Deutsche Bank

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

Deutsche Bank's response to the Basel Committee on Banking Supervision consultative document on the Fundamental Review of the Trading Book.

Deutsche Bank welcomes the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) second consultation on the Fundamental Review of the Trading Book (FRTB).

We welcome the Committee's clarification of the delineation between the Trading and Banking Book and the avoidance of double counting when calculating regulatory capital against Trading Book. We think that good work has been done to eliminate fragmentation between Value-at-Risk (VaR) and Stressed Value-at-Risk (SVaR).

Nonetheless we believe that further improvements are necessary and that this can be best achieved with industry and regulators working together.

We therefore welcome the Committee's willingness to consider improvements as expressed at the public hearing on 10 December 2013. Deutsche Bank has contributed to the counterproposals provided to the Committee via the trade associations – as requested at that hearing. This consultation response should be seen as a supporting document to that work.

We wish to reiterate the Trade Associations' request for a longer and more iterative process for Quantitative Impact Studies (QIS). We suggest running a QIS on hypothetical portfolios in the second half of 2014, after the feedback of this consultation round has been incorporated, and a full QIS in 2015. This approach would allow the rules to develop and mature, and for banks to build the systems necessary to ensure the accuracy and quality of the QIS data.

Consistent with the trade association responses, we believe that revisions to the proposed rules need to be made in various areas, but the proposed Standardised Approach and the reflection of the liquidity horizons are the areas most in need of revision.

In the Annex to this letter, we highlight some of the key concerns we have identified with the FRTB proposal. We remain at your disposal for follow-up discussions.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government & Regulatory Affairs

Annex: Deutsche Bank detailed comments on the proposed framework

Standardised Approach (SA)

We understand and share the Committee's intent that a SA should be a backstop to the model based approach and to provide a simple and comparable metric between peer banks. However we believe that the SA proposed by the Committee has certain technical flaws and elements of unnecessary complication. We have previously provided the BCBS' Trading Book Group (TBG) with some examples of flaws in an email sent on 17 December 2013. In our view, the most significant flaw in the proposed SA is that it does not take into account floating and contingent cash flows. The trade associations response goes into detail on these points. We flag, below, areas where we see the most significant room for improvement and factors we believe need to be taken into account during any reassessment.

We believe that the optimal way for the Committee to meet its objectives would be to recast the SA to take advantage of pre-existing risk factor sensitivities. The trade association response provides practical examples. Such an approach would mitigate concerns that the current proposal is unable to capture many of the specific risk-types, for example in relation to the management of multi-name or multi-factor products or anything of a credit contingency where the counterparty credit is integral to the product and not separate. Further to capturing these more embedded risks, using risk factor sensitivities would greatly reduce the time and resource required to build, validate and run a totally new SA.

Risk factor sensitivities are a key tool for banks across numerous areas of internal risk management. Consequently, banks dedicate large resources and expertise to ensure they are accurate and reliable and subject them to intensive scrutiny, checks and balances. They have been developed over many years, reflecting market changes and historical knowledge.

Implementing new rules which consider (part) of cash flow structure removes all of these benefits as they would only be used for capital calculation purposes and therefore lack the constant challenge of day-to-day risk management. Changes to the existing risk factor sensitivities would be needed to ensure that uniform definitions existed across banks, using these would ensure comparability and simplicity.

We strongly urge the BCBS to consider revising the SA in the ways suggested above and developed in the trade association response.

Liquidity Horizons

As set out in our response to the first consultation on the FRTB, we strongly advocate improvements to how liquidity risk is captured in the trading book framework. We appreciate the work the Committee has undertaken in this regard. There nevertheless remain areas in need of improvement in the liquidity risk framework. We refer to the trade association counterproposals where these are elaborated.

We highlight factors we believe require clarification when the liquidity risk tools are revised.

First, we believe that the construct method of market data returns by overlapping periods may give preferential capital treatment to internal models based on historical simulation models over those using the Monte Carlo method. The FRTB should remain neutral on these equally valid methods.

We suggest that a simplification can be made to the current proposal to calculate VaR once covering different time horizons. In our view, making separate VaR calculations for different risk factors and time horizons (for example 60-day, 120-day and 250-day), and then aggregating the outcomes would provide a simpler and more robust measurement.

The other key element of the liquidity horizon proposal is the bucketing of different risk factors. We consider that the buckets need revision as they do not reflect the reality of unwinding or hedging risk in specific products. There are numerous examples of this highlighted in the trade association response, but we note in particular, the proposed treatment of FX rates which appear to have a significantly overestimated horizon allocation.

We also have concerns about major cliff-effects when a ratings change will bring about a major horizon change – this can cause very large shocks and impacts on capital stability. One possible solution to this would be reducing the number of different categorization buckets – this would reduce the number of drop-off points where these cliff-effects can occur.

<u>Securitisations</u>

We urge the BCBS to view the treatment of securitisations in the FRTB in the context of calls from regulators, policy makers and politicians for securitisation markets to be rekindled following a period of much needed regulatory improvement.

Basel 2.5 significantly increased capital requirements for securitisations with internal market risk models no longer allowed to be used for specific risk. Instead, a capitalisation framework in line with banking books is being used. This is far more conservative than an internal market risk model. We note that significant investments have been made by banks over the last few years to implement the banking book framework for trading book securitisations. Furthermore, other modifications are being consulted upon in BCBS269.

While we are supportive of the Committee's stated objective of creating consistent capital treatment for securitisations in the regulatory trading book and regulatory banking book, we are very concerned that the current proposal will not achieve this. Instead we fear that inconsistencies perpetuate and potentially increase the penalty for holding positions in the regulatory trading book, by increasing the capital charge for credit spread risk and at the same time potentially increasing the capital charge for credit default risk. It is important for the Committee to consider the aggregate RWA impact across credit spread risk and default risk components, and with regard to positions in the banking book, so that the updated methodology is appropriate but not punitive to trading book securitizations. It should also encourage prudent risk management practices through appropriate capital benefit for hedging.

