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Dear Mr Farkas,

EBA discussion paper on possible treatments of unrealised gains of assets and liabilities measured at fair value, other than including them in Common Equity Tier 1 without adjustment.

Deutsche Bank (DB) welcomes the opportunity to share with the European Banking Authority (EBA) our views on the discussion paper on possible treatment of unrealised gains.

We recognise the concerns raised in the proposal, however, we believe they are significantly mitigated for the reasons outlined below, including the fact that in many cases unrealised gains are offset on a portfolio basis by hedge positions. Further, we strongly suggest retaining Basel 3 treatment as currently implemented in the CRR (Art. 35, i.e. no filtering of unrealised gains and losses). The following paragraphs explain the rationale for our recommendation.

The reliability in the valuation of the fair valued assets and liabilities is already ensured by the valuation requirements of the applicable accounting framework (e.g. IFRS) as well as by additional regulatory requirements, especially the provisions on prudent valuation. In addition, for trading book items, the applicable capital requirements cover the risk that the unrealised gains may not materialise. For the banking book, these risks are at least partially covered or fully covered if additional Pillar 2 requirements are also taken into account. Moreover, the fundamental review of the trading book might align the treatment of fair valued positions in the banking book to the trading book. Therefore, no additional filter is needed especially for positions in the trading and banking books.

DB would, however, like to raise broad concerns arguably beyond the scope of the EBA's mandate under Article 80 (4) of the CRR, but nevertheless integral to the policy debate. Keeping the Basel 3 treatment as currently implemented in the CRR is the best way to ensure a level-playing field between European banks and non-European banks. Moreover, it should be noted that a symmetrical treatment of unrealised gains and losses reduces volatility and procyclicality (as netting of gains/losses will do). Moreover, an asymmetrical filter for gains leads to a distorted picture of the bank's true economic situation.

It is also important to note that the current German prudential filter regarding unrealised gains only relates to unrealised gains through other comprehensive income (OCI). Accordingly the impact of the current types of filters is limited. However, since the scope of "unrealised gains" in the sense of the discussion paper is much wider and also covers unrealised gains reported as part of the profit and loss account, the impact would be very substantial (especially for IFRS banks with large fair valued positions).



The context leads us to three conclusions. First, the exemption of all trading book positions. We strongly agree with the EBA's assessment indicated the discussion paper that the introduction of a filter in the trading book is not appropriate since the prudential concerns in this area are already addressed by existing regulatory requirements (i.e. capital requirements and prudent valuation). Our view on this point is explained in more detail below in our answer to Question 18.

Secondly, if any prudential filters are used, they should be applied only at a portfolio level, based on net gains. In this context, we suggest that the determining factor should be how the instruments are risk managed, rather than distinguishing between different categories of instruments/items as proposed in the discussion paper. Only such a portfolio approach adequately takes into account that the respective financial instruments and related risks are also managed on a portfolio basis. An item-by-item approach is likely to provide misplaced incentives and moreover leads to a distorted picture of the bank's true economic situation.

Finally we note the importance of the interaction between prudential regulatory requirements and IFRS accounting standards with respect to financial instruments. While accounting standards are of course outside the regulators' remit, it would not be satisfactory to global capital markets were prudential capital rules to, even inadvertently, affect financial reporting in such a way that made financial reporting less relevant. IFRS 9, the future accounting standard on financial instruments classification and measurement, is still in development. We therefore request that prudential regulators maintain a dialogue with the accounting standard setters on this topic before finalising the capital requirements as they relate to unrealised gains.

