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EU Transparency Register ID Number 271912611231-56

18 July 2013

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Dear Mr. Farkas:

Deutsche Bank's response to the European Banking Authority's Consultation Paper on Own Funds (part III).

Deutsche Bank (DB) welcomes the opportunity to comment on the EBA's consultation paper (CP) on Own Funds (part III).

Our response is divided into general comments, responses to the specific questions asked in the CP and finally a number of important points which we cover in more detail that are not addressed by the specific CP questions.

General Comments

First, DB would like to raise significant concerns with the Capital Requirement Regulation's (CRR) broadening of the "Financial Sector Entity" (FSE) definition compared to the definition put forth by the Basel Committee. Under Basel 3, regulatory adjustments are limited to investments in the capital of "banking, financial and insurance entities". The CRR definition goes beyond this with the inclusion of "Mixed Activity Holding Companies", "Mixed Activity Insurance Holding Companies" and with a broad interpretation of "Financial Institutions". As a result, literal application of the CRR FSE definition covers corporate parents with operative business (for example, car manufacturers or energy companies), even when the financial activities within the group are insignificant, or corporate parents without any financial subsidiaries, simply due to the fact that a corporate has chosen to organize the group as a holding structure. (Please see our detailed explanation in Comment 1, below).

In our opinion, the extension of the FSE classification beyond the financial sector will lead to severe unintended negative consequences. It will not only strongly impact banks' deductible positions, driven by exposures to any corporate with a holding structure or with subsidiaries that are institutions or insurance undertakings, however small; it will also mean that large corporates will find it increasingly difficult to raise financing as loans will become more expensive due to the asset value correlation factors for FSEs. We understand that it is intended that the definition should be amended in the October corrigendum to the CRR. We believe that both issues should be addressed.

Second, a key concern regarding the draft RTS is the proposal that the notional amount shall be used to calculate deductions for synthetic holdings. It is established practice for banks to manage synthetic (i.e. derivatives) exposures on a cash delta basis which is recognized by many related regulatory standards, notably the market risk standardized approach developed by regulators for banks trading businesses. We believe the proposed notional representation is not only an inadequate exposure value from a prudential point of view; it will also disproportionately impact banks' equity derivative business and – if retained – provide incentives for position management directly in conflict with prudent risk management, in fact creating as opposed to mitigating risk. (Please see our response to Question 5 below for more detail).

Linked to the calculation of capital deductions for holdings in capital instruments issued by FSEs, we also see considerable issues with the calibration of rules for netting long and short positions. The text is drafted such that it conflicts with the market risk capital requirements of the CRR and it is consequently ill suited for positions in the trading book. The only exemption from the general maturity match requirement provided by the CRR relates to situations where the bank has a "contractual right to sell" and the counterparty is contractually "obliged to purchase". However, typical cash settled derivatives, which provide the same level of economic protection and which have proven effective over time, including during the recent financial crisis, do not meet this requirement and would consequently be excluded. We note that the wording of the CRR exemption is based on a Basel FAQ that specifically relates to the treatment of a physically settled forward sale and the treatment of cash settled products was not addressed by the BCBS. The CRR exemption from the maturity match requirement should be formulated so that it applies the underlying rationale of the Basel FAQ to all types of short positions. This should also cover cash settled products that provide the same economic protection (Please see the detail provided below in the section on "Maturity of long positions" Article 14h of the CP).

Moreover, it should be noted that even if a cash delta based measurement is used and cash settled derivatives as discussed above are included, the current netting rules do not fully reflect the way banks manage their trading books (i.e. on a portfolio level, and not matching individual long positions with an individual hedge) as the intent is to facilitate client flows through a balanced portfolio, with residual risk captured in market risk measures such as VaR. This residual risk covers basis risk across issuers, product sets, strikes, maturity and across the capital structure (subordinated vs. senior). Accordingly, many economically valid hedging strategies will paradoxically no longer be viable. It is concerning from a prudential and systemic point of view if as a result banks will be incentivized not to hedge synthetic short positions since the economic hedge may be treated as a deductible FSE long position. Ultimately, unwinding FSE holdings by a number of firms in response to concerns about holding regulatory FSE deduction positions will create material pressure on stock prices during Q4 of 2013 unless clarification of the matters discussed above is provided.

