Deutsche Bank

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Dear Mr. Farkas,

DB response to the European Banking Authority (EBA)'s consultation on Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)

Deutsche Bank (DB) welcomes the opportunity to comment on the EBA's draft RTS regarding the valuation of derivatives for the purpose of bail-in.

In general, bailing-in derivative contracts can present unique and complex challenges. Given the potential negative implications on financial stability, the resolution authority will play a key role when determining whether or not derivative liabilities should be excluded from bail-in. Risks associated with the bail-in of derivatives also need to be accounted for in the upcoming Delegated Acts 'on circumstances when exclusions from the bail-in tool are necessary'. There are four reasons why the resolution authority should contemplate excluding derivatives:

- **Impacted counterparties would be predominantly non-financial stakeholders (i.e. end users of financial services)** - Given that secured liabilities are exempted from bail-in, authorities will look at uncollateralised derivatives liabilities. The majority of derivatives are, or will soon be, collateralised. Cleared derivatives are subject to far reaching collateralisation requirements and the joint Basel Committee on Banking Supervision – International Organisation of Securities Commissions' (BCBS-IOSCO) standards increase margin requirements for uncleared derivatives, for financial counterparties. As a result, the remaining uncollateralised derivatives, i.e. those that can be bailed-in, will often be with counterparties such as corporates or public sector entities which use derivatives to mitigate risks associated with their activities. The resolution authority will likely want to protect these counterparties in the event of a crisis to limit the spill-over from the financial sector to the wider economy.
- **Contagion risk and impact on critical economic functions** - If derivative liabilities are not excluded from bail-in, the institution under resolution would have to close out a large number of separate derivative arrangements with its clients and re-establish hedges accordingly - in order to re-balance the economic risks of its portfolio. This activity could pose a threat to the survival of the firm's critical economic functions and as a result cause market dislocation and contagion to other market participants.
- **Destruction in value** - The early termination of derivative contracts may lead to destruction in value that will increase the bank's losses, which will be borne by other creditors in the bail-in. The early close-out of derivatives may give rise to re-hedging costs for the counterparty and the bank under resolution.

An additional important element that should be taken into account in the RTS is that the bail-in of derivative liabilities would leave the firm under resolution exposed to one-sided, un-hedged risk in a potentially volatile and illiquid market, which could be net capital destructive.

- **Delays and obstacles to the bail-in process** – It is very complex to determine an adequate methodology for a swift valuation of derivatives in the event of bail-in, which creates a major obstacle to an efficient bail-in process.

When it comes to deciding on exclusions, we expect the resolution authority to consider various options, depending on the causes of failure and the resolution strategy. It might decide to preserve the bank's derivatives portfolio; or choose to do a portfolio transfer or novation to another bank. Novation of derivatives would be closely aligned with fair value principles, and would preserve the value of portfolios for counterparties, respecting the No-Creditor-Worse-Off (NCWO) principle. Novation of whole portfolios of derivatives would be less value destructive for shareholders and other creditors of the firm in resolution than closing out certain portfolios and finding replacement hedges.

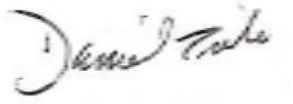
Our annex provides detailed responses to the consultation questions. While we understand the EBA's methodology and the reference to replacement costs for the final valuation, this approach would lead to a substantial increase in losses to be borne by shareholders and creditors during the bail-in and would present contagion risk.

We have also some concerns regarding the timing of the bail-in and risk of predatory pricing if counterparties come up with replacement trades. The resolution authority (and the firm under resolution) would need time to review the pricing of replacement trades and ensure that these are commercially reasonable. As such, for a swift bail-in process, a provisional valuation by the resolution authority would be necessary. In this case, we suggest that the authority should take the IFRS fair value (with some adjustments) as the basis for this provisional valuation.