Our more detailed responses are provided in Annex 1 and Annex 2. We trust you find these comments helpful and please let us know if further information would assist.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and
Regulatory Affairs



Annex 1:

1. Do you agree with the scope of the discussion paper for the technical advice? Are there other elements that should be covered? If yes, please state why

We generally agree that the scope of the discussion paper matches the Consultation request. We would however urge that, although unrealised losses are not covered by the EBA's mandate pursuant to Article 80 (4) of the CRR, they should nevertheless be considered in the EBA's technical advice. In particular, we request that the effect of hedging activities be considered in conjunction with primary positions, and only the net unrealized gain or loss be considered for prudential adjustment. As portfolio hedged positions are not subject to the uncertainty concerns expressed in the Consultation, we believe this is logical. We believe it is inappropriate to analyse the prudential and economic impact of filters on unrealised gains without taking into account the treatment of corresponding unrealised losses.

Applying a prudential filter on gains contradicts the Basel 3 provisions as currently implemented in Art. 35 of the CRR which eliminate prudential filters for unrealised gains and losses. Even if the alternative to apply no filter, is not covered by Article 80 (4) of the CRR, it should nevertheless be considered in the analysis of policy options. This would ensure a consistent overall approach and take into account the issue of creating a level playing field.

2. Do you agree with the description of the different criteria provided on this section in order to assess the possible treatments of unrealised gains? If not, please state why. Do you think there are other criteria that should be considered?

We generally agree that the criteria raised need to be explored. However, we feel that some of the risks discussed are often diminished through prudent risk management, and that the magnitude of unrealized gains does not necessarily offer any insight as to the durability of the gain.

For capital purposes, positions are subject to the standards for Prudent Valuation, as expressed in Articles 34 and 105 of the CRR. Through this process, valuation adjustments are made to address many of the concerns raised in this Consultation, including adjustments for:

- Market price uncertainty;
- Close out costs;
- Unearned Credit spreads;
- Model risk;
- Position concentration;
- Funding costs;
- Administrative costs;
- Early termination loss; and
- Operational risks.

Prudent valuation adjustments for these issues supplement accounting reserves already held, to ensure that the net value reflected for capital purposes represents the true position exit cost at a 90% degree of certainty, given normal market conditions, and that CT1 is adjusted to reflect this cost. Capital is held to cover market risk and credit risk, both in normal and stressed periods

Great care must be taken to avoid double counting these risks within the current Consultation; we feel the large majority of the concerns expressed are actually already prudently reflected in capital requirements, and thus need no further adjustment.

Regarding the criterion provided in the discussion paper "*For banking book items, the risk that the unrealised gains will disappear is not covered by a capital requirement*":

We note also that for banking book positions market risk capital requirements for FX and commodities risk exist, i.e. the risk that unrealised gains may not materialise is already covered by a



Pillar 1 capital requirement. In addition, all other market risks (e.g. interest rate or credit spread risk) are covered in Pillar 2. Thus, these risks are already measured and do attract regulatory capital. We believe it appropriate, therefore for banking book positions to take unrealised gains and losses into account – without applying a prudential filter – when determining regulatory capital.

We are concerned by the distorted overall picture that would be the result of an asymmetrical filter for unrealised gains only, while unrealised losses continue to reduce regulatory capital. Such an asymmetrical treatment overstates a bank's risk positions and leads to a definition of own funds that no longer reflects the bank's true economic situation. This would especially and disproportionately impact banks subject to IFRS accounting with a large portfolio of fair valued assets and liabilities. It should be taken into account that even under a prudent approach, the solvency requirements are not intended to reflect a worst case scenario in contrast to the large exposure regime.

3. Do you agree with the proposed approach based on the prudential classification (distinction between the trading and banking book) to analyse the different policy options? If not, please state why. Do you envisage any operational issue if the prudential approach is followed?

As stated in our response to Question 2 and the cover letter, we oppose the insertion of an asymmetric filter, and are generally opposed to the use of any prudential filters, consistent with the Basel 3 guidance.

However, should the EBA decide there is a need to distinguish trading book and banking book positions, we would support this dichotomy for the purpose of policy distinction. If this is the case, we would urge the trading book to be exempted from prudential adjustment.. This approach is in line with solvency regulation and ensures that the different capital requirements that apply for the trading- and banking book (which do not depend on the respective accounting classification) are adequately taken into account.

