/EC („The Capital Requirements Directive“, „CRD”) and the reform program of the Basel Committee we have thoroughly analyzed the proposals, their impact on our businesses and welcome the opportunity to share our position and the results of the impact assessments we conducted.

Deutsche Lufthansa AG is one of the world’s leading airlines and is an aviation group operating in five business segments strategically related to air traffic. Given our business set-up we have a natural exposure towards the foreign exchange, interest rates and commodity markets. Lufthansa is addressing these risks by hedging. Insofar the operation of derivatives provides an important contribution to our financial stability.

Given the nature of our business we have focused our input on the subjects related to counterparty risk and the enhancement of risk coverage in derivatives transactions. Regulatory changes to the current market framework will have an impact on our business model and the perspectives for future earnings, investments, growth and the creation of jobs.

I. General Remarks

As corporate end-user of derivatives we have raised our concerns on the legislative initiatives to strengthen the use of collateral agreements and central counterparty clearing from the very beginning of the political process. Today, almost 18 months after the culmination of the financial crisis and having access to more and more details of the developments in 2008, we can only reiterate our general warning: “Please be careful with any kind of collateralization”. Public is always talking about the “Financial Crisis”. It would be more appropriate to talk about the “Collateralization and Valuation Crisis”. These two elements produced dangerous procyclicality in the financial system. It was a vicious circle. Adverse mark-to-market changes forced to post additional margins, which forced the sale or transfer of assets causing new adverse mark-to-market changes and new collateral obligations. The proposed changes to the CRD and the Basel regime are governed by the idea of promoting collateralization in the OTC derivative markets. Insofar they are thought to complement the overall regulatory framework and political project presented in earlier occasions. We are still missing the argument. If safeguarding financial stability is the overall

goal, promoting collateralization is contra productive, regardless of being bilateral or channeled via central counterparties. Collateralization produces artificial and very volatile cash obligations and has severe procyclical side effects, “collateral damages” in the purest sense of these two words.

II. The proposed changes to the CRD

1. Capital Requirements for Derivatives

a. Due differentiation

The Staff Working Document discusses several ideas of how to handle derivatives and the potential exposure resulting from derivative transactions in view of capital requirements. The same discussion is held in the Consultative Document “Strengthening the resilience of the banking sector” issued by the Basel Committee on Banking Supervision. In both documents we are missing a due differentiation between Credit Default Swaps (CDS) on one side and derivatives having currencies, interest rates and commodities as underlying on the other side. We agree that there is a need to address the CDS market, particularly taking in consideration the inherent and systemic wrong-way risks of CDS transactions. Insofar we share the position of the Commission and the Basel Committee, that writing a CDS is economically equivalent to providing a guarantee. As a consequence we support regulatory action establishing or increasing capital requirements for CDS. However, different is our position on other derivatives, particularly those having currencies and commodities as underlying. These types of derivatives played no role in the Financial Crisis and functioned well and unimpressed by the turmoil’s. There is no empiric evidence, which suggest changes to the capital requirement regimes (CRD and Basel II) for currency, interest rates and commodity derivatives.

b. Measuring derivatives exposure

Despite our general doubts on a case for regulatory changes for derivatives having currencies, interest rates and commodities as underlying we are surprised about the proposed techniques to address the counterparty risks related to derivatives transactions. This holds particularly true for the idea of using a bond equivalent as a proxy for the credit valuation adjustment risk. The counterparty risk profile of a derivative transaction is anything but comparable with the lending situation. In a derivative transaction the counterparty risk is bilateral and not unilateral. The regulated counterparty subject to capital requirements could have a counterparty risk. However it could also well be that there is no exposure at all, because the transaction shows a negative mark-to-market for the regulated counterparty during the entire term of the contract. It is proposed that the notional of the bond shall be determined based on the exposure at default (EAD). This approach ignores several aspects and particularities of a derivatives transaction.

