Please note that the comments expressed herein are solely my personal views

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
www.bis.org

Chris Barnard
Germany

05 January 2012

Your Ref: Comment letter on Consultative Document
- Application of own credit risk adjustments to derivatives

Dear Sir.

Thank you for giving us the opportunity to comment on your consultative document on Application of own credit risk adjustments to derivatives.

Basel III aims to ensure that a deterioration in a bank's own creditworthiness (increase in own credit risk) does not at the same time lead to an increase in its common equity as a result of a reduction in the value of the bank's liabilities. Such a result is counterintuitive, imprudent and "...raises significant supervisory concerns"[1]. This result has been observed in many banks' recent quarterly reporting (see "Fairyland value accounting", Financial Times, 23 October 2011[2]), where up to 80% of banks' reported quarterly net profits resulted from falls in their own credit standing. This is counterintuitive, imprudent and unrealistic.

Paragraph 75 of the Basel III rules requires banks to "[d]erecognise in the calculation of Common Equity Tier 1 (CET1), all unrealised gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk." You note in the Executive Summary that the application of paragraph 75 to derivatives is not straightforward. I agree with this. In response, your proposed approach is full deduction of the debt valuation adjustment (DVA) in the calculation of CET1. I fully agree that this approach is generally more conservative than under paragraph 75, which only requires derecognition of changes in the DVA, but it is more simple, transparent, credible and reasonable than either of the alternative approaches that you have considered, and which I will briefly discuss below.

[1] See http://www.bis.org/press/p040608.htm, 8 June 2004.
[2] Available at http://www.ft.com/intl/cms/s/3/4211f932-fbd4-11e0-9283-00144feab49a.html#axzz1iaSSfxzT

Alternative (a) Recognition of initial DVA assuming a linear decay: this alternative approach is completely inappropriate, as it does not realistically represent the market evolution and actual credit risk position of the bank post-inception. It is akin to a planned margin approach, which has no place in a realistic, timely and market-consistent framework.

Alternative (b) Derecognition of DVA changes due to the bank's own creditworthiness: this approach is more complex than the proposed approach, but it is a theoretically sound and reasonable approach nonetheless. As a minimum, I would recommend that you give more consideration to the details of the allocation model used for allocating the netting set DVA to individual trades, for completeness.

Alternative (c) Adjustment based on liquidation claim and balance sheet value: whilst this is conceptually sound, currently most banks cannot accurately and objectively determine the close-out value of derivatives in order to sufficiently and completely apply this approach.

Yours faithfully

C.R. Barnard

Chris Barnard