Deutsche Bank

Basel Committee on Banking Supervision
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Dear Sir/Madam,

DB Response to Basel Committee consultative document on application of own credit risk adjustments to derivatives

Deutsche Bank (DB) welcomes the opportunity to comment on the Basel Committee's consultation on the application of own credit risk adjustments to derivatives.

The Basel Committee has taken the position that Debit Valuation Adjustment (DVA) may be recognised as regulatory capital for debt liabilities at the time of issue, but that further gains and losses arising from changes in an institution's own credit risk should be excluded to avoid an increase in a specific bank's capital when its own creditworthiness deteriorates.

The Committee is now considering how to extend this principle to derivatives. Having set out the limited range of options considered, the short paper concludes that there is no feasible mechanism for calculation which is sufficiently straightforward and prudent, and thus recommends that all DVA be disallowed as regulatory capital.

DB believes that the above approach is inconsistent with the economics of trading uncollateralised derivatives and their fair value, and would not always achieve the Committee's intended outcome as explained below. Moreover, if imposed in its current form, it could lead to severe distortions in the market, i.e. by raising transaction costs and reducing liquidity. The counterparties particularly affected by this would likely be supra-nationals and Sovereigns. For example, we estimate that this additional cost to the counterparty (which the bank would have to pass on, due to increased capital demands) would amount to 20-30 basis points in the case of a 10 year cross-currency swap. This would widen bid-offer spreads and effectively close the market to many current counterparties.

However we do recognise the Basel Committee's concern that financial institutions should not benefit from the worsening of their own credit but believe that there is a more appropriate solution available which would address this whilst remaining robust in an economic sense. One such option would be to recognise a component of the DVA that would reflect typical credit risk among market participants and is inherent in normal trading activity (but, for a very high quality institution, not to exceed own credit). Further consideration should therefore be given to ensuring that the approach is compatible with the market environment and the requirements of fair value accounting.

In this regard we believe it is relevant to consider both the asset and liability management action undertaken by many institutions and how fair value is reached. For example, DB's portfolio contains both uncollateralised derivative assets and liabilities which are valued and

risk managed on a net basis. This means that counterparty credit, own credit and term-funding are considered together in the pricing and risk management of these trade types at inception and once they form part of the consolidated risk portfolio. There is therefore an interaction between the various components: the counterparty risk affecting assets (i.e. CVA), own credit affecting liabilities (i.e. DVA) and term funding affecting both assets and liabilities. DB considers that best way to manage its funding requirements and credit risk is on this netted basis and so derecognising DVA from capital would result in a less effective risk management strategy, not achieve fair value (without a charge passed on to the client) and would therefore be uneconomic.

To the Committee's concern and for further consideration:

- Since DVA is an own credit adjustment to liabilities it can lead to benefit as the bank's credit spread widens. Whilst true, it is possible that DVA could also grow as the exposure increases with credit spreads remaining constant or decreasing. It would seem wrong to apply the proposed approach in that case, particularly as this is inconsistent with the Committee's objectives.
- Managing term funding on a net asset and liability basis means that the widening of the funding spread is not always a benefit; on the asset side it would be a cost. The funding risk can therefore be netted/hedged. Any component of this related to DVA should not be treated under the Committee's current proposal.

We would encourage the Basel Committee to reconsider the proposal and consider alternative approaches such as those described above. We would be pleased to discuss this in more detail to support your work on this issue.

Yours sincerely,

Andrew Procter
Global Head of Government and Regulatory Affairs