27 March 2015

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

baselcommittee@bis.org

Dear Mr. Coen,

**Deutsche Bank's (DB) response to the Basel Committee on Banking Supervision consultative document on Capital floors: the design of a framework based on standardised approaches.**

Deutsche Bank welcomes the opportunity to comment on the Basel Committee on Banking Supervision’s (BCBS) consultation on Capital floors.

Faith in the accuracy and reliability of internal models has been shaken over recent years. We, both individually and as an industry, are committed to addressing this. There have been numerous studies investigating the reasons for, and drivers of, variance in risk weighted assets calculated using bank internal models. Studies at global and European levels have proven that the vast majority of variance reflects genuine differences in risk profiles, this is a positive sign that these models are accurate and risk sensitive. It must be kept in mind that just because a product or portfolio has the same name globally, does not mean it carries the same risk globally. There are very different risks resulting from a residential mortgage portfolio in, for example Germany, and the US. A key benefit of internal models is that these portfolios are not treated in the same way. However, as per the BCBS study on credit risk variation\(^1\), some 25\% of variance results from drivers not reflecting actual risk differences. Much of this 25\% is the result of inconsistent supervisory interpretations, and will be vastly reduced by more uniform application and supervision. The shift to a single supervisor for large Eurozone banks under the Single Supervisory Mechanism will help greatly in tackling this issue. The onus is on the industry to work with regulators to eliminate the remainder – and we are committed to achieving this. The recently published paper from the Institute of International Finance on risk sensitivity and internal models\(^2\) provides a significant number of possible improvements in the form of harmonized definitions and practise. In addition to the BCBS’s ongoing project to ensure supervisory and regulatory harmonization across member jurisdictions, both the European Banking Authority\(^3\) and the European Central Bank are also

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\(^1\) http://www.bis.org/publ/bcbs256.pdf
\(^2\) https://www.iif.com/file/6245/download?token=jacU7WKZ
\(^3\) http://www.eba.europa.eu/newspress/calendar?p_p_id=8&__8_struts_action=%2Fcalendar%2Fview_event&_8_eventid=1003457
conducting work in this area which the industry actively supports. We elaborate further on this later in our response.

Whilst we understand and share the desire for increased transparency and comparability, and reduced variability, in capital models, we have strong reservations about the role of capital floors in achieving this. We elaborate on this below, but in summary we are sceptical about the need to turn a temporary tool into a permanent feature given the range of new tools in place that meet the objectives of capital floors, whilst minimising the unintended consequences floors can have. These tools include the leverage ratio, stress testing and rigorous capital and liquidity rules. We further do not understand the timing – the standardised models that form the basis of this proposal are unfinished, meaning that it is impossible to understand fully the impacts that these floors could have at any given calibration level.

The initial introduction of capital floors by the BCBS achieved the aim of incorporating a temporary tool whilst the industry fully transitioned to a more sophisticated framework in Basel III. Work led by the BCBS since the financial crisis has created a vastly improved regulatory framework than existed before the crisis. The framework today is not only based on established internal models and rigorous risk mitigation, but also includes backstop provisions such as the leverage ratio which was recently strengthened and globally harmonized. The true benefits of this framework are demonstrated by the overwhelmingly positive results of recent stress tests which examine how the banking sector copes under extreme scenarios. The full impact of other improvements still under development, such as revisions to the liquidity framework and Total Loss Absorbing Capacity are yet to be fully realised. A permanent capital floor based on totally revised standardised approaches would be a radical change to this framework. We strongly caution against further rules based on unclear models that will fundamentally alter the way that banks and the financial sector function as a whole. The shifts in business model, product offering and risk management should not be underestimated. Only once the full benefits of the regulatory repair since the financial crisis are absorbed and understood should any consideration be given to further radical overhauls.

Given this, we do not agree with statements made in the paper which suggest the independence of issues to be addressed by capital floors and the leverage ratio. There is a clear overlap between the two as they are both risk-insensitive constraints to metrics that are designed to measure risk. ‘RWA dispersion’ is constrained by the leverage ratio in the same way as ‘low level of models based-RWA.’