Q4. Do you have instruments that are classified as held for trading for accounting purposes included in the (regulatory) banking book or available for sale instruments classified as a position of the (regulatory) trading book? Could you quantify the relevance of these situations?

Yes, while the regulatory and accounting treatments are often the same, the classification rules are not identical and therefore, under certain circumstances, instruments may require different treatment between accounting and regulatory classifications. DB does have regulatory banking book positions that are held at fair value through profit and loss, either as trading assets or financial instruments elected under the Fair Value Option. Additionally, DB does have available for sale instruments in the regulatory trading book. Items elected under the Fair Value Option for IFRS accounting purposes are the only instruments in which DB has a one-time election at inception to account for the instrument at fair value through profit or loss instead of at amortised cost. All other differences between accounting and regulatory classification are dictated by the rules.

Q5. Do you see any differences in the analysis that should be taken into account with the requirements in the forthcoming IFRS 9?

We believe there is an important interaction between prudential regulatory requirements and accounting standards that must be factored into the regulators' consideration before making any final decision on this topic. The current exposure drafts and IASB discussions lead us to expect that, IFRS 9 will narrow the definition of financial instruments that can be held at amortized cost, and therefore, increase in the classification of financial instruments at fair value through OCI ("FVOCI") and fair value through profit and loss ("FVPL"). Additionally, under IFRS 9, many instruments that are held for the purpose of collecting cash flows may be classified at FVOCI or FVPL because of



terms that result in cash flows that are not solely payments of principle and interest. It is possible that this rule could increase the number of instruments classified as banking book for regulatory purposes, but held at fair value through profit and loss or FVOCI for accounting purposes.

Were there to be asymmetric capital filter for unrealised gains on instruments in the FVOCI category, this may potentially lead to behaviour where entities would classify such instruments in a FVPL category (which they may not have otherwise done absent the asymmetric filter), so that they can achieve a symmetrical capital treatment for the unrealised gains and losses whilst at the same time being relieved from an operational perspective of hedge accounting requirements under IFRS. Such outcomes would be inconsistent with their true business model for their instruments and as such not provide relevant financial reporting.

In any case, due to the interdependency between IFRS 9 that increases the scope of fair value classification and solvency regulation we request that the EBA wait for the final issuance of IFRS 9 and conduct an impact assessment before any decision regarding an asymmetric prudential filter is taken.

6. Do you agree with the proposal to distinguish between different categories of instruments/items (interest bearing financial instruments, non-interest bearing financial instruments and tangible assets) in analysing the different policy options? If not, please state why

We do not agree with an approach that distinguishes between different categories of instruments/items. The determining factor should be how the instruments are risk managed, rather than the form of the instrument.

Risk management for trading book position is in general performed on portfolio level, i.e. the trading book. There are circumstances where a position that qualifies as equity¹/own funds for regulatory purposes (e.g. a Tier 2 or Additional Tier 1 instrument) is used to hedge debt positions of a counterparty. Hence a split between interest and non-interest bearing instruments is not appropriate.

In our view a prudential filter for unrealised gains is not required for the trading and banking book. If a prudential filter is imposed, then it needs to be applied on portfolio level, i.e. the trading and banking book respectively.

For more detail see the answers to Questions 7 and 8 below.

Q7. Do you agree with the arguments in favour of an item-by-item basis or a portfolio basis? Are there other arguments that should be considered for the decision to apply the policy options on an item-by-item or on a portfolio basis?

We generally agree with the arguments supporting the portfolio basis. The application of a filter on an item-by-item basis leads to a distorted picture of the bank's true economic situation.

