



25 September 2013

Mr. Adam Farkas
Director General
European Banking Authority
Tower 42
25 Old Broad Street
London EC2N 1HQ
United Kingdom

Deutsche Bank AG
Winchester House
1 Great Winchester Street
London EC2N 2DB

Tel: +44 20 7545 8000
Direct Tel +44 20 7545 8663

EBA-CP-2013-24@eba.europa.eu

Dear Mr Farkas,

Deutsche Bank's response to the European Banking Authority (EBA) consultation on "draft Regulatory Technical Standards (RTS) on Credit valuation adjustment (CVA) risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383 of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR)".

Deutsche Bank (DB) welcomes the opportunity to respond to the draft RTS.

In our enclosed detailed response we elaborate on our concern about the unintended consequences of the RTS if it was also to be applied to new CVA VaR and therefore the existing VaR applications for the trading book.

DB's key concerns follow from the proposed levels of granularity of proxy spreads:

- a) The proposed RTS address a prescriptive level of granularity however it is missing key components such as the number of underlying constituents and market data quality;
- b) Loss of quality of VaR;
- c) Prescribed granularity may lead to under- or overcapitalisation; and
- d) Introduction of new idiosyncratic risks to the financial system.

If the proposed levels of granularity were to be applied only for the purpose of CS01 calculations (as per paragraph 2b), then our concerns regarding proxy spread granularity would be largely alleviated. This is because the market data quality requirements are significantly higher for a volatility-based model like VaR compared to a spread-level based sensitivity like CS01.

Furthermore, a conservative interpretation of the RTS could lead to significant implementation costs and efforts.

We have provided more details in our enclosed response. Please let us know if further information would assist.



Yours sincerely,

A handwritten signature in blue ink, appearing to be 'A. Procter', with a long horizontal stroke extending to the right.

Andrew Procter
Global Head of Compliance, Government and Regulatory Affairs



Responses to the consultation questions:

Q1. Please provide information and data concerning the availability of CDS data with respect to the minimum categories for 'rating', 'industry' and 'region' defined in points (b), (c) and (d).

The proposed specific levels of granularity for proxy spreads are rating, industry and region. These would generally include seven different non-default ratings AAA-CCC; at least six different industries; and four different regions. This amounts to 168 possible combinations of rating, industry and region to be populated for proxy spreads.

To understand this further, we have undertaken an analysis regarding the number of CDS by which to build proxy spreads. To this end, DB has analysed a CDS universe from Markit with the following relevant attributes:

- Only for entities which have a Markit Liquidity Score¹⁾
- Liquidity Score for each issue of 1-4 (out of a possible range of 1-5, 1=highest level of liquidity)²⁾
- Currencies of EUR for Europe and USD for North America and Rest of the World
- On senior claims only (Tier = SNRFOR)
- 5-year tenor
- Underlying entity having an external rating³⁾.

As of August 2013, the above universe entails 1,214 CDS against 1,214 different entities with the breakdown into rating, industry and region as shown in Table 1.

1) Markit CDS Liquidity provides independent measures of liquidity on CDS single names and indices, giving insight into trading liquidity risk, the risk a firm will not be able to convert an asset into cash without occurring minimum loss of value due to inadequate market depth or other market disruptions.

2) Liquidity score of 5 is discarded in this analysis based on the observation that no constituent of on-the-run ITRX or CDX indices has a liquidity score of less than 4.

3) Average of the Moodys and S&P ratings adjusted to the seniority of the instrument.



Table 1: Number of CDS issuers as per proposed EBA level of granularity⁴⁾

Region EBA	Industry	Rating MARKIT							Grand Total
		AAA	AA	A	BBB	BB	B	CCC	
Asia			10	22	26	10	5		73
	Banks			7	2				9
	Industrials			2	4	2			8
	Insurance								0
	Other Financials				5		1		6
	Others		9	10	14	5	3		41
	Public Sector		1	3	1	3	1		9
Europe		13	25	121	160	64	26	8	417
	Banks	3	6	39	21	11	3	3	86
	Industrials			11	23	14	3		51
	Insurance		2	15	6	1	1		25
	Other Financials		2	8	6	4	3	1	24
	Others	1	11	47	98	33	15	3	208
	Public Sector	9	4	1	6	1	1	1	23
North America		2	17	137	266	85	72	22	601
	Banks		2	11	2				15
	Industrials		2	19	21	17	5	1	65
	Insurance		2	18	18			1	39
	Other Financials		1	19	11	5	5	2	43
	Others	2	9	70	214	63	62	18	438
	Public Sector		1						1
Rest of World			11	23	56	17	12	4	123
	Banks		4	6	11	4	3	1	29
	Industrials		1		4	1			6
	Insurance			3	1				4
	Other Financials			1	1				2
	Others		1	7	11	9	5	1	34
	Public Sector		5	6	28	3	4	2	48
Grand Total		15	63	303	508	176	115	34	1,214

63 (38%) out of 168 possible combinations does not present a single underlying CDS to contribute to a proxy spread construction. Highlighted in green are those segments with 10 or more constituents.

