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Basel Committee on Banking Supervision
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Dear Sir, Madam,

DB response to the Basel Committee on Banking Supervision consultation on Total Loss Absorbency Capacity (TLAC) Holdings

Deutsche Bank (DB) welcomes the opportunity to comment on the Basel Committee's proposals concerning the deduction treatment for banks' investments in TLAC.

We welcome the Financial Stability Board (FSB) and the Basel Committee's efforts to prevent contagion risk by limiting cross-holdings of TLAC. However, when defining the regulatory treatment of TLAC holdings, it is important to carefully consider potential consequences on the bank debt market and demand for TLAC.

In our response, we highlight that the regulatory treatment of TLAC holdings should make some allowances for market making activities by banks. To preserve a liquid market for bank debt, we suggest some changes to the approach proposed by the Basel Committee, principally moving away from a Tier 2 deduction and rather adopting a corresponding deduction approach for G-SIBs and a more proportionate regime for TLAC holdings by other banks. We also recommend a re-calibration of the deduction threshold.

Please let us know if you would like more information or to discuss any of these points further.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Daniel Trinder'.

Daniel Trinder
Global Head of Regulatory Policy



DB comments on the Basel Committee's proposed approach to TLAC Holdings

- **Ensuring market liquidity for TLAC instruments**

The investor base for TLAC instruments is already quite narrow, given that asset managers and insurers have established limits in their mandates for investing in subordinated instruments. In addition, conduct regulators in several jurisdictions restrict the ability to distribute bail-inable debt instruments to retail investors, either through prohibition or enhanced suitability requirements. Prudential constraints limiting investment in TLAC for all banks (and potentially in the future for insurers) will further narrow the investor base - the holding of TLAC instruments will be concentrated in less regulated parts of the financial sector. While all of these restrictions are individually prudent, the cumulative impact needs to be taken into account when considering the potential consequences of the proposed approach to TLAC holdings. Given the amount of subordinated debt that would have to be issued for banks to meet the TLAC standard, there is a risk that there would be a considerable gap between supply of TLAC and demand from investors.

Banks are important facilitators of bank debt markets and play a significant broader role as sponsors, distributors and secondary market participants. The Basel proposal on TLAC holdings would restrict this intermediation role at a time when market making capacity is already diminished. Banks' ability to warehouse risk has already been constrained by recent prudential regulation. As noted in the recent fixed income market liquidity report by the Committee on the Global Financial System (CGFS), financial institutions' corporate bond holdings have declined significantly in the past five years (25% in Japan and the euro area) and Basel II market risk revisions had most significantly affected firms' risk appetite for holding such instruments. These effects are of course part of the intended consequence of regulatory reforms, but before a deduction regime for TLAC-eligible debt instruments is introduced, the cumulative impact of this additional constraints on banks' ability to support market liquidity needs to be considered. As the CGFS report notes, the current fragility of fixed income market liquidity as it adjusts to dealers' deleveraging can lead to higher market volatility in times of stress.

While ensuring the protection of financial stability by limiting the risk of contagion, the regulatory treatment of TLAC holdings needs to make some allowances for market making by banks and be calibrated in proportion to the overall market. We suggest below some changes to the Basel Committee's proposal which aim at striking this balance.

- **Corresponding deduction approach rather than Tier 2 deduction for G-SIBs**

The Tier 2 deduction proposed by the Basel Committee would have a severe impact on TLAC bond liquidity as it would make investment in TLAC eligible instruments economically unattractive for banks. With the Tier 2 deduction approach, banks will want to reduce their investment in senior unsecured subordinated debt (i.e. eligible for TLAC) given that the cost of these instruments will increase (i.e. increase in liquidity premium). While we understand that the Basel Committee's objective is to limit cross-holding of TLAC, it is important to remember that banks will need to issue a wide amount of subordinated debt to meet their TLAC standard.

