Deutsche Bank

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Mr. Adam Farkas
Executive Director
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 1903
Direct Fax +44 20 7547 4179

EBA-CP-2012-09@eba.europa.eu

Dear Mr. Farkas,

DB Response to EBA consultation paper (CP) on Draft Regulatory Technical Standards (RTS) for credit valuation adjustment (CVA) risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios (EBA/ CP/ 2012/ 09)

Deutsche Bank (DB) welcomes the opportunity to comment on the EBA's draft RTS for determination of proxy spread and specification of smaller portfolios for CVA risk. Our detailed comments on the proposals are included in Annex to this letter.

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

Determination of the Proxy Spread and further clarification of RTS details

- We are concerned that the proposed methodology for extending VaR proxy methodology in Article 5 is too restrictive and are unlikely to be suitable for all banks. Given a limited number of names consistently traded in the market, some of the proposed sub-categories would have less than 10 contributors. It would be more helpful for the RTS to provide guidance on how the categories and any sub-categories should be defined by each institution instead of insisting on a pre-defined list.

- During the public hearing we were told that the RTS would only apply to the VaR of CVA approach, and not to Market Risk VaR. It would be useful for the EBA to formally clarify the situation with regards to existing VaR model approvals.

Determination of the LGD_{mkt} and an explicit link with Basel 3 FAQ documentation[1]

- DB believe that an explicit referencing to the "Basel 3 counterparty credit risk – FAQ from July 2012" (B3 FAQ) should be added to the RTS. The CVA formula in the Basel 3 text actually contains 2 different LGD measures – An LGD based on actual market losses ($\mathbf{LGD}_{mkt}^{actual\ loss}$) and an LGD based on market spread ($\mathbf{LGD}_{mkt}^{spread}$) – The differentiation should be explicitly defined so as to avoid any potential understatement of the CVA charge. Further details are given in the Appendix (see P1.3). Use of an LGD "amended to take into account those cases where a netting set of derivatives has a different seniority than those derivative instruments that

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[1] Basel Committee for Banking Supervision 228

trade in the market" ($\text{LGD}_{\text{mkt}}^{\text{Sec}}$) (as per B3 FAQ), should be restricted to $\text{LGD}_{\text{mkt}}^{\text{actual loss}}$ and banks be allowed to determine the most appropriate $\text{LGD}_{\text{mkt}}^{\text{actual loss}}$, including calibrating it to historical experience.

Need for maintaining a stable capital demand when determining Thresholds on the number and Size of Qualifying Portfolios

- We are broadly supportive of the criteria based on the size of portfolio. Criteria based on the number of non-IMM portfolios appears to be arbitrary and may lead to market distortions.

- In response to Question 7 of the RTS our preference for the definition of '*size of portfolio'* is Option 1 as stated in P2(4) of the RTS,

- However, if a non-risk based measure is required, instead of using count of portfolios, a measure based on the count of trades would be more appropriate.

- The threshold proposed in *P7.2* is unrealistic and may potentially lead to substantial capital demand fluctuations. In our view the non-IMM standard method is already providing sufficient incentive for banks to enhance their CVA model coverage. Introduction of an additional punitive capital charge, which will potentially switch on and off without any changes in the risk profile, may result in substantial and variable capital demands ("cliff effect") that would be unsustainable. We would be supportive of a broader boundary for the threshold to ensure a stable capital requirement.

It is important to mention that DB is broadly supportive of the industry response to the CP, which is being coordinated by ISDA. We have also provided some specific data on the impact of the proposed requirements to our home Regulator, the BaFin, and the data can be obtained from them upon request.

We look forward to continued dialogue with the EBA on these important issues. Indeed, we would be happy to arrange a separate meeting with yourselves to provide additional information supporting our response.

Yours sincerely,

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

Appendix

Article 6 – Identification of LGD_{mkt}

1.1 Article 6 is helpful in clarifying the approach to identification of LGD_{mkt}. This is particularly pertinent given that other than for a small number of high yield names or entities close to default, LGD_{mkt} in a true sense has very little coverage (as recognised in B3 FAQ – 2b.5).

1.2 However no explicit reference is made to the clarifications provided in the B3 FAQ for LGD_{mkt}:

- "LGD_{mkt} needs to be consistent with the derivation of the hazard rates – and therefore must reflect market expectations of recovery rather than mitigants or experience specific to the firm." (paragraph 2b.4).

- "In cases where a netting set of derivatives has a different seniority than those derivative instruments that trade in the market from which LGD_{mkt} is inferred, a bank may adjust LGD_{mkt} to reflect this difference in seniority." (paragraph 2b.5). This adjustment is referred to as LGD_{mkt}^{Sec}.

We support both B3 FAQ statements above and believe they both should be explicitly referenced to in Article 6.

