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Mr. Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
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Dear Mr. Byres,

Deutsche Bank's (DB) response to the Basel Committee on Banking Supervision "the Committee" consultation on revisions to the Large Exposures regime

DB welcomes the opportunity to comment on the Committee's proposed revisions to the Large Exposures regime. We support the Committee's goal to ensure that banks consistently measure, aggregate and control exposures to single counterparties across their books and operations.

To be effective, the new reporting framework must provide supervisors with meaningful information, whilst ensuring that the volume of required reporting does not lead to information overload or dilute focus on the critical exposures.

The regulation of Large Exposures is intended to keep the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency. Going-concern capital as per the Basel III framework (i.e. Tier 1 Capital) should be the relevant capital measure for Large Exposure purposes.

We wish to highlight two critical concerns with the proposals:

We strongly oppose replacing the internal models approach with the Current Exposure Method (CEM) for calculating exposures:

- Internal models are subject to rigorous validation processes and backtesting, and require a regular dialogue with supervisors. As a result, supervisory-approved measures become part of a dynamic process that allows for necessary modifications; and
- Furthermore, establishing two separate processes for Large Exposures and risk-based capital could lead to considerable operational risk. Should regulators decide that despite the points made above, a standardised measure is required, a number of significant modifications would be necessary, including recognition of netting agreements.

We believe that the proposed look-through approach (LTA) for investments in funds, securitisations and other vehicles with underlying assets should be modified to ensure the following:

- Look-through is currently hindered by the fact that in many instances, the required information is not available - particularly not in "real time". We propose that the "best available information" for assessment be used where fully contemporaneous data is not available;
- The proposed granularity threshold of 1% of the total value of the transaction is so low that it would only rarely be met (even in the case of highly regulated and granular funds like UCITS). Banks would accordingly be required to aggregate those exposures to a

single so-called “unknown counterparty”, leading to a significant build up of this type exposure and potentially reaching the hard limit. This would in effect preclude banks from investing in any further instruments where full information on underlying assets is not accessible. We recommend that the proposed granularity threshold be set at 5% (in line with the current threshold applicable in the EU[1]). Failing that, we suggest that where the bank is able to identify the outliers (over 1%) and to aggregate and monitor the LTA exposure with other directly held exposures to the outlier, the remaining portfolio should still benefit from the non-LTA approach if the 1% threshold is met. As a further refinement to the treatment of “unknown clients” we think more than one bucket for unknown clients could be established where they can be distinguished in a meaningful way. For instance, where certain underlying exposures cannot be identified, it may nonetheless be possible to further characterise these exposures through information disclosed in prospectuses, or through stated investment policies and concentration limits; and

- Finally, neglect of credit enhancement as a key risk driver of any securitisation product seems inappropriate, especially in the context of a Large Exposure framework that aims to capture the effect of a single counterparty default.

Our detailed comments are attached in the Annex. We would be happy to meet with the Secretariat of the Committee to discuss further any of the points raised in our response.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and
Regulatory Affairs

[1] Committee of European Banking Supervisors guidelines on the implementation of the revised Large Exposures regime, December 2009 http://eba.europa.eu/documents/10180/37070/Guidelines-on-Large-exposures_connected-clients-and-schemes.pdf

Questions & Answers

1. The Committee welcomes views on the proposed definition of Large Exposures and on the proposal for reporting.

It is clear that the proposal to lower the reporting limit primarily has the purpose of raising early warning flags. That said, to capture relevant exposures, the new reporting framework needs to provide supervisors with meaningful and useful information, whilst ensuring that the volume of required information does not lead to information overload and a diluted focus on critical exposures.

The proposed reduction of the threshold for defining Large Exposure from 10% to 5% will lead to a disproportionate increase of clients subject to the reporting requirements. The proposed 5% threshold is significantly more stringent than current requirements especially when considered in combination with: a) narrowing the basis of the capital calculation from total capital to either Common Equity Tier 1 (CET1) or Tier 1; and b) stricter exposure measurements. The indicative calculation for DB shows the number of clients in scope will increase by the factor greater than ten. Consequently, there will be a significant increase in processing costs resulting from the increased utilisation of the approval process and continuous monitoring during the quarter.

