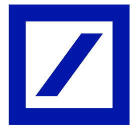
Deutsche Bank



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Dear Mr Farkas,

Deutsche Bank welcomes the opportunity to comment on the EBA consultation on conditions that competent authorities shall take into account when determining higher risk-weights and higher minimum loss given default (LGD) floors under the Capital Requirements Regulation.

Whilst we realise that the intended audience of these proposed rules are competent authorities, the impact of both the process to bring about changes, and the potential impact of changes themselves are materially impactful for banks. We welcome the emphasis that the EBA places on the need for a thorough consideration of the impacts of any changes to risk weights and LGD floors on proportionality and broader financial stability impacts. Not least due to the reciprocity provisions, any changes in one jurisdiction are likely to bring about significant changes throughout the single market and must be well researched and understood. We would however like to provide thoughts in three broad areas:

- **Definitions:** Making judgements about the calibration of the proposed benchmarks at this stage is not possible as there is no clarity about the definition of “property segment.” We appreciate the need to keep some level of flexibility to reflect perceived risks in specific sectors, but some more granular guidance is required.

- **Industry engagement:** We are concerned about the lack of provision for industry engagement in calibrating the benchmarks and when calculating potential impacts of any calibration changes to risk weightings or LGDs. We urge the EBA to conduct further evidence gathering, potentially in the form of a Quantitative Impact Study (QIS) to better understand historical and expected losses of different asset types, and also how different levels of changes would impact products, market functioning and financial stability. The current emphasis appears to be entirely on competent authorities without consultation with industry.

- **Broader impacts:** It needs to be borne in mind that the governance and approval processes for changes to parameters in models can be time and resource intensive. Additionally changes which can alter a bank’s strategic approach to business planning and balance sheet allocation lead to additional complexity. The more time and clarity that can be provided, the better placed banks will be to minimise any broader negative changes on business planning and client services. Finally, changes to the price and availability of credit for property is a key indicator and driver of consumer and market confidence. We hope that any decisions around LGD and Risk Weight changes will be considered in the broader context of the push for greater growth and investment in the EU.

Chairman of the Supervisory Board: Paul Achleitner.
Management Board: John Cryan (Co-Chairman), Jürgen Fitschen (Co-Chairman), Stefan Krause, Stephan Leithner, Stuart Lewis, Henry Ritchotte, Marcus Schenck, Christian Sewing.
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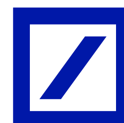
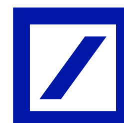


Our detailed comments are attached. We hope you find these comments helpful and we would be happy to provide further information on any areas not sufficiently covered.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy



Annex I: Detailed points

Definitions:

The EBA should give further consideration to definitions of "property segments." It is unclear to us how broad or narrow these segments are intended to be, and what types of common features make up a 'segment' in this context. For example are we talking about immoveable properly of above a certain value, property that is purchased using the 'buy-to-let model' or something totally different? Having more detail here would ensure that banks can make the necessary preparation for a specific segment needing risk weight adjustments in both the standardised and internal models.

There are pros and cons to the breadth of these definitions that the EBA should give consideration to. For example, a more narrowly defined segment may allow better targeted changes in risk weighting or LGD floor, but would mean that certain threshold are more easily and regularly exceeded. The pros and cons of a broader definition would be the opposite.

The EBA should consult the industry over the design the list would be the optimal next stage, this could then also be used to inform the QIS necessary to best calibrate benchmarks and parameters. Collaboration in this area would ensure that policy makers and regulators fully understand the definitions banks currently use, and that banks fully understand the types of categories that are potentially used for LGD or risk weighting changes using pillar 2 tools. This way both regulators and the industry can be best prepared in advance of any changes to both rapidly implement, and better understand, the impact of changes.

