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Mr. Wayne Byres
Secretary General
Basel Committee on Banking Supervision
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Dear Mr. Byres,

Deutsche Bank response to BCBS: Discussion paper: The regulatory framework: balancing risk sensitivity, simplicity and comparability

Deutsche Bank (DB) welcomes the opportunity to comment on the BCBS (Committee) discussion paper on balancing risk sensitivity, simplicity and comparability.

Banks using advanced modeling and calculation methods are generally able to identify risk elements with more precision than those banks using simpler approaches. This also generally coincides with better risk management. Where banks have improved their level of risk control and measurement precision, it is appropriate that this should result in lower RWA calculations. This treatment also provides the appropriate incentive for risk management improvements.

Following this logic it is appropriate that a bank using more advanced methods should compare favourably against a bank using simpler methods that lack precision. These simpler approaches often over compensate because the clarity provided by advanced methods is lacking. For this reason, truely useful comparability would be between peers; advanced approaches banks with advanced approaches banks, and simpler approach banks with simpler approach banks.

We strongly believe that risk sensitivity is key to adequately measuring, monitoring and controlling risk to individual banks and to the broader financial system. Without risk sensitivity the regulatory framework development that has been underway for the past two decades could be lost. This negative outcome could open both micro and macroprudential supervision to the unintended consequence of increased risk taking, poor risk capture, and transmission of these risks into the broader financial system without the proper controls.

In DB's view, simplicity should only be used as a secondary objective. The primary objective needs to be accurate risk capture at the firm level so that the collective risk to the financial system is properly understood. Additionally, simplicity should not be understood as interchangeable with banks having identical results. In fact risk measurement should be held as a goal that all banks strive to attain so that their ability to measure risk can be viewed as best in class. This approach will incentivise banks to continue to develop better risk management techniques.

Therefore, blunt instruments, such as floors, damage the benefits gained though risk modeling resulting in lower levels of understanding about the underlying risks and relative safety of banks. We do not believe that this is in the best interest of the safety and soundness of the financial system and is the unintended result of simplicity for simplicity sake.

From this point, it is paramount that there is comparability between banks; however, to be meaningful this must be done on a peer bank basis. A true horizontal view can only, in our

opinion, be informative if regulators are comparing banks in this way. Additionally, regulators have to determine how they will account for the national and regional differences which currently limit comparability such as accounting regimes and recovery and resolution frameworks.

From this departure point, the Committee can help foster increased consistency in implementation and interpretation of regulation with the goal of eliminating conflicting requirements, decreasing nationalistic approaches, and requiring increased disclosure and transparency.

Our responses to the Committee's questions build upon these general comments and are set out in the Annex.

We would be happy to discuss further any of the points in our response.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and
Regulatory Affairs

Annex

Questions

Q1. Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?

We believe that the current framework goes a long way to meeting the objectives delineated in the paragraph 29.

Looking specifically at the objectives listed therein:

1. Produce a sound minimum standard of capital adequacy for internationally active banks, but also be capable of application to smaller institutions;

We believe that the provisions in the Basel III capital framework mandate appropriate minimum standards. The inclusion of provisions such as capital buffers for the largest banks, as well as the option for standardised approaches for smaller banks ensures the necessary proportionality is incorporated into the regime. Consequently, it is our view that the framework can be applied to, and provide a meaningful understanding of, banks across the size and risk spectrum.

2. Deliver a well-understood measure of capital adequacy that is comparable across banks and over time;

We believe that the framework goes a long way to being comparable across banks and time. There is however room for improvement in this area which we are encouraged to see the Committee is exploring. We see great value in the Regulatory Consistency Assessment Programme (RCAP) and note that in cases where material and unjustified discrepancies have been identified, jurisdictions have generally been quick and thorough in addressing short-comings. The key to comparability is ensuring that as far as possible, universal rules are applied, implemented and adhered to in the same way.