Finally, the EBA should mention in the recitals that 'secured liabilities' can be fully exempt under Article 44(2) of the BRRD where they are collateralised in a continuous basis in compliance with regulatory requirements or under Central Counterparties (CCP) rules providing overcollateralisation through initial margin. This would ensure consistency with Article 2.1 of the final draft RTS on Article 55 of the BRRD.

Please do not hesitate to let us know if you have any questions about these points, or if there are any issues related to this topic you would like to discuss further.

Yours sincerely,



Daniel Trinder
Global Head of Regulatory Policy

Draft Regulatory Technical Standards on valuation of derivatives (BRRD)

Q1: Do you agree with the definition above? Do you consider it necessary to specify some of them further and in particular the definitions of 'commercially reasonable replacement trades' and 'unpaid amounts'?

The EBA defines a 'commercially reasonable replacement trade' as "*the replacement trade entered into on a netted risk exposure basis, on terms consistent with common market practice and making best efforts in order to obtain best value for money*".

Article 7.1 (a) of the BRRD refers to "the applicable terms of the relevant netting agreement". According to the close-out process in standard master agreements, the non-defaulting party is under no obligation to enter into actual replacement trades. Therefore, the EBA's approach does not seem in line with Article 7.1 (a). To respect the terms of standard master agreements, the counterparty should have the right to come up with quotes rather than actual trades.

Counterparties may have an economic interest in coming up with prices for replacement trades which are not 'commercially reasonable' from the perspective of the bank in resolution; as such, the resolution authority needs to take the risk of predatory pricing into account. Indeed, the authority will want to avoid having to enter into long commercial negotiations with the bank's counterparties. If the counterparty has several replacement prices from different market participants (four or five, for instance), this would provide the resolution authority with some reassurance that the trade would be commercially reasonable.

Furthermore, we recommend that the EBA clarifies that replacement prices can be given for a group of closed-out transactions that can be netted, rather than necessarily for each transaction.

Finally, we welcome the definition in Article 1.5 of these technical standards, which refers to the independence of the valuer. This is important to ensure a fair process.

Q2: Should the deadline given by the resolution authority to the counterparty be further framed? If yes, explain why and how. Does this drafting allow the resolution authority to conclude resolution actions in a sufficiently swift manner?

The RTS should state explicitly that the notification of closing out of the derivatives contracts would be undertaken at the same time as the bail-in announcement. Otherwise, this may encourage counterparties to "run" to avoid an imminent resolution and lead to a liquidity squeeze, thereby impeding the bail-in process. Also, if not announced at the same time as the bail-in, the notification could be seen as equivalent to market signalling and may be a breach of market abuse rules.

Moreover, the wording of Article 2.1 may need to specify more clearly that the master agreement will be terminated. The current wording could lead to uncertainties around the termination date. If that date is too far out, this uncertainty may have a negative impact on the legal opinions for netting under the relevant master agreements and impair the nettability for regulatory capital purposes (cf. 295 et seq. of the Capital Requirements Regulation). We recommend the following addition: "of its decision to close-out the derivative contracts **and to terminate the master agreement**".

The sequence of events outlined in the draft RTS is not entirely clear. Therefore, we would like to emphasise that in the event of an 'open bank bail-in', valuations would need to be finalised and the haircut applied over the 'resolution weekend'. Operationally, it would be very difficult for counterparties to come up with replacement trades and for these to be analysed by the authority (to ensure they are commercially reasonable) over a weekend. For structured transactions and derivatives traded in illiquid markets it will be difficult to obtain adequate pricing of replacement trades within the required time frame.

In practice, we believe the resolution authority should:

1) Conduct a provisional valuation of derivative contracts during the weekend. The bail-in of derivatives should be carried out on the basis of this provisional valuation.

2) Subsequently, the replacement trades approach could be used to adjust the valuation, as defined in Article 5. The resolution authority will need to set a deadline that leaves enough time for replacement trades to be found but not too long to avoid market volatility and market movements against the bank in resolution.