Furthermore we would like to emphasise that the definition of the Large Exposures threshold of 10% of eligible capital is already significantly below the Large Exposure limit of 25% and thus should be sufficient as an early warning indicator.

Finally, no clear rationale has been given for lowering the Large Exposure reporting threshold. If the intention is to use the data for macro-prudential purposes, we consider the Large Exposure regime to be inadequate for obtaining valid data for meaningful analysis of relevant risks. The Large Exposure regime is focused solely on the limitation of credit risk. Other regulatory and statistical reports can provide better information on sectoral and geographic risks.

2. The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.

DB is already subject to Large Exposure reporting requirements under the German Banking Act and the Large Exposures and Million Loan Reporting Regime. The provisions and aims of this existing legislation regarding identification of connected counterparties are almost identical to the proposals in the current consultation. As part of our compliance with these regulations, we have well-defined processes in place that identify connected counterparties, and feel these work well.

Our concerns regarding the "connected counterparties" definition put forward by the Committee are that the wording is broad and vague, which leaves room for inconsistency in how this language might be translated into technical requirements across jurisdictions. The Committee should elaborate upon this section to provide more clarity and further detail. In this context we point the Committee to the rules that are set out in German regulation.

We feel that much more detail is needed in the "connected counterparties" section to mitigate the uncertainties noted above.

3. The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1.

We agree with the Committee's assessment in paragraph 44 that no compelling reason was found for "departing from the definition of going-concern capital in the Basel III framework for large exposure purposes". Therefore the limit should not be based on Common Equity Tier 1 Capital

(CET1) only, but should instead be based on Tier 1 Capital in its entirety, i.e. including Additional Tier 1 (AT1) Capital.

This is consistent with the definition of going-concern capital in paragraph 49 of the Basel III framework. It is also adequate since the qualitative requirements for AT1 capital are much stricter than that for hybrid Tier 1 Capital under Basel II. It should also be taken into account that from a regulatory perspective, the use of AT1 Capital is already restricted, with banks being allowed to meet only a small part of their minimum capital requirements (1.5%) with AT1 Capital.

4. The Committee welcomes views on the extent and nature of the use of internal models (when they have received supervisory approval for being used for Pillar 1 capital requirements purposes) to measure Large Exposures.

We believe the Committee should affirm the use of internal models, where these are approved for Pillar 1 risk-based capital calculations, as this would be the most accurate way to assess the exposures concerned. In addition, we feel the Committee's view that model use "could generate differences in the way that individual banks measure similar exposures" cannot be substantiated by evidence, and such concerns should be addressed through peer review and other cooperative efforts.

It would seem inconsistent for the Committee to question whether it is appropriate to use internal models for the Large Exposure calculation, while supporting their use for the calculation of bank capital and evaluation of capital adequacy (where models are used for the evaluation of extreme credit and market stress events). Forcing banks to create an entirely separate process for Large Exposures that would not otherwise be used for risk or regulatory purposes could result in increased operational risk, as this would not be fully integrated into firms' existing processes.

We understand that to calculate maximum exposure estimates for individual counterparties, model parameters would be adjusted beyond normal bounds. However, we believe this could easily be accommodated in the model environment, and that appropriate estimates would be generated. This is therefore not a valid reason to reject the use of models.

Counterparty exposure estimates would inaccurately represent the risks and be potentially seriously deficient when compared to other methods. Further detailed evaluation would be needed in order to quantify the risks of any approach, particularly as revised Current Exposure Method (CEM) rules are under consideration. All acceptable alternatives should be considered, including use of the Standardised Method. Banks should be encouraged to use the most accurate acceptable framework.

Finally, we recommend that the Committee provide further clarification regarding the time period(s) relevant for Large Exposure evaluation. Many counterparty exposure elements refer to current mark-to-market values (e.g. loans, securities), but others consider value migration to a horizon (e.g., Current Exposure Method (CEM) for over the counter derivatives (OTC), incorporating Potential Future Exposure (PFE) adjustment). These should be harmonised.

