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Basel Committee on Banking Supervision
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Deutsche Bank's response to the Basel Committee on Banking Supervision Consultation on "the Review of the Credit Valuation Adjustment Framework"

Dear Mr. Pykhtin, Mr. Quibel,

Thank you for providing us with the opportunity to comment on the Basel Committee on Banking Supervision (the Committee) Consultation on Credit Valuation Adjustment (CVA) (herein Consultation). We fully support the Basel Committees efforts to revise the current CVA framework.

We highly appreciate that the Committee is proposing to align the CVA framework more closely with the market risk framework as the sensitivities of CVA risk management and measurement are to a large extent similar to those of the market risk framework. Furthermore, widening the scope of eligible hedges to include proxy hedges and market risk hedges will improve the management and measurement of CVA risk. Lastly, aligning accounting and regulatory CVA further will result in a regulatory capital requirement that is closer to the potential accounting losses that can arise from CVA.

Support for a Standardised and Internal Model Approach

We note that the Committee is still debating whether it should include a proposal allowing for an internal model approach. We agree with the Committee that the robustness and comparability of risk management and measurement in general can and should be enhanced and believe that improving the robustness, governance and transparency of internal models will restore faith, understanding and reliability in banks' internal models. However, variance in risk management practices and outcomes of internal modelling does not imply that internal models are flawed. The variance reflects genuine differences in banks' risk profiles, their client behaviours and banks' strategy which likely reflects that models are accurate and risk sensitive to the actual risk factors.

The CVA risk internal modeling approach allows banks to prioritise model improvements, therefore making the model increasingly sensitive to changing risk drivers. This results in more effective risk management and measurement of CVA risks. Relying solely on Standardised Approach (SA) modeling will unnecessarily reduce the accuracy of risk management and result in less effective pricing. We therefore strongly believe that the proposal should contain both a standardised and an internal model based approaches.

Suggestions for improvement of the current proposal

We have provided detailed constructive recommendations on the proposal in Annex I. These recommendations are in addition to comments raised by ISDA in their response. These suggestions should, further improve the CVA framework and would lead to more effective, efficient and comparable risk management.

We have specifically focused on the following elements:

- **Calculations for the capital requirement:** We agree with the proposal for calculating the capital requirements and believe that the proposal would benefit from reviewing the use of identical risk drivers and the application of the two multipliers.

- **Aligning accounting-based CVA with regulatory CVA:** we support the alignment between accounting and regulatory CVA calculations. We are concerned however, that the language in paragraph 15 of the proposal would have the unintended consequence of requiring changes in accounting CVA best practices, in order to comply with the technical requirements for a regulatory CVA model as outlined by the Committee. We would request the Committee clarify that this is not the intention and allow for some variance between accounting and regulatory CVA models in order to comply with regulatory CVA technical requirements.

- **Implementation of the new standard:** This proposal introduces new elements for measuring CVA risk (most notably Vega). The calculation of the Vega risk plays a central role within the new framework and its impact could be assessed further. Furthermore, the current Quantitative Impact Study (QIS) did not appropriately research the portfolio effect by focusing only on the top 50 counterparties. We would therefore advise the Committee to perform a second QIS to be able to better assess the true impact of its proposal.

In the Annexes to this letter, we provide more detailed comments on the Consultation and answers to the questions raised in the Consultation. Please do not hesitate to contact us if you have questions or wish to discuss these comments further.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy

Annex I: Deutsche Bank overarching comments

Focus on aligning accounting-based CVA with regulatory CVA

We fully support aligning the calculation of regulatory CVA with accounting CVA (i.e. in-line with financial statements). As stated in the Consultation, the framework aims to capitalize for the potential accounting losses that can arise from CVA. It is therefore appropriate to align accounting CVA which is the driver of P&L losses. This approach will result in an exposure calculation that is generally consistent with P&L movements and regulatory capital that more accurately reflects economic impacts. Also, this approach would align the CVA framework more closely with the Fundamental Review of the Trading Book (FRTB) market risk framework, which as currently proposed is P&L based.

In the context of the internal model approach, the accounting CVA approach would also improve the efficacy of P&L attribution and backtesting requirements. We are concerned however, that the language in paragraph 15 of the Consultation would have the unintended consequence of requiring changes in accounting CVA best practices, in order to comply with the technical requirements for a regulatory CVA model as outlined in the Consultation. We would request that the Committee clarify that this is not the intention and allow for some variance between accounting and regulatory CVA models in order to comply with the regulatory CVA technical requirements.

Furthermore, the current Internal Model Method (IMM) approach has the unintended consequence of generating P&L volatility due to divergence of regulatory and accounting CVA. Banks currently manage P&L volatility due to CVA through the use of accounting CVA hedges. However, because the regulatory CVA methodology differs from accounting practice banks must enter into regulatory CVA hedges on top of the accounting CVA hedges to manage their regulatory capital requirements. These regulatory hedges have no offsetting P&L effect and as such generate P&L volatility. As a result, when implementing regulatory CVA hedges, banks have to weigh the impact of increased P&L volatility against management of capital requirements. This trade-off is at odds with the actual goal of risk management which should be both focused on reducing P&L volatility as well as on accuracy of capital requirements. The alignment of exposure calculations to the accounting practice would align P&L volatility and capital requirements to a higher degree.

