Deutsche Bank

1 October 2010

Deutsche Bank AG
Winchester House
1 Great Winchester Street
London EC2N 2DB

Tel: +44 20 7545 8000

Direct Tel +44 20 7545 7471
Direct Fax +44 20 7547 4179

Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland

Dear Sirs,

Response to BCBS Consultative Document 174: Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability

Taken as part of the overall approach to strengthening the resilience of the banking sector, Deutsche Bank (DB) welcomes the opportunity to feed into the BCBS consideration of ways to ensure the loss-absorbency of regulatory capital. This is one of a number of approaches intended to minimise the likelihood of tax-payers having to provide support to banks and we fully support this objective.

Our analysis has identified a number of obstacles that are logistical or legal in nature. However, a consistent theme throughout is the impact on investor appetite. This obviously has significant implications for the ability of some or all banks to issue such instruments and on funding costs. These concerns could be exacerbated by the significant and substantial amount of capital-raising across the market anticipated in response to 'Basel 3'. We note that the extremely important issue of implementation has not been considered in the paper and must emphasise that the transition has be managed carefully if this type of regime is to be adopted. (We recognise that this is a likely consequence of the consultation being issued ahead of the 12 September press release.)

Options considered by the BCBS: This consultation focuses narrowly on the 'entry criteria' for regulatory capital and at a high level considers three options for ensuring that *any* instruments used for regulatory capital purposes must be capable of absorbing losses if a bank cannot support itself privately. Regarding Option 1, we agree with the conclusion and support the continuation of work to achieve the aim of ensuring that losses are covered by <u>all</u> capital instruments. We also agree with the conclusion regarding Option 2 and the rationale. This highlights the difficulty in identifying or categorising systemically important banks and thus supports our view that any additional requirements under consideration could only be applied on a firm-by-firm basis.

Harmonisation: There is no doubting the importance of global standards for capital and liquidity requirements and accordingly the need for maximum harmonisation. Although we recognise that the current diverse legal frameworks make it difficult to achieve in the short-term, steps should be taken to achieve consistency. Harmonisation is particularly important in relation to triggers and the conversion/write-off requirements to be applied, and in order to minimise complexity for cross-border groups.

Applicability: We note that the proposal applies to "all non-common Tier 1 instruments and Tier 2 instruments at internationally active banks" although this term is not defined. While this is familiar language in a Basel context, inconsistent implementation will result in an uneven playing field and promote a two-tier market structure. This could result in a restriction of the evolution of business models and on cross-border consolidation. It fails to ensure regulatory capital loss absorbency for non-viable non-internationally active banks – some of which have been recipients of government support.

Triggers: The type and transparency of the trigger are vitally important aspects from both an issuer and investor perspective. We accept that authorities should be able to make the decision, although this process is inevitably somewhat opaque and as such could be problematic for investors. A tension exists between authorities wishing to retain as much discretion as possible and investors looking for a basis for determining (to the extent they can) the likelihood of the trigger being used.

As mentioned above, the proposal does not explicitly preclude exclude additional triggers such as conversion at management discretion. Accordingly this may be an area where implementation may vary by jurisdiction. We note that the BCBS does not support the concept of 'automatic triggers', even though they would be more objective and transparent (e.g. breach of minimum capital requirements or other pre-agreed measure). We believe there should be no restriction on including additional triggers. While the debate continues about the merits and mechanics, ultimately investor appetite will be a decisive factor.

Pre-existing authorisation: It is right to require that authorisations are in place to ensure that conversion into common shares can be achieved. In practice there will be difficulties in meeting this requirement. In Europe the Second Company Law Directive requires that restrictions apply to pre-authorisation, such that the issuance of new shares excluding subscription rights is limited to a set percentage of shares already issued. This results in severe constraints with regards to (i) conversion of instruments in common shares and (ii) providing compensation (after write down) in common shares. If all capital authorisation is already designated for issuing Tier 1/Tier 2 notes, no further capital authorisation for 'traditional' ex-rights capital raisings are available. Also, the pre-authorisation remains valid only for a limited period and will need to be re-approved by shareholders – they may not agree to this depending on the prevailing circumstances. Accordingly, instruments could include terms which recognise that conversion is not necessarily a right, although a possibility. Again, this uncertainty would be a potential problem for investors.