Finally, if banks cannot hold FSE positions overnight as part of normal market-making activity, they will be restricted in their ability to provide liquidity and make markets in FSE cash equity, sub-debt and derivative positions. The unintended consequence of a loss in liquidity provision is that these rules will also increase costs to financial market end-users, including pension funds and asset managers, who enter into FSE investments directly, through index derivatives or via collective investments. This can only weaken the attractiveness of investing in FSEs at the moment of increased capital requirements and heightened need for issuance.

DB does not have specific responses to Questions 3, 7, or 9 to 11.

We would be very happy to meet with the EBA to discuss any points raised in our response.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and
Regulatory Affairs

Responses to specific questions in the CP:

Q01: Are the provisions of Article 14a sufficiently clear? Are there issues which need to be elaborated further?

There are a number of areas where DB would request further clarity on issues covered by Article 14a of the CP.

In Article 14a (1), which defines indirect holdings of capital instruments we have concerns with the two sections here underlined: "*Indirect holdings of capital instruments pursuant to Article 33(1) (f) (h) and (i) of Regulation xx/XX/EU [CRR], shall include but are not limited to, any exposure, including senior exposures, to an intermediate entity that…"*

The words "but are not limited to" indicate a broadening of the definition of "indirect holding" from what the co-legislators decided at level 1. This creates legal uncertainty and we understand that it is not the intention of EBA to broaden the conclusive definition of 'indirect holding' in Article 22 (17) CRR. The words "Including senior exposures" are unnecessary - the term 'any exposure' in Article 22 (17) CRR is all-encompassing. We therefore request that the EBA delete these two sections.

We welcome that the EBA's intention to clarify what qualifies as 'intermediate entities' in the sense of Article 22 (17) CRR, and we generally agree with the examples provided in Article 14a (1).

However, we suggest replacing "other than institutions" with "other than financial sector entities". This is because direct exposures to FSEs are already covered by 'synthetic holdings' as defined in the CRR.[1] The broad definition of 'financial instrument'[2] ensures that all exposure types are covered and that no circumvention of the related provisions is possible. This clarification would help to avoid confusion when distinguishing between indirect and synthetic holdings.

It would also be helpful if the EBA clarified that "intermediate entities" does not relate to operating entities carrying-out business activities in their own right irrespective of whether such entities have holdings in capital instruments issued by FSEs. For example if a car manufacturer directly holds shares issued by an insurance company; no indirect holding regarding the insurance shares exists where a bank has an exposure to the car manufacturer.

We would appreciate further clarity about the intention of point (i) (given that Article 14a (1) is not conclusive ("*but are not limited to"*). As currently drafted, our interpretation is that entities not included in the same scope of prudential consolidation as the institution which do *not* fulfill these additional requirements do *not* qualify as intermediate entity. We do not believe that this is the intention of the provisions.

Q02: Provisions included in paragraph 1 of the following Article 14a refer in particular to pension funds. These provisions have to be read in conjunction with the deductions referred to in Article 33(e) of the CRR. Would you see any cases where there might be

[1] Article 22 (30a) CRR: 'synthetic holding' means an investment by an institution in a financial instrument the value of which is directly linked to the value of the capital instruments issued by a financial sector entity'
[2] Article 4 (57) CRR (of 16 April 2013): 'financial instruments' means any of the following: (a) contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party; (b) any instrument specified in Section C of Annex I to Directive 2004/39/EC; (c) derivative financial instrument; (d) a primary financial instrument; (e) a cash instrument. The instruments referred to in points (a) to (c) are only financial instruments if their value is derived from the price of an underlying financial instrument or another underlying item, a rate, or an index').

an overlap between the two types of deductions? Please describe precisely these situations and the nature of the problem.

