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Dear Mr. Farkas,

DB Response to EBA consultation papers (CPs) on Guidelines to the Incremental Default and Migration Risk Charge (IRC) and on Guidelines to Stressed VaR

Deutsche Bank (DB) welcomes the opportunity to comment on the EBA's draft IRC and Stressed VaR implementation guidelines. Our detailed comments on both proposals are included in Annexes to this letter.

The clarity provided in the CPs on a number of issues is helpful. However, we have a number of high level concerns:

- **Need for flexibility in the guidelines:** It is essential that the guidelines remain sufficiently flexible to allow for differences in banks' risk profiles and for different approaches to capturing risk. The Capital Requirements Directive (CRD 3) is already quite prescriptive and achieves a high level of harmonisation which is welcome in the context of the Single Rule Book. This will be further enhanced by the incorporation of CRD 3 into the new consolidated Regulation (CRR 4). Therefore, the focus of the guidelines should be on achieving the desired outcomes of Basel 2.5 rather than prescribing how banks achieve those outcomes.

  DB went through a lengthy implementation and validation process with the BaFin and dedicated substantial resources to building high quality market risk models in preparation for CRD 3 which came into effect on 31 December 2011. These new draft guidelines introduce amendments to the design of the models that, while minor, are not simple to implement. Meeting these new requirements, introduced so late in the process, will require significant resources. The same resources are currently dedicated to Basel III implementation, and in particular building the Credit Valuation Adjustment (CVA) capital charge model.

  As an example, the requirement in Section B.12 of the IRC CP to produce both upswing and downturn LGDs is a significant change to models that have already been approved. In addition to the difficulty of implementing such an approach, we feel that it would lead to potential inconsistencies (e.g. inconsistent capital costs for long versus short positions) which could hamper a bank's ability to manage and steer the portfolio in the context of the use test.

To highlight that point, we have differentiated in our detailed comments between areas of the guidance where we feel more flexibility is needed and areas where we have additional comments on the approach taken.

- **Timing:** The timing for making the model changes remains unclear. We understand that the EBA will issue final guidance late in the first quarter of 2012 and that there will then be a six month period in which the guidance will be transposed into national requirements at which point banks would have to be compliant. This means that banks will not have clarity on what is required by their national regulators until late-2012. We believe this timetable is too short to implement any potential model changes.

- **Level playing field with US and other jurisdictions:** The US continues to be stalled in the implementation of the Basel 2.5 Trading Book amendments because of the Dodd-Frank Act requirement to remove all references to ratings from regulation. However, the Notice of Proposed Rulemaking that was issued by the US authorities in December 2010 already diverges in a number of areas from the CRD 3 requirements. The EBA draft guidelines further tie EU firms to an inflexible model before the US has implemented Basel 2.5. Flexibility should be retained so that a level playing field can be achieved if the US moves ahead.

- **Fundamental Review of the Trading Book:** The Basel Committee's Fundamental Review of the Trading Book will most likely lead to a comprehensive change in the treatment of market risk. We expect that the Basel Committee will issue new proposals before the end of 2012. The adjustments to the models set out in these EBA consultation papers may be redundant following the Fundamental Review.

We look forward to continued dialogue with the EBA on these important issues.

Yours sincerely,

Andrew Procter
Global Head of Government and
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David Stevens
Global Head of Market Risk Management

Annex A: Stressed VaR

Need for greater flexibiltiy in the guidelines

- *P9/10, 4 and 5*: The proposals demand the selection of a specific 12-month historic stress period for each legal entity that reports VaR. This would be extremely problematic from a process perspective. Banks would have to run the period selection process for multiple legal entities. Globally active banks should be permitted to apply universally the stress period they select on group level. Paragraph 5 states "On the other hand, if the supervisor permits different legal entities' positions all to feed into a single internal VaR model at a consolidated level, then the stressed period may be defined based on the entire group's trading book positions". This should explicitly state that the group level window is eligible for local reporting.

- *P13, 9*: This section is overly-conservative regarding regular review and monitoring of the appropriateness of the SVaR time window (e.g. when de-risking trades have been put onto the book), although in practice there may not be a large impact if the SVaR window changes by a few months during the financial crisis (which is likely to be the relevant period for most banks).