Partial write-off: The proposal requires permanent write-off, however we believe that there are merits in a partial write-off (or a 'waterfall' conversion to reflect the seniority of the instruments) and a subsequent write-up. We urge the BCBS to reconsider both these options, as well as exploring the possibility of providing compensation in some form other than common shares. The point above regarding pre-authorisation is also relevant here.

Groups: In relation to the group/subsidiary treatment, conceptually the proposal is logical for cross-border groups. However, this will be complex to manage, particularly as requirements will vary by jurisdiction. The conversion of regulatory instruments issued by a subsidiary would change the local shareholder ownership and create new shareholders. This could have repercussions for the governance at a holding company level as well as the subsidiary, with practical implications. It is also unclear whether a trigger event at group level would automatically result in a write-down/conversion at subsidiary level.

Cost to banks: The funding cost for banks will increase significantly as result of limited investor appetite. We disagree with the assumptions about there being less differentiation in funding costs between smaller banks in comparison to larger banks which seems to be based on the premise that the market will accept that state support will not be forthcoming for large banks on account of having issued this form of capital. The assumption that authorities would not use the trigger for smaller firms reintroduces the type of uncertainty that led to the rejection of option 2. Again, we support a level playing field and it is overly simplistic to ignore the fact that some small banks have also been bailed-out by governments during the crisis.

Mechanics of conversion: The mechanics of conversion remain unclear as the paper provides no specific detail about how the amount of the write-down will be determined. It could be envisaged that this would be agreed at the time of issuance, but if this is the case

would it be subject to regulatory approval or included in the terms subject to investor appetite? Investors may challenge the decision taken at the point of non-viability.

Investor appetite: This is a hugely significant issue and it is difficult to predict with any certainty whether there would be a deep enough market for these instruments. Drawing upon our discussions with investors, it is possible to identify some general conclusions although there is still notable inconsistency.

- Potential investors in these instruments will (and should) expect the credit hierarchy to be maintained. Therefore it is reasonable to expect to receive compensation (by delivery of shares or in another form), rather than the write-down resulting in a better outcome for equity holders. Investors may also consider the permanent write-down feature and rejection of the potential for 'write-up' as too great a limiting factor on the potential upside potential, although conversion is preferable so as to avoid introducing contingent liability. The absolute nature of a 100% write down as opposed to a partial write-down may also affect investor appetite.

- The discretionary trigger event makes it difficult to compare these instruments with traditional convertible debt and so tap this investor base. This will limit the ability of banks to replace existing Tier 1 and Tier 2 notes with these securities, particularly as they seek to meet the new Basel 3 requirements.

- Other difficulties include assessing the risk and consequently price of the instruments, and provision of ratings. There appears to be disagreement amongst ratings agencies as to whether it is possible to rate the instruments, thus highlighting the uncertainty regarding the proposal. Nonetheless, we expect that over time credit rating agencies will rate the instruments. It is important for the success of the concept that these instruments are rated as investment grade and included in relevant indices.

- The investor base may be limited due to the features of the securities. Current mandates and other restrictions on investors (such as those applying to insurance companies and pension funds) may mean they are unable to invest in instruments which are unrated, with permanent write-down features and/or where the trigger event is not transparent. The result may be to skew the investor base towards the less regulated part of the financial industry, such as hedge funds and private equity funds, although it is reasonable to expect that mandates will be adjusted to accommodate these instruments over time.

- As well as potential difficulties in valuing these instruments, they will also be impossible to hedge.

We believe further dialogue is necessary to develop these proposals, in conjunction with possible approaches to contingent capital and 'bail-in', and look forward to continuing to engage with you on these issues in future.

Yours sincerely

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