Our financial instruments are managed on a portfolio basis and the regulatory treatment should be consistent with risk management. If a prudential filter is imposed, then it needs to be applied on portfolio level, i.e. the trading and banking book respectively, see also our answer to Question 6. An item-by-item approach is likely to provide misplaced incentives (e.g. to sell and buy back, instead of encouraging diversification) and moreover leads to a distorted picture of the bank's true economic situation because unrealised gains within a given portfolio (under the current proposal: within a certain category of financial instruments) are usually available to offset the corresponding unrealised losses. A portfolio approach would be in line with the current application of regulatory

¹ On p. 18, the discussion paper uses the term "equities". It is not clear what exactly is meant by that (i.e. IFRS equity, equity investments in the sense of the RWA framework, own funds instruments etc.?).



filters in most countries (including Germany) and the portfolio approach as permitted under IFRS 13. This also illustrates that the better arguments are the ones in favour of a portfolio approach.

We, therefore, strongly support a portfolio approach that distinguishes only between trading and banking positions.

Q8. Do you consider that the application of the policy options on an item-by-item or on a portfolio basis would be more justified for certain types of instruments/items than for others (for instance, debt securities, equity instruments, tangible assets)?

No, the determining factor for the use of a portfolio basis should be how the instruments are risk managed, rather than the form of the instrument. The unrealized gains and losses calculated on a group of assets and liabilities should include all types of instruments risk managed on a portfolio basis. For example, unrealized gains and losses on a loan due to interest rate risk could be hedged with a derivative, or a debt security, or any other instrument with interest rate risk. The form of the instrument is not relevant in the risk management of the risk creating the unrealized gains/losses. We would reiterate our view, as expressed in response to Question 2 that many adjustments are already reflected in capital requirements through market risk, /credit risk and prudent valuation charges, and policy options should avoid double counting the same risks.

9. Please provide quantitative information about the difference between applying a filter on a portfolio basis or on an item-by-item basis and the impact of this difference in your capital ratios.

We envisage the impact to be material.

10. Do you agree with the alternatives presented in this section? Do you have a preferred alternative? Please explain the reasons.

We do not agree with the alternatives presented. We believe that unrealised gains should be included without adjustment in Common Equity Tier 1 (i.e. the treatment envisaged by Basel 3, as currently implemented in Art. 35 of the CRR), inter alia, to ensure a level playing field.

Of the options presented in the discussion paper, we would be in favour of a partial inclusion in Common Equity Tier 1, subject to a haircut only, but not subject to an additional threshold. Inclusion in Common Equity Tier 1 would at least ensure a more level playing field between EU and non EU banks than would be the case if unrealised gains were completely derecognised in own funds (while outside the EU they would be fully included as a Common Equity Tier 1 item). Moreover, partial recognition in Common Equity Tier 1 would be the consistent approach since unrealised losses are also deducted from Common Equity Tier 1.

It is true that a bank's balance sheet positions are subject to constant fluctuations in value. However, on the whole, most of these fluctuations cancel each other out, largely because positions hedge one another. A filtering out of all gains would ignore this equalising effect. And banks' risks would be substantially overstated, triggering considerable and adverse procyclical effects.

We believe that no prudent adjustment should be considered. If, nonetheless, it is decided to apply a filter for unrealised gains, a haircut would be sufficient to address the prudential concerns regarding unrealised gains: it is not a realistic scenario to assume the unavailability of all unrealised gains to cover losses. An additional hard limit for the recognition of unrealised gains in own funds is not necessary. A hard limit for the recognition of unrealised gains in own funds, whether additionally or exclusively applied, would in any case disproportionately impact banks subject to IFRS accounting with a large portfolio of fair valued assets and liabilities. Moreover, it would ignore the fact that unrealised gains are usually available to offset the corresponding unrealised losses and should therefore qualify as own funds to a corresponding extent, possibly subject to a



haircut, as unrealised losses decrease own funds irrespective of the overall amount of all unrealised gains/losses.

11. Do you agree that the haircut may be different depending on whether it affects the different layers of capital and also on whether the adjustment is applied on a portfolio or an item-by-item basis? Do you have a view regarding the level of the haircut?

