Deutsche Bank

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07 September 2012

Deutsche Bank AG
Winchester House
1 Great Winchester Street
London EC2N 2DB

Tel: +44 20 7545 8000

Direct Tel +44 20 7545 1903
Direct Fax +44 20 7547 4179

Mr. Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
Basel
Switzerland

baselcommittee@bis.org

Dear Mr. Byres,

Basel Committee Consultation Paper on the Fundamental Review of the Trading Book

Deutsche Bank welcomes the opportunity to share with the Basel Committee (BCBS) our views on the fundamental review of the trading book. We have also contributed to, and support the points contained with the ISDA/IIF consultation response.

We agree with the Committee's objective to seek a more consistent framework for trading book risk and in general are positive about the review given concerns around a number of issues such as the use of Value at Risk (VaR) and the risk of market illiquidity stemming from the financial crisis. These are very valid concerns that need addressing.

The new framework should be based on the following:

- A realignment of capital rather than starting from the presumption that yet more capital is needed;
- A comprehensive risk sensitive framework and should not result in supervisors using add-ons or calibrating the framework to achieve a particular capital outcome. Pillar 2 should be used for that purpose; and
- A comprehensive quantitative impact assessment.

Finally, putting in place new rules around the trading book is not only complicated but raises very complex issues around implementation. Consequently there is a trade-off between accuracy and precision versus effective implementation. In addition, the fundamental review should cover the current patchwork of market risk capital frameworks in its entirety.

If it would be useful we would be happy to meet with the Committee to discuss our response

Yours sincerely,

Andrew Procter
Global Head of Government and Regulatory Affairs

Detailed Comments in Response to CP Questions

1. The Trading Book/Banking Book Boundary

Q1. Which boundary option do you believe would best address the weaknesses identified with the current boundary, whilst meeting the Committee's objectives?

Although there are advantages and drawbacks to both approaches, Deutsche Bank prefers the trading evidence based boundary approach. We believe that the boundary should be defined at the portfolio and not the position level.

We share the views expressed in the joint associations (ISDA/IIF) response on the valuation Approach, namely the way in which it requires AFS and other portfolio's which are fair valued to be included in the Trading Book and assigned market RWAs. A valuation based approach would force a material break between the regulatory categorisation of risk and how the risk is actually managed.

The Trading Evidence Based Approach aligns capital with how risks are managed by banks and importantly eliminates the break between the way in which fair valued portfolios in the Banking Book are managed and their accounting treatment. However, we believe that this approach brings with it difficulties in assessing trading liquidity. We also agree with the trade associations observations about the assessment of trading liquidity. Regard should be had to the availability of hedging, so that products are included where they are actively hedged by liquid instruments. We believe that this allows the inclusion of portfolios according to the trading-evidence criterion which would otherwise only be captured under a valuation-based approach. A typical example of such portfolios would be fair-value banking book loans for which an active CDS market exists.

We agree that migration between the Trading and Banking Books should be rare and closely controlled, however that the boundary should not be impermeable: the liquidity of markets together with trading intent, may change. This may occur if market liquidity dries up and the bank chooses to hold to maturity rather than continue to hold the assets in a trading portfolio. If trading intent changes due to exogenous conditions then the evidence supporting that intent will also change. However, as a condition of migration there should be both strong supervisory oversight and bank governance that controls and monitors these movements.

2. Moving from value-at-risk to expected shortfall

Q8. What are the likely operational constraints with moving from VaR to ES, including any challenges in delivering robust backtesting, and might these be best overcome?

Deutsche Bank supports in principle the move from VaR to Expected Shortfall (ES) which is a purer risk measure given that it is based on statistics in capturing the full tail behaviour. We believe, however, that the 95th percentile would be a more appropriate threshold from which to calculate Expected Shortfall for a number of reasons:

- Expected Shortfall computed from a lower percentile delivers a similar capital standard to VaR computed at the 99th percentile.
- Calculations at the 99th percentile bring with them more volatility and instability when scenarios use historical simulations – this also applies to allocation of regulatory capital to individual business lines.

- Choosing a threshold that is too high may result in some businesses not attracting any regulatory capital allocation at all – despite taking some tail risks.

Direct backtesting of the ES metric, which is by definition a complex aggregation of parts of a distribution, is not meaningful. However, the established outlier backtesting can remain to continuously monitor model performance. This is because the quality of the ES metric (or any other aggregation metric) is directly implied by the quality of the simulated or projected P&L distribution. Regulatory backtesting at present, however, could be enhanced by considering the full distribution rather than one selected percentile.