Q2. Please provide information concerning the usefulness, appropriateness and coherence with market practices of the approach to the use of single-named proxies described in Article 3.

We have concerns regarding the proposed levels of granularity of proxy spreads.

a) The proposal sets out a prescriptive level of granularity however it is missing key components such as the number of underlying constituents and market data quality

4) The sample of 1,214 CDS has not been submitted to market data quality checks. It is expected that a number of these CDS would not meet a bank's market data standards for use in a daily VaR process (where returns of proxy spread levels are needed). However, they are still be useful for determining proxy spread levels for the determination of CS01s.



We believe the proposal should include a statement regarding the minimum number of CDS issuers required to be able to create a proxy spread. The Executive Summary of the RTS, page 4, second bullet, states that even a single issuer is considered appropriate to build a proxy spread. Such an approach would translate into the advanced CVA risk weighted asset (RWA) being driven by the idiosyncratic characteristics of a single name. That approach could significantly under- or overestimate the risk. Additionally, we believe that this could lead to an inaccurate VaR model result when it is applied to the trading book. The general risk component of VaR, which is what proxy spreads feed into, is expected to capture broad market movements not the potentially erratic spread movements of a single issuer.

Typically, a sufficient number of time series is required to build a proxy spread such that it can be used adequately in VaR. For illustration purposes, if we estimate that a minimum of at least 10 time series are necessary for a proxy spread to be representative (see green highlighted cells in Table 1 above), then 30 (18%) out of 168 possible combinations have a sufficient number of representative time series. This shows that a significant amount of merging segments is necessary to create proxy spread. Depending on market data quality, this may lead to one of the dimensions (i.e., rating, region and industry) not being appropriate in practice for proxy spread creation while two of the other dimensions are a selection criterion.

Therefore, we recommend that the RTS should focus less on reducing the level of granularity of proxy spreads and should instead provide flexibility to merge segments for proxy spread creation where there is insufficient data to create statistically appropriate proxy spreads. For example, the segment BB/Asia/Banks has no entry in Table 1. Instead, a proxy spread might be created from and applied to all 10 constituents of Asian BB-rated companies.

Market data quality requirements are significantly higher for a volatility-based model like VaR than they are for a spread-level based sensitivity like CS01. We would be less concerned regarding proxy spread granularity if the proposed levels of granularity were to apply only for the purpose of CS01 calculations (as per paragraph 2b).

b) Loss of quality of VaR

In addition to the concern discussed above, the data analysis and conclusions that we draw in response to Question 1 demonstrates that the RTS does not consider data availability by tenors. Tenor granularity is important in a VaR model where curve risk is prominent in a portfolio. If granularity requirements are too high, a full tenor proxy spread structure may no longer be available. Exposures which are important to be monitored in the trading book are therefore at risk of being overlooked because of the CVA VaR requirements.

c) Prescribed granularity may lead to under- or overcapitalisation

By default, the proxy spreads for VaR are also used for Stressed VaR. This means that the resulting RWAs are largely dependent on how a particular rating, region or industry segment performed during the time of high market volatility. Often, the corresponding time horizon for VaR calculations is the 12-month period around the Lehman-default. Some industries, e.g. in North America, have demonstrated much higher volatility than the equivalent industries in Europe. Continuing with capital “surcharges” for certain industries may drive banks to consolidate their activities in other industries which are less capital intense. Similarly, a high level of granularity, i.e. too many segments with individual proxy spreads, invites further crowding. This could lead to undercapitalisation if and when a future crisis is driven by other industries or segments and therefore increases the systematic risk in the financial system.

d) Introduction of new idiosyncratic risks to the financial system



Reliance on a small number of issuers for a proxy will accentuate the impact of the idiosyncratic risk from those issuers and not only impact the debt and credit trading activities on those names, but also any CVA or traded market risk that is using those proxy spreads. It may also negatively impact the credit spreads for the issuers in the proxy and their cost for raising capital due to volatility not caused by their own credit quality but from using the name as a singular proxy spread.

Banks typically manage their CVA risk via hedging by single-name or index CDS. For the purpose of recognising a hedge benefit in the CVA RWA, over-hedging by single-name CDS is not permitted. As a result, the most common products used to hedge CVA risk are credit indices. Where granularity is very high, the available index product range can quickly become too scarce for an efficient hedging of the CVA risk.

The creation of proxy spreads out of a limited number of CDS issuers will result in crowded trades. Many CDS issuers outside of the index constituents already have a fairly shallow liquidity pool at the 5-year maturity point. Banks hedging CVA risk will potentially create significant demand for protection of CDS issuers where term structure liquidity is already constrained, leading to an increase in market volatility, idiosyncratic risk in CVA VAR and the potential of real economic consequences for the issuer.

e) Industry attributes have uncertainly attached which lead to ambiguity

The allocation of CDS issuers to industry categories is not trivial. For example, some US broker-dealers are categorised as “Other Financials” by Markit. However, from a business mix perspective, they may often be very similar to issuers categorised as banks. Therefore, we believe that a level of granularity below “Financial Institutions” would not be appropriate.