We see potential problems related to the interplay between Article 14a (1)(b) on defined benefit pension funds and the deductions referred to in Article 33 (1)(e) of the CRR.

There will be an overlap between the two types of deductions in situations where the respective net assets on an institution's balance sheet subject to the deduction pursuant to Article 33 (1) (e) CRR, are based on assets that have to be deducted pursuant to this RTS (Article 14a (1)(b)). It is our view that such 'double deductions' should be avoided. We suggest, therefore, that the total capital deduction against defined benefit pension fund assets be reduced by the value of the deduction amount for the pension fund's FSE investments.

Q04: Do you agree with the examples of synthetic holdings provided in paragraph 2 of the following Article 14a? Should other examples be added to this list?

We agree with the examples provided.

Q05: Are the provisions contained regarding synthetic holdings in paragraph 2 of the following Article 14a and in Article 14e sufficiently clear? Do you agree that the amount to be deducted shall be the notional amount? Would you see any situations where another amount shall be used?

Our comment relates to Article 14e (1) which reads: '*Regarding synthetic holdings referred to in paragraph 2 of Article 14a, the amount to be deducted from Common Equity Tier 1 items referred to in points (f), (h) and (i) of Article 33(1) of the Regulation xx/XX/EU [CRR] shall be the notional amount of the relevant instruments*.'

We do not agree that the amount to be deducted should be the notional amount. As the meaning of 'notional' is not specified in the RTS, our comments are based on the assumption that notional for derivatives, for example, a long call, refers to the market value of the corresponding stock, and not the par value of the underlying shares.

Deductions calculated on a notional basis for synthetic holdings will have a disproportionate impact on non delta one derivative businesses (that is, equity derivative businesses). Banks do not manage derivative positions according to their notional amounts. As this is not the correct economic measure of the risk, hedging activity is not undertaken on a one-to-one basis with the contract notional. The synthetic holding positions should be approached on a delta-equivalent basis to reflect how these risk positions are managed economically.

We would also believe that this requirement for calculating the deduction amount conflicts with the Basel 3 definition of the amount to be deducted for synthetic (and indirect) holdings, which is the loss that the bank would suffer if the capital of the respective financial sector entity is written off.[3] The notional cannot be equated with the loss the bank would suffer in case of an insolvency of the respective financial sector entity and is therefore an unsuitable proxy for that loss. A helpful example would be the case of a long call with a market value of zero and delta of 10%, the deduction amount would be as follows:

- the notional value of the long call (that is, the market value of the respective FSE stock) according to the draft RTS;

[3] See Basel 3 FAQ, Q15 on Paragraphs 78–89; i.e. '*In all cases, the loss that the bank would suffer on the exposures if the capital of the financial institution is permanently written-off is to be treated as a direct exposure (i.e. subject to a deduction treatment)*'.

- Zero according to the Basel 3 provision 'loss the bank would suffer', as the bank would simply not exercise the long call.

As noted above, a more appropriate benchmark is the delta equivalent for options, in accordance with the Market Risk Standardised Approach (MRSA). This ensures consistency between the calculation of RWA and regulatory capital within the CRR. It leads, moreover, to results that are consistent from a prudential point of view. The requirements for the deduction amount of synthetic long positions have to be seen in context with the provisions on the netting of long and short positions. To illustrate this, we hope the following example will be of use:

A bank has a cash equity long position in Common Equity Tier 1 (CET1) instruments issued by an FSE; the corresponding hedge is an out-of-the-money, physically settled put option with a residual maturity of three days.[4] If applying the nominal amount as suggested by Article 14e (1) for synthetic long positions, it also has to be used for synthetic short positions. In our example, this would lead to a full recognition of the put option with its notional as a means to reduce the deduction amount for the cash equity long position. This result does not seem prudent, as the maturity of the put is only three days and there is no economic incentive to exercise the put, except in case of a jump to default of the reference asset in the next two days.

