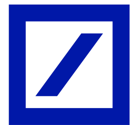
Deutsche Bank



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Dear Mr. Farkas,

Deutsche Bank's response to the European Banking Authority's Consultation on draft Regulatory Technical Standards (RTS) on prudent valuation (EBA/CP/2013/28)

Deutsche Bank (DB) welcomes the opportunity to comment on the EBA's consultation paper on prudent valuation.

Our views are largely aligned to the industry perspective on prudent valuation as reflected in the Association for Financial Markets in Europe (AFME) and International Swaps and Derivatives Association, Inc. (ISDA) response letter.

General Comments

Many aspects of the RTS are reasonable and consistent with our interpretation of the aims of the legislation, and consistent with principles underpinning firms' internal assessment of valuation uncertainty. These aspects include:

1) Establishing a minimum list of alternative methods and related information sources, that is based upon (but not limited to) independent price verification methods and information;
2) Introduction of a threshold to determine when to use the simplified approach (provided that it takes into account only on-balance sheet fair-valued assets);
3) Introduction of a Core approach (in principle) which seeks to not add operational cost or significant complexity; and
4) Introduction of the principles behind Additional Valuation Adjustments (AVA) Articles 11, 12 and 15.

There are, however, some aspects of the RTS that we believe are not reasonable and which do not have a discernible benefit that outweighs the cost such as:

1) Life-to-date unrealised profit and loss is not a fair or consistent measure of valuation uncertainty and would likely result in unanticipated outcomes due to timing and accounting regime differences. It would also be very costly to implement for very limited benefit in this context;
2) AVA approaches delineated in Articles 8 and 9 which, as proposed, are punitive and do not take into account the cost of implementation, especially given the requirements of Article 20;
3) Potential overlap and non-independence of certain Articles could lead to a sum of AVA's which exceed the intended exit-cost principle (e.g. between Articles 8, 9, 10, 11 &12);
4) Potentially punitive AVA's on Banking Book assets which are under Fair Value, and where full appreciation of the total capital already provided on those assets is needed; and
5) Prescription of netting and diversification (as laid out in the CP, and its enclosed worked-examples) which are not reflective of the underlying economics or established risk-

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Management Board: Jürgen Fitschen (Co-Chairman), Anshuman Jain (Co-Chairman), Stephan Leithner, Stuart Lewis, Stefan Krause, Rainer Neske, Henry Ritchotte
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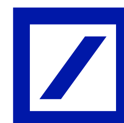


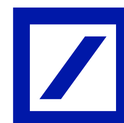
management practices, and in the case of some parameters (e.g. for curve- or surface construction) could result in improbable (or in some cases even impossible) outcomes.

Our responses to the EBA's questions build upon these general comments and are set out in the Annex.

We would be happy to discuss further any of the points in our response

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and
Regulatory Affairs



Annex

Questions

Question 1: Do you agree with the minimum list of alternative methods and sources of information defined above for expert based approaches? If not, what others could be included, or which points from the current list should be removed? State your reasons.

The minimum list is reasonable; however, the relevant data sources utilised should be those which are most appropriate given current market conditions. They should utilise consistent sources of expertise, technology and process.

Additionally, clarity is needed within Article 3(2) and Article 3(3). This clarity can be achieved by amending the text as suggested below (emphasis added to represent the amendments):

Article 3(2)
"The market data used to determine a prudent value shall *consider available and reliable data sources, including the following, where relevant:"*

Article 3(3)
"For cases where an expert based approach is applied for the purpose of Articles 8 to 10, alternative methods and sources of information shall be considered, *including the following, where relevant."*

Moreover in both Articles the list of information sources should be flexible so that they are not all required for every valuation but are an indicative list of sources that can be used individually or collectively.

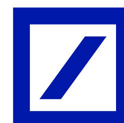
Question 2: Do you agree with the introduction of a threshold below which a simplified approach can be applied to calculate AVAs? If so, do you agree that the threshold should be defined as above? State your reasons.

In our opinion the use of a threshold to determine when to use the simplified approach is appropriate and the proposed level is reasonable. However, this approach would be the most useful if it takes into account only on-balance sheet fair-valued assets. The inclusion of off-balance sheet fair-valued assets could cause confusion and incomparability across banks positions. Furthermore, we believe that the inclusion of liabilities in the threshold is not useful and is not aligned with the scope in Article 34 of the Capital Requirements Regulation (CRR) which only pertains to assets. Thus, we would request that the provisions contained in the text be revised to reflect this change.

DB also supports the concept that the AVA calculation take into account multipliers for different levels of the Fair Value Hierarchy (FVH) and amendments to the RTS text which includes the definitions of FVH taken from GAAP.

Question 3: Do you believe there are any practical issues with a parent institution being required to apply the 'core approach' to all fair value positions whilst a subsidiary is allowed to apply the simplified approach? State your reasons.

In DB's view this provision does not add any additional operational cost or burden beyond that which would be placed upon the parent institution's core requirements. However, we do question the benefit of potentially pursuing differing approaches within a single bank.