Q3: This valuation principle is intended to be aligned with common market practice that recognises replacement costs in an early termination event, whilst giving certainty to the resolution authority on the methodology to be followed. Do you agree that this valuation principle would result in a fair valuation for the closed-out netting set and as such avoid a breach, from the counterparty's perspective, of the no-creditor-worse-off principle?

We understand why the EBA chose the replacement costs approach which takes into account the losses incurred by counterparties to replace the terminated contract. With this approach, which is standard in the close-out rules contained in master agreements, the EBA seeks to ensure that the creditor is not worse off in resolution than in insolvency. Nevertheless, this approach in the context of bail-in would have negative implications.

As mentioned above, inviting counterparties to come up with replacement trades would put tremendous pressure on markets and could lead to predatory pricing, which would as a result increase the losses of the bank in resolution – losses to be borne by shareholders and creditors. Moreover, the replacement cost approach means that the bank under resolution's portfolio would be broken apart. As a result, the re-hedging would be potentially more costly and the bank could be exposed to open market risk in a volatile market, which would further increase the bank's losses. The destruction in value would be such that the resolution authority is likely to conclude that it is not worth bailing-in derivatives.

It is very complex to determine an adequate methodology for a swift valuation of derivatives in the event of bail-in. As explained in our general comments, in addition to the destruction in value, the bail-in of derivatives presents contagion risk.

Therefore, when it comes to deciding on exclusions, we expect the resolution authority to consider various options, depending on the causes of failure and the resolution strategy. It might decide to preserve the bank's derivatives portfolio; or choose to do a portfolio novation to another bank. Novation of derivatives would preserve the value of portfolios for counterparties, respecting the NCWO principle. Also, novation of whole portfolios of derivatives would be less destructive of value for shareholders and creditors of the firm in resolution than closing out certain portfolios and finding replacement hedges.

Q4: Do you agree with the preferential status given to commercially reasonable replacement trades? Should there be also a prioritisation among other sources of data?

In light of the replacement costs approach chosen by the EBA, we understand the preferential treatment given to commercially reasonable replacement trades. However, this approach has shortcomings.

As explained in our answer to Question 1, according to the close-out process in standard master agreements, the non-defaulting party is under no obligation to enter into actual replacement trades. Even if the counterparty had to come up with several quotes rather than actual trades, it would be difficult to obtain these in a very short timeframe and under a stress scenario, especially for structured and illiquid transactions. Moreover, the authority would need time to verify that these are commercially reasonable.

In practice, the authority should conduct a provisional valuation to determine whether derivatives should be bailed-in and to determine the bail-in amount (see our answer to Question 5). The replacement trades approach does not seem operationally realistic to inform the bail-in decision, but it could be used in a second stage.

Q5: Do you agree with the method described under paragraph 2 for the resolution authority to calculate the close-out amount? Is there a reason to believe that mid-market prices might not always be available nor possible to derive from other data sources? Under which circumstances? In that case, what do you consider as an appropriate reference for calculating the close-out amount?

We consider that internal models should provide a reasonable valuation of derivatives, given that valuation models are approved by regulators under the Capital Requirement Regulation (CRR) and respect prudent valuation rules developed by the EBA. The valuations arising from these models reflect all available and appropriate market information, and are subject to IFRS fair value and regulatory audit.

To determine swiftly the value of derivatives, the valuer could look at IFRS Fair Market Value (FMV), with the following adjustments:

- Exclude DVA, or adjust it, such that it reflects the actual losses to be absorbed by the derivative liabilities.

  For the purpose of valuing the net derivative liability to be bailed-in, DVA should be excluded from/adjusted in the FMV calculation because DVA represents the fair market value of the bank's default risk on its own liabilities which may not accurately reflect the loss that a counterparty might suffer under a resolution.

  For example, a derivative liability with a theoretical default-risk free value of €100mn, may be recorded on the balance sheet as a liability of €95mn after DVA of €5mn has been factored in as part of the fair value to reflect the market's perceived default risk of the institution. However, in insolvency the counterparty's claim would normally be based on the full €100mn FMV of the liability and under a resolution, the derivative counterparty might not be required to absorb any losses (depending on where the derivative liability ranks in the creditor hierarchy and the amount of capital that is left when the bank has been taken into resolution).