Using the delta equivalent instead, results in a short position close to zero that takes both the remaining maturity and the likelihood of exercising the put option into account. Consequently, the offset available under the netting rules for the long position would also be virtually nonexistent. The delta equivalent additionally avoids large jumps in the FSE deduction amount if a short position reaches maturity, as the delta equivalent will reduce over time. For these reasons, we strongly urge the EBA to use the delta equivalent calculation method to accurately reflect the actual hedging properties of short positions as well as the actual risk profile of long positions.

Q06: Are the provisions relating to the deduction of serial or parallel holdings through intermediate entities sufficiently clear? Do you see any unexpected consequences? Are there issues which need to be elaborated further?

Our comment relates to Article 14c (1) (b) which reads: '*b) if the exposures of all investors in these entities do not rank pari passu, as the percentage of funding multiplied with the lower of :(i) the amount of Common Equity Tier 1 instruments held by the intermediate entity in the financial sector entity or (ii) the institution's exposure to the intermediate entity together with all other funding provided to this intermediate entity that rank pari passu with the institution's exposure. (…)*'.

This requirement for calculating the deduction amount conflicts with the Basel 3 definition of the amount to be deducted for indirect holdings, that is, the loss that the bank would suffer if the capital of the respective financial sector entity is written off (see Basel 3 FAQ, Q15 on Paragraphs 78–89; '*In all cases, the loss that the bank would suffer on the exposures if the capital of the financial institution is permanently written-off is to be treated as a direct exposure (that is, subject to a deduction treatment)*'). In the interest of a level playing field, we suggest an alignment with Basel 3.

We hope the following example will provide greater clarity: The intermediate entity in question (to which the bank has an exposure) has an investment of 50 in an FSE and of 50 in a government bond. The bank provides senior funding of 40 to the intermediate entity; the rest of the entity's funding is 60 junior funding provided by another investor. In our example,

[4] Short position eligible for netting pursuant to Article 70a CRR.

"senior funding" denotes positions with a privileged position higher up in the loss waterfall (such as senior bonds or loans), while "junior funding" relates to positions lower in the waterfall.

If the Basel 3 rules are applied to this example, the bank would suffer no loss if the capital of the FSE is written off – and accordingly no deduction has to be made.

Contrary to that, Article 14c (1) (b) would require a deduction of 40.

The correct rule – in line with Basel 3 – would be: [max(FSE investment of intermediate entity – junior funding by other investors;0)] * [bank's investment in intermediate entity/ (bank's investment in intermediate entity + investment of other investors ranking pari passu)] capped at bank's own investment in intermediate entity.

We would also request that the EBA give consideration to the practical implications of assessing the indirect and synthetic FSE holdings of, for example, funds, and even more so funds of funds. Such a wide scope of indirect exposures will result in very large data gathering exercises for all banks on the exact nature of underlying exposures which would be extremely time and labour intensive and which may result in supervisors receiving a volume of information not anticipated or desired.

We urge the EBA to keep in mind obstacles that can be faced when banks look to determine underlying exposures. This is true even within Europe when dealing, for example, with a fund of funds. In such circumstances the bank may act as a market maker for the "parent" fund (Fund A) and Fund A may invest in units of other funds (that is, Fund B, C, …), some of which may be outside of Europe. While Fund A will have the relationship with the bank and be motivated to disclose its positions, Fund B, in which it invests, may not have any legal obligation to do so and the bank may have no legal right, or sufficient relationship, to force Fund B or C, etc. to disclose its positions. Forcing a bank to rely on the investment mandate of Fund B, C, etc. and assuming that the FSE component comprises own shares is extremely conservative. This risks incentivising the bank to withdraw liquidity from investors in Fund A due to onerous process and capital costs. In this context it is important to remember that many of these fund products are for the retail or institutional sectors and are already highly regulated.

