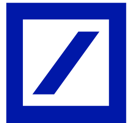
Deutsche Bank



EU Transparency Register ID Number 271912611231-56

4 March 2015

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

Mr. Adam Farkas
Executive Director
European Banking Authority
Floor 46, One Canada Square
London E14 5AA
United Kingdom

DB response to the Regulatory Technical Standards on assessment methodology for the IRB approach

Dear Mr. Farkas,

Deutsche Bank (DB) welcomes the opportunity to comment on the European Banking Authority's (EBA) consultation paper on its draft Regulatory Technical Standards (RTS) on assessment methodology for the internal ratings-based (IRB) approach.

We support the harmonisation of the supervisory assessment methodology. It is of the utmost importance that institutions, especially cross-border banks, and their supervisors work from to consistent procedures and processes when establishing, adjusting or reviewing internal models.

To further support the harmonisation of the assessment methodology we would like to highlight the following suggestions:

- **Clarity on definitions:** Further guidance or clarity on specific terminology would be helpful for increased consistency and accuracy. For example, phrases such as "material portfolios", "reasonable" and "limited timeframe". This will contribute to a clearer understanding and more effective implementation.

- **Implementation suggestions:** We have made some suggestions that hopefully improve the implementation of the RTS methodology. This will allow for increased efficiency and provide added value in the model assessment process for supervisors.

- **Rating system impact:** The implementation of some of the requirements of this RTS may trigger notable changes within rating systems. Further clarification on definitions and information parameters would potentially minimise this impact.

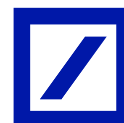
- **Calculation of the IRB shortfall:** We support the approach taken which requires that the IRB shortfall calculation is completed on two sub-portfolios (i.e. on the aggregated portfolio level for defaulted exposures and for non-defaulted exposures). We therefore agree with the EBA in choosing option 3a as the preferred option.

More detailed comments are provided in Annex I and Annex II. Please do not hesitate to contact us if you have questions or wish to discuss these issues further.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy

Chairman of the Supervisory Board: Paul Achleitner
Management Board: Jürgen Fitschen (Co-Chairman), Anshuman Jain (Co-Chairman), Stefan Krause, Stephan Leithner, Stuart Lewis, Rainer Neske, Henry Ritchotte, Christian Sewing
Deutsche Bank Aktiengesellschaft domiciled in Frankfurt am Main; Local Court of Frankfurt am Main, HRB No 30 000; VAT ID No DE114103379; www.db.com



<u>Annex I – Specific Comments</u>

Outsourcing
We agree that supervisors need to verify that the implementation of the IRB supervisory methodology is not constrained by the outsourcing of specific functions. The concept of outsourcing is however not clearly defined in the CRD and CRR. We support the assessment of outsourcing by supervisors when tasks are outsourced to third parties outside the group. However, we would like to note that there is a difference when tasks are "outsourced" within the same banking group.

Important elements of group wide risk management as well as operational necessities would become challenged if intra-group tasks were to be treated as third parties outside the group. This, for example, could affect joint risk models, joint risk infrastructure or IT and data platforms. We would like to propose that the scope of assessments of supervisors on outsourcing in Article 4 is restricted to third parties outside of the whole banking group.

Roll-out plan
We agree with the approach taken in Article 7(3) of the RTS. We would like to suggest adding an additional condition to the Article to provide more clarity. Due to potential dependencies when implementing IRB (e.g., IT requirements, new regulatory requirements), the audit readiness date for still to be approved rating systems might change over time in comparison to the initially approved implementation plan. Therefore, we would like to extend the conditions in Article 7 (3) to include changes of stated time periods for individual rating systems if such changes remain within the overall time period of the implementation plan.

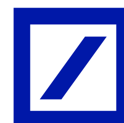
Independence of the validation function
In principle we agree that the validation function should be independent from the credit risk control unit. We would like to propose to include in Article 10 a grandfathering approach, which upholds the existing validation function structures, up until the moment when an internal framework receives a complete reworking (and subsequently supervisory approval). This would provide the banks the opportunity to keep using existing independence structure, in agreement with the supervisors, which would otherwise be negatively impacted. For instance, group wide validation functions could be adversely affected if outsourcing requirements are stringently interpreted and also apply to intra group "outsourcings".

Frequency of the validation
Within Article 11, 2 (b) it is stated that the validation process (b) "for the rating systems covering material types of exposures, the performance of the rating systems as referred to in point (c) of paragraph 3, is performed at least on an annual basis". The current validation process already contains annual back testing in conjunction with monitoring of the performance of the rating systems. This is performed on a regular basis during the annual validation period.