The Quantitative Impact Assessment (QIS) concludes that the impact of the Basel Committee's approach would be limited, however the QIS results need to be interpreted cautiously given that the data provided was sometimes incomplete, as acknowledged by the Basel Committee. Several elements are not fully reflected in the QIS: i) instruments *pari passu* with TLAC instruments but with a residual maturity of less than one year might not



have been included by all responding banks; ii) it is unclear whether synthetic and indirect holdings were included or not; iii) a significant part of non-G-SIBs did not participate to the QIS, iv) TLAC has not been issued yet so the data is based on today's market equivalent rather than precise estimates. As a result, we believe that the impact of the Basel Committee's approach is not fully reflected in the QIS.

As the Basel Committee is aware, the consultation document concerns only TLAC eligible instruments that are not Tier 1 and Tier 2 (i.e. eligible debt) – indeed, among TLAC eligible instruments, Tier 1 and Tier 2 holdings are already subject to a deduction regime. Applying a Tier 2 deduction to TLAC eligible debt is unnecessarily conservative as it penalises these instruments, disregarding their lower risk profile in relation to regulatory capital. Banks would need to completely exhaust their capital before TLAC eligible debt would be written-down / converted. Even the FSB's own historical loss analysis showed that only in exceptional cases did banks lose more than 7% of Risk Weighted Assets (RWAs), and this was before more conservative risk weights were introduced. This shows that G-SIBs capital would be unlikely to be exhausted at resolution, lowering the overall amount of write-downs to TLAC eligible debt required to recapitalise the bank. In addition, as banks will likely have instruments *pari passu* with TLAC but which are no longer eligible due to maturity restrictions, the degree of losses would be mitigated by a broader pool of loss-absorbing instruments. In light of these factors, restrictions on holdings of TLAC eligible debt should not be more severe than those already in place under the Basel framework of deductions for capital instruments or under large exposure rules.

The Basel Committee should therefore retain the existing Basel III corresponding deduction approach and apply it to TLAC holdings rather than using a Tier 2 deduction approach for these instruments. Holding of TLAC instruments should be deducted to corresponding instruments in investing banks (i.e. a symmetrical 'like-for-like' corresponding deduction approach). This would be a more logical and fair system, consistent with the Basel III approach to capital instruments.

- **Large exposure approach rather than Tier 2 deduction for non- G-SIBs**

Concerning non-G-SIBS, we agree that there is a need to mitigate potential contagion risk from TLAC. However, as outlined above, a Tier 2 deduction approach would be overly punitive. It would also impose a significant operational burden on smaller banks, given the need to develop new systems to monitor TLAC holdings. Among the other options proposed in Section 3, extending the large exposures regime would be the most appropriate approach for non-G-SIBs, given the relative ease of implementation.

In particular, the Basel Committee should further consider the idea of an aggregate limit on holdings of TLAC issued by all G-SIBs. Contrarily to what is stated in the consultation document, we do not believe that the concept of an aggregate limit would be a "significant departure" from the large exposure regime, as connected counterparties and unknown counterparties are already subject to aggregation. However, to determine the appropriate calibration for this limit, the Basel Committee will need to conduct a specific impact study to obtain comprehensive and accurate data on overall TLAC holdings by non-G-SIBs.

- **The deduction threshold should be set higher**

While we understand the use of the Basel III deduction threshold for non-significant investments in the capital of financial sector entities, we consider that it is now too low (10 % of a bank's own common equity) as it would include TLAC. Even the QIS conducted by the Basel Committee shows that the cross-holding of non regulatory capital instruments that



qualify as TLAC would be at least twice as big as the amount of regulatory capital held among G-SIBs. And, as noted above, we believe this data may have underestimated the amount of TLAC holdings. The deduction threshold was set at 10% for the specific case of capital instruments; however it is not the appropriate level in the case of TLAC holdings given that the size of the pool of instruments is much larger than just capital instruments.

