



EU Transparency Register ID Number 271912611231-56

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06 July 2016

Consultative document on revisions to the Basel III leverage ratio framework

Dear Mr Coen,

Deutsche Bank is grateful for the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) consultation on revisions to the Basel III Leverage Ratio framework. We welcome the BCBS decision to update the exposure measure calculation, and to do so in an open and consultative manner.

The Leverage Ratio has become the binding constraint for a large number of banks. Therefore it is even more important that the ratio be designed and calibrated such that it maintains incentives for good risk management and does not adversely impact the ability of banks to support the economic activity. In this context we strongly support points made in the consultation response submitted by the Joint Trade Associations (IIF, GFMA and ISDA). In addition to the points raised there, we provide more detailed comments in the Annex to this letter. In summary there are five key areas that the BCBS should clarify when finalising the framework:

- Any higher ratio for Global Systemically Important Banks should be applied through a buffer with which automatic triggers are not associated;
- Pending settlements should be netted for purposes of calculating leverage exposure. This ensures a consistent treatment that accurately reflects actual leverage and avoids unnecessary volatility;
- While Credit Conversion Factors should be consistent across the prudential framework, those proposed in the Standardised Approach to Credit Risk should be recalibrated to reflect historical draw data. At current levels they are disproportionately onerous and will negatively impact important services such as credit lines, trade finance, securitisation and cash liquidity management;
- An offset for segregated initial margin should be incorporated into the Standardised Approach for Counterparty Credit Risk. Without this offset, banks will struggle to offer clearing services at economic prices. This offset would help banks to provide the level of



clearing services needed to lower systemic risk in derivatives markets and to meet the G20 mandate to move a greater number of over-the-counter derivatives into the cleared space;

- Notional cash pooling arrangements not to be treated on a gross basis if the balance arising from them would be recognised as a single unit of account in any major global banking jurisdiction.

Finally, although not part of this consultation, we reiterate our view that central bank cash deposits should not be included in the exposure measure for the leverage ratio. We believe that a specific exclusion for cash balances at central banks is necessary to accommodate flows of new deposits to firms perceived as strong in times of stress. We note that the Bank of England's Financial Policy Committee has recently published a report¹ covering this topic.

We hope that these comments will be helpful in the finalisation of the rules on the leverage ratio and we would be happy to discuss any of the topics covered here in more detail.

Yours Sincerely,

A handwritten signature in black ink, appearing to read 'MH', written over a horizontal line.

Matt Holmes
Head of Group Regulatory Policy

¹ <http://www.bankofengland.co.uk/publications/Documents/fsr/2016/fsrjul16.pdf>



Annex 1:

Additional requirements for Global Systemically Important Banks (G-SIBs)

DB recognises the need for an additional leverage ratio buffer requirement for G-SIBs, reflecting the additional risk based G-SIB buffer requirement.

To support the orderly functioning of bank capital and debt markets it is necessary that such an additional requirement take the form of a buffer which can be utilised without triggering automatic consequences, such as restrictions on capital distributions. Introducing automatic leverage-based triggers alongside RWA-based triggers would introduce unnecessary complexity, and risk considerable uncertainty particularly in times of stress when there may be some volatility in the leverage exposure measure.

DB considers that the calibration and composition of leverage G-SIB buffers should reflect those of the risk-based G-SIB buffers. As such, leverage G-SIB buffers should be scaled at 35% of risk-based G-SIB buffers, reflecting that the backstop minimum leverage requirement is scaled at 35% of overall Tier 1 requirements applicable to all banks. Moreover, it should comprise CET1 only. This will ensure that it can be used fully to absorb losses without requiring any conversion to CET1 or write down of AT1 instruments.

Treatment of pending settlements

We welcome the BCBS decision to consult on the best way to align global rules on the treatment of 'pending settlements.' The divergent accounting treatment of pending settlements globally has created the possibility of an unlevel playing field, as well as making leverage ratios less meaningfully comparable across global peers. In selecting between Option A and Option B, we would support Option B, however, we agree with the view expressed in Institute of International Finance (IIF) response to this consultation, that some modifications to Option B are needed.