Furthermore, the BCBS studies into RWA consistency have begun the process of identifying areas where greater consistency could be ensured. Whilst more work needs to be done to identify the actual route-causes of RWA discrepancies and as yet the reports cannot form the basis of new policy, we believe continuing this work will be helpful.

We would also wish to highlight our view that comparability does not mean identical results or risk-weightings from risk models. Even if the same models are applied, banks with a greater ability to measure risk will inevitably have different results from those that can only calculate risk in a less-sophisticated manner. Comparability between peers (i.e. Advanced Approaches banks being compared with one another, and simple banks being compared with one another) is a more suitable objective.

3. Support a reasonable level playing field between banks;

Similarly to our views on objective 2, a level playing field hinges on consistent application of rules and standards.

When compared to alternative regimes, such as one including a binding leverage ratio, the current framework maintains a level playing field. Whereas a leverage ratio would strongly favour certain business-models over others (for example a balance sheet with low leverage, but high risk assets would compare favorably to a balance sheet with higher leverage but more conservative assets), the current framework is universally applicable as it looks at the fundamentals of balance sheet composition.

4. Take into account the effects of capital requirements on banks' risk-taking incentives, e.g., when faced with regulatory constraints on their capital (and therefore the size of their balance sheet), to seek higher-risk assets as a means of boosting expected returns; and

In our response to BCBS 251 on the Revised Basel III leverage ratio framework and disclosure requirements, we identify the risks associated with a binding leverage ratio leading to banks shifting the asset mix on their balance sheet towards higher yielding, and therefore potentially more risky and/or less liquid assets.

The current framework with risk-based capital at its core ensuring that the focus for banks is on RWAs. Banks continue to find a balance between highly liquid safer assets and higher-yielding assets as the focus is on return on equity, and not return on assets, which could create perverse incentives for banks.

5. Promote improved risk measurement and management within banks.

As we mention in our response to BCBS254 on the Non-Internal Model Method (NIMM), we share entirely the BCBS position that maintaining incentives for banks to improve risk management is a vitally important part of the prudential framework. This is done by ensuring that banks derive benefit from investing resources into improving and monitoring their internal models and risk management. The current RWA-focused framework maintains this incentive and DB firmly believes there have been significant benefits for financial stability as a direct result of this. Increasing the role of standardised regulatory models over internal models would reduce the value of investment in the latter. It would be deeply damaging to the further improvement of risk management in the banking industry if these incentives were to be eroded.

Q2. Are there other objectives that should be considered in reviewing the international capital adequacy framework?

We believe that the objectives identified by the Committee are the generally correct, even if the balance may need careful consideration. We also believe that given the importance of consistency, this could be further emphasised by making it an explicit objective of the framework.

We would however suggest that the BCBS place more emphasis on the ensuring comparability between peers. Banks using Advanced Approaches should have comparable risk-weightings. Again, this does not mean they will produce identical outcomes – some banks are better than others at accurately quantifying risk. Banks that are more advanced and sophisticated should not be penalised for being more accurate. However, banks that are not resourced to use Advanced Approaches should also be compared against one-another and consistency between simple approaches should be sought.

We would also see value in the BCBS sharing the underlying analysis behind its proposals. Access to this analysis, including how methodologies and calibrations have been determined, would help ensure an informed dialogue between industry and the Committee.

Q3. To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?

The ultimate aim of a prudential framework has to be to properly measure risk and to ensure that banks are appropriately capitalised to minimize the impact of unexpected losses on consumers, tax-payers and the broader economy. For this reason, we believe that risk-sensitivity is the most important of the Committee’s objectives. We believe that the current framework largely strikes the correct balance between important, but at times competing, objectives. As we have stated in our

response to BCBS 251, a binding leverage ratio would undermine this balance and negatively impact the financial system and broader economy.