Moreover, since the financial crisis, stress tests have become far more stringent and thorough, restoring credibility in the global framework, and quickly identifying areas where recapitalisation or changes in processes are needed. Transparency and scrutiny of internal models has increased markedly, and continues to do so through collaboration between regulators and the industry. Given these changes, it is very difficult to see what benefit will be provided to regulators, investors, firms or clients by making transitional floors a permanent feature of the prudential regulatory toolbox. In fact there is a risk that a false sense of comparability is established by using a crude standard approach measure to report on risk
where a more representative measure from a tightly controlled and verified model could be used.

We also outline some ideas that we feel will best serve the BCBS objective of restoring faith and enhancing understanding and reliability of banks’ internal models. This revolves around enhancing work already underway, particularly at the ECB level to benchmark and scrutinise banks’ internal models. Last year’s Asset Quality Review (AQR) went a huge way to rebuilding trust and understanding in capital levels and balance sheet quality – we propose a similar test for internal models. A third party auditor should be appointed to support the BCBS and its members in their work conducting an in-depth analysis, benchmarking and peer review of internal models. The results should be made public in as much detail as the AQR was. In addition, banks should be willing to ensure full transparency, cooperation and funding as regulators may not have the resources to ensure this. It is in the interest of the industry to ensure credibility and trust is restored, so a genuine and deep commitment should be assured.

In the annex to this letter we have prepared some more detailed comments, and our views should be seen in conjunction with response letters sent by the Joint Trade Associations which we have contributed to. However, we would like to draw your attention to some key points we feel the BCBS must be taken into consideration when deciding what type of prudential regulatory framework will be created.

1. Timing

We question the setting of timelines and deadlines for finalising rules before there is a clear understanding of the impact and further work needed to ensure the finalised rules will achieve their objective in an optimal way. Particularly now that the crisis repair rules are in place, sufficient time needs to be taken over rules that will fundamentally alter the way banks and the financial sector as a whole will function. The potential impacts on lending to the real economy and funding growth need particularly careful assessment. For these reasons, we do not support the attempt to finalise capital floors based on standardised, and advanced, approaches which are themselves still under development.

Furthermore, we do not believe that adding another layer of complexity at this time in the development of the regulatory framework is appropriate. In addition to the ongoing work around capital, leverage and stress testing, there is a significant effort underway to improve the aspects of the internal model framework that need improvement – principally transparency and the removal of unjustified variance.

2. Unintended consequences of further simplification

Simple tools are important, but come at a cost. We must be very careful in how they are designed and how they impact on risk management, business models and financial stability. Overemphasis on simple, non-risk sensitive tools could not only result in a homogenous banking sector, but one where actual balance sheet risk is not properly risk weighted. Risk insensitive tools such as standardised approaches and capital floors camouflage the specific
risk profiles as well as the riskiness of the portfolios to which they are applied. As we have already seen with the leverage ratio becoming a de-facto binding constraint for many banks, the shift from balance sheet allocation based on return on equity, to return on assets, incentivises banks to shift their balance sheet asset mix towards higher yielding, and potentially more risky and/or less liquid assets. This would be exacerbated by the proposed capital floors. There is a very real risk that the focus on simplicity that drives much of the recent BCBS agenda will lead to a banking sector where there is more risk on balance sheets, and where the primary regulatory tools are too insensitive to appropriately identify the risks. A multi-layered floor framework would also likely add to the complexities in comparing across peers as financial statement users will struggle to understand where banks’ risk models were used, and where and why they were overwritten by standardised models. We strongly caution the BCBS against this combination of likely less conservative asset choice, and tools that make it harder for regulators and investors to judge the risk carried on a firm’s books.