A further example where a look through is not possible would be in the case of certain pension funds, where the trustee may not have a legal obligation to disclose underlying exposures to the bank.

Q08: Are the provisions of Article 24b sufficiently clear? Are there issues which need to be elaborated further?

Our comments relate to Article 24b (a) and (b) which read: *'(a) it is <u>used to set interbank lending rates</u> in one or more currencies; and (b) it is <u>used</u> as a reference rate for floating rate debt issued by the institution in the same currency, where applicable*'.

Taking into account the rationale for this RTS (prevention of credit sensitive dividend features), the restriction on interbank lending rates in Article 24b (a) is inappropriate. We believe that the use of stock indices (such as DAX, FTSE 100, MSCI World, S&P Global 100) should be possible, provided the further criteria prescribed in the RTS are met. Since the objective of this RTS is to prevent the rate paid on an instrument increasing when the institution's credit standing declines, we do not see the rationale for reference to a stock index being prohibited. There is no danger that a stock index that, *inter alia*, includes the bank's stocks will rise because of a decline of the bank's creditworthiness.

The same applies for other indices, such as consumer price indices (CPI) or commodity indices which are uncorrelated with the bank's credit standing. Whilst these examples may come as a surprise at a first glance, it should be considered that in the area of Tier 2 instruments, there is a certain demand for bespoke issuances. Since the broad wording of the CRR ("*institutions may use a broad market index*") does also not indicate a limitation to interbank lending indices, the EBA should reconsider whether the prohibition of other indices that are by nature not credit sensitive is really advisable from a prudential point of view.

We would appreciate further clarity about what is meant by "it is <u>used</u> as a reference rate for floating rate debt issued by the institution" in Article 24b (b), and why this is required.

Finally, we suggest a clarification regarding broad market indices "*An index shall be deemed to be a broad market index if it meets all of the following criteria <u>in the ordinary course of its publication</u>*". When a rate of interest is based on an index, it is usually sourced from a public data provider (for example, Reuters); if such a public data provider fails to publish prices (realistically only in case of a natural disaster or act of terror), fall back provisions apply which are agreed among market participants and frequently reassessed in standards recommended by market organisations (such as ISDA). Article 24b of the CP should not prevent the application of such market standards.

Q12: How would you treat minority interests arising from a subsidiary not subject to supervision on a sub-consolidated basis although it is the parent undertaking of other institutions? If the subsidiary would be allowed to undertake the calculation referred to in Article 79(1) on the basis of its sub-consolidated situation, some conditions would have to apply in order to secure this calculation in the absence of a supervision on a sub-consolidated basis. What would you propose as conditions?

We would propose using the Group requirement where the local subsidiary is not subject to supervision under the CRR. According to the Formula set out in the Annex 1, Page 28 of the draft RTS, if an unregulated entity was included, the output would always be 20% of 0 which is counter-intuitive. Therefore, the formula should not apply in that case.

Specific points related to the Consultation Paper not covered above:

<u>Comment 1: Broadened scope of the definition of FSE</u>

As indicated in the cover letter, DB is very concerned with the Capital Requirement Regulation's (CRR) broadening of the "Financial Sector Entity" (FSE) definition compared to the definition laid out by the Basel Committee. Under Basel 3, regulatory adjustments are limited to investments in the capital of "banking, financial and insurance entities". The CRR definition goes beyond the financial sector by including "Mixed Activity Holding Companies" (MAHC), "Mixed Activity Insurance Holding Companies" (MAIHC) and with the broad interpretation of "Financial Institutions" (FI).[5][6] MAHC refers to a parent undertaking which includes at least one institution among its subsidiaries.[7] MAIHC refers to parents with a (re)insurance subsidiary.[8] Neither definition considers the materiality of the respective

[5] Article 4 (92) CRR.