The problem with Option A is that the grossing-up of pending settlements creates artificial leverage and increases volatility. The mechanism creating artificial leverage is as follows: Banks purchasing securities where the security is recorded on the balance sheet at trade date with no respective reduction in cash on hand (instead, a corresponding pending settlement liability is recorded in the same amount). This balance sheet representation reflects a double count of the security and cash on hand at trade date, which only reverses at settlement date when the cash asset and the corresponding pending settlement liability are eliminated. The balance sheet representation between trade and settlement date is artificial in the sense that it gives an impossible result, i.e. the bank will either physically hold the cash or the security purchased but never actually hold both simultaneously. Banks with an active trading business have significant amounts of unsettled purchase and sale transactions on any given day, so that the artificial balance sheet increase between trade and settlement date leads to a permanent uplift of their balance sheets.

Option B results in banks recognising the purchases and sales of assets on the trade date, but offsetting the cash receivables for sales of assets by the cash payable for the purchase of assets. At the point of settlement this artificial inflation goes away, leaving only the actual balance sheet consumption to be factored into the leverage ratio calculation. We do, however, agree with the IIF response which states that two of the three conditions the BCBS attaches to permitting the netting approach should be eliminated.



There is no reason to limit this fundamentally more accurate and appropriate pending settlements treatment to securities where the bank is a market maker. It seems illogical to limit the accuracy of the exposure measure calculation in this way. The artificial leverage created by grossing up pending settlements applies to all securities, and should be eliminated in all cases. Additionally, the BCBS Net Stable Funding Ratio (NSFR) already removes pending settlements in a manner similar to Option B and likewise, it provides an initial margin (IM) off-set for client clearing.

Similarly, there is no reason to only limit netting to trading book exposures. This not only adds significant complexity to what is intended to be a simple measure, but again offers no benefit in terms of capturing or limiting leverage.

Finally, we would note that this change would increase consistency across the BCBS workbook by more closely aligning the calculation methodology with the Net Stable Funding Ratio².

Credit Conversion Factors

For the sake of consistency and the simplicity of the prudential regulatory framework we agree that the Credit Conversion Factors (CCFs) should be aligned between the Credit Risk Standardised Approach (CRSA) and the Leverage Ratio. However, the CCFs are currently under review in the CRSA, and we believe that they need significant revisiting in that context before they should be used in the leverage ratio.

We do not find that the proposed CCFs accurately reflect the probability of their being drawn down. This is particularly the case with the proposed 50-75% CCFs for Commitments (except retail unconditionally cancellable lines) and 100% for securitisation. These inflated SACR CCFs will significantly enlarge bank balance sheets for Leverage Ratio purposes. As a result, to maintain a similar level of return on assets, banks would have to increase customers' interest rates and to collect fees for accommodated but unused commitments, which currently is not the case.

We follow the BCBS logic in applying preferential rates for unconditionally cancellable commitments, but we do not see why this only applies to retail commitments. The same level of protection applies for non-retail unconditionally cancellable commitments. In our view these should receive equal treatment. As stated in our response to the BCBS SACR consultation³, we believe the overall calibration of CCFs would benefit from taking into account Exposure at Default. Again this would result in a more risk sensitive and reliable CCF regime for both credit risk capital requirements, and for the Leverage Ratio.

Ultimately, incorrectly calibrating the CCFs will pass on additional costs to clients and negatively impact the working capital funding of corporates. As the BCBS proposal does not reflect historical data on drawing behaviour around the use and loss levels associated with such credit lines, we have significant concerns that this proposed treatment will impede banks' abilities to provide funding and meet client demand in areas such as, trade finance, corporate working capital needs and project finance.

The breadth of products and services impacted by CCF calculations is considerable, and a miscalibration in this area would impact many clients, corporates and financials. Under the

² <http://www.bis.org/bcbs/publ/d295.pdf>

³ <http://www.bis.org/bcbs/publ/comments/d347/deutschebank.pdf>



current proposal, we believe that unintended additional costs and pressures would be applied to a range of areas including:

- Other retail credit lines, which are not unconditionally cancellable;
- Credit lines for corporates (providing working capital for daily functioning of corporates and cash management);
- Securitisation (working against the policy push to promote simple and transparent securitisations);
- Trade finance (negatively impacting on growth, exports and so on);
- Project finance (ensuring capital and liquidity for infrastructure investment);
- Corporate finance (revolving credit lines providing working capital to multinational corporates).

As per the Joint Trade Associations, we believe that the treatment of CCFs should be reconsidered and calibrated according to the following risk drivers: i) the type of commitment, ii) whether the facility is unconditionally cancellable or not, iii) the type of counterparty to which the facility is granted, and iv) the residual maturity of the underlying facility. Taking these risk drivers into account, the Joint Trade Associations have proposed alternative CCF segmentation in their consultation response, which we have contributed to and strongly support (see Figure 1). We believe that such a recalibration would help meet the intention of policy makers globally to increase funding for trade, growth and jobs.