Another key feature of the original Basel III framework was that it maintained incentives for banks to invest in improving internal models, risk management and risk mitigation. This was done by ensuring that banks derive benefit from such investments. The current RWA-focused framework maintains this incentive and we 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 such investment. It would be deeply damaging to the further improvement of risk management in the banking industry if these incentives were to be eroded. Furthermore, where standardised models and blunt tools become the benchmark for capital requirements, this decouples the methods banks use to calculate regulatory requirements from the more sophisticated methods used for internal risk management. The resources needed to maintaining rigorous and ever-improving internal models is considerable, and further reflected in the robust pipeline of regulatory initiatives to enhance the quality and comparability of internal models. The less value placed on these models by regulators, the less benefit banks will derive from continuing to operate using sophisticated and accurate models, even internally. As this also clearly impedes regulatory use test requirements, we strongly urge the BCBS to avoid a situation where high quality risk modelling and managing is discouraged.

3. Broader considerations

As stated above, we share the BCBS aim of improving the consistency, transparency and understanding of capital models. Whilst much has been done in this area, there is room to do more, whilst remaining consistent with maintaining the strengths of the Basel III regulatory framework. Stress tests in the US and EU have proven to be a highly credible way of ensuring banks can not only withstand periods of extreme stress, but that there is clarity to regulators and the market about how each bank is set to cope. The BCBS already has plans to work on a global framework to ensure that best practice from different jurisdictions is shared and incorporated globally. Stress testing provides a valuable tool, based on a comprehensive and accurate range of extreme scenarios, calibrated to historical extreme events, to capture and control risks that may not be fully captured by standard RWA. This is
particularly the case when considering the most systemic banks. Stress tests additionally incorporate standardised scenarios designed by regulators, which can address variance issues in a similar way to capital floors. For those banks subject to comprehensive stress testing, it is therefore difficult to see any added value from a risk management standpoint of introducing of a separate SA floor provides an additional constraint that offers no value added.

The recent Asset Quality Review (AQR) in the EU showed the value of having third parties help to thoroughly test and scrutinise bank balance sheets. A rigorous test, accompanied by clear and detailed disclosure and benchmarking, could be applied at the global level to bank internal models. This would go much further than capital floors in ensuring the models are reliable, prudent and understood. Industry and regulators could use such a tool to build upon work underway in various jurisdictions to enhance this and use the momentum to further harmonise the definitions, modelling practises and supervisory inconsistencies that result in excess variation. We would be very happy to dedicated resources to helping the BCBS create this type of enhanced model scrutiny.

We strongly feel that this is where the BCBS and member regulators should be focusing time and effort, rather than reintroducing capital floors that are less comparable and risk undoing the good work to date and creating a weaker regulatory regime, and weaker banking system.

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

1. Timing

We do not support the proposed timeline of finalising the capital floors rules by the end of 2015. There are numerous elements of the capital floor design that cannot be properly understood or analysed in such a limited timeframe. This is primarily due to the fact that the standardised approaches, upon which the capital floor is built, are not yet final. Indeed it is our understanding that all three proposed standardised approaches are likely to change materially from the most recently available consultations. We urge the BCBS to finalise those rules and not build further regulation on unfinished foundations. Questions such as whether a floor should be based on risk type, or aggregated RWA levels cannot be reasonably answered whilst the final design, let alone calibration, is unknown.

Furthermore, any changes to the nature of, or design of, standardised approaches need to be considered in the context of the full regulatory framework. Tools such as the leverage ratio and Total Loss Absorbing Capacity (TLAC) take the standardised approaches and calculation of risk weighted assets (RWA) into account. The calibration of these tools is already uncertain and highly complex; this situation should not be exacerbated by bringing out changes to the RWA framework in a siloed manner.

Finally, the banking sector, particularly in the prudential regulation sphere is currently implementing, or finalising, a vast amount of rule changes. It is simply not possible to understand how new capital, liquidity and structural requirements will impact on the banking sector, regulatory tasks, and the ability of banks to continue providing services to clients. Given the limited value of capital floors in a world with vastly improved internal models, capital requirements, stress tests and a strong leverage ratio, we urge the BCBS to seriously reconsider whether making floors a permanent feature is indeed of value.

2. Policy Foundations

Basel I floors were designed as a temporary measure to enable a smooth transition to the new framework for credit risk. They are still in place for that purpose, i.e., to mitigate swings in capital requirements for late Basel II advanced model joiners. They are not needed post that transition. Even if their intention was changed to focus on capturing risks that internal models may miss, for example idiosyncratic risks or model risk, this is now done by a combination of rigorous stress tests and a strong leverage ratio. Particularly once the leverage ratio migrates to a fully binding mechanism, capital floors will simply be duplicative in their value.