  The fair value of DVA is set by the market and should reflect the losses that uncollateralised derivatives would suffer under resolution. The DVA will change

depending on how the market perceives the bank's loss absorbency capacity (i.e. once the Minimum Requirement for own funds and Eligible Liabilities and the Total Loss Absorbency Capacity are publicly known). The resolution authority would need to make adjustment to the valuation process accordingly.

- Use Prudent Valuation Additional Valuation Adjustments (AVA) under existing EBA requirements to add an extra layer of conservatism and so that financial valuation and capital accounting are aligned.

  Under IFRS, derivative liabilities are measured at fair value using quoted prices in active markets where data is available (i.e. Level 1 in the IFRS hierarchy). However, active markets do not always exist, particularly for tailored derivative contracts that are traded over-the-counter (OTC). Therefore, IFRS allows banks to calculate fair values for these instruments using valuation techniques (i.e. Level 2 and 3 in the IFRS hierarchy).

  Valuations for Level 2 transactions are largely based on active markets for constituent parts, whereas valuations for Level 3 transactions can contain a larger number of unobservable inputs. However, banks are expected to use the maximum amount of observable market data available to calculate a derivative's fair value and to test the validity of their models.

  AVA is an additional regulatory adjustment to accounting fair value that is subtracted from regulatory capital. AVA is calculated as the difference between the valuation recorded for accounting purposes and a 'prudent valuation' of fair value positions. Under the 'core approach' (applicable to large banks) a series of adjustments are applied to the fair value of positions based on a conservative market value with a confidence level of 90%. For example, for a derivative liability that is trading in active markets, the 90th percentile ask price would be used rather than mid-market prices or prices assessed to be reasonable for IFRS accounting purposes adding an additional layer of conservatism to the valuation.

Q6: Should adjustments to the bid-offer spread, other than those specified under Article 5(4) (c) be considered?

In addition to the adjustments specified under Article 5(4)(c), we would recommend that the resolution authority verifies the ability of market participants to trade at the indicated bids by looking at whether these stakeholders have enough liquidity or whether they are in stressed position. Authorities should also seek to understand the economic motivation behind the trade, to see whether these would be carried out with the sole aim of moving the market.

Q7: Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs as laid down in this Article could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?

We agree with the EBA that liabilities of a bank under resolution to a CCP are likely to be exempted from bail-in. Indeed, positions against CCPs are, in most cases, overcollateralised. Also, closing-out liabilities to a CCP would limit hedging opportunities

for the bank under resolution at a critical time, when the firm would have to re-hedge its book.

If the resolution authority does decide to close-out derivatives with a CCP, it should not deviate from the default procedures as these have been developed to protect the CCP and prevent systemic contagion. While we understand that Article 5.2 of the RTS would only apply in very exceptional circumstances, this procedure might have risky implications for the CCP.

Regarding the timing, we have the same concerns as regards the early termination date as described in our response to question 2.

Q8: Article 7(1) is intended to be aligned with market practice in early termination events. Do you see a risk of increased market volatility on the first market day following the close-out notification, which could adversely affect the termination value? Do you consider the notion of 'commercially reasonable' date sufficiently self-evident or should it be further specified?

Considering the volume of outstanding positions held by a Global Systemically Important Bank (G-SIB), we do believe that there would be increased market volatility following the notification to close-out and that this could adversely affect the termination value.

Q9: As provided for under Article 7(2), the resolution authority will have the possibility to produce a valuation at a date or time earlier than the earliest commercially reasonable date as part of a provisional valuation carried out pursuant to Article 36(9) of the BRRD. This possibility is intended to allow for a swifter resolution process as resolution authorities will be able to apply the write down and conversion powers on the basis of the early determination. As in all cases where taking resolution action based on a provisional valuation, resolution authorities will update their determination either as part of a subsequent provisional valuation or the final valuation. At that point they will either adjust the write down and conversion of creditors, provided they have previously made the necessary arrangements such as holding sufficient equity, or provide alternative compensation, if necessary, on the basis of the final valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU. Do you consider this optional early determination appropriate, or do you consider that this option would unreasonably increase the risk of litigation or ex post compensation according to Article 74 of the BRRD?