5. The Committee welcomes views on the proposal to calculate exposure value of banks' investments in OTC derivatives.

It is our view that the CEM grossly overstates exposure to derivative transactions. This is caused by the fact that netting benefits across trades within one netting set are only recognised up to a certain level due to the application of a floor and because diversification benefits due to different tenors or underlyings are not recognised at all.

Trying to extend such an approach to will not provide meaningful results. In particular we believe that one aspect of the CEM cannot be adapted in a meaningful way to larger, market-making portfolios. Large portfolios will generally have significant hedging benefits across positions referencing the same underlying risk drivers. The risk of such positions cannot be simply the sum

of the risk of each position when looked at in isolation. Critically, trying to adapt a CEM-like approach to account for the complexity of actual portfolios will be extremely challenging and is better achieved using an approved internal model method (IMM) calculation. For example, for CDS a simple, rules-based approach to provide netting benefits quickly becomes difficult as parameters are required to account for variations, such as where CDS on the same obligor have different coupons or maturity dates, CDS on an obligor hedges versus that within an index or tranche position, CDS across different obligors, etc. and can only be properly accounted for within a more complex model;

We estimate that using the CEM approach for derivatives exposures rather than IMM increases exposures by between 600 and 1200%. This results in figures for large counterparties that far exceed any potential exposure and which would in many cases grossly exaggerate and distort a bank's true large exposure risk. The objective of the large exposure regime should remain focused on exposures that could realistically exist. As such, we do not feel the intent of the Large Exposure framework is served by such exaggeration.

If, notwithstanding these concerns, the Committee feels a "non-model" approach is warranted, an alternative exposure methodology should be developed that:

- respects the full extent of exposure netting and collateral offset legally permitted under the master agreement;
- recognises risk offsets in the underlying master agreement portfolio, as well as offsets with non-derivative positions; and
- represents an actual net exposure value that could actually exist at a single point in time.

Lastly, it is important to take account of the continuing discussions between the Committee's Risk Modelling Group and industry representatives in relation to replacing CEM with a new non Internal Model approach, with consideration of recognition of thresholds and frequency of margin calls and changes to add-ons.

6. The Committee welcomes views on the proposal for how the exposure values of banks' investments in securities financing transactions should be calculated, in particular on the need to deviate from the risk-based capital requirement rules given the objectives of a Large Exposures framework.

As stated in our response to Question 4, we recommend that the Committee affirm the use of internal models, where these are approved for Pillar 1 risk-based capital calculations, as this would most accurately assess the exposures of concern.

The current proposal will result in overstating exposures to securities lending as a result of applying different haircut on both the loan and collateral legs of the transactions. In addition, the proposed hybrid approach to financial collateral will materially increase exposures to collateral providers, failing to address the 'double default risk' outlined in our response to Question 8. Failure to address the above concerns will have material impact on the real economy to the extent that financing will be reduced.

If internal models cannot be used, supervisory haircuts should be aligned with market observable haircuts to reflect true exposures.

7. The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.

The uniform 100% CCF for all "traditional" off-balance sheet commitments likely does not appropriately calibrate the CCF for the vastly different types of off-balance sheet commitments that exist. The flat 100% CCF is even more conservative than the CCFs in the Basel II Standardized Approach, contrary to the overall goal of remaining consistent with the risk-based

Basel Framework. We suggest having an unchanged 50% risk weight for all commitments not used (free limits) which have an original lifetime with up to 1 year.

We agree with the Committee that applying the flat 100% CCF would be inappropriate to exposures linked to trade finance activities.

That being said, we respectfully request the Committee to recommend the use of internal CCFs for banks using the advanced approach under the Basel framework and standardised CCF for banks using standardised approach.

8. The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals.

The Committee has explained that the Large Exposure regime should serve as a backstop in the event of a sudden default of a certain counterparty (or group of connected counterparties), hence a joint default scenario should not form the basis of the rules. The proposed hybrid approach would combine haircuts, substitution, and transferral to the issuer of the collateral, although the total amount would only be lost when both the original counterparty and the collateral counterparty default at the same time. Therefore, the direct exposures to the counterparty and "secondary" exposures (generated by collateral) should be treated differently, and the comprehensive approach for the purpose of large exposure limits should be used. This also is better aligned with the risk-based capital regime.