Finally, there are some specific references in the proposal that we would appreciate further clarity or discussion about, for example in Article 2 there are some important elements that are rather vague:

- Art 2 1(a). What time periods are used to determined loss experience? This should be consistent with any methods used to determine LGDs under internal models and observed levels of default for the relevant facility grade.

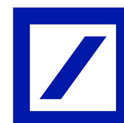
- Art 2(a): The relevant data indicators should be part of ongoing dialogue between industry and regulators.

- Art 2 2 (b): The terms "expected evolution in immovable property prices" and the "expected volatility of those prices" are vague, especially in a low interest rate environment with further uncertainty relating to future movements in interest rates.

- Art 2 2(c): What time horizon is being considered, and what are the forward-looking property market developments? We would appreciate a dialogue about how these can be determined and calculated.

- Art 2 2(d): are the Loan to Value ratio and the Debt Service to Income ratio: to be determined on an average basis for the population? These are normally determined on an individual basis.

- Art 2 3(b): What does the EBA consider a "sufficiently longer period"?



Industry Engagement:

The EBA proposal currently places the onus and responsibility entirely on competent authorities to evaluate the data and perform assessments leading to decisions about changes to risk weighting or LGD calibrations. This not only places very significant burdens on competent authorities, but also fails to take advantage of the level of data and expertise that banks have in this area. We strongly encourage the EBA to amend the process to ensure that there is sufficient input, both in finalising these rules, and then in the tools being implemented, from the industry. Rather than relying on a information pulled from the Common Reporting Framework (CoRep) alongside general data and key metrics on market expectation for determining loss expectation, we believe that a QIS should be conducted to ensure that authorities have the best possible data, and that benchmarks can be set at levels best reflecting historic and expected future loss levels.

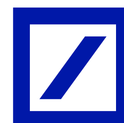
As mentioned above, any judgement about the suitability of the benchmarks proposed in the consultation will be of limited value due to the vagueness of the segment definitions. However, mapping historical losses against the benchmarks as accurately as possible, we feel that the benchmarks and loss figures are overly conservative. The benchmarks on pages 13, 16 and 17 of the consultation only refer to standardised approach mortgages and are well below our internal loss experience. There is significant value in revisiting these following an industry wide QIS. We would also flag that our analysis shows that exposure at default (EAD) weighted LGDs vary from country to country. There are very material ranges (with higher end losses being many multiples of lower end losses) which would be best understood following evidence gathering.

Another factor that should be part of an open engagement is that banks already factor a conservatism buffer into their loss expectations and benchmarks. Naturally the EBA would do the same with its own benchmarks and it would be optimal if only one conservatism buffer were worked into the calibration so as not to have overly conservative rules that curtain credit and growth more than is needed.

The EBA should consider ways to better harmonise the models used to calculate loss expectation. Whilst the consultation provides for some general guidance, this still leaves considerable room for variation and fragmentation. One possible option to consider is basing the methodology on existing models such as regulatory Expected Loss or Expected Loss accounting as per International Financial Reporting Standards 9 (IFRS9). Using existing and well known models as a basis would minimise fragmented approaches and can be modified to provide greater levels of flexibility where needed.

Broader Impacts:

We would like to draw the EBA's attention to the fact that changes in the LGD or risk weightings could have broader impact on bank internal models. In cases where the calibrated LGD is below the LGD floor and there is an RWA impact, banks will have to go through the internal and external approval processes to get the changes signed-off. This means seeking internal committee approval as well as submitting model change request to the European Central Bank. Depending on the complexity and granularity of floors, this may be complex. It is imperative that the EBA take this into account both by ensuring early industry engagement, and ensuring that as much guidance as possible is provided about possible changes so that banks can ensure the correct preparatory mechanisms are in place.



Binding floors can create perverse incentives and change risk appetites in an undesirable way. Floors inevitably reduce the risk sensitivity of prudential rules and can lead to the same levels of capital being attracted by different risk-levels. In this case, incentives to take on more risk for the same level of capital can lead to a riskier asset mix on bank balance sheets, running contrary to financial stability aims.