At first it presumes that the default materializes when the exposure (EAD) is at its maximum level. Unlike in the loan situation with a determined notional for the entire term in a derivative contract it is very unlikely that the default event and the (maximum) EAD happen at the same time. There is a random factor. This random factor has to be taken into consideration in order to adequately reflect the inherent risks and not overestimate them. We admit that the EAD determined based on back- and stress testing is already reflecting a likelihood momentum. Nevertheless there are two levels where likelihood plays a role. The EAD is computed or shall be computed based on the likelihood of a certain mark-to-market situation. The likelihood of a default is the second dimension, and insofar we have to be more precise: It is the likelihood of a default at the same time which matters. Applying mathematics to this problem would only suggest the application of a fraction of the notional value, given the low likelihood of the coincidence.

The proposed mechanism to calculate the capital requirements further ignores the typical overall risk profile of a derivative transaction. The financial industry usually acts as intermediary. For example for a swap on crude oil there is one counterparty selling the swap, usually a major oil company or a sovereign like Kuweit, the financial intermediary is buying and selling the swap to end-users, refineries or airlines. The application of the notional value concept would lead to a double counting of the EAD and result in a doubling of the capital requirements. The notional of the EAD would be considered on the buying and the selling side, even though the EAD on one side excludes the EAD on the other side. We are missing any fundamental logic for this approach and have to stress that this will lead to major cost burdens for the industry. Cost burdens which are not justified because the counterparty and the systemic risk patterns of non CDS derivatives transactions are overestimated by applying these inappropriate risk measurement techniques.

Under the bond equivalent approach it is further suggested that single-name credit default swap hedges shall be recognized to incentive for institutions to hedge the CVA risks. In general we agree to such recognition mechanism. However in this case it is a perfect example of how regulatory measures bring in additional risk momentum to the financial system by multiplying notional values. In the crude oil transaction example one single derivative transaction complex having a seller, a buyer and one financial institution as intermediary results in 2 OTC trades on the underlying crude oil and 2 artificially generated CDS trades to cover the CVA risk. This is only the first level. Consequently applying the regulatory proposals it is to expect that these CDS trades again will be subject to capital charges and will again bear the incentives for new CDS. In other words a 100 Mio US Dollar derivative transaction complex on crude oil can easily cause 200 to 500 Mio US Dollar of notional value in subsequent CDS transactions resulting only because unreasonable capital requirements apply. This will add risks to the financial system. Derivatives on currencies, interest rates and commodities played no role in the Financial Crisis. There is hence no reason to include them in the current revision of capital requirements. They should be expressly exempt.

c) Incentives to move OTC derivative contracts to CCP clearing

CCP clearing is based on the concept of exchanging collaterals. As already described above we have great reservations with regard to any kind of collateralization. It is important not to underestimate the liquidity risk and the procyclicality inherent to any form of collateralization. It is contradictory to promote CCP clearing on one side and express concerns about the procyclicality of accounting standards and the margining practices on the other side. The Lehman and AIG cases would have taken a better path without the vicious circles initiated by the margining and valuation practices in connection with their derivatives portfolios and the repurchase operations. Again: The Financial Crisis was mainly a "Collateralization and Valuation Crisis". It was the extreme market volatility and the short term asset deterioration which made the tax payer injections and guarantees necessary. Today we know that the Financial Crisis was heavily driven by market exaggerations. The market exaggeration itself wouldn't have been a problem; they resulted as a problem because of the collateralization and valuation set-up in the financial industry. Incentives to use CCP clearing for all derivatives transaction would extend this set-up to the real economy and result in a dangerous risk accelerator for the entire economy. Insofar it is wise to recall the price development of crude oil in 2008, it dropped from above 147 USD per barrel to below 40 USD. Imagine CCP clearing in place. CCP clearing would have caused hundreds of billions in variation margin, probably eliminating countless counterparties in a domino chain of defaults because the cash needed wasn't available with the further consequence of even more transaction to be closed out accelerating the price decline. CCP clearing sounds good in theory, in practice it bears severe risks for the financial system. There is no case for implementing regulatory incentives to move OTC derivative transactions to CCP clearing, at least not for non – financials.