1.3 Furthermore, it is our firm view that an additional clarification is required to make the two answers consistent. The following formula from the draft Capital Requirements Regulation (CRR), in fact, has two different types of LGD_{mkt}:

$$CVA = LGD_{mkt} * \sum_{i=1}^{T} max \left\{0, exp\left(-\frac{s_{i-1} * t_{i-1}}{LGD_{mkt}}\right) - exp\left(-\frac{s_i * t_i}{LGD_{mkt}}\right)\right\} * \frac{EE_{i-1} * D_{i-1} - EE_i * D_i}{2}$$

(Article 373 of draft CRR)

- LGD_{mkt} outside of the summation sign ("$LGD_{mkt}^{actual\ loss}$") scales the exposure one has to the counterparty in line with the expected recovery.

- LGD_{mkt} inside the exponential brackets ("LGD_{mkt}^{spread}") ensures that the default probabilities are calculated consistently.

Give the notation, the above formula should be viewed as:

$$CVA = LGD_{mkt}^{actual\ loss} * \sum_{i=1}^{T} max \left\{0, exp\left(-\frac{s_{i-1} * t_{i-1}}{LGD_{mkt}^{spread}}\right) - exp\left(-\frac{s_i * t_i}{LGD_{mkt}^{spread}}\right)\right\} * \frac{EE_{i-1} * D_{i-1} - EE_i * D_i}{2}$$

This is comparable to the distinction between rating and LGD in the IRBA calculations, the input pair of spread and LGD_{mkt}^{spread} effectively determine the rating, whereas $LGD_{mkt}^{actual\ loss}$ is the actual LGD amount.

1.4 It critical for LGD_{mkt}^{spread} "to be consistent with the derivation of the hazard rates" (paragraph 2b.4 of B3 FAQ) and therefore the spread (s_{i-1} or s_i in the formula).

It is consequently as critical for the LGD_{mkt}^{Sec} only to be applied to $LGD_{mkt}^{actual\ loss}$, as applying it to both would undermine the mathematical integrity of the calculations of hazard rates.

1.5 It is also important to ensure that $LGD_{mkt}^{actual\,loss}$ is determined is such a way that it does not result in an underestimation of the exposure as can be seen in the following example.

Consider two companies, which have the same rating. Company one is a BB rated company with no tangible assets, e.g. a servicer company whose value derives mainly from intellectual property. Company two is also BB rated but in this case is a company with many tangible assets such as a utility company. The BB rating means that the probability of default should be similar between the companies and hence we should keep LGD_{mkt}^{spread} in the equation above the same. However, it would seem incorrect to assume they both have a standard 60% $LGD_{mkt}^{actual\,loss}$ (if all other methods to proxy are not available), as it would understate exposure to company one.

1.6 RTS should encourage a consistently defined approach to estimating $LGD_{mkt}^{actual\,loss}$. Such approach should include a clear waterfall structure, defined by each bank, to include an option to use LGD calibrated to historical experience.

Article 7 – Quantitative limits

2.1 We are supportive of the provisions of CRR requiring a set of thresholds to be established to incentivise banks to move to an IMM-based approach. However, the approach proposed in the RTS does not fully serve this purpose.

2.2 Criteria outlined in *P7.1* may have a number of unintended consequences. The following examples provide an illustration:

- **Capital charges incommensurate with the risk profile.** Bank A has only 5 counterparties, each of them falling under a unique netting agreement. A large number of derivatives are transacted with each counterparty. Without any changes to the risk profile, if a small number of trades (e.g. two) in each portfolio fail the IMM calculation, they will form additional 5 netting sets, all of them falling into the definition of non-IMM portfolios (excluding single transaction portfolios). The ratio suggested in *P 7.1* will be 50%.

- **Restriction of financial services available to smaller companies.** Bank B is an international bank with a large share of the domestic mid-cap corporate market. All international banks and corporate have sufficient resources to invest into drafting of legal agreements. The domestic corporates try to limit their costs and are reluctant to spend money on additional legal fees. As a result, Bank B has a majority of its exposures in a small number of portfolios and a minority of its exposures in a large number of portfolios. This may inadvertently incentivise Bank B to stop providing an important service to its smaller clients, reducing their competitiveness.

2.3 In our view a criteria based on a number of portfolios is not risk based, outside banks control and may lead to unintended consequences.

2.4 In terms of definition for *'size of portfolio'*, we are supportive of Option 2 outlined in *P2(4)* provided that the 'current exposure' referred to is risk-based, such as Current Exposure Method as described in Article 373 (4) of the draft CRR.

2.5 However, in our view the proposed threshold is unrealistic. Market surveys conducted by independent bodies show that DB has significant amount of IMM coverage compared to other banks. Our internal data (shared with our home Regulator and could be obtained from them on request) demonstrates that despite our extensive coverage, DB would be close to the threshold in some cases and as a result would be potentially facing large fluctuations in capital demand. We would be supportive of a broader boundary for the threshold to ensure a stable capital requirement.