In additional, the approach should take into account that physical collateral under the appropriate procedures (for example, precious metals conforming to market standards) is liquid, in the sense that it can be immediately used in the event of a counterparty default. Hence it should be permitted to reduce exposure values.

9. The Committee welcomes views on whether the approach proposed for calculating exposure values for trading book positions raises specific issues.

We agree with the Committee that a large exposure framework should only capture single-name concentration risk stemming from a counterparty default and not other types of concentration risk. However, we would like to point out that current standards for (internal) market risk capital models already require consideration of concentration risk under Pillar 1 (for example, BCBS 158, art 718(lxxxviii), 718(xciii), and 718(xcix)).

Regarding instruments where an LTA would be appropriate please see our comments under Q12 and Q13. Also, given the typical holding periods in the Trading Book, the LTA would not necessarily help in achieving the stated goal of the proposal.

10. The Committee welcomes views on the proposals for offsetting long and short positions, in particular when these positions are in different issues.

In theory, we support the requirement to consider seniority in the application of netting. Banks already differentiate and control risk based on a distinction between Senior/Subordinated and Equity tranches. We recommend a simple approach, allowing the distinction only between the 3 levels as stated in paragraph 93. However, we consider it harsh to assume 0% recovery for all subordinated issuance compared to 100% for senior issuance, as this is inconsistent with the proposal's principles which specifically address ignoring recovery rates. We recommend the committee use market data to refine the recovery assumption.

As per paragraph 92, CDS curves and bonds are marked and managed in a similar way. Therefore, the proposal not to have a percentage adjustment between bonds and CDS positions is appropriate. Rather, as noted above, netting should incorporate different recovery rate assumptions across different subordination levels.

Furthermore, given the focus is on the risk resulting from a counterparty's jump-to-default, prohibiting the netting between trading and banking book positions does not reflect risk management in practice.

11. The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.

DB supports the proposal to exempt specific intraday and overnight exposures meeting the conditions set out in paragraph 102, in particular to avoid unintended consequences for the interbank market. We note that this type of exposure is often uncommitted; allowing banks greater flexibility to manage such exposures in periods of stress. In conjunction with this, the case for special treatment with stricter limits for global systemically important banks (G-SIB) has not been made. G-SIBs are already subject to more intense supervision and enhanced prudential requirements, including additional capital buffers, as well as being more advanced in recovery and resolution planning. Hence, G-SIBs are arguably more resilient to losses than other banks. Furthermore, G-SIBs are in practice the main international liquidity providers and trading counterparties - limiting G-SIB exposure could potentially affect global financial markets, particularly in times of stress.

12. The Committee welcomes comments on the calibration of the granularity threshold and whether the mandatory application of the look-through approach to the transaction where an underlying exposure may exceed the granularity threshold will raise specific issues.

For collective investment undertakings/funds, securitisations and other vehicles with underlying assets, a strict LTA and a very conservative granularity threshold of 1% is proposed. This would require significant effort, and despite this, in many instances information is simply not available to the bank. Due to the lack of required 'real time' information on the underlying assets and the fact that the granularity threshold of 1% will almost never be met in practise, there will be a significant concentration of banks' exposures to the 'unknown client'. This does not provide useful information from a prudential perspective and calibrating the LTA and granularity threshold should be done in a way so that application is possible in practice, not just theoretically.

We therefore propose the following, with more detailed explanations and suggestions below:

- banks be allowed to use the latest available and reasonably current information on asset composition, even if it is not 'real time';
- the granularity threshold be raised to a more practical level. This should be at least 5% (as currently prescribed under CEBS guidelines in the EU and also in line with concentration limits prescribed by e.g. UCITS[2] regulation), and in certain cases at least 10% – in line with existing regulation on the entities in question;
- in the absence of such adjustments, we suggest that where the bank is able to identify the outlier (over 1%) and to aggregate and monitor the LTA exposure with other directly held exposures to the outlier, the remaining portfolio should still benefit from the non-LTA approach if the 1% threshold is met.
- a feasible alternative to the single 'unknown client' bucket should be considered, in order to provide more meaningful results that are still prudent. This could be achieved by using more than one bucket for unknown clients where it is possible to find a way to distinguish between them. Our proposal is detailed in the section below.