<u>Trading Book/Banking Book Boundary</u>

We appreciate that the Committee has decided to continue the application of 'trading intent' as a key feature to define the trading book and that the Committee provides additional guidance based on general presumptions from which banks can deviate based on clear internal policies and a robust governance process. Some parts of the consultation seem however to contradict this criteria, e.g. paragraph 25 explicitly prohibits a reclassification in case of a failed trading intent or if the market liquidity of a financial instrument changes. The ability to reclassify a financial instrument in the aforementioned scenarios – subject to a robust governance process – from e.g. the trading to the banking book in these scenarios is crucial.

While we acknowledge that additional guidance is provided by establishing general presumptions from which a bank can deviate (as established in paragraph 11), paragraph 13 is currently drafted such that positions mentioned (e.g. unlisted equity) cannot be included in the trading book at all, even if all trading book requirements are met. We suggest that paragraph 13 should provide a list of instruments for which the general presumption is a banking book allocation, but allowing for a trading book classification – again subject to a robust governance process – if all trading book criteria are met. The same applies to paragraph 14 which seems to require that instruments included in the trading book are fair valued through P&L, i.e. instruments classified as 'Available For Sale' in AFS would no longer qualify for a trading book assignment. While it might be a plausible presumption that instruments classified as AFS are not included in the trading book, these instruments might nevertheless fulfill the trading book criteria and thus be eligible for the trading book.

With respect to the general presumption of paragraph 11 we have the following comments:

1. It is not clear to us why there is a presumption that all investment funds for which e.g. daily real prices are available or a daily look-through can be performed should be included in the trading book. Depending on the mandate of the fund (e.g. long term investment) and the trading intention of the bank holding the investment a banking book classification is equally plausible.
2. It is not clear to us why there is a general presumption that all options should be included in the trading book. Again, depending on the actual circumstances, a banking book assignment is equally plausible. For example, for options used to hedge interest rate risk from banking book exercises.

The consultation suggests that any deviation from the general presumptions (see paragraph 12) or a reclassification of instruments (see paragraph 27) must be pre-approved by the regulator and in the latter case be publicly disclosed. In

our view the pre-approval leads to unnecessary administrative burdens for both banks and supervisors e.g. due to the short timeframes involved and the number of such approval requests. A robust internal governance process that is subject to regular audits is sufficient to ensure a consistent application of the trading book requirements.

Treatment of Credit Incremental Default Risk

We believe that the revised FRTB's IDR proposal helps to eliminate some concerns highlighted in the industry responses to the first FRTB consultation, namely the potential double-count around rating migration risk. We welcome this as a positive development in terms of simplicity and the accuracy of risk-calculation.

Although we view the move from IRC to IDR as positive, we would appreciate some clarity on elements of the proposal:

1. We understand that due to the unique relationship between credit spread and default risk, banks must seek approval for each desk with exposure to these risks, both for credit spread risk and default risk. However, it is not clear to us if there is one combined IDR calculation for all eligible desks or is the IDR to be calculated at desk level?

2. In order to avoid double counting of the risk from mark-to-market losses and the risk of loss from default, the model may assess default risk from the perspective of the incremental loss from default in excess of the mark-to-market losses already taken at the time of default. This makes sense, however it is not clear how the increment in excess to MTM losses is to be calculated?

3. We would like to better understand if there is a specific economic interpretation of the two-factor default simulation model that banks are required to use?

Also in line with the trade association response we question whether the impacts of imposing a 0.03% Default Probability floor for AAA and AA sovereigns have been fully considered. This is likely to have a significant detrimental impact on the liquidity of sovereign debt markets. There will be knock-on effects for the real economy as marking-making using G4 currencies becomes more expensive. We do not believe that the historical default data justifies this increase in PD and would request the BCBS to reconsider following a full QIS.

Model Independent assessment tool

We strongly object to the use of a leverage ratio as a Model Independent assessment tool (MI). As has been covered in responses to the BCBS on the Leverage Ratio and NIMM, blunt instruments by their very nature and design are unable to accurately reflect risk.

A desk-level leverage ratio can simply give an indication of the number of a specific desk's credit exposure, but is certainly not a proxy or even indicator of that desk's market risk.

We believe that this proposal needs rethinking, and a more risk sensitive method should to be used. A suitable alternative would be a rigorous stress testing approach as it has successfully been introduced alongside other capital measures in the past. A stress testing approach would also naturally align with a bank's existing stress testing and Economic Capital frameworks, thereby providing strong governance and controls.

To mitigate concerns about stress tests not picking up certain (previously unobserved) basis risks or historically calibrated shock sizes being insufficiently small, a stress test framework could be extended to also include extreme but plausible stresses which are not substantiated by historical market data. Instead, they could investigate the impact of potential distortions in the market which have not (or have) been realized before by

1. Identifying potential drivers of severe p&l movements
2. Discussing the economic market environment which would lead to these potential drivers having a severe impact
3. Linking into historically observed market stresses
4. Estimating impact on the capital supply and capitalize under Pillar 2

5. Determining thresholds for the ratio of the FRTB internal model capital charge over stress test results which trigger further dialogue[1] with supervisors

Not only would a stress test based tool be a more suitable assessment tool, but also it would strengthen the existing stress test and Economic Capital frameworks of the bank rather than creating yet another, completely independent, infrastructure.

[1] Comparable to the Basel 2.5 stress test framework currently in place for Comprehensive Risk Measure