Q3. Paragraph 3 allows for the proxying of the spread of the subsidiary by the spread of the parent company. Where no rating is available for the subsidiary or the parent undertaking or both, should the entities be considered equal in terms of the ratings attribute? Do you think that this treatment is appropriate? Please state the reason(s) in favour and / or against.

In our experience, it is common that there are no external ratings available for subsidiaries as external ratings often exist only for entities that have issued publicly traded debt. We think that it should not be a prerequisite for a subsidiary and its parent to both have to be rated before the subsidiary can assume the credit spreads of the parent in the CVA credit spread sensitivity calculation.

The relationship between the parent entity and the subsidiary must be taken into account when assigning the parent’s credit curve as proxy for the subsidiary. As an example, if there is a legally enforceable guarantee in place, it should allow use of the parent’s credit curve legitimate regardless of rating, industry or region of the subsidiary.

It is therefore appropriate not to require matching ratings, industry or region between parents and subsidiaries where there is an enforceable cross-default connection between the two entities. If the relationship is weak, for example if the subsidiary is minority owned or other restrictions apply such that it cannot be taken for granted that the parent will assume the obligations of the subsidiary, then the rating, industry and region mapping between the parent and the subsidiary should be considered before using the parent as a proxy.

It is possible that the parent entity in a group has a different industry or region classification than a subsidiary, but nonetheless remains the best possible proxy available. It is common that a group parent is based in one region with subsidiaries around the world in other regions.



Within the corporate sector, the local subsidiary may have the same industry classification as the group parent, given the broader purposed industry classification for corporate. But within the more detailed industry sector split of the financials, group parent and local subsidiaries may be in different categories.

We suggest the EBA should also allow alternative credit quality assessment procedures in order to justify proxy spread mapping for subsidiaries and would be happy to elaborate on our suggestion.

Q4. Paragraph 4 allows for the proxying of the spread for a regional government or local authority by the spread of the relevant sovereign. Where no rating is available for the regional government or local authority, should the entities be considered equal in terms of the ratings attribute? Do you think that this treatment is appropriate? Please state the reason(s) in favour and/or against.

In-line with the response to Question 3, the same argument may be applied to regional governments and local authorities.

Q5. Please indicate other particular cases in which single named proxies might be appropriate.

Our concerns regarding the unintended consequences of constructing proxy spreads for the calculation of VaR as discussed under our response to Question 2 are less pronounced for the calculation of CS01. This is because a high level of granularity for the CS01 calculation may have some inconsistencies (e.g., spread levels not increasing with lower ratings for all regions and industries) but does not negatively impact the quality of the VaR model for the trading book.

Q6. Do the proposed thresholds of [15] % for the number of non-IMM portfolios, of [1] % for each individual non-IMM portfolio, and [10] % for the total size non-IMM portfolios, together with the definitions, provide an incentive for institutions to limit their portfolio exposures not covered by the IMM? Will the defined thresholds of [15] %, [1] % and [10] % cause any impact for your institution?

The thresholds and the penalty of having to use a standardised approach if breached for two consecutive quarters do provide an incentive for institutions to ensure that portfolios not covered by IMM are at a minimum. Please note that the additional penalty of using the carve-out approach with flat-lined exposure profiles for non-IMM portfolio would also incentivise institutions to keep the non-IMM portfolio as low as possible. In DB's opinion, the thresholds are potentially too low.

Q7. The EBA expects that only a limited number of counterparties/names will receive a proxy spread. Do you agree with this conclusion? If not, could you explain why and state how many of your names will require a proxy spread?

DB does not share the expectation that only a limited number of counterparties to receive a proxy spread. On the contrary, we expect significant differences in the composition of credit risk from the CVA portfolio vs. what to expect from a credit trading portfolio. A large portion of our derivative counterparties do not have publicly traded debt and therefore no liquid CDS market to reference when calculating CVA exposure. Instead, there is a reliance on using proxy spreads. In many cases, these are close proxies from within the same company group



(e.g. using the CDS spreads from the financing arm to proxy the probability of default of a local subsidiary abroad). However, many smaller companies do not have any suitable single-name proxy and instead VaR proxy spreads are used for the CVA CS01 calculation. We are happy to share specific data via our home regulator.

Q8: Do you agree with the above analysis of the costs and benefits of the proposals? If not, please provide any evidence or data that would further inform the analysis of the likely cost and benefit impacts of the proposals.

Where banks need to adjust their proxy spread granularity for CS01 and VaR calculation, we expect that significant investments are required. The implementation time for the proposals in the RTS is likely to last at least 6-9 months, plus the time required to seek approval from the supervisor on the new methodology.