Deutsche Bank

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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. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
Basel
Switzerland

baselcommittee@bis.org

Dear Mr. Coen,

Deutsche Bank's (DB) response to the Basel Committee on Banking Supervision consultative document on Revisions to the Standardised Approach on credit risk.

Deutsche Bank welcomes the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultation on the standardised approach for credit risk. We support the intentions of the BCBS but wanted to flag three fundamental issues before responding to the individual questions.

Timing

We support the BCBS intention to review the standardised approach for credit risk (SACR) and are keen to contribute to the process as much as possible, through comment letters, meetings and providing data for impact assessments. This process is however extremely complicated and operationally burdensome, we are concerned that the intended timeline does not allow enough time for the revisions to the SACR to be thorough and underpinned by credible data and analysis. We hope that this will be an iterative process with at further QISs, and further discussion between regulators and the industry on the correct calibration. The improvements made over the past months to the Fundamental Review of the Trading Book should be used as a template for how the BCBS and industry can collaborate.

Data availability

The proposed revision to the standardised approach, along with the Quantitative Impact Assessment for credit risk involve a vast amount of data being collected by banks that is not available in internal bank systems since it is not currently required for capital calculation and reporting purposes. In addition, Financial Institution counterparts need to be classified under the corporate asset class if required risk drivers for the bank asset class are not reporting. Therefore, a substantial portion of the respective portfolios will be assigned to the punitive. 300% risk weighting. The BCBS should reconsider the proportionality of this and not run the risk that the standardised approach for credit risk be more of a test of data availability than credit quality. Under the current proposal, a weak data point risks impacting materially on the risk weighted asset requirements of banks. It must be kept in mind that many smaller firms that do not currently disclose data that might be required under this proposal would either have to change their reporting and data calculation, or be faced with less favourable funding conditions.

Use of external ratings

We share the BCBS position that excessive reliance on external ratings should be avoided, however we believe that the other extreme, total removal of external ratings is undesirable.

External ratings are based on sophisticated and rigorous methodologies that capture numerous risk drivers. Replicating their accuracy using a limited number of risk drivers, and applying these universally across jurisdictions cannot be considered a suitable substitution. As with our responses to BCBS consultations on capital floors, the Fundamental Review of the Trading Book and the leverage ratio, the Committee should maintain as much risk sensitivity in its simplified approaches as possible.

In the credit risk space, portfolios and products of a similar nature can vary significantly depending on factors such as the jurisdiction they operate in. It is not accurate to consider residential mortgages in, for example, Germany as being identical from a risk perspective, as a residential mortgage exposure in the US or even other areas of the EU. Differences in legal and tax regimes, national traditions and housing markets must be taken into account. The most workable and accurate way to do this is by incorporating external ratings. The same arguments can be made for commercial real estate, corporate exposure and retail portfolios. We support the sentiments detailed in the responses to this consultation submitted by the Joint Trade Associations, that the BCBS should reconsider this blanket removal of external ratings and work to reinsert these in the Standardised Approach for Credit Risk.

We hope you find our comments useful and we remain at your disposal for follow-up discussions.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy
Deutsche Bank

Annex I: Deutsche Bank detailed comments on the proposed framework

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

Including some role for capital ratios makes sense – they are drivers that banks generally also include in assessments for internal models. The significant downside that using them has, however, is that this can result in procyclicality. As ratios decline, the associated risk weighting would make exposures to the bank less attractive. Banks would generally use capital ratios as part of a much broader set of drivers, partly to avoid this procyclicality. The same issue exists when using non-performing loans – the risks of using limited drivers that both have procyclical impacts is considerable.

The use of capital ratios is most helpful when used in combination with other factors that are missing under these proposals. For example, the stability and financial health of the sovereign in which the bank operates is materially impactful on the credit risk that the bank carries – we would like to see an incorporation of sovereign risk back in this framework. Looking at recent history, it is clear that liquidity problems have been the primary driver of decreased credit quality of banks during periods of stress, we therefore request the BCBS to include a liquidity measure in this exposure calculation.

There are also various questions that need addressing about how the phase-in of Basel III in different jurisdictions will be taken into account; this will result in a less reliable set of capital ratios for banks. Furthermore, there are of course jurisdictions which are not following the Basel rules (particularly in emerging markets), and banks in these jurisdictions would receive a 300% risk weighting – this seems both overly punitive given that they could still be very soundly capitalised banks. A more proportionate treatment is needed for firms that are not currently subject to the full Basel III regime.