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Deutsche Bank has no comment with regard to this question.

12. Regarding the second adjustment (the threshold): do you agree to establish a limit to the recognition of unrealised gains in own funds? Do you have a view regarding the level of the threshold?

No, we do not agree with a threshold whether additionally or exclusively applied.

13. Do you think equity and debt securities should be subject to the same policy options / treatment? Do you agree with the reasons provided in this section about the difference between equity and debt?

Financial instruments (debt and equity positions) are managed on a portfolio basis and if a filter is applied at all, then such a filter needs to be applied on a portfolio basis. Hence we consider a split between equity and debt instruments to be inappropriate.

14. Do you agree with the analysis for hedge accounting? Please provide quantitative information about the relevance of hedge ineffectiveness in hedge accounting

We agree with the analysis of hedge accounting. We note, however, that there appears to be an asymmetry in treatment with the existing economic hedges where hedge accounting is not applied. This may be due to the fact that the requirements for hedge accounting under IFRS are very specific. An economic hedge that is not eligible for hedge accounting is nevertheless effective for purposes of risk management and should therefore be treated similarly for regulatory purposes. Also Hedge accounting may not always fully reflect the economic position of the entity.

Hedge ineffectiveness is very small due the way hedges are designated hedge accounting. The same applies to economic hedges that qualify as an effective hedge under the internal control processes of the institution, as assessed by the competent authorities. Moreover, please note that other provisions of the CRR in the area of own funds already take into account effective economic hedges (e.g. Art. 76 of the CRR). Accordingly it would therefore make sense to recognise economic hedges also in the area of potential filters for unrealised gains in-line with the proposed treatment for hedge accounting. This is amplified when the use of a prudential classification is proposed instead of a distinction based on accounting.

15. Do you see any difference in this analysis under the forthcoming hedge accounting requirements that the IASB is expect to publish in the second half of 2013?

The level of ineffectiveness recognised may increase due to changes proposed in the forthcoming hedge accounting requirements, instead of failing the hedge accounting if the hedge effectiveness is outside of the 80—125% range, any ineffectiveness will be recognised in the P&L without failing hedge accounting.

16. Do you agree with the analysis for fair value option accounting? Do you classify assets and liabilities managed on a fair value basis and financial instruments with embedded derivatives in the banking or the trading book? Please state the reasons for the classification



We understand the logic of the proposal not to apply the filter to unrealised gains and losses where the fair value option election is made to eliminate or reduce accounting mismatch. Economically an entity may be in a similar position where the FVO election is done on “managed on FV basis” – as that usually means economic hedges and managing open risk to reduce such open risk, however no “credit” is given to these situations. In many situations the FVO election can be made on the basis of either accounting mismatch or managed on a FV basis, so it seems inconsistent that one type of FVO election is treated differently from the other. We strongly oppose any asymmetric filter to be applied both either fair value option or trading instruments under IFRS.

17. Please provide quantitative information about the use of the fair value option

Deutsche Bank has no comment on this question.

18. Do you agree with the description provided in this section? Can you quantify the amount of unrealised gains included in the trading book?

We strongly agree with the EBA’s assessment indicated in paragraph 100 on page 28 of the discussion paper that the introduction of a filter in the trading book is not appropriate. The EBA rightly points out why such a filter for trading book financial instruments is not required. The capital requirements for market risk already cover the volatility of the instruments. Moreover, trading book positions are held with the intention to sell and only short term. Any remaining concerns regarding trading book positions are better addressed by the RTS on Prudent Valuation and additional requirements in the Pillar 2 process. The concern that banks may reclassify financial instruments from the banking book to the trading book (paragraph 98 on p. 27) is unjustified since for a trading book classification, trading intent needs to be demonstrated.

19. Do you think that there is a risk of double effect when applying a prudential filter and the requirements on prudent valuation?

