Deutsche Bank

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Mr. Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
Basel
Switzerland

baselcommittee@bis.org

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

Tel: +44 20 7545 8000

Direct Tel +44 20 7545 1903
Direct Fax +44 20 7547 4179

Dear Mr. Byres,

Deutsche Bank's response to the Basel Committee on Banking Supervision ("the Committee") on recognising the cost of credit protection purchased

Deutsche Bank (DB) welcomes the opportunity to comment on the Committee's proposed framework on recognising the cost of credit protection purchased. We are supportive of the Committee's commitment to ensure that the cost and the benefit of purchased credit protection are appropriately recognised in regulatory capital. It is crucial that the final proposal does not conflate true balance sheet risk transfer techniques with true risk transfer with 'regulatory arbitrage' trades. As currently stated, the proposed provisions may result in banks being discouraged from applying techniques which distribute risk in an equitable and economical manner to third-parties. We believe that this unintended negative outcome should be avoided.

DB does not believe that the recognised cost of purchased credit protection for a transaction should simply be based on the absolute cost of the protection. Our view is that such an approach would disregard legitimate risk mitigants techniques and as a result overvalue the riskiness of the exposure. Instead, we suggest that the present value (PV) of the spread income be included in the calculation of credit protection costs. It would be unreasonable to deduct the cost of protection to the extent that it is covered by income produced by a position that is being hedged, as this takes into account only one side of the equation.

In our response we provide a number of suggestions for those areas that should be excluded altogether from the scope of this proposal including trade finance, counterparties that receive zero percent risk weighting under the Credit Risk Standardised Approach and all exposures hedged by fair value credit default swaps (CDS). We also believe that it is important to clarify that hedges of assets in the trading book and credit valuation adjustment (CVA) hedges should be out of the scope of this proposal.

Finally, in order to allow for an orderly and smooth transition, we recommend that a grandfathering clause be provided for credit protection bought prior to the implementation date of the final framework.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and Regulatory Affairs

ANNEX I – Deutsche Bank comments on the proposed framework

Incentives & impact

DB recognises the Committee's concern that there could potentially be capital arbitrage opportunities when purchasing credit protection and that addressing this issue will further strengthen the credit risk mitigation framework. However, the broader impact of introducing the upfront deduction of the protection cost should be carefully considered. As currently proposed, the rules could inadvertently discourage institutions from undertaking a number of reasonable and desirable risk management transactions.

The proposed 150% risk-weight cut-off will have the direct consequence of discouraging banks from hedging exposures that have reached that risk weight. This will in practice discourage banks from prudent risk management (including dynamic hedging of higher risk transactions) and, in relative terms, incentivise them to hedge less risky exposures. It should also be considered that premia for protection are determined by a number of factors, such as the global credit market environment and macro-economic factors, which will vary over the economic cycle and reach high levels at times of global stress[1]. It would create a counter-cyclical incentive for banks to hedge risky exposures in benign credit environments and discourage them from hedging risky exposures at times of global credit market stress.

It is important to recognise that the purchase of credit protection can be an effective risk management technique. For example, the exposure arising from a set of derivative trades against a counterparty varies with changes in the valuation of those trades, which in turn are driven by underlying market rate changes (e.g. FX rates and interest rates). A bank has no control over those underlying rates and therefore no direct control over the magnitude of the exposure arising from derivative counterparty risk. This means that large changes in the underlying market rates may lead to high exposure to a single counterparty. It is a customary and prudent risk management technique to hedge such concentration of risk with Credit Default Swaps (CDS), Credit Linked Notes (CLN) or other securitisation methods. Banks should not be discouraged from doing so.

We do not believe that a bank should be discouraged from buying protection on high yielding exposures because of the asymmetry of capital treatment between the cost of protection and the income of the exposure. This disincentive would be more evident for high premium and hence more risky exposures.

In an effort to arrive at a solution that prevents uneconomical capital arbitrage transactions, we urge the Committee to ensure that no burden is placed on hedging transactions that are fair and legitimate, simply because they carry a high premium. The cost of purchased credit protection for a transaction should not be based on the absolute cost of the protection, which can be high as a legitimate reflection of the riskiness of the exposure. We suggest that the calculation should include the present value (PV) of the spread income in the calculation of credit protection costs.