[2] Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) of 13 July 2009
http://ec.europa.eu/internal_market/investment/docs/ucits-directive/directive_2009_65_ec_en.pdf

Treatment of entities

The LTA and the granularity threshold raise specific issues in regard to the different entities in question, i.e. securitisations and fund investments.

Securitisations:

The benefits of requiring a bank to apply a LTA to all underlying assets, even if only one underlying asset exceeds 1% of the total value of the transaction, would not in our view bring about the desired benefits. The neglect of credit enhancement as the main risk driver of any securitisation product would be inappropriate, especially in the context of a Large Exposure framework targeting the effect of a single counterparty default as specified in No. 9, p.3 of the consultation document.

For more senior positions with significant credit enhancement, the structural buffer provides a significant cushion against credit degradation of individual smaller positions; for more junior tranches, higher capital charges result in many of these potential losses already being accounted for in Tier 1 capital, hence reflecting these in the large exposure regime would be an extreme penalty. This holds especially true for tranches of index CDS: The division into tranches should be taken into account since it makes no sense to allocate a mezzanine tranche or senior tranche held in the trading book to the large exposure credit, if it is clear from the thickness of the subordinated tranches that the mezzanine or senior tranche will not suffer any loss, at least during the life time of the transaction.

Establishing a higher granularity threshold (e.g. 5%, as is currently the case in the EU through CEBS guidelines), especially for non-corporate portfolios, (e.g. consumer/retail exposures) would be more appropriate, as it would allow institutions and regulators to focus on those exposures that represent true potential concentration risks for the institution. An exemption for Senior Notes with a credit enhancement level higher than any underlying exposure would be an option to further narrow the focus to relevant exposures.

Building the technology to look through and map all underlyings on a dynamic basis would, apart from being operationally burdensome, risk seriously decreasing the liquidity of certain types of securitisation transactions, which would raise costs of many borrowers (corporate and financial alike). Additionally, if the threshold remains at 1%, institutions would have issues with transactions that have substitution rights (ie. senior portions of Loan CDOs) - such limitation would drive up borrowing costs and potentially limit the ability of banks to provide financing to these vehicles.

As noted above, coupled with the lowered reporting threshold, this proposal would lead to the adverse scenario that the number of reported Large Exposures gets inflated, drawing the attention away from the actual material Large Exposures.

We also suggest to appropriately consider the different properties of trading book securitisations in order to reflect the shorter term hold periods required on trading positions, the fact that those securities must be carried at market value (a price that should reflect credit risk of underlying positions), and that the price volatility of these positions should be captured in Value at Risk (VaR).

Funds:

The Committee should consider specific granularity thresholds for mutual funds, which are subject to clearing requirements under EMIR and which therefore tend to have higher exposure concentrations with respect to its clearing members. Article 22 (1) of Directive 85/611/EEC (UCITS) limits the risk exposure to a counterparty of the UCITS in an OTC derivative transaction to 5% of its assets or, if the counterparty is a credit institution, to 10% of its assets. The assumption is that all mutual funds that deploy CCP cleared OTC derivatives for risk management purposes will fully consume these thresholds (in particular due to the need for cash margining

required in central clearing, typically resulting in an exposure to the deposit bank above 5%) and, hence, will always be subject to the LTA even if all other assets comply with the 1% granularity requirement. Since central clearing is not only incentivised by regulators, but also mandatorily required for standardised OTC derivatives (EMIR), it should not be 'punished' under the large exposure framework.

Alternative proposal for unknown counterparty:

We propose an alternative to the single "unknown client" bucket that leads to more meaningful results that are still prudent. This could be achieved by using more than one bucket for unknown clients where they can be distinguished in a meaningful way.

In situations where the "look through approach" must be applied and certain underlying exposures cannot be identified, it may nonetheless be possible to further characterise these exposures through information disclosed in prospectuses, or through stated investment policies and concentration limits.