As mentioned in our previous responses, we would see value in the BCBS ensuring that the “comparability” objective is properly calibrated towards comparability between peers, and with the understanding that identical results are the desired outcome. Not only would this be unrealistic, but would not allow for the fact that banks have varying abilities to measure and capture risk. Banks that are better than their peers should see benefits to the extra resources they have applied in this area and incentives for other banks to come up to the same level should be maintained.

A cost that is often overlooked is the embedded cost of internal models that Advanced Approaches banks have. These systems have been developed and implemented and banks make considerable ongoing investments in maintaining and improving them. Any move away from these towards a more standardised model is a cost that should be considered when considering revisions to the framework.

Moving to more standardised models would also likely result in greater regulatory capital being required. The economic reality of these two costs must be considered. The possible decrease in market efficiency and liquidity as banks are forced to reduce funding activity will inevitably have real economy impacts.

**Q4. Which of the potential ideas outlined in Section 5 offer the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital
adequacy framework?**

1. Explicitly recognising simplicity as an additional objective

We do not support the BCBS listing simplicity as an explicit objective of the capital framework. We believe it has an important role to play, but strictly as a secondary objective. The nature of the global financial system, and both measuring and managing risk, are necessarily complex – placing simplicity as a primary objective could leading to a situation where the underlying risk are masked by unsophisticated models or blunt tools.

DB strongly believes that the starting point must be to ensure an accurate understanding of risk. Once that has been achieved, eliminating unnecessary complexity to facilitate comparability is the next step. There are numerous ways in which this can be achieved such as ensuring consistency of interpretation, application and adherence with rules. Additionally, greater disclosure, particularly under pillar 3, can go a long-way to demystify some areas of the framework.

Certainly where a simpler approach can be used to replace a more complex model, and achieve the same degree of risk-sensitivity, DB would strongly support such an approach.

2. Enhancing disclosure

To complement existing prudential measures, consistent and enhanced quality of disclosure (on underlying risks, regulatory inputs, modeling factors, etc) will promote better understanding of and differentiation between the risk levels of bank portfolios.

Work in this area is ongoing, particularly through the Financial Stability Board’s Enhanced Disclosure Task Force (EDTF). The latest EDTF progress report, published 21 August 2013 highlights some of the key achievements that have been made so far. Banks have invested considerably in coordinating templates and improving technology and systems for disclosure ensuring more information is shared in a clear and comparable way. There are still recommendations made in the October 2012 'Enhancing the Risk Disclosures of Banks' report that

are yet to be implemented and we urge the BCBS to throw its weight behind ensuring the recommendations become industry practice.

Groups such as the EDTF and the Committee's Working Group on Disclosure are the optimal way to develop new disclosure requirements that provide meaningful information and also keep in mind the need for requirements to be cost-effective.

3. Using additional metrics

As mentioned above, we believe that enhanced supervision, greater market discipline and efforts to advance global consistency are crucial in addition to continued reliance on RWAs.

Enhanced quality of disclosure, including around underlying risks, regulatory inputs and modeling factors, will promote better understanding of and differentiation between the risk levels of bank portfolios.

We believe there may be value in the BCBS exploring a greater role in validation of underlying parameters. For example, at times there are global discrepancies where there is no sound economic reason – variations in peer counterparty Loss Given Default being a good example.

4. Ensuring the effectiveness of the leverage ratio

We understand from the BCBS 251 consultation paper that the leverage ratio (i) is intended as a simple, transparent, non-risk based "backstop" to the risk-based capital framework, in order to (ii) restrict the build-up of leverage in the banking sector to avoid destabilizing deleveraging processes

We agree with these objectives. That said we would like to stress that the Committee's goal to design a non-risk sensitive, simple Leverage Ratio inevitably means that it has inherent weaknesses when measured against the objective of capturing banks risks and ensuring appropriate capitalization. Leverage - by design - treats more or less risky assets equally and therefore provides no insight into (i) the riskiness of a specific bank, or (ii) the amount of capital that must be held to ensure a bank is sufficiently protected in times of stress.