CCP clearing may offer some advantages for derivative transactions between financial institutions. This results form the typical portfolio structure of financial institutions. Financial institutions are mostly active as intermediaries. They are "long" with one counterparty and "short" with another one. Central counterparty clearing could allow financial institutions to net their overall exposure and positions across the CCP system. This would generally and in absolute terms reduce the exposures in the market and provide transparency. In summary CCP clearing might be a solution for inter-banks transactions. It is no solution beyond this circle of market participants.

2. Wrong way risk

Given the variety of derivatives it is important to carefully differentiate the different risk characteristics of each product category. Some derivatives have specific wrong way risks. CDS portfolios having Monoliners as counterparty fall under this category. We support regulatory measures to limit wrong way risks, particularly in the CDS market. However wrong way risk should be no issue in the majority of derivative transactions entered for hedging

purposes by non-financials. Given the nature of a hedging transaction there is always a compensation mechanism due to the combination of hedging transaction and underlying business. Negative mark-to-markets in the hedge transaction are correlated with positive market values of the underlying business cash flow and the other way around. Taking this into consideration we would welcome a clarification in the regulatory framework expressly excluding hedging transactions from Pillar 1 capital charges based on specific wrong-way risks.

3. Multiplier for the asset value correlation for large financial institutions

The idea of applying a multiplier to the asset value correlation of exposures to regulated financial firms makes sense under the presumption that increased capital requirements for derivatives transaction contribute to financial stability. This may hold true for the CDS market. Beyond CDS derivatives we are still doubtful on the appropriateness of the proposed measures. However from a methodological perspective it cannot be the right answer to a problem to just raise the capital requirements, rather than addressing the roots for this higher correlation of exposures. One reason might be the wide use and need of CDS in the financial industry. Insofar we support the application of capital requirements. A second reason might also be the wide use of collateralization in the financial industry. This has not been duly analyzed yet. However we are already happy with the acknowledgement expressed in 163 of the Consultative Document of the Basel Committee confirming the position of corporate end-users. We have stressed from the very beginning of this regulatory debate, that the “presence of a margin agreement itself [is] a source of risk for the counterparty since it is a mechanism that can threaten its liquidity” (Page 46 of the Consultative Document). LTCM, Lehman, AIG and many others are the best examples that collateralization is not the way forward to strengthen the resilience of the financial markets. Taking this finding into consideration and in the interest of financial stability regulators should generally depart from the idea of promoting collateralizing and central counterparty clearing.

4. Reducing procyclicality

We welcome the initiative to reduce the procyclicality in the financial market set-up. Many procyclical predispositions base in legislative frameworks or accounting and valuation standards. In many cases it was the mandatory valuation/accounting principles and the mark-to-market concept, which led to the dramatic deterioration of assets, causing a domino chain of new problems. We fully support changes to this set-up which reduce the procyclicality in the system, this holds true for procyclical predispositions on the way up and on the way down. However we have concerns regarding the consistency of the regulatory proposals in view of this goal. We have already stressed the procyclicality of OTC clearing. There is another area of concern: The proposed idea of requiring capital for mark-to-market losses due to credit valuation adjustments. The Working Document and the Consultative Document explain that roughly two-thirds of counterparty credit losses were due to CVA losses and only one third were due to actual defaults. The presented regulatory answer and

proposal to this finding is the implementation of a capital charge for mark-to-market losses associated with deterioration in the creditworthiness of a counterparty. This is definitely the wrong answer. It is good that the current Basel II does not address such CVA risk, because it reduces procyclicalty. In 2008 we have experienced severe market exaggerations in the valuation of counterparty risks. Mark-to-markets of CDS portfolios only knew one direction. CDS levels went up and up. The proposed capital requirements in place would have caused additional stress for the financial system and destabilized even more financial institutions. Good regulation would shield financial institutions and balance sheets from the volatility and short term irrationality of markets. The idea of applying capital requirements on CVA risk is doing the opposite; it would expose balance sheets to volatility and market exaggerations. Unfortunately this is a general momentum and problem we perceive in the political discussion. The initiatives to extend the collateralization practice or even force OTC transactions to central clearing are heading in the same direction. We still have difficulties in understanding why? In the interest of financial stability it would be appropriate to limit these practices. This is our lesson from the Financial Crisis. LTCM in 1998, Lehman and AIG support our case. Unfortunately regulators are heading into the other direction increasing the exposure of market participants to market risks.