We therefore do not believe that an additional annual validation is necessary given the process already in place to monitor and potentially trigger an overhaul of the rating systems. Furthermore, the definition of "material portfolios" remains unclear, which makes it difficult to assess the added value of the proposed annual validation in depth. Therefore, a clear and specific definition of "material portfolios" is crucial.

Use test and experience test
We strive for consistency in the use of data and estimates when calculating own funds and those used for internal purposes. Article 18 states that discrepancies should be properly justified, fully documented and "reasonable". More guidance would be welcome on examples for reasonable discrepancies of estimates, specifically for credit approval.

Experience test
When looking at the text in Article 22 of the RTS and Article 145 (3) of the CRR on the experience test, it is our understanding that the period of three years for using the rating systems prior to the use of the IRB approach is applicable to the institution as a whole and does not apply to each



specific rating system, provided that the exposures are of a similar nature. It would be useful for the EBA to confirm that this is the correct intention. If otherwise intended, we believe that this could conflict with the fulfilling the Implementation Plan in the five years as defined in Article 7.

Treatment of outdated ratings
Further clarification on conservative adjustments in RWA calculations for outdated ratings is required to allow consistent implementation across institutions. Materiality thresholds are deemed beneficial to avoid undue implementation costs for rating systems evidenced to have only immaterial exposures with outdated ratings in place.

Definition of default
The RTS text of Article 28 1(d) implies that as soon as an institution chooses the identification of default at the obligor level, this has to be ensured consistently across the whole banking group regardless of obligor type. There are good reasons for some banks to apply a default definition (and rating) at obligor level also for retail rating systems, where the requirements of Article 28 1(d) are difficult to fulfill. Banks would have to modify existing infrastructure to allow for aggregating existing exposures and relevant default triggers under one retail customer identifier across locations. This would force banks to use the less sophisticated default definition/rating on individual loan level. We would therefore welcome a limitation of this paragraph to non-retail exposures as is provided for by Articles 172 and 178 of the CRR.

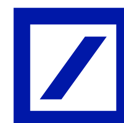
Article 28 3(b) seems to impose limitations on how banks assess their retail portfolios. The choice of obligor or facility level default definition in retail portfolios is often driven by the business model of a bank. For instance a bank with a broad product range will choose for identification at the obligor level. A more specialised bank, which might have a specific product range in mortgage/consumer loans will choose for identification at the facility level. Especially in the case of acquisitions of a portfolio with a different approach than the parent institution, would this lead to unnecessary modifications in the infrastructure of banks.

Therefore, we propose to amend this paragraph to allow either obligor or facility level default identification for different locations, legal entities or other appropriate segments as long as the respective policy is sufficiently clear to assure unambiguous and consistent identification of defaults over time.

Map of rating systems
Clarification on the requirement to build a register including changes over time would be appreciated in relation to Article 33. A phase-in period would also be welcome to avoid retroactive collection of changes.

Risk differentiation
We recognise the necessity to assure and monitor the risk differentiation of rating methodologies as stated in Article 37. However common metrics of measuring separation power do not allow a comparison of those metrics across portfolios (within an individual bank and between banks). These metrics depend, amongst others, on the portfolio size and are therefore not directly comparable. A common benchmark, in this case, would not have added value from a supervisory perspective. The risk differentiation observed with a rating method on a given portfolio is not only a characteristic of the rating methodology (what Article 170 CRR is intended to achieve) but also of the portfolio composition. From our perspective it would make more sense to monitor one measure for one specific portfolio over time to assess quality of the rating method.

Experience furthermore shows that it is not uncommon that the separation power achievable on a portfolio can systematically decrease with time due to ongoing selection of a subpopulation of borrowers that changes the portfolio composition. We propose to change the text of the RTS to revisit the requirement on clearly established fixed targets and tolerances. Instead competent authorities should verify that adequate processes exist to ensure that risk differentiation is assessed and monitored. If there is evidence that the risk differentiation is lower than could be realistically achieved, it should be explained why a better risk differentiation cannot be achieved on a given portfolio.



In addition, Article 38(2) proposes that the probability of default (PDs) needs to be reviewed within the same pool. The CRR assigns obligors and transactions to a specific grade or pool with the same PD or Loss Given Default (LGD), or Credit Conversion Factor (CCF). This grade or pool will then receive an overall PD (or LGD or CCF). The proposal in Article 38(2) does not seem practical as the PD would only be assigned to the pool. Generally default rate, LGD and CCF usually display bi-modal or u-shaped distributions. Evaluation of the distribution of those metrics would consequently not provide useful information since it does not allow judgment on homogeneity.