3. Calibrating to a period of significant financial stress

Q5. What are commenters' views on the merits of the "direct" and "indirect" approaches to deliver the Committee's objectives of calibration the framework to a period of significant financial stress?

The indirect method first calculates the ES on the most recent market data returns of the full set of risk factors, then the ES is scaled up by a ratio of ES (using historic market data) divided by ES (using recent market data) where this ratio is only calculated on a representative subset of factors. In contrast, the direct method calculates the ES using historic market data on the full set of risk factors.

We support the use of the indirect method for several reasons:

(1) The indirect method introduces more flexibility where historical market data may not be available. Thereby, it reduces operational complexity of creating proxy time series for days gone past.

(2) As the indirect method calculates an ES based on the recent market data, it would have practical use in day-to-day risk management, i.e. a "Use Case". Depending on the time horizon over which ES is to be constructed, it could be quite similar to the Value-at-Risk, albeit calculated at longer liquidity horizons.

(3) The requirement of successfully meeting backtesting thresholds for model approval would tie in more naturally with an ES based on recent market data. Also, backtesting on historical market data would be particularly difficult and at times not very meaningful.

Notwithstanding our support of the indirect method, we also recommend that the indirect method formula should be adjusted in conformance with the ISDA/IIF response.

4. Comprehensive incorporation of the risk of market illiquidity

Q2. What are the commenters' views on the likely operational constraints with the Committee's proposed approach to capturing market liquidity risk including the endogenous component and how might these be best overcome?

We are supportive of having a set of different liquidity horizons in place; however, we believe it would be more effective to base liquidity assumptions on underlying risk factors rather than on specific instruments. Therefore liquidity horizons should be assigned to classes of risk factors. There are a number of operational issues that need to be resolved including the length of stressed periods, the granularity of the chosen periods to be assessed and the frequency of assessment.

While capital add-ons may be appropriate in limited circumstances where there are concerns about the liquidity horizon, they would lead to double counting and will not result in a fundamental improvement of the framework. Conservative adjustments to the liquidity horizons on the other hand would increase capital requirements but keep the model relatively simple.

An endogenous liquidity constraint is difficult to measure and capitalise. Stress tests are more appropriate for large, concentrated positions, and idiosyncratic events. Therefore, we are not supportive of an overly complicated, endogenous, liquidity test.

5. Treatment of hedging and diversification

Q6. What are the commenters' views on the merits of the desk-based and risk-factor-based aggregation mechanisms to deliver the Committee's objectives of constraining diversification benefits?

The recognition of diversification and netting in the framework is a welcome development and will help better align risk with regulatory capital.

Although we conceptually support the direction this section is taking, there are shortcomings to the proposed approach. As stated in our cover letter, the fundamental review should lead to a model which is risk-sensitive and delivers a consistent framework for quantifying risk. The hedging and diversification approach suggests a group of fragmented stand alone models which are connected by supervisory correlations.

- The formula needs to be more clearly defined: The level of granularity is not clear – Is a "risk factor" a particular trade, an asset class, a time series or a business? Depending on the definition it could require thousands of correlations.
- The correlations between different risk classes are position dependent and cannot be prescribed as fixed correlations.
- Although the reasoning behind having supervisory correlations is understandable, they are likely to lead to unusual model effects and regulatory arbitrage.
- The aggregation is in fundamental contrast to the detailed modelling requirements for a meaningful expected shortfall implementation. Replacing portfolio models by supervisory correlations will clearly have a negative impact on the future development of more realistic models for risk quantification in the banking industry.
- Backtesting of total capital demand is not possible.
- It is not entirely clear how the approach would work for hybrid instruments which spread across risk classes. An artificial floor to correlations will lead to poor capital allocation.
- The definition of L_i is unclear in that it would be difficult to detect whether a particular trade leg is long and/or short in a complex portfolio with thousands of risk drivers.

We believe that the model should be driven off real data and full correlation.

6. Relationship between internal models-based and standardised approaches

Q3. What are commenters' views on the proposed regime to strengthen the relationship between the standardised and internal models-based approaches?

The calculation of the standardised capital requirements for all banks would be beneficial as a uniform benchmark but needs to be designed so as not to overburden internal model banks:

- It may lead too many regulatory processes, particularly if the Basel 1 transitional floor remains in place.
- The reporting frequency should reflect its use as a fall back mechanism not used for day-to-day risk management and should not be as frequent as for internal models.