As mentioned in our cover letter, and discussed in our responses to BCBS 258\(^4\) and BCBS 251\(^5\) we are concerned that the ideological shift from risk sensitive tools in Basel III, to blunt, risk insensitive tools will have significant unintended consequences. Not only will banks be disincentivised from investing in sophisticated risk management techniques and internal

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\(^4\) The regulatory framework: balancing risk sensitivity, simplicity and comparability, October 2013

\(^5\) Revised Basel III leverage ratio framework and disclosure requirements, September 2013
models, but they will be incentivised to take on greater risk when allocating artificially constrained balance sheet space.

From a risk governance perspective an important part of the risk weighted asset measure is the "use test" that requires risk measures to be used as part of a bank's day to day risk monitoring, managing and business decision making process. Introduction of capital floors which become the binding constraint is likely to make such "use test" redundant as such a measure becomes less risk sensitive and hence less relevant in business decision making process.

3. Potential unintended consequences

If banks are incentivised to move to a riskier asset mix in order to find the needed return under risk insensitive tools, it will be the low margin, low returning businesses that become less attractive. These tend to not only be the most conservative businesses, such as retail mortgage lending, but they also play a key role in the fundamental functioning of the economy. Services such as client cash management, Government repo and trading in high quality liquid assets are likely to feel the brunt of such regulatory changes. Concerns such as this were part of the reason that the global regulatory world shifted from Basel I to Basel II and III.

Amending risk measurement metrics by less risk-sensitive floors will decrease regulator/market understanding of bank risk profile. While this is already the case due to the increase of blurring of Pillar 1 and Pillar 2 metrics under the Supervisory Review and Evaluation Process (SREP) for actual reporting, floors will also adversely impact the quality of stress test results as key output (RWA) metrics are dampened. In combination with new standardised approaches introducing further levels of conservatism, which appear at times unrelated to true risk, (for example the punitive 300% risk weights under revised Credit Risk Standardised Approach for missing data), these important risk management tools will lose their purpose of identifying vulnerabilities of the institution. The same mechanics also amplify procyclicality, as only a dampened adjustment of capital requirements would be expected once an economy moves out of a trough.

It should also be kept in mind that despite the BCBS's stated intention of not increasing the overall capital in the banking system, any capital floor above zero will increase the overall capital requirement. Moreover, banks with a more conservative asset mix are the most impacted. Since the introduction of Basel III, RWA levels have generally fallen as a reflection of more conservative asset choices and better risk management. A floor which is based on standardised approaches that fail to fully recognise these traits will inevitably mean that the most conservative banks lose the RWA benefits from their choices. They will be the ones hit by the capital floor before banks that already had higher RWA levels to reflect a greater risk appetite.
4. Further options

We believe that there are numerous options that would meet the BCBS objectives of restoring trust, limiting excessive variance and enhancing transparency around internal models. The key is to find the options that do this without the many negative consequences that capital floors would result in, as shown above and in great detail in the industry responses to this consultation. These include options such as simply maintaining the existing Basel I floors whilst we wait for the full impact of Basel III, plus tools such as enhanced stress tests and TLAC to take effect. However, whilst this would likely ensure that the correct levels of prudence exist in the industry, we believe more can, and should be done.

As per our cover letter, we propose that the EU’s Asset Quality Review be used as a template for carrying out a thorough, credible and transparent test of bank internal models. The AQR combined rigorous scrutiny, third party audits and highly transparent benchmarking and publication to ensure that banks were forced to clean-up outstanding issues, provide a high level of access and that regulators and investors were able to understand the processes being undertaken as well as the results found.

It is our strong belief that such an option could be developed by regulators and the industry and that this, in combination with a move to a binding leverage ratio and ever more rigorous stress tests would be the optimal way to meet the BCBS objectives, without creating the wrong incentives in risk management and investment decisions.