[6] For more detail on broad current interpretation of 'Financial Institution' please see FAQ on Directive 2006/48/EC: http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=869. We consider a more appropriate interpretation to be that delineated in the BaFin Circular 19/1999 on pure industrial holding companies without holdings in the financial sector: http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Rundschreiben/rs_9919_ba.html

[7] Article 4 (71) CRR ('mixed activity holding company' = a parent undertaking, other than a financial holding company or an institution or a mixed financial holding company, the subsidiaries of which include at least one institution). Notably, the carve-out ("other than") relates to entities that are already FSE in their own right).

[8] Article 4 (77) CRR ('mixed activity insurance holding company' = a parent undertaking, other than an insurance undertaking, a 3rd country insurance undertaking, a reinsurance undertaking, a 3rd reinsurance undertaking, an insurance

financial subsidiary and both apply within multilevel group structures.[9] FIs also comprise "undertakings other than a credit institution, the principal activity of which is to acquire holdings", and therefore capture pure industrial/corporate holding companies with no financial sector subsidiaries.[10] The CRR FSE definition captures corporate parents with operative business (for example, car manufacturers or energy companies), even when the financial activities within the group are insignificant, or corporate parents without any financial subsidiaries, simply due to the fact that the group has a holding structure.

This extension of the FSE classification beyond the financial sector will have unintended consequences which are twofold. First, banks' deductible positions will be negatively impacted by exposures to any corporate with a holding structure or with subsidiaries that are institutions or insurance undertakings. Second, large corporates will find it increasingly difficult to raise financing both through loans that will become more expensive due to the asset value correlation factor for FSEs and through the capital markets as banks are strongly dissuaded from buying capital instruments issued by these types of corporates.

Comment 2: Article 14i of the CP on goodwill

We welcome the clarification that institutions are not required to identify goodwill separately for non-significant investments (in contrast to the situation for significant investments / Article 34 (1) (b) CRR).

Comment 3: Maturity of long positions (Article 14h of the CP)

We welcome the EBA's intention to clarify the application of the CRR rules for the netting of long and short positions, since they significantly impact institutions - particularly banks with numerous trading book positions.
However, we do not feel the approach taken in the CP; to slightly amend a provision in the Basel 3 FAQ[11] relating to a situation that is covered elsewhere in the CRR[12] is optimal.

The wording of both Article 70a CRR and Article 14h of the CP ("contractual right to sell", "obliged to purchase") is based on a Basel FAQ which specifically relates to the treatment of a physically settled forward sale.[13] Even if the treatment of cash settled products was not covered by the BCBS provisions, the CRR exemption from the maturity match requirement should be formulated in a way that applies the underlying rationale of the Basel FAQ to all types of short positions, including cash settled products that provide the same economic protection.

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holding company or a mixed financial holding company under FICOD, which includes at least one (re)insurance undertaking among its subsidiary undertakings among its subsidiary undertakings).

[9] Since they are not limited to the ultimate parent and since the CRR prescribes that all subsidiaries of subsidiaries shall be considered subsidiaries of their original parent (Article 4 (61) CRR).

[10] Article 4 (3) CRR.

[11] Question 17 of the Basel 3 FAQ on Paragraphs 78–89, "('this point in time may be treated as the maturity of the long position"'

[12] Article 70a CRR (Deduction and maturity requirements for short positions)
The maturity requirements for short positions referred to in Articles 42(a), 56(a) and 66(a) shall be deemed to be met in respect of positions held where the following conditions are met;
(a) the institution has the contractual right to sell on a specific future date to the counterparty providing the hedge the long position that is being hedged;
(b) the counterparty providing the hedge to the institution is contractually obliged to purchase from the institution on that specific future date the long position referred to in point (a).