We assume that the intention of the EBA was to assure that appropriate risk drivers or segmentation criteria are used to assure homogeneity. In our view this is done via an analysis of available segmentation criteria or risk drivers, and not on "loss characteristics ('estimates of PD, LGD, conversion factor and total losses')" as stated in Article 38 (2). Clarity on this assumption would be useful.

Length of the historical observation period
Under current practice, banks have the freedom to apply different weights for observations within the default history for retail portfolios, for example higher weights for more recent data to better reflect current risk profiles. It is our impression that Article 48 b) and c) requirements taken together will lead to a more uniform and linear approach to applying weights, thereby reducing the appropriateness of risk assessments for retail portfolios. It would be helpful if the RTS could be more specific on this point for retail portfolios, (i.e. whether the expectation is that the PD calibration is always to be based on a linear weighting approach).

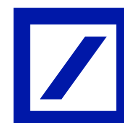
Article 49 states that the intention is to have PDs set to an average over an economic cycle. Using those PD's for the actual current risk measurement/management of banks is in our opinion not appropriate. We therefore propose to be consistent with the corresponding use of the same PDs in the internal processes as is used for the capital requirements calculation (use test). This would allow banks to use appropriately scaled parameters for the application process.

Default weighted average of LGD
It is unclear to us whether Article 51(c) requires institutions to take recent defaults into consideration in their LGD estimate where sufficient time has not passed to receive recoveries, and that this should be taken into account in a manner that future expected recoveries are not considered at all. Alternatively it is not clear if the uncertainty of future recoveries should be considered, but rather taken into account in a conservative manner reflecting the uncertainty of future cash flows.

Treatment of multiple defaults
Additional clarity on the definition of "limited timeframe" as mentioned in Article 52 would be helpful. The RTS provides just one example, stating that if two defaults are observed within four months, it is expected that they will be counted as one default for PD and LGD computation, with the date of the first observed default. To achieve the goal of consistency in model outputs and comparability of RWAs, we would welcome a clear definition of "limited timeframe", instead of having only one example. The outlined requirements induce a complex implementation effort which needs to be undertaken with precision. Therefore, a phase in period is deemed necessary, once the definition is clarified, allowing implementation in strategic IT infrastructure.

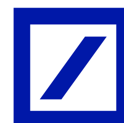
Use of LGD estimates appropriate for economic downturn
Article 53 could be clarified as to whether the long-run average LGD should be set in case that a downturn LGD is less conservative than the long-run LGD, or whether an add-on to the long-run LGD is always required.

Method of conversion factors estimation
Article 57 requirements to group level multiple defaults for PD/LGD determination applicability to CCF is not clear. More specification avoids different approaches and if that requirement exists, the choice of the default to be considered for CCF should be defined. If this requirement does not exist, or every multiple default needs to be considered for CCF, there could be a situation where the discrepancy of the data basis is used for the different parameters.



Sequencing
According to Article 64 of the draft RTS, the competent authorities must verify whether a certain sequencing of the assignment to the IRB exposure classes is implemented. We agree that the IRB exposure classes listed in Article 64 (a) of the RTS are being assigned first (i.e. the exposure classes equity, securitisation and non-credit obligation assets). If this list is intended to express a clear order between these three exposures classes in Article 64 (a) RTS, we believe that the exposure class 'securitisation' must then be named first. The reason being that where an exposure fulfills the criteria for a securitisation in accordance with Article 4 (1) point (61) of the CRR, it must be assigned to the corresponding exposure class regardless of whether this would fulfill the criteria in Article 147 (6) CRR for the exposure class 'equity'.

Calculation of IRB shortfall
We agree with Article 73 (h) which requires that the IRB shortfall calculation is applied to two sub-portfolios (i.e. on the aggregated portfolio level for defaulted exposures and for non-defaulted exposures). There is no CRR requirement to calculate the IRB shortfall on an individual level. Therefore, if the RTS proposed Option 3b or Option 3c RTS were chosen as the approach, this would contradict the Level 1 text. In addition, it would be difficult to define "homogenous portfolio" in a manner that this is clear and comparable between different institutions. Furthermore, the IRB shortfall calculation under the Basel framework is defined on a global aggregate portfolio level and therefore Option 3b and Option 3c would even go well beyond the Basel framework. We are unclear if this was actually intended.