In terms of the value of other possible metrics, the leverage ratio is by its very nature a risk insensitive tool, so we do not feel it is a useful standalone metric to use when looking at credit risk resulting from bank exposure. We also believe that using Tier 1 ratio rather than CET1 makes sense and we would recommend the BCBS alter the proposal to reflect this. This is because the credit risk measure is intended to look at covering losses from counterparty default, the total capital number is most relevant here, rather that CET1 which is designed as a measure of going concern viability.

Looking at the various metrics that are missing from this exposure measure, and the risks of inaccuracy and procyclicality that the current proposal has provides the strongest possible argument for the BCBS to reconsider the role of external ratings in addition to some other metrics.

A clear example of the risks that come from using such a limited number of risk metrics is that if we take a bank that is currently well capitalised, but with NPA well above 3% (this could be up to 50%). This would attract a 60% risk weight under the new proposed approach. This risk weight would be the same as for a bank with 11.5% CET1 ratio and NPA of 3%, which is counterintuitive from a Risk management perspective. Therefore we propose that more granularity be incorporated into the NPA scale. "Above 3%" is too broad, and we suggest a differentiation between 3% and 50% be added.

We would also like to flag that the proposed definitions of “bank” and “securities firms and other institutions” are too narrow and the resulting reclassification of non-bank financial institutions into the ‘corporate’ exposure class is inadequate. We would point to the Joint Trades response which provides further thought in this area.

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure’s credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

Non-performing loans ratio is considered as quantitative support in the rating guidelines for most banks’ rating sheet and is certainly helpful in measuring the probability of default of a bank. However, as a standalone measure it is insufficient to assess the default risk of a counterparty and as with the CET1 ratio, it introduces pro-cyclicality in the Standardised Approach.

When used in isolation, or as proposed with only one other driver, a key deficiency of the NPA ratio is that it is a backward looking risk driver with no forward looking view. Its use in such in the way proposed also results in numerous implementation problems, as there is no uniform definition of "non performing" across jurisdictions. For example, there is a high probability banks in different jurisdictions use varying definitions, including Impaired, forbearance levels, Basel II default and so on.

In addition, the NPA ratio fails to capture trading book risk or account for the business model of the bank (a bank's business model can be to take on high risks but to be very well capitalised to cover unexpected losses). It further fails to take into account the diversification of assets (concentration risk), which may lead to the view that a bank has a very strong NPA, while this is actually only the product of a very high concentration on a few - currently performing - assets. The NPA could therefore dramatically change if a few borrowers were to default.

As per the use of the CET1 ratio addressed in Question 1, we strongly urge the BCBS to reconsider its exclusion of external ratings and find a way to incorporate the CET1 and NPA ratios alongside external ratings that help provide a far more balanced and all-encompassing view of bank exposure risk.

Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

The criteria "expected to be rolled over" is subjective and open for interpretation, and could therefore lead to arbitrage situations. In addition, this ‘risk metric’ is not currently widely available, meaning that there would be a significant IT development and operational complexity to the process.

It should finally be noted that this current treatment does not differentiate between secured (Repo) and unsecured funding. Clearly these present very different levels of credit risk.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

The operational costs involved in switching to the proposed standardised model are very material, and these could potentially impact small banks more than large international banks.

As we have mentioned above, we strongly recommend maintaining a role for external ratings for bank exposures under the Standardised Approach. This would be a simple and cost effective way to mitigate many of the short-comings identified both in the consolation paper, and the industry responses.

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

In addition to being difficult to find revenue data for corporates that are unlisted, historically, revenues have not proven to be a consistently meaningful indicator of counterparty risk when looking at corporates. This proposed penalisation of lower revenue counterparties would also have negative consequences on SME financing, making funding more costly for these clients at a point in which the global economy needs them to drive a return to sustainable growth. Revenues are additionally impacted by where a firm is on the economic cycle, and there is no measure of this incorporated in the proposed framework.

Our analysis emphasises the importance of this as we find default risk to be rather homogenous unless revenues become very high (above EUR 1bn). Therefore revenue usually does not contribute much in terms of differentiation different risk levels within a corporate portfolio, and is not considered a key risk driver. In fact, our analysis shows that industry and country of incorporation are stronger determinants of risk than revenue.

Looking specifically at the treatment of corporates, leverage can provide some extra information as part of a range of drivers. Nevertheless the suggested calculation methodology needs revision. Generally speaking, the best way to calculate a corporate’s leverage is Debt/EBITDA. However, given that collecting EBITDA data can be problematic, a simpler solution would be to use replace the proposed Total Assets/Total Equity metric with: Financial Debt/(Financial Debt+Equity).

Once again we urge the BCBS to reconsider the role of external credit ratings, which include several dimensions and provide a balanced view of the risk across multiple relevant risk drivers.