[13] Q17. Consider a bank that invests in an equity position (a long position) and sells it forward (a short position) to another bank (with maturity of forward sale below one year). Is it correct that both banks in this example will include a long position on the equity exposure, i.e. the selling bank cannot net the forward sale (as it has less than one year maturity) and the buying bank must recognise the forward purchase (as all long positions are added irrespective of maturity)? Also, given the fact that cash equity has no legal maturity, how does the maturity matching requirement apply?

Cash settled products provide the same economic protection, that is, if a long position defaults:

- Before the short position has reached its maturity, cash settled derivative hedges fully compensate the loss - no different to physically settled derivatives
- After the short position has reached maturity, derivative hedges – regardless of their settlement – may no longer provide protection as the contractual right to sell may have not been exercised and consequently the long position may still be held by the bank. For example, a physically settled long put provides for a right to sell but will not be exercised at maturity if the strike is below the market value of the stock

Finally, we suggest not only applying Article14h for CET1 instruments / Article 42(a) CRR, but also for the corresponding cases in Articles 56(a) and 66(a) CRR regarding Additional Tier 1 and Tier 2 instruments.

Comment 4: Assessment of the threshold of Article 40(a) (determination of the significance of an investment) (Article 14f of the CP)

To carry out the calculation required in Article 40 CRR to determine whether an investment is significant, we do not feel that summing up the amounts of the gross long direct, indirect and synthetic holdings of Common Equity Tier 1 instruments of an FSE is the right approach. Instead, we believe that the focus should be on direct holdings. This specifically relates to Article 40a CRR (‘*the institution owns more than 10 % of the Common Equity Tier 1 instruments issued by that entity*’), but also to the meaning of ‘owns CET1 instruments’ under Article 40 CRR.
The inclusion of all types of holdings in this assessment does not seem to be in line with the rationale of Article 40 CRR. This article deals with three basic scenarios:

(i) ownership of more than 10 % of the CET1 instruments issued by the financial sector entity (FSE) in question (Article 40a CRR),
(ii) close links (Article 40b CRR) and
(iii) Accounting consolidation (Article 40c CRR) (while the two last scenarios also require ownership of CET1 instruments).

This structure indicates that the definition of ‘significant’ investments aims at situations where the bank owns a substantial part of the respective FSE’s capital and/or has voting rights or a significant influence over the FSE in question. Notably, such influence is typically not the consequence of indirect holdings (for example, fund investments) or synthetic holdings (for example, total return swaps). Exceptional cases where indirect or synthetic holdings do lead to such an influence are covered by the scenarios provided for elsewhere in the CRR. For example Article 40b CRR ‘close links’ provisions, which cover such influence through voting rights for example, or Article 40c CRR ‘accounting consolidation’ covering, amongst others, funds dominated by the firm, or where options providing an opportunity for such an influence already lead to a consolidation in accounting). Accordingly, ‘owns CET1 instruments’ in the sense of Article 40 CRR should be interpreted as ‘direct holding’. Article 40 CRR specifically uses the term ‘*owns* CET1 instruments’ – and not the term ‘*direct, indirect and synthetic holdings* of CET1 instruments’ which otherwise prevails throughout the CRR. This further indicates that ‘owns’ (in contrast to the broader ‘holds’) relates to ownership in the legal sense. The fact that holdings in Additional Tier 1 and Tier 2 instruments are not relevant for the determination of the significance of an investment also illustrates that ‘significant’ investment in the sense of Article 40a CRR indeed only refers to direct holdings of CET1 instruments (i.e. the respective ownership- and voting rights).

The inclusion of synthetic and indirect holdings could also lead to an unwanted volatility of the classification of investments as either 'significant' or 'non-significant'. This is particularly so for banks with large trading book positions. Finally, it should be kept in mind that EBA's mandate under Article 33 (2) CRR does not cover amendments to Article 40 CRR.