<u>Annex II – Responses to the Consultation Paper Questions</u>

Question 1
What views do you have on the nature and appropriateness of the proportionality principle in Article 1(2)?

Answer: We support the principle of proportionality, since it takes the business model of each bank into account. We do feel that the complexity of the rating "model" as a measure for applying assessment methods is not sufficient. Elements relating to the process of the rating model also need to be taken on board. Rating models can be relatively simple, but the process complex and vice versa. From our perspective, it would therefore be better to refer to the rating "system", instead of "model" in Article 1(2,b), which would then also capture the rating process.

Question 2
Do you agree with the required independence of the validation function in Article 4(3) and Article 10? How would these requirements influence your validation function and your governance in general?

Answer: In principle we agree that the validation function should be independent from the credit risk control unit. The new draft RTS might however use slightly different definitions which could impact the current independence. We would like to propose to uphold the existing validation function structures, via grandfathering of the existing structure up until the moment when an internal framework receives a complete reworking (and subsequently supervisory approval).

Question 3:
Are the provisions introduced in Article 49(3) on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects which need to be elaborated further?

Answer: The provisions are not completely clear. Further clarification is needed on what defines a complete economic cycle, on how representativeness should be demonstrated and on what are deemed to be acceptable reconstruction methods.

Question 4:
Do you agree with the required number of default weighted average LGD calculation method introduced in Article 51(1)(b) and supportive arguments? How will this requirement influence your current LGD calculation method? More generally, what are your views as to balance of arguments for identifying the most appropriate method?

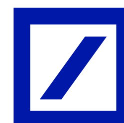
Answer: Yes, we agree with using the default weighted average LGD calculation. . As outlined under (ii) on page 80 of the draft RTS, the default weighted average should be taken for reason of consistency with respect to calibration approaches applied for other risk parameters.

Question 5:
Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?

Answer: We welcome the additional guidance given in Article 52 of the draft RTS. However, we would ask for more clarity on the definition of "limited timeframe". The RTS provides one example stating that if two defaults are observed within four months, it is expected that they will be counted as one default for PD and LGD computation, with the date of the first observed default. To achieve the goal of consistency in model outputs and comparability of RWAs, we would welcome a clear definition of 'limited timeframe' instead of giving an example.

Question 6:
Are the provisions introduced in Article 60 on the treatment of eligible guarantors for the purpose of own-LGD estimates sufficiently clear? Are there aspects which need to be elaborated further?

Answer: The provisions introduced in Article 60 are sufficiently clear.



Question 7:
Do you support the view that costs for institutions arising from the implementation of these draft RTS are expected to be negligible or small? If not, could you please indicate the main sources of costs?

Answer: We support the main objective of the RTS which from our perspective appears to move towards harmonising supervisory methodologies and to provide more guidance and clarity on interpretations of various Articles of the CRR. The costs of adjusting systems and policies accompanying the changes need to be taken into account. The exact impact will depend on further clarifications on definitions and questions we have raised in our consultation response. Once we know what, for instance, "material portfolios" and "reasonable discrepancies" are, we will be able to forecast a clearer impact assessment.

Question 8:
What are the main benefits for institutions that you expect by the adoption of these draft RTS?

Answer: In addition to the guidance and clarifications already given by the draft RTS, which is helpful, standardisation of supervisory practices is welcomed. Notably, we support the specific proposal on calculating the shortfall on the IRB (Article 73 (h)). This together our request for additional clarifications that we have put forth in this response, the draft RTS should provide the necessary harmonisation within the European context.

Question 9:
Do you expect that these draft RTS will trigger material changes to the rating systems (subject of the RTS on materiality of model changes)? If yes, could you please indicate the main sources of the changes (please list the relevant Articles of these draft RTS)?

Answer: The implementation of some of the requirements of this RTS will likely trigger changes within rating systems. As stated in our answer to question 7 the exact impact will depend heavily on further clarifications on definitions and questions we have raised in our consultation response. Below a list of some of the main changes and the corresponding articles referred to in our response:

- Article 4: outsourcing, depending on the definition and scope of outsourcing.
- Article 10 and Article 11: could lead to changes in the validation process.
- Article 28, 1 (b): regarding retail exposures, in case of no limitation of this paragraph to non-retail exposures as is provided for by article 172 and 178 of the CRR should be factored.
- Article 28, 3 (b): in case of acquisitions.
- Article 52: the requirements outlined in the article could trigger high implementation effort changes in the source systems and underlying data.