The proposals suggest that there should be regulatory capital floors based on the standardised approaches. We believe that this would be contrary to Basel objectives by disincentivising the improvement and development of risk modelling. It would also be very challenging to find the appropriate level of any floor. Instead we believe there should be a convex calculation based on weighted averages to smooth any cliff effects.

The desk level approach to putting in place standardised models would be particularly difficult from an operational perspective and would lead to a clear risk of arbitrage. Thought also needs to be given to the treatment of netting and diversification benefits. We believe that more supervisory attention should be paid to the ensuring firms make internal models are robust rather than forcing everyone to use the standardized approach.

7. Revised models-based approach

Q4. What are commenters' views on the Committee's proposed desk-level approach to achieve a more granular model approval process, including the implementation of this approach for banking book risk positions? Are there alternative classifications that might deliver the same objective?

The proposed three step approach to model approval is neither practical nor appropriate. It is not clear how one would remove risk factors from an internal model (using full revaluation) to be treated under the standardised approach. In practice, desk-level based internal model approval could easily lead to regulatory arbitrage. We would propose that model approval should be product-based, i.e. for a particular product the same capitalisation method should be used across the bank (irrespective of desk) as long as the same VaR valuation techniques are in place. Then desk-level add-ons (e.g. via VaR outliers) could be introduced in addition to the standardised approach floor.

We also believe that the review of the CVA charge being carried out by the Basel Committee's Risk Model and Methodology Group (RMMG) should be integrated into the fundamental review. Otherwise the treatment of credit could end up misaligned with the models proposed under the review.

8. Revised standardised approach

Q9. Which of the two approaches better meets the Committee's objectives for a revised standardised approach?

We believe that the ideas underlying the revised standardised approaches constitute a step in the right direction as they consider key elements of modern market risk measurement, in particular long-/short offsetting and risk driver dependencies. However, implementation of either approach will require a substantial investment both at inception (e.g., feeding all relevant information into the regulatory calculation process) and for regular production (market data, mapping maintenance).

From a methodology viewpoint, neither approach (based on simple Gaussian and Taylor assumptions) is capable of reflecting complex tail risks. The bucketing is also unlikely to capture basis risks. Hence, in order to avoid results well below those derived from internal models, a conservative calibration will be essential.

It is also not clear to us how the output of the approaches shall be validated as no direct link to a loss distribution approach and relevant time horizon is given.

At this stage, we are not in a position to decide on which one of the two proposed new standardised approaches should be preferred. Such a decision should be based on a thorough quantitative impact study following a detailed model description and an initial parameterisation proposal. Our initial observations in this context are as follows:

Partial risk factor approach:

- Simple approach (inner product of risk weighted market values aggregated over buckets)
- Strict reliance on regulatory prescribed method and parameterisation will help comparability and support level playing field
- Input requirements broadly in line with COREP framework – reducing additional implementation work

Full risk factor approach:

- More sophisticated approach (applying prescribed shocks to positions mapped to respective risk factor)
- Similar complexity to an internal (full revaluation) model but simple aggregation method reduces quality of the result
- Reliance on bank's own valuation routines curbs comparability

9. The appropriate treatment of credit

Q7. How can regulators ensure robust supervision of integrated market and credit risk modelling? In particular, how would an integrated modelling approach affect other elements of the proposed framework (e.g. the choice of the quantile parameter for ES, the P&L attribution and backtesting processes etc)?

Our preference would be for an integrated model although we accept there are challenges in achieving that. It would deliver significant benefits, e.g. if the current patchwork of models and

infrastructure could be simplified, there would be greater transparency and it would be possible to achieve better management of individual portfolios. We also anticipate that an integrated approach would allow for more efficient correlations between risk factors and would eliminate much of the double counting of risks in the current framework. Where double-counting remains, banks should be allowed to quantify and deduct capital stemming from double-counting of credit spreads and rating migration effects.

An integrated approach would result in additional complexity however if a desk-level approval or withdrawal of internal models was implemented. As default risk and credit migration are common to most desks, a partial model application would not appropriately reflect those risks across the whole portfolio. In particular, concentrations in single issuer names may not be picked up.

10. Do Commenter's propose any amendments to these approaches?

Refer to our answers to the above questions.