Comment 5: Article 14g (2) (Holdings of Additional Tier 1 and Tier 2 – paragraph 2 on defined benefit pension funds)

We do not understand the intention of Article 14g (2). We believe that the general principle outlined in Article 14g (1) is sufficient as it is complemented by Article 14g (2) which ensures that deductions for own fund instruments have to be applied first, as opposed to capital instruments issued by other FSE, but always within the same tier of capital (in line with the general corresponding deduction approach). Moreover, we do not see the necessity of a specific rule for defined benefit pension funds in addition to Article 14g (1) of the CP.

Even if such a rule would be necessary, some wording in Article 14g (2) is unclear. We question why the first part relating to CET1 instruments is dealt with in an article with the heading '*Holdings of Additional Tier 1 and Tier 2*'. The reference '*other holdings of CET1*' is also unclear: is this a reference to holdings of CET1 instruments issued by other FSE – that is, not own shares issued by the bank calculating its deductions?

We propose the following drafting clarifications:

Proposed Article 14 g:

Article 14g-
~~*Holdings of Additional Tier 1 and Tier 2*~~ *Corresponding deduction approach*

1. The methodology outlined in Articles 14a to 14e will be applied to Additional Tier 1 holdings for the purposes of Article 53(a), (c), (d) (f) and to Tier 2 holdings for the purposes of Article 63(a), (c), (d) of Regulation xx/xx [CRR].
2. ~~For the purposes of Article 14a 1 b)~~ The corresponding deduction approach shall be carried out as follows within each tier of capital:~~,~~ ~~i~~In case the intermediate entity holds Common Equity Tier 1 instruments of the institution, those shall be deducted first. If the deduction of Common Equity Tier 1 instruments of the institution ~~to be deducted~~ as a result of the calculation above is less than the deductible exposure ~~total funding provided~~ by the institution to the intermediate entity, ~~other~~ holdings of Common Equity Tier 1 instruments issued by other financial sector entities shall be considered for the deduction of Common Equity Tier 1 instruments. For deductions of Additional Tier 1 instruments and Tier 2 instruments, similar principles shall apply. ~~Similarly, i~~

3.In case the intermediate entity holds Common Equity Tier 1 instruments, Additional Tier 1 instruments and Tier 2 instruments of financial sector entities and where the institution is not able to determine the maximum percentage for its investment in the respective tiers of capital, the Common Equity Tier 1 instruments shall be deducted first, the Additional Tier 1 instruments shall be deducted second, and the Tier 2 instruments last.

Comment 6: Credit Instruments and Risk

The specific nature of instruments, hedging and exposure in the credit markets need to be considered when calibrating exposures to FSEs and the associated capital deductions. For example we have a market making desk offering a service to clients hedging market moves in the European financial credit indices referencing either senior or subordinated debt of 25 European financial names. These are generally not long term strategies/trades yet would be heavily penalised under the regulations by incurring a capital charge. We urge the EBA to give consideration to the treatment of these types of market making instruments.

Secondly, the FSE regulations discuss "loss" in the context of the capital of the FSE being "permanently written-off". Whilst this makes sense in the equities markets, in the credit markets this implies default or restructure, either of which would constitute a credit event under ISDA. Therefore, the "loss" would be determined by the recovery set by the CDS auction where the debt is split into three maturity buckets (<2.5 / 2.5-5 / 5+), each of which has one recovery per tier of debt. Hence, the language currently in place which prohibits offsetting positions longer than 1 year with positions of less than 1 year is not reflective of the economics. Furthermore, the likelihood is for "cross default" which means that the senior debt referencing CDS would also be triggered and, thus, offset any potential losses incurred. Again we urge the EBA to consider the specific nature of credit risk and exposure when calibrating these rules.

Finally, we would like to highlight the fact that for Trading Book positions the capital charges introduced under CRD III, for example the Incremental Risk Charge (IRC), were designed to capture loss from default in these instruments already (as well as rating migration). Any additional capital charge on Trading Book credit instruments only serves to reduce liquidity and increase funding costs for European FSEs with no clear benefit.