We agree that there is a significant risk of double counting as the prudent valuation adjustments taken together with IFRS fair value reserves ensure that it is prudential to take unrealised gains and losses into account to determine regulatory capital. Hence in our view imposing a prudential filter on unrealised gains constitutes a double counting and should thus be avoided.

20. Which are your views on the different issues described in point a) to d) of section 5.6.4? Please provide reasoning supporting your response

Please see our response to Question 2.

21. In case a prudential filter is applied, do you agree that unrealised gains on investment property and property, plant and equipment measured at fair value should not be included in own funds? If not, please state why

Please see our response to Question 19.

22. Do you think that there are more reasons to apply a filter on an item-by-item basis for tangible assets (investment properties or property, plant and equipment) than for the investment portfolio classified in the banking book? What would be the rationale to apply a prudential filter on a portfolio basis for tangible assets?

If at all, a prudential filter should be applied on portfolio and not item by item basis.



Annex 2:

Below please find specific points related to the discussion paper not covered above.

Regarding the EBA's comments on the current transitional rules on unrealised gains (Art. 468 of the CRR):

Although the current transitional rules of the CRR on unrealised gains (Art. 468 of the CRR) are not in scope of the EBA's mandate under Art. 80 (4) of the CRR, the discussion paper nevertheless contains some statements regarding these transitional rules.

In this context, we are concerned that some of the content may be misleading and should be clarified. This relates in particular, to the statement: "*In particular, Article 468 establishes that from the date of application of the CRR to 31 December 2014 all unrealised gains shall be removed from CET1*" (page 6 of the discussion paper).

While the transitional rules of Art. 468 (1) and (2) of the CRR ("*institutions shall remove from their Common Equity Tier 1 items the applicable percentage of unrealised gains related to assets or liabilities measured at fair value and reported on the balance sheet, excluding those referred to in Article 33 and all other unrealised gains with the exception of those related to investment properties reported as part of the profit and loss account*"; "*For the purposes of paragraph 1, the applicable percentage shall be 100% during the period from 1 January 2014*") prescribe a full removal (i.e. applicable percentage of 100%) of relevant gains in 2014, they do not apply to all types of unrealised gains.

Removal of the applicable percentage of the unrealised gains related to assets or liabilities measured at fair value, i.e.

- applies to such unrealised gains reported on the balance sheet (i.e. through OCI),
- but generally excludes unrealised gains reported as part of the profit and loss account (i.e. no removal),
- but applies with the following exceptions from the above general rules (i.e. removal of unrealised gains through OCI, but not through P&L):
 - No removal of gains referred to in Art. 33 CRR (i.e. apply the special rules related to those instead), and
 - removal of (only) those unrealised gains through P&L that relate to investment properties (e.g. land and buildings owned by the bank).

Finally, please note that we understand this interpretation (exclusion of unrealised gains through P&L, with the exception of those related to investment properties) is also in line with the view expressed by German regulators in their draft on the German implementation of the CRR transitional rules.²

² See, Referentenentwurf des Bundesministeriums der Finanzen Verordnung über nähere Bestimmungen zur angemessenen Eigenmittelausstattung von Instituten, Institutsgruppen, Finanzholding-Gruppen und gemischten Finanzholding-Gruppen (Solvabilitätsverordnung – SolvV)“ of August 2013 (SolvV-E), page 33 et.seq.: "Zu § 17: Die Regelung dient der Umsetzung von Artikel 468 Absatz 2 der Verordnung (EU) Nr. 575/2013 und ermöglicht das Hereinwachsen in die Behandlung von unrealisierten Gewinnen aus zum beizulegenden Zeitwert (Fair Value) bewerteten Vermögensgegenständen oder Verbindlichkeiten nach Artikel 35 CRR (ausgenommen die in Artikel 33 genannten Gewinne aus Absicherungsgeschäften und Gewinne (mit Ausnahme von solchen aus als Finanzinvestitionen gehaltenen Grundstücken und Gebäuden), die über die GuV er-fasst werden)."