While we understand the Committee's rationale for certain modifications to "pure" accounting CVA, we believe that certain aspects, which are detailed below, of the proposed accounting based CVA calculation in the Consultation are overly complex and would not contribute towards the achievement of the Committee's stated objectives for the review of the CVA framework.

Securities Financing Transactions (SFTs)

Post financial crisis there has been increasing demand for collateral, driven by the global regulatory agenda (e.g. Liquidity Coverage Ratio, OTC derivatives reform and a shift toward central clearing), increased risk-aversion of market participants, and Central Bank monetary operations.

SFTs are an essential tool used for collateral management. They are generally subject to conservative haircuts and overcollateralised with high quality collateral. SFTs have already been impacted by a number of regulatory initiatives, including the Leverage Ratio and Net Stable Funding Ratio (NSFR), as well as proposed minimum haircuts, which have made the economics of such transactions challenging and forced banks to trim activities in this area. Charging regulatory CVA for SFTs could therefore result in further collateral shortage. We would advise the Committee to take these developments into account when reviewing the Consultation.

Legal netting enforceability

Legal enforceability requirements are intended to capture default risk. Paragraph 67 of Annex IV of the Basel Framework states which requirements banks should take into account:

"For a bank that qualifies to net transactions, the bank must have internal procedures to verify that, prior to including a transaction in a netting set, the transaction is covered by a legally enforceable netting contract that meets the applicable requirements of paragraphs 96(I) to 96(v) of this Annex, this Framework text on credit risk mitigation techniques, or the Cross-Product Netting Rules set forth in this Annex."

In our view, this would require a burden of proof that is too high for a non-default risk measure. Where firms are able to conduct robust legal assessments to determine that netting is highly probable, we propose that netting enforceability should be recognised for purposes of the CVA framework. We believe that this should follow a binary approach rather than a probabalistic approach. The binary approach is more direct in implementation and analysis. These characteristics are aligned with the concepts of simplicity and comparability.

CVA desk definition

The Committee proposes to use a single CVA desk for the entire bank. We would recommend permitting the use of more than one CVA desk that can be organised across asset classes or regions. Under such an approach, banks would be able to seek Internal Model Approach (IMA) approval on a desk-by-desk basis, which is aligned with the trading desk approach under FRTB. This would allow banks to use the Standardised Approach or Basic Approach for more simplified CVA desks and IMA for CVA desks where the risk is more material and complex thereby requiring specialised risk management.

Capital calculations

We agree with the Committee's proposal on the calculation of capital requirements. However, there are two areas which we believe would benefit from further review. The first element relates to the calculation of the expected shortfall values on the six different risk types and the second element relates to the use of the multipliers for calculating the capital requirements.

1) Separation of identical risk drivers

The proposal states that for the calculation of capital requirements, banks need to calculate six partial expected shortfall values for each of the following risk types: Counterparty credit risk (Regulatory cs01), IR, FX, Reference Credit Spreads (exposure cs01), EQ, CMDY. These buckets are used in the SA-CVA as well as the IMA-CVA.

We note that credit risk appears on the list twice in the form of counterparty credit and reference credit risk. We understand the purpose of different buckets is to separately capitalise risk types and take a conservative view with respect to inter-asset class correlations and stress timings. However, the split of identical credit risk into two separate buckets has unintended consequences of capitalising an event which cannot happen in the future, since they use the same underlying contract which is benchmarked against. This is outlined in the illustrative example below:

> A bank has -100 €k/bp cs01 in counterparty credit and +100 €k/bp cs01 in reference credit from a hedge, both against the same counterparty. Assume the stress scenario contains 50% observations of a 5bp up-tick and 50% observations of a 5bp down-tick. The actual CVA P&L in each scenario is zero because counterparty credit and reference credit P&L sum to zero. However, the expected shortfall amounts to -50 €mm in the counterparty credit bucket (due to the +5bp observations) and -50 €mm in the reference credit bucket (due to -5bp observation), totalling an expected shortfall of -100 €mm.

Furthermore, the segregation of counterparty and reference credit increases the complexity around hedging these risks, which would counter the Committee's effort to strive for complexity reduction. For example, any single name credit hedge booked by the CVA desk would need to be marked as a counterparty credit or reference credit hedge. We would ask the Committee to clarify whether hedges should in this instance be identified twice, with the reference credit and also the counterparty credit (if traded OTC). Also, the economics of the hedge trade are independent of the mapping, thus the mapping of the trade may need to be changed frequently to align with the economics of the underlying risk. If the hedge references a basket of counterparties, this would add further complexity as banks may need to consider partial mappings of constituents of the baskets.