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

The proposed treatment risks disproportionately penalising SMEs by applying higher risk weights due to their relatively low revenues. This is especially concerning given their role as the 'backbone of the European economy.' We are concerned that this treatment will erode the benefits of recent policy measures such as the EU’s Capital Markets Union and initiatives to re-vive the securitisation markets. Given that for start-up companies a more lenient treatment has been considered in order to avoid penalisation, we believe that the treatment of SMEs should also be revisited in this light.

We would also flag that the current definition of SMEs could potentially create a cliff effects when a firm is moves from the Retail to the Corporate scorecard (caused by the sudden increase in risk weighting); And then a decrease in risk weighting when the client grows in size and the increased revenue leads to a reduced risk weighting.

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

We strongly believe that building external ratings t back into the framework is the optimal way of balancing simplicity and maintaining the necessary levels of risk sensitivity. This would also meet the request of capturing both the corporate's sovereign of incorporation and the industry type – key drivers for a corporate's risk.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

While the introduction of a specialised lending category itself is considered to enhance the risk sensitivity, we strongly recommend that the counterparty risk weight for specialised lending counterparties in the real estate sector be removed and replaced with LTV tables similar to option B under paragraph [46]. This is driven by the different nature of corporates and capital intensive SPV lending like real estate finance (both income-producing and ADC). This results in the majority of SPVs holding single real estate assets at book value falling into the bucket Leverage > 5x and revenues < € 5mn / € 50mn, which can result in immaterial differentiation between high and low risk transactions.

We also believe that the following more technical implications should be considered:

- Leverage in real estate SPVs is often driven by the structure and accounting rules like accounting at amortised cost, which may result in a 300% risk weight, but is not reflective of the risk of the underlying transaction.

- For commercial real estate transactions lending to multiple SPVs which are cross-defaulted / cross-collateralised requires rules on which financials to be used (e.g. consolidated financials, financials of the largest/smallest SPV)

- For Specialised Lending, alignment between banks using Standard Approach and banks using Advanced Approaches needs to be treated carefully. Due to the risk sensitive nature of this business it is appropriate to treat exposures in the Standard Approach with a specific risk weight. The consultation outlines that this assessment of the Specialised Lending segment applies specifically to banks where the relevant subtype of Specialised Lending reflects "only a small part of their business activity." In this case, a 'simple' approach (with an increased floor) is sensible. However, applying the same floor to Internal Ratings Based models is counterproductive since the floor and the increased risk sensitivity of these advanced approaches serve the same purpose. Applying the floor to Internal Ratings Based models means penalising these models as heavily as standardised approaches and removes the incentive to develop more accurate models.

- We do not feel that the definition of eligible counterparties under Option B fits with the definition of Specialised Lending. We believe that a insignificant amount of counterparties would be eligible under Option B, as most counterparties would either classify as either Specialised Lending or Exposure Secured by Commercial Real Estate, for which either the Corporate Unsecured grid or the Option A grid are relevant. We would welcome an approach where Option B was considered eligible for Specialised Lending – at least for the subtype Income Producing Real Estate.

- The definition of Specialised Lending as stated in Appendix 1, could encourage a restructuring such that none of one of the four criteria are met (i.e. lack of appropriate collateral - especially a perfected mortgage). This is because failed to meet the criteria could lead to a favourable exposure treatment (for example being classed as a Corporate Senior Unsecured exposure versus Specialised Lending exposure). In our view this does not reflect the underlying risk structure, and in fact from a good risk management perspective, the opposite treatment should be in place.

- Leveraged Finance SPVs typically have high leverage (this is the nature of the business) that does not impact on credit riskiness. Revenues are also not reflective of the risk of a Leveraged Finance SPV (as there is no revenue at the beginning of the project lifecycle). Negative Equity is also common (e.g. dividends), and this would result in an inappropriate 300% risk weighting.

Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

We believe that the current treatment of retail portfolios is well designed and we support it being maintained.

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

In principle, LTV and/or DSC ratios in combination are reasonable indicators of loan default and/or loss incurred.

However, when considering the practical implementation of using such a combination in determining risk weight, we recommend only using LTV ratios as the basis for the calculation. This is because the use of DSC ratios is linked to several discrepancies from different jurisdictions that do not enable systematic annual updates of obligors' income/financials – this results in the data becomes stale and hence losing accuracy and reliability.

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at

origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

We refer here to our response to question 10.

We recommend using the latest available LTV, which in some jurisdictions might also be the LTV at origination. We also believe that LTV calculations should be adjusted for eligible financial collateral that might be provided in addition to the real estate collateral - these amounts could be netted from the loan amount in the LTV calculations.

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

Please see our response to question 10.

Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

We believe that days past due information can be a good predictor of risk.

Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

Option 'B' is found more suitable as the loans are backed by 'secured' commercial real estate collateral and hence should not be treated as 'unsecured'. It should however be noted that for corporate counterparties, loan default depends primarily on the financial strength of the counterparty, rather than the individual property serving as collateral. Loss given default depends both on the recovery rate of the property company level (unsecured insolvency recovery) and recovery from the individual mortgage. Therefore any risk measurement should mainly reflect the financial health of the corporate, which can be measured via a LTV / Debt Yield grid as per Question 15.

Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

For pre-existing loans to retail counterparties, days past due information can be a good predictor of risk. For corporate counterparties Debt Yield (EBITDA to Total Debt) at the corporate level is also a good risk indicator. A grid based on LTV and Debt Yield would reflect both static (value) and dynamic (income/ debt service) risk.

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

We believe that a simpler way to address this risk would be to include a higher threshold for cases where there is a currency mismatch between the income and the loan.

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

The proposed categories could be defined more clearly since, for example, a definition of 'direct credit substitute' and 'short-term self-liquidating' could be provided.

We have a specific concern with the category "unconditionally cancellable." The ambiguity about this means that consistent interpretation between banks is unlikely. We further deem the 10% risk weight is to be too high given that commitments can be withdrawn without notice.

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

We support the objective of aligning CCFs across different approaches. However we do not understand why the BCBS considers increasing the existing CCFs to 75% is necessary. This appears disproportionately high compared to the actual drawdown rates we observe in the market. Whilst we support the BCBS intention to align the internal risk based approach and the standardised approach in this regard, we believe that using the 20/50% CCFs across both models would be the most accurate way of doing this in a way that will also support international trade.

We also question the approach of removing maturity distinctions which add a minimal level of complexity, but provide a considerable increase in risk sensitivity. The BCBS proposal also penalises off-balance sheet exposures which are typically short-tenor in nature, and are core to the overall capacity of the banking industry to finance international commerce. Consideration needs to be given to the possibility that disincentives for issuing short term commitments means that firms will look to issue longer commitments, thus increasing risk in the system.

In this context, providing guidance that Annex 1, section 10, clause 55 will apply when the availability of off-balance sheet exposures (e.g. import L/C, export L/C confirmations, acceptances and guarantees) and officially supported export credits are structured as committed facilities/limits is an important addition to the current BCBS paper in our view. These terms are used interchangeably to reflect current practices within banks and in line with both regulatory intent and banking practice, the CCF for these facilities will be the exposure/product based CCF of 20% and 50% and not 75%. This will assist in keeping the existing risk sensitivity but also help in achieving the Committee's objectives of greater alignment across different approaches. We note that such a clarification will maintain consistency with existing practise and reduce variability in reported risk weights.

For further detail here we strongly align with the view and comments provided by the International Chamber of Commerce (ICC) Banking Commission.

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

We support the current framework which is risk sensitive and appropriately takes into account the amount of provisions in place.

Q20. Do respondents agree with the proposed treatment for MDBs?

The proposed framework seems to be similar to the current framework for qualifying MDBs. However, MDBs are - in essence - something between Banks and Sovereigns, so the proposal to use a corporate scorecard does not seem to be suitable. The main responsibility of MDBs is to provide loans. They are not aiming to maximize revenues like corporates or financial. By offering loans, their leverage might be very high and determining their risk weight with the method suggested for corporates (using revenues and leverage) will likely result in unduly high risk weighting.

We would also urge the BCBS to review the list of MDBs that are considered highly rated. We believe that local MDBs like Cofide in Peru, or the African Trade Insurance, should be included on the list as well.

Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

The proposed framework seems to be similar to the current framework for "other assets". Cash as eligible financial collateral, however, is explicitly given a 0% haircut, whereas cash in hand and equivalent cash items that do not serve as financial collateral are not explicitly covered in the 'other asset' class. Therefore we propose to including a risk weight of 0% for cash in hand and equivalent cash items. In addition, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities can be treated as cash and is therefore risk-weighted at 0%. In addition, cash items in the process of collection can be risk-weighted at 20%.

Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?

Please see response to Question 23

Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

[For questions 22 and 23, we support the positions taken by the joint trade associations. The justifications for the increased supervisory haircuts risks exacerbating the previously covered issues around the risk-insensitive approach to calculating exposures.]

Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?

The proposed restrictions regarding guarantors risk sending the wrong signal: if a guarantee only creates additional workload but no incentive (for example positively influencing the risk parameters), sales will procure less guarantee agreements and in consequence the bank will observe higher losses in case of default events. This is due to the fact that the entity eligibility criteria b) and c) in paragraph 130 do not say anything about the intrinsic value of the guarantee.

The proposed definition of eligible guarantors seems so broad that it seems difficult to see which entities would be excluded.