It should be possible to distinguish between types of customer groups even if the underlying individuals´ identities are not known. For example, if a pool of auto loans encompasses exclusively natural persons as borrowers, those debtors cannot at the same time be legal persons so that there is no need (or justification) to group them under the same "Unknown Counterparty" proxy for Large Exposure purposes. This would also apply for funds where the investment mandate prescribes investments in, for instance, certain industry types or in certain countries/regions that are mutually exclusive (i.e. an investment in a car manufacturer cannot be an investment in a bank).

Where an institution can demonstrate that mutually exclusive groups of unknown counterparties exist, multiple "unknown counterparties" should be permitted. Likewise, where a particular investment embodies clear limits on counterparty exposure concentration within the underlying portfolio, the contribution of to the appropriate "unknown counterparty" exposure should be limited to the maximum single counterparty exposure that would be allowed.

13. The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the Large Exposures framework.

The standards for assessing "possible additional risks" are very broad and represent an inappropriate extension of the large exposure definition. We do not believe it is the right approach to measure these second order exposures where an institution is looking to one main source of repayment (ie. underlying assets or guarantor). Using the same framework and metric as additional direct exposure would vastly overstate risk, particularly when exposure would be added on a notional basis. Hence this should only be used in exceptional circumstances where a failure of more than one party involved in a trade would result in a material impairment to the creditworthiness of that exposure. While it is reasonable to require an institution to track various additional risk components (ie. how much exposure there is to a particular servicer) and to require firms to have policies on how it measures and manages these risks, the threshold for inclusion in direct risk exposure must remain high. These added risks may also be mitigated by the structure of a securitisation owned (e.g. a senior portion of a securitisation will be minimally exposed to servicer risk due to credit enhancement, and therefore should not be included).

Recognising that these dependencies (e.g. within scope of "additional risks") are very real constraints and the cost/benefit should be carefully evaluated. The broader the scope, the more significant the data requirements and costs, regulatory uncertainty and lender constraints will impede the trading liquidity and therefore pricing of credit. If, for example, the Large Exposure definition requires aggregation of all asset backed securities (ABS) bonds that are backed by receivables originated and serviced by Ford Motor Credit on Ford vehicles (to completely independent granular borrowers), this could create Large Exposures where there really is no large

exposure concentration risk. To the extent institutions are required to manage exposures on this basis, it would dramatically drive up borrowing costs for the ultimate originators.

14. The Committee welcomes views on the options for the treatment of banks' exposures to CCPs.

DB endorses option 2, described in paragraph 125, i.e. not to apply hard limits to bank's qualifying central counterparties (Q-CCP) exposures. Considering the fact that banks are required to clear standardised trades through CCPs and given the strong push by the international community and domestic regulators toward centralised clearing, the future shape of the market and the traded volume cannot be estimated at this time. Consequently we suggest exempting trade exposures and default fund contributions to CCPs from large exposure limits. Should the Committee decide otherwise, it should strongly consider the effect it would have on CCP resilience given the direct implications the hard limit would have on reducing the initial margin.

If the Committee chooses Option 1, enforcing a hard limit on each CCP entity, bank trading would cease when approaching the limit. Coupled with regulatory requirements mandating the use of CCPs for many transactions, trading activity in broad sectors (e.g. interest rate swaps, credit derivatives) might abruptly cease, posing a serious risk to banks abilities to manage their risk and provide liquidity to the market.

Also the concept of connected counterparties should not be applied to CCPs for the reasons mentioned in art 129.

Finally, there are two technical points for consideration. First, we believe that Footnote 30 should read "This means that if there is a preferential treatment of bank's exposure to Q-CCPs under the risk-based capital requirement purposes, this would be extended to those indirect transactions that are recognized for large exposure framework".

Secondly, paragraph 115 of Annex 4, new section IX to the revised Basel Framework gives a 4% risk weight if a client is not protected from losses in the case that the clearing member and another client of the clearing member jointly default or become jointly insolvent, but all other conditions in the preceding paragraph are met (which is the situation if the omnibus client segregation model has been applied). It should be clarified that this 4% risk weight is still "a preferential treatment of bank's exposure to Q-CCP" under the Large Exposure regime.