In order to maintain the very qualities that make a Leverage Ratio a useful complementary tool, namely simplicity and transparency, one must accept these shortcomings and the consequent (limited) role that the Leverage Ratio can play – a backstop to risk-based capital requirements that look at the genuine economic and systemic risk that bank balance-sheets and activities represent.

On this backdrop we encourage the Committee that – following the finalisation of the exposure measure to be used for Leverage purposes – the calibration of the minimum threshold must be done such that the risk-based capital framework remains the primary constraint for banks and Leverage does not become the predominant factor. Only then can the leverage ratio be a genuinely useful addition to the regulatory tool-box. Our views on the leverage ratio are fully developed in our response to BCBS 251.

5. Utilising added floors and benchmarks to mitigate the consequences of complexity

We have strong concerns about the introduction of further floors in the capital framework. Floors by their very design decrease the accuracy of risk-calculations by ignoring risk mitigants beyond a certain point. This of course also means that comparison between banks becomes less useful as the outcomes are artificially truncated. This also penalises banks that are better than their peers are capturing risk and consequently diminishes firms' incentives to develop better risk-management techniques – something the Committee has numerous times said would be damaging.

Instead we would encourage the BCBS to continue to use the established back-stop mechanisms in the regulatory tool box, not least the tools provided for under pillar 2.

6. Reconsidering the linkage between internal and regulatory models

We would support a move to bring regulatory models more in-line with internal risk management models. Regulatory models better capturing internal risk management procedures will help to ensure the risks carried and represented by banks are more accurately understood by regulators.

Whilst we appreciate that regulatory models serve a different purpose to internal models – capturing systemic risk as opposed to measuring a specific firm's risk tolerance, we believe that regulatory models would be improved by reflecting advances in internal models that better capture risk.

Limiting national discretion and improving supervisory consistency

As mentioned above, DB supports the work the BCBS is doing to assess implementation of the Basel III rules globally. Recent BCBS studies into RWA consistency have identified that national discretions and interpretations are responsible for a considerable percentage of existing variance.

Whilst there are times when variation is necessary, these should be limited to where they serve the purpose of best reflecting regional practice and do not increase risk in the system. We support the idea of a consolidated list of divergences and explanations for them.

Where there are unjustified national discretions there is a risk that, especially global banks, is subjected to duplicative and conflicting requirements.

Improving the accessibility of Basel Committee documents

We welcome the Committee's publication and notification of documents on the website. However we would welcome greater transparency about the responses submitted to the BCBS. In a similar fashion to the European Supervisory Authorities, respondents could choose whether to have their responses published on the website or not.

As mentioned in our response to Question 2, we see great value in the BCBS sharing more of its underlying analysis and methodology. Where appropriate, these documents could be shared in much the same way that other working papers are.

Addressing factors driving complexity in a more fundamental manner

We strongly share the view expressed in the GFMA response to this consultation paper that there have been a vast amount of improvements made to regulation of the banking system and that more time is needed for these changes to be fully on boarded and understood. A fundamental review at this stage would be premature.

Q5. Are there other ideas and approaches that the Committee should consider?

As mentioned above, we do not believe that now is the correct time for an overhaul of the framework. Rules to implement Basel III have only just been agreed, and in many jurisdictions have not even entered into force yet. There are key elements of the Basel III framework that have a phase-in period and these cannot be judged at this time. We urge the Committee to wait for the new rules to take effect and give them a chance to bring about change in the banking system.

We would however urge the BCBS to look at ways it can expand its remit on ensuring global consistency. At the moment there are a raft of different ideas around capital, liquidity and bank structure that are inconsistent and at times conflicting. A body with the global oversight that the BCBS has can help to find ways to ensure various jurisdictions cooperate in their plans and that firms have a clear understanding of how the various provisions are intended to fit together.