As a threshold set too low would have a negative impact on banks' ability to conduct market making and on market liquidity for senior unsecured funding, we recommend for the Basel Committee to set it at a higher level. The current 10% of common equity threshold for non-significant investments in the capital of financial sector entities should be topped up with a separate TLAC-specific (holdings of TLAC eligible instruments excluding instruments that qualify as regulatory capital) 10% threshold. With this separate threshold, the Basel Committee would acknowledge that banks need to hold some TLAC issued by other banks for market making purposes.

Simply increasing the existing threshold for capital instruments to a higher level may have the unintended consequence of allowing some banks to invest in a greater amount of capital instruments of other financial institutions without incurring capital deductions. The solution proposed above addresses this potential issue.

Furthermore, the Basel Committee stated in its paper on Minimum Capital Requirements for Market Risk that it intends to consider exemptions or adjustments to the existing Basel III threshold requirement for deductions of holdings of regulatory capital for market making. We are supportive of this review and suggest also taking into account the need for market making when setting the threshold for TLAC holdings. A blanket exemption for market making altogether should also be envisaged by the Basel Committee, as is the case in the EU Capital Requirements Regulation, where institutions exclude underwriting positions held for five working days or fewer from the calculation towards the threshold.

- **Only subordinated instruments should be considered as TLAC holdings**

The Basel Committee proposes a wide definition of what constitutes a TLAC holding. It proposes to include any exposure eligible for TLAC but also instruments ranking pari passu with TLAC but not eligible for TLAC, as well as instruments qualifying for TLAC despite ranking pari passu with excluded liabilities (in countries applying the exemption). The definition of TLAC holdings proposed by the Basel Committee, which is different than the TLAC definition in the FSB term sheet, could create confusion for investors. Ideally, it would be better to have a similar definition in both cases.

Nevertheless, we recognise that it is important to reflect the fact that some instruments which do not meet the TLAC eligibility criteria but rank pari passu with TLAC may be subject to loss in resolution to the same extent as TLAC. The excessive cross-holding of these instruments could present a risk of contagion; therefore it seems logical to include these in the definition of TLAC holdings. As a result, we agree with the Basel Committee that the following instruments should be considered as TLAC holdings for the purpose of regulatory treatment:

- Instruments issued by banks that formerly counted as TLAC but now no longer qualify as they have fallen below the 1 year residual maturity requirement; and
- Subordinated instruments that rank pari passu with TLAC instruments and are subject to conversion / write-down at the point of non-viability or in resolution, but have never qualified as TLAC (e.g. subordinated debt with a 6 month original maturity).

Concerning **instruments that qualify as TLAC despite the fact that they rank pari passu with excluded liabilities (in jurisdictions allowing the exemption)**, we do not support the Basel Committee's proposal to apply the deduction rule. It would be extremely difficult



operationally for investing banks to identify these instruments. As a consequence, they may have to apply the deduction rule to all senior unsecured instruments with a residual maturity of more than one year. This would create a disincentive for banks to invest in bank debt, which is not the objective of the FSB and the Basel Committee. Given that it is unlikely that the holding of these limited instruments by banks could have a destabilising effect, we recommend excluding these from the definition of TLAC holdings.

- **There should be a phase-in approach to implementation**

To identify their TLAC holdings and comply with the deduction rules, investing banks will need to rely greatly on disclosures. Given that the Basel Committee has yet to consult on TLAC disclosure proposals, and it will take time to finalise these and to implement them in national law, we do not see how banks will be able to identify their TLAC holdings immediately from January 2019. Disclosure to a high comparability standard will be key to accurately identify TLAC holdings, and so a phase-in approach is necessary, from an operational perspective.

The FSB has adopted a two stage implementation for TLAC and a similar approach should be followed by the Basel Committee for the deduction rules. In a first stage (2019-2022), we suggest a supervisory monitoring regime where banks report to supervisors on a “best efforts” basis and a second stage (2022-onwards), once investing banks can rely on disclosures and are in a position to accurately identify their TLAC holdings, the full regime would apply. This would also allow time to appropriately calibrate: i) the threshold above which deductions would apply, based on more accurate data; and ii) design a more appropriate regime to limit contagion risks to non-G-SIBs’ from aggregate TLAC holdings.