- *P13, 9 para. 3*: Monitoring of new trading book positions which materially reduce the SVaR assumes the existence of a coherent VaR sub-allocation, which is not common (this is currently an area of research). The EBA should clarify that this provision would not require banks to monitor individual hedges through the life of the position. This would be impossible to do given that many thousands of trades change daily in the trading books of large institutions - hence making it impossible to test each individual new trade for its SVaR impact. From the open hearing, we understood this provision is intended to prevent inappropriate use of proxies to reduce stressed VaR. The wording should be re-drafted to make it clear that the point relates to the prevention of “arbitrage” actions involving the inappropriate use of proxy data rather than genuine hedging activities.

- *P16, C.10 .7 & 8 and table in para*. *C.10.10*: "Preference of the use of a full revaluation approach for SVaR". The wording implies much higher process and computational efforts and potentially the implementation of a different model for SVaR than for VaR. We would recommend deleting this text. Similarly with respect to the point on "Use of Taylor series approximations" in the table.

- *P18, C.13*: Separate validation of the same proxy for VaR and SVaR would be extremely burdensome. It would effectively force the implementation of two inconsistent VaR models.

Additional Comment

- *P12, 7*: A VaR-based selection process creates a circular reference and is thus not ideal as it amplifies model risk.

Annex B: IRC

Need for greater flexibiltiy in the guidelines

- *P14, B.12 and P20/21, 20.5*: More clarity is needed on the recovery rates/LGDs. It is not clear whether the EBA is requiring banks to start calibrating "upside" LGDs, nor is it clear how "downside" and "upside" LGDs should be applied:

    - If "downside" LGDs were applied to long positions and "upside" LGDs to short positions, then (nearly) perfectly matched long and short positions would show an inappropriately large net loss;

    - On an issuer level there are various recovery rates pertaining to the same issuer (senior secured, unsecured, subordinated, local currency, foreign currency, etc.);

    - Applying "upside"/"downside" LGDs on portfolio level conditional on upturn or downturn scenarios would introduce a new stochastic risk factor which would exceed the scope of capturing losses from rating migrations and defaults. This would require significant implementation efforts;

  In the context of the use test it is crucial to have consistent LGDs and corresponding capital costs (or savings for hedges) in order to manage and steer the portfolio in a meaningful way.

- *P20, D.20 para. 4*: When performing a full revaluation upon rating change, the current CRD 3 would allow for discounting with spreads or with historical PDs (as used for modelling rating migrations). We assume that the section stating that “The impact of a rating migration on market prices may be estimated using either currently observed market data (e.g. spreads); or an average of historical market data observed” still allows for both choices.

- *P21, E.22*: The preference to assign liquidity horizons on product/issuer level is extremely granular and not in line with current practice which looks at the liquidity of homogenous position classes grouped by e.g. product type, issuer type, rating, concentration, etc.

- *P11, A.4 para. 3*: It is not clear whether recoveries for defaulted positions need to be modelled in IRC if they have already been captured in VaR. There is a risk that the text implies double counting. The spirit of IRC should be to capture only incremental changes. Ultimately a defaulted asset will no longer imply any migration risk and any price changes and recovery risk will already be reflected in VaR given that the market prices distressed assets at their future recovery rate.

Additional comments

- *P14/15, C.14*: The requirement to test various copula assumptions is an academic exercise. Data scarcity implies that they cannot be back-tested. Moreover if complying with 12.2 (“no refreshment of systematic factors”), the multivariate distribution of risk factors would depend on granularity of the time grid used to model the path of risk factors except for Gaussian copula.

- *P16, 15.2*: We agree that if liquidity horizon A is a multiple of liquidity horizon B, the full path of the risk factors (i.e. no refreshment at end of liquidity horizon B) has to be used to model rating migrations and defaults of positions with liquidity horizon A. However, only the increments of the risk factors in each roll-over period of liquidity horizon B should be used for modelling the positions with the shorter liquidity horizon in order to achieve a constant level of risk.