III. Impact of regulatory proposals

We have conducted an impact assessment of the regulatory proposals. Without going into details, as a general remark we can record that the proposed changes will turn out in severe cost burdens for risk management operations in the non-financial-sector. The impacts vary in accordance to the applied methodology to measure the CVA risk.

The bond-equivalent approach could increase the capital requirements by up to 350 % in a regular FX hedging transaction. The FX transaction is just an example; the same or similar outcomes are true for other underlying. The increase of capital requirements if the VaR approach is applied in contrast seems to be reasonable; however our analysis has not been finalized yet and some regulatory parameters and details for conducting the assessments haven’t been defined yet.

One major disadvantage of the VaR approach is that only few banks will be in a position to operate the VaR model in the required sophisticated manner. This could negatively influence competition among banks, because the high capital charges for those not having the means for the VaR methodology would price them out of the market. Already today we perceive a lack of competition in certain market segments, particularly the commodities markets. This leads to concentration and unjustified high margins. In view of the overall regulatory goal: Financial stability, protecting the market balance and avoiding unwelcome concentrations should also be considered. It should be at least avoided that regulatory measures accelerate the concentration process. The extreme bandwidth in capital requirement in dependence of the methodology applied would cause this unwelcome side effect. We assume that this

bandwidth results because the capital requirements under the bond equivalent approach are way too high.

Our analyses show that in principle the VaR approach could serve as a very good instrument to assess CVA risk; however it should not be ignored that this approach might have some unwanted procyclical side effects. As of today this is only a first assumption. It is too early to assume a firm position. Regulatory details are not yet developed.

Our impact assessments have further shown that the limited degree of differentiation among the different products and the purposes they are applied for leads to a situation that derivatives are subject to capital charges regardless of the risk profile. In consequence for some categories of derivatives risks are over- and for other categories risks are underestimated. This holds particularly true in view of those derivative applied for risk management purposes. Under the proposed capital requirements they are subject to the same rules as all other derivatives. The contrary should be the case. In our opinion there should be no penalization of risk management activities. Corporations should be encouraged to operate risk management transactions. It is in the interest of financial stability, investment activity, creation of jobs and securing future prosperity in Europe.

In this context we also want to express our disagreement with the “common sense” in the public opinion and political discussion that we as non-financial users of derivatives have externalized costs. This might be true for the CDS market and general credit markets, which however plays no or only a minor rule for the risk management derivatives of corporate end-users. It is not true for derivatives having currencies, interest rates and commodities as underlying. The counterparty risk profile of a derivative transaction is bilateral, hence in the same degree counterparties have borne their credit exposure towards us, we have borne the risk of their default. There was and is no room for externalization and this is not only a theoretical assumption. With the Lehman failure we had a real default case with bad debt losses and considerable write downs for many market participants.

Deutsche Lufthansa AG

Executive Summary

- We support the revision of capital requirements for credit default swaps, the financial system needs a comprehensive framework for CDS related risks, loopholes are to be eliminated

- We have major concerns with regard to the application of capital requirements for derivatives having currencies, interest rates and commodities as underlying. These financial instruments played no role in the Financial Crisis, and their uses give no rise to systemic risk justifying the proposed changes

- We do not consider there are any proven and material advantages from mandating central clearing for transactions involving the overwhelming majority of non-financial end users that use derivatives solely to mitigate their underlying business risk

- The intention to use capital requirements as an incentive to move end user transactions into central clearing brings no incremental benefits to financial stability, causes substantial cost burdens and is wrong in principal