Figure 1: Alternative CCF Segmentations

Segment	CCF
Unconditionally cancellable commitments (UCCs)	
Retail	0%
Corporate	0%
Contingent facilities	
Short term self-liquidating trade letters of credit arising from the movement of goods	20%
Certain other transaction related contingent items	50%
Cash commitments, retaining a differentiation according to the current maturity distinction (less than and over 1 year) and split by retail and corporate	
Corporate, split by underlying product type (e.g. term loans, revolving, and with term loans received a lower CCF than revolving facilities)	42-54% depending on product

Leverage Ratio impact on Client Clearing



We support the BCBS proposal to replace the Current Exposure Measure with the Standardised Approach for Counterparty Credit Risk (SA-CCR). However we share the view expressed by the Joint Trade Associations and the Futures Industry Association (FIA) that the SA-CCR must be modified to include offsets for clearing members posting initial margin (IM) to central counterparties on behalf of their clearing clients.

Failure to recognise the exposure reducing effects of segregated IM would disincentivise the continued provision and use of central clearing services for derivatives. The adoption of the SA-CCR approach without an IM offset will continue to penalise clearing member banks that post IM on behalf of their clients. Without an offset it will be more expensive for banks to provide clearing services, which will reduce the availability and increase the costs of clearing for end users. This needs to be considered alongside historical low returns on equity for clearing businesses and increased focus on banks maximising returns on allocated balance sheet. These increased costs and internal balance sheet competition are could result in fewer banks operating as clearing members, which – in addition to reducing competition – will lead to greater concentration risk and fewer options to achieve porting in the event of a default. This could undermine the successful implementation of mandatory clearing obligations.

As currently proposed, the methodology does not take into account that segregated IM reduces risk in the system and is mainly held in segregated accounts and is not used for investment or leverage by a clearing member bank. Without an offset, the leverage ratio counts IM as both an asset (as banks receive it from clients) and a liability (as banks pass it onto a central counterparty or CCP) on the balance-sheet. The result is that client IM payments increase the size of the balance sheet and drive clearing member banks' leverage ratios higher, thereby making such banks appear more leveraged than they really are. In turn, the provision of clearing services becomes more expensive from a capital perspective. Furthermore, IM is itself a leverage control measure. The higher the IM requirement, the lower is the leverage allowed on the derivatives contracts, resulting in a safer overall financial market. Therefore, we believe that a robust Leverage Ratio framework should include IM as a factor in measuring exposure and leverage.

Our analysis shows that the application of the shorter five-day margin period of risk for client cleared trades within the SA-CCR framework is insufficient to offset the impact of this double-counting on clearing members' potential future exposure (PFE). This finding is consistent with the analysis that is being submitted independently by FIA.

Furthermore, our analysis shows that – without a margin offset – the move from CEM to SA-CCR will have a material impact on the costs associated with providing client clearing services to “real” money and sovereign counterparties.

First, the capital costs for banks providing clearing services to clients are not evenly distributed and affect counterparties differently. In our analysis, the increased PFE is particularly significant for clients that have large directional portfolios or are not eligible for position netting. This group of clients consists of pension funds, asset managers, insurance companies, and sovereign counterparties; entities that are closely related to the success of the real economy. These conclusions are supported by analysis being submitted by FIA.

Second, SA-CCR without an IM offset would generate a significantly higher PFE than CEM for most asset classes including Equities, Rates, FX, and Commodities. While SA-CCR is more sensitive to the effects of netting, that increased sensitivity is not effective at reducing the PFE impact for directional portfolios, leading to PFE increases that are material and significant for such clients. For a given hypothetical trade, our analysis shows that SA-CCR without an IM



offset results in significantly higher PFE than CEM without an IM offset, depending on the asset class. When the same hypothetical trade is run with an IM offset, the PFE for SA-CCR is demonstrably lower for several important derivative asset classes including FX, Interest Rates, and most Commodities – although it remains higher for equity derivatives. This impact analysis is outlined in the following table:

CEM add-on vs. SA-CCR PFE

Single trade example

	CEM	SA-CCR without IM offset	Change	SA-CCR with IM offset	Change
Equities					
Single name	1.70%	9.47%	+458%	4.60%	+171%
Index	1.70%	5.92%	+249%	3.31%	+95%
Commodities					
Electricity	2.83%	11.83%	+318%	6.62%	+134%
Oil/Gas	2.83%	5.32%	+88%	2.80%	-1%
Metals	2.83%	5.32%	+88%	2.80%	-1%
Agricultural	2.83%	5.32%	+88%	2.80%	-1%
Other	2.83%	5.32%	+88%	2.80%	-1%
Rates					
3m	0.00%	0.04%	N/A	0.01%	
3y	0.14%	0.41%	+191%	0.13%	-6%
5.1y	0.42%	0.67%	+57%	0.22%	-49%
10y	0.42%	1.16%	+174%	0.38%	-11%
30y	0.42%	2.30%	+442%	0.74%	+75%
FX					
All	0.28%	1.18%	+318%	0.23%	-18%
Credit					
IG Index	1.41%	0.11%	-92%	0.01%	-100%
HY Index	1.41%	0.31%	-78%	0.02%	-99%

All contracts assumed less than 1y maturity, except Credit at 5y and Rates as designated

CEM assumed lowest netting possible at 40%

All transactions assumed to be centrally cleared

Third, a move from CEM to SA-CCR without an offset provides no benefit to the cost of clearing exchange traded derivatives (ETD) and as compared to OTC clearing, results in higher cost of clearing for clients with directional portfolios such as asset managers, insurance companies and sovereigns. This is supported by industry analysis provided by FIA.

Overall, this analysis shows that a move from CEM to SA-CCR without an IM offset is particularly punitive with regards to cost of clearing services for real money and sovereign counterparties, especially for Equities, FX, Interest Rate derivatives and ETD products. End users (and in particular asset managers, insurance companies, pension funds and sovereign counterparties) seeking to clear their portfolios are therefore likely to face increased costs and/or reduced clearing options and access to clearing services. In our view, this outcome



undermines regulatory efforts to reduce systemic risk and increase transparency in the OTC market by encouraging all market participants to clear as many standardised OTC derivatives trades through CCPs as possible. Furthermore, the disproportionate impact on clients' ETD positions creates additional costs related to trading listed instruments despite broader regulatory efforts to increase the use of transparent and accessible trading platforms for derivatives.

It is important to note that our impact analysis does not fully capture the long-term impact on the client clearing model, as it is based on data from December 2015 that precedes the application of mandatory clearing in Europe. As more and more market participants – including large asset managers and non-financials counterparties (above the EU clearing threshold) come within the scope of mandatory clearing requirements, the aggregate cost of clearing will increase commensurate with the increase in volume of cleared trades.

The increased costs to clearing members are highly significant as the leverage ratio has become the binding constraint for many European banks. Internal balance sheet allocation means that businesses within a bank compete for risk capital and balance sheet allocation. If one business cannot meet the necessary ROE target, it will lose balance sheet allocation to a business that achieves the required returns. It is important to note that clearing businesses are high fixed cost businesses with ROE that is significantly lower than banks' internal targets. Furthermore, banks' clearing businesses are already under increased pressures as a result of broader regulatory and structural changes affecting bank balance sheets. As higher volumes of OTC derivatives trades clear through CCPs, the additional capital required for leverage ratio purposes becomes an important factor in determining whether these client clearing services are economically viable offerings. Even if the inclusion of an IM offset may not materially change the bank's ratio at a group level, at a clearing business level it makes a very significant difference.

Without the inclusion of IM offset, it is unclear whether banks will be able to clear the volume of trades that end users need and new regulations require. To the extent that clearing member banks choose to exit this market – as has already been observed⁴ – it would also increase concentration risk among clearing brokers and reduce the availability of alternative brokers in the event of a default, thereby reducing opportunities for porting. We therefore request that the SA-CCR be modified to provide IM offset in order to provide for a robust and sustainable clearing framework.

Cash pooling

We agree with the Joint Trade association response that balances arising from notional cash pooling arrangements should be recognised on a net basis if they are treated as a single unit of account for accounting purposes. However, divergences in accounting treatment mean that achievement of such recognition may not be possible in some jurisdictions, including Germany. We understand that it is possible in other jurisdictions and that this has created a competitive distortion in the market. Extending this uneven treatment to the leverage ratio could exacerbate this. Our view is that the BCBS should provide for notional cash pooling arrangements not to be treated on a gross basis if the balance arising from them would be recognised as a single unit of account in any major global banking jurisdiction. This would not affect the actual accounting treatment applied to them in any way but it would help to avoid worsening an uneven competitive playing field.

⁴ <http://www.cftc.gov/MarketReports/FinancialDataforFCMs/HistoricalFCMReports/index.htm>