We recommend that the cost of purchased credit protection for a transaction should not simply be based on the absolute cost of the protection, which can be high as a legitimate reflection of the riskiness of the exposure, but should instead include the PV of the spread income in the calculation of credit protection costs

It would be unreasonable to deduct the cost of protection to the extent that it is covered by income produced by a position that is being hedged given that this approach is looking at only one side of the equation.

[1] There are also examples specific to a single exposure, such as the credit worthiness of such exposure, for the premium to be significant and reflective of the actual risk. This is particularly true of low rating/high risk-weight exposures.

It should also be noted that the current regulatory framework does not permit banks to account for a position's future earnings until the earnings are accrued into income. The consultation's provisions would require consideration of the expense to protect such position against loss: the resulting earnings, which in most cases continue to be paid until such time as the debt repays or there is a default and the protection is realised, should be incorporated for consistency.

Where spread income would exceed credit protection costs, the PV of material credit protection should be taken as zero. If this were not the case, an institution would be discouraged from hedging its position to lock in a stream of profits or minimise loss.

As an extension to the prior point, in cases where a bank undertakes a new transaction or a series of new transactions where one or more legs of the transaction is a hedge, then the cost of protection should be measured against the profitability of the trade as a whole when considering if there should be a negative spread NPV taken to capital. In our opinion that approach should be taken as long as a positive net spread is reached. If it is not, the series of transactions should be decomposed into individual trades.

Scoping exercise

We recommend that a grandfathering clause apply to credit protection bought prior to the implementation date of the final framework.

While it could be argued that higher risk weights would generally tend to correlate with higher premia, the proposed 150% risk weight threshold does not appear to be based upon empirical evidence. We are concerned that, the current threshold proposal does not sufficiently take into account the impact of the Committee's *Proposed Revisions to the Basel Securitisation Framework*[2], which would greatly increase risk weights on higher-quality securitisation tranches, and so could result in applying the proposed rule to many more transactions with relatively low credit risk.

The consultation proposes modifying the credit risk mitigation framework by adding provisions to paragraph 189 of the Basel 2 framework that is applicable to counterparty credit risk exposure in the Credit Risk Standardized Approach. Cross references in the Basel 2 framework make it clear that the requirement is also applicable in the Foundation and Advanced IRB approach. For clarity we suggest adding a paragraph that explicitly states that these requirements do not apply for CDS hedges in the trading book and Credit Valuation Adjustment (CVA) hedges as well as for the additional cases described below.

We also propose that all exposures guaranteed by a counterparty receiving a zero percent risk weight under the Credit Risk Standardised Approach rules should be exempt from the scope of the consultation. This is consistent with the logic that a direct exposure to such counterparties would not generate a risk weighting. Therefore, the guaranteed exposure should be treated identically (even where the premium is not fully recognised in the Common Equity Tier 1 (CET1)).

An illustrative example of this is where the exposure is guaranteed by a government's export credit insurance. In that instance, a bank grants a loan to an export firm and receives export credit insurance where the performance is guaranteed by a central government. The premia paid for this export credit insurance are generally passed on to the export firm and the loan is often only granted if the exposure is guaranteed by a central government. If transactions of this type are not excluded from the scope of this proposal, these loans may no longer be granted which would in turn negatively impact the real economy.

We believe that trade finance transactions with guarantees should also be excluded. They are normally small in value and short in duration and thus do not appear to match the profile of

[2] Published in March 2013, http://www.bis.org/publ/bcbs236.pdf

transactions that could raise concern. Consistent with the BCBS' paper *Treatment of trade finance under the Basel capital framework*[3] which introduced beneficial rules for trade finance transactions to foster the import of goods for low income countries, we think it is important to exclude this type of the instrument from the scope of this framework. If these transactions are not excluded, the availability of these transactions may considerably decrease leading to an increased cost to commerce. As a consequence, and given the current fragility of economic growth, the wider economy could be negatively impacted.