In practice, we consider that the provisional valuation provided for under Article 7(2) would be necessary to ensure a swift resolution process.

As explained in our answers to questions 1-4, an 'open bank bail-in' involving derivatives would not be feasible if the resolution authority was required to wait for final valuations based on commercially reasonable replacement trades before bailing-in net uncollateralised derivatives.

The provisional valuation would need to be based on IFRS fair value, with certain adjustments, as explained in our answer to question 5.

Q10: Alternatively, should resolution authorities always wait until there is pricing available in the market before producing their valuation, and therefore wait until that date before applying the bail-in tool?

No, we support the idea of a provisional valuation.

Q11: The possibility to produce an early determination is available also in relation to claims of a CCP. In this case the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article. Do you consider it appropriate to also allow an early determination in relation to CCP claims?

The default management procedures already establish a clear process to auction and close-out portfolios of a clearing member. We do not support the idea of an early determination in relation to CCP claims, as it would introduce a lack of transparency in the market.

Transactions with a CCP will be overcollateralised in principle. In the event that a bank has an unsecured liability at the point of resolution, before applying the close-out of those liabilities based on a provisional valuation, the resolution authority should have to account for the cost of closing access to a CCP at a point when the institution might need to continue hedging its risks following the bail-in. In that sense, the bank should be allowed to meet its collateralisation requirements before a decision is made on the bail-in of these derivatives.

Q12: If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process should hold back the finalization of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?

In the event that a portfolio of derivatives with a CCP is undercollateralised at the point of the provisional valuation, the resolution authority should consider the cost of closing-out these derivatives. The bank under resolution would lose access to a CCP at a time where it still needs to hedge its risks. The entity under resolution should be allowed to re-establish its collateralisation before a decision is made on the bail-in of these derivatives.

If the CCP determination process holds back the finalisation of the bail-in, then we agree with the proposal of using the NCWO principle as a backstop.

Q13: Do you find the guidance provided in paragraph 2 of this Article sufficiently clear as to the terms of comparison?

Yes, we consider the guidance sufficiently clear.

Q14: Do you agree with the main drivers of the destruction in value as described in this Article?

We agree that these elements would be the main drivers of the destruction in value. In addition, the RTS should also require the resolution authority to consider the impact of bailing-in derivatives on the ability of the bank in resolution to re-hedge, the timing for re-hedging and the net impact on capital of having one-sided un-hedged risk in the days subsequent to a bail-in, in a potentially volatile and illiquid market.

Q15: Do you agree with the provision for a precautionary buffer? Do you consider the indicative elements supporting precautionary buffer as sufficient? Do you see other considerations that should be taken into account when calculating a precautionary buffer?

While we understand the objective of a precautionary buffer, we do not see the need for having a specific buffer for the valuation of derivative liabilities. The final draft RTS on valuation (EBA/CP/2014/38) mandate that any provisional valuation should include a buffer for additional losses. Any uncertainty regarding derivative valuation could be built into this buffer, rather than defining a separate precautionary buffer specifically for the valuation of derivatives.

Q16: In determining destruction in value, should resolution authorities incorporate into their analysis the impairment to the firm's franchise value that would result from the termination and closing-out of a firm's derivatives contracts and the cessation of its related business operations?

The resolution authorities should be required to consider the impact on the firm's franchise value from the termination and close-out of derivative contracts. This is particularly important for banks with an 'open bank bail-in' strategy, where the franchise value of the 'new' recapitalised bank will have an impact on the market value of shares issued to bailed-in creditors and will thus directly impact losses imposed on those liability holders.