We would ask the Committee to review the separation of these risk drivers into two different buckets and would recommend merging these into one, while retaining the difference in granularity of their respective risk factors for operational ease.

2) Addressing the risks via a multiplier

We understand the Committee's rationale for incorporating a multiplier to compensate for reduction of risk factor granularity and simplification of expected shortfall as well as to capture non-modellable risk factors. However, this is already achieved through the use of the CVA multiplier (paragraph 33). The trading book multiplier m_TB is determined by testing the trading book risk model and is not relevant for the CVA charge. Furthermore, we believe that the multiplication of m_CVA and m_TB results in quadratic scaling of the multipliers (suppose m_CVA is set at 2, then any increase in m_TB is actually twice as impactful in IMA-CVA as in FRTB-TB). The inclusion of a multiplier would result in a significant overstatement of capital requirements.

We believe the floor for m_CVA would be best set at 1.0. This because the proposal already explicitly provides for the ability of national supervisors to increase the multiplier if dependency between exposure and credit is not modeled. Furthermore, idiosyncratic spreads of illiquid counterparties need to be modeled to obtain IMA-CVA approval. Beyond this, experience shows that there are not any other material non-modellable risk factors in CVA. Lastly, there is substantial conservatism built into IMA-CVA through the dynamic stressed period, diversification reduction, expected shortfall, and extended time horizons. A multiplier floor higher than 1.0 would therefore result a overstatement of CVA model risk.

As a general comment on multipliers, we would ask the Committee to provide specific guidance and clarity on the application of the multiplier by national supervisors. It would be useful to understand how the Committee intends for supervisors to apply the multiplier in practice, including determining the appropriate level of the multiplier where required. Specific guidance would also support the convergence of supervisory practices across the globe, thereby providing for a more global level playing field.

Implementing the final standard

We fully support the objectives of the Committee's proposals for the review of the CVA framework. This includes introducing new elements for measuring CVA (most specifically Vega) and bringing the CVA framework more in line with the market risk framework. Against this background, we believe it would be useful to take an appropriate amount of time to test these new elements to ensure their suitability. This will lead to a higher quality of implementation and management of CVA risks. We would support the release of a second QIS, to able to better reflect the impact Vega risks are likely to have. Furthermore, the current QIS did not appropriately research the portfolio effect by focusing only on the top 50 counterparties. This narrow focus created a bias in counterparty selection - in particular, for instance, High Yield counterparties are generally not part of the top 50 counterparties and therefore are not

included in the QIS. We would therefore recommend a second QIS with broader scope to provide more clarity around the calculation of Vega risks as well as the impact on the entire portfolio.

Finally, we would recommend that the Committee provide for a phased-in implementation, taking into account the significant effort required to implement changes to the market risk framework addressed in FRTB. Banks will face challenges to implement the revised CVA framework with insufficient time-lag, as generally the same resources will be required for implementation of both frameworks.

Annex II: Responses to the Consultation Questions

Question 1: To what extent do large netting sets; potentially illiquid transactions inside a netting set; and recent disputes affect the internal assessment of the margin period of risk (MPoR)?

Answer:
For internal CVA risk management, these factors do not affect the CVA calculation

Question 2: Is Alternative 1 or Alternative 2 preferred with regard to the calculation of MPoR?

Answer:
We prefer Alternative 1, since it is more aligned to industry best practice for accounting CVA.

Question 3: Should IMM approval be included as an additional eligibility requirement for the FRTB-CVA framework under Option A (i.e. accounting-based CVA method for generating scenarios of discounted exposure?

Answer:
We do not believe that IMM approval should be included as an additional requirement for the FRTB-CVA framework within Option A. It is our understanding that the supervisor would need to approve the FRTB-CVA model and process aligned to accounting CVA which in that case no longer has a link to IMM.

Question 4: To what extent is there synergy between the calculation of accounting CVA and the EAD calculation for IMM with respect to processes, data and methodology?

Answer:
There is limited synergy between the calculation of accounting CVA and the EAD calculation for IMM. For businesses that are covered by the CVA desk, there are no synergies, given that the risk management of the CVA desk is based on the accounting / economic CVA risk, and not on IMM. However, there are certain businesses which are currently not managed by the CVA desk, which use the IMM-based process for accounting CVA reserve. These represent a small part of the banks CVA exposure.

Question 5: Is Option A (accounting-based CVA) or Option B (IMM-based CVA) preferred for exposure calculation?

Answer:
We prefer Option A, as we are supportive of alignment between accounting and regulatory CVA calculations, as indicated in Annex I. We are concerned however, that the language in paragraph 15 of the Consultation would have the unintended consequence of requiring changes in accounting CVA best practices, in order to comply with the technical requirements for a regulatory CVA model as outlined by the Committee. We would request that the Committee clarify that this is not the intention and allow for some variance between accounting and regulatory CVA models in order to comply with regulatory CVA technical requirements.

Question 6: Is Option 1 or Option 2 preferred for simulation time horizons?

Answer:
We prefer Option 1 due to the alignment with FRTB liquidity horizons.