Further, we believe that hedges of counterparty credit risk arising from trading, as well as banking book, positions where both the assets and liabilities are marked-to-market, should be exempted from the scope of the current proposal. This is because movements in the valuation of these positions are already recognised in earnings or otherwise recognised in CET1.

Similarly, all exposures hedged by a fair-valued CDS should be exempted from the scope of this proposal, as implicitly (via the market value of the protection instrument) the premium paid by the protection buyer is already reflected in the market value and thus has effectively been recognised in CET1.

With regard to banking book transactions, where a hedge is purchased in contemplation of a new transaction (referring to fresh origination activity, as opposed to a restructure of an existing asset / pool), such hedging activity should be exempted where it can be demonstrated that the transaction results in a positive profit and loss (P&L) and the economic (cost) of the hedge are considered as a part of a new trade structure in its entirety. It should not, in our opinion, be looked at on a standalone basis.

DB respectfully suggests that the management of the relationship banking loan portfolios be excluded from the scope of the proposal. Relationship banking loan portfolio managers provide a vital role, managing risks by actively controlling concentrations, creating capacity for new business through risk distribution, reducing loan losses whilst preserving valuable client relationships and reducing risk via synthetic collateralised loan obligations.

Securitisation (particularly synthetic) is one hedging method employed by relationship banking loan portfolio managers, which has long been recognised as a risk mitigation technique. Securitisation enables institutions to effectively distribute risk without negatively impacting client relationships, while making additional credit available to their customers and increasing the bank's ability to lend. "Bank balance sheet" synthetic securitisation portfolios typically comprise newly originated commitments to large multinational corporate borrowers. These commitments play an important role in the banking and corporate business models, as they provide corporations an inexpensive source of liquidity for various purposes. Additionally, they consume a relatively low level of risk weighted assets and receive de minimis fee and spread income. Therefore the cost of such securitizations outweighs the income generated by its reference portfolio. Regulation that includes penalties for hedging would be significantly disruptive to the investment grade corporate loan market, and would likely result in significantly higher cost and less liquidity for borrowers. Banks would be strongly disincentivised from holding and hedging large positions, forcing borrowers to alternative lenders who cannot efficiently issue revolving credit facilities. Therefore, for all of the reasons outlined above, it is imperative, to ensure that securitisation, as a risk mitigation tool for relationship lending commitments, be preserved as it has proven to be an effective tool for hedging.

While it is understandable that the Basel Committee may want to restrict certain characteristics in bank balance sheet transactions (such as upfront payments, guaranteed coupons and rebates), it is crucial that the proposal does not associate true balance sheet risk transfer techniques - such as effective securitisation with true risk transfer - with 'regulatory arbitrage' trades. Doing so could

[3] Published in October 2011, http://www.bis.org/publ/bcbs205.pdf

inhibit bank portfolio managers from maintaining the safety and soundness of their respective financial institutions. Restricting banks' ability to hedge through effective securitisation could inhibit future economic growth, as financial institutions would be hesitant to use their balance sheet for unhedged commitments to corporates which generate very little income.

If these transactions were captured, the increasing cost for regulatory capital would have an impact on the volume of the business going forward and would result in an increased cost of this product, and therefore an increased cost to lend.

Retained position for the assessment of the significant risk transfer

According to the current proposal, the PV of the premia receives a risk weight of 1250% and should be deemed as a retained position for the assessment of the significant risk transfer (SRT). We propose that the PV of the premia should be calculated using the 'risky' discount rate instead of a risk-free discount rate. A credit protection premium generally reflects all risks (expected and unexpected) of the protected position as the premium exceeds the expected loss amount of the protected tranche. In jurisdictions where mechanistic/quantitative tests are used to assess SRT, these tests have to be adjusted covering any new potential retained position from the premium. It should also be taken into account that the volume of this position might change over the lifetime of the transaction. As a consequence, further harmonisation standards of the SRT assessment are required to achieve a level playing field. If the present value of the premia is deemed as a retained position for the SRT assessment, then the present value should also be considered as a retained position for the retention requirement of 5% of the material net economic interest in those jurisdictions in which this retention requirement applies.