Question 4: Do you agree with the proposed simplified approach? Do you think the risk sensitiveness of the approach is appropriate? Are there alternative approaches that you believe would be more appropriate? State your reasons.

We recommend the utilisation of the FVH as a measure of observability and liquidity, which adheres to the spirit of the regulation, whilst also providing a simplified approach.

In our opinion, life-to-date unrealised P&L is not a fair or consistent measure of valuation uncertainty and would result in unanticipated outcomes given timing differences, the use of FIFO, LIFO or average cost, and the direction of the position held. Additionally, this would be very costly to implement for very limited benefit as a means of managing the valuation uncertainty of the organisation.

Question 5: Could a differentiated treatment for some asset/liability classes be considered, for example with regard to their liquidity? Please state the pros and cons of such a differentiation. How would you define the degree of liquidity of an asset/liability class (e.g. fair value hierarchy, eligibility for the LCR, other)?

Please see our response to Question 4.

Question 6: Do you agree with the approach defined above to calculate an AVA where the approaches in Article 8 and 9 are not possible for a valuation exposure? If not, what other approach could be prescribed? Explain your reasoning.

In our view, the approach detailed in the Articles is overly punitive and does not take into account the unintended impact of their implementation as proposed. Three examples are:

First, unrealised profits and losses are typically not stored within a bank's systems. A change to this infrastructure would require significant development and cost.

Second, the 25% charge related to balance sheet market value is approximately 250 times as large as the charge proposed under the simplified method.

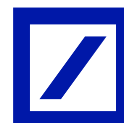
Third, the charge in Article 7 is pro-cyclical and in distressed market conditions estimating the charge could be impracticable.

Thus, a phased-in approach to the requirements would be beneficial to allow for all necessary changes to be made to systems and processes.

Question 7: Do you agree with the approaches defined above to calculate AVAs for market price uncertainty, close-out costs, and unearned credit spreads? If not, what other approach could be prescribed? State your reasons.

We agree with the approach principles described in Articles 8, 9 and 10. We propose that the wording is amended such that it ensures no ambiguity in proving confidence in 'exit price' once only, i.e. avoiding duplicative charges.

In relation to the detailed approach supplied, we agree with AFME that any surface generated to facilitate the calculation of Market Price AVA should not be unrealistic i.e. should not create discontinuities, for example, via the use of points directionally biased by specific risk exposures. This could, for instance, be an unintended consequence of a literal interpretation of the example provided, where we envisage problems producing realistic forwards that can be used by the



bank's analytic models and also when trying to extend the logic to a surface (e.g. for volatility) in practice.

The back-testing requirement as proposed is impractical for most circumstances (and extremely expensive where possible). We propose a less frequent and more informative test be derived that would fulfill the intended requirement, and make better use of firms' resources. Such a regime could include sampling of transactions, combined with information gathered from the independent price verification processes (i.e. leveraging existing practices).

Question 8: Do you agree with the approaches defined in Articles 11 to 16 to calculate the various categories of AVAs? If not, what other approach could be prescribed for each AVA? State your reasons.

Article 11: It is appropriate to consider Model Risk uncertainty alongside both Market Price and Close-out Cost uncertainty and therefore qualifying for the same aggregated AVA diversification treatment.

Article 12: This approach is reasonable. Notwithstanding this view, when defining liquidity, one should consider all potential market activity.

Article 13: The text should be amended to highlight that it is the expected contractual life of the trade from which to calculate the costs and benefits.

Article 14: The future administrative cost text is incongruent with our understanding of the AVA's. From our perspective the AVAs are designed to estimate a prudent exit value. Therefore, in our opinion, a bank should be allowed to calculate this AVA by taking into account the lower of the costs incurred managing the portfolio or the incremental costs charged by a market participant managing the portfolio.

Article 15: The text is reasonable and we do not have any recommended changes.

Article 16: In our opinion operational risk additional valuation adjustments (AVAs) should not be included in a prudent valuation regime. Operational risk is already captured through the Advanced Measurement Approach (AMA).

Question 9: Are there cases where the above AVAs may have a zero value that could be defined in the RTS? If yes, please specify.

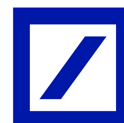
We do not believe that a further definition is required beyond the guidance provided in the RTS.

Question 10: Do you agree with the approach defined above for the aggregation of valuation exposure level AVAs within the market price uncertainty and close-out cost AVA categories? If not, what other approach could be prescribed? State your reasons.

We agree with the approach but reiterate the point we made in response to Question 8 where we discussed our view of model risk under Article 11.

Question 11: Do you agree that category level AVAs described in Articles 11 to 16 within the core approach should be aggregated as a simple sum? If not, what other approach could be prescribed? State your reasons.

It should be recognised that the outcome will tend to be more conservative through the simple aggregation of the constituent AVA.



Please also refer to our responses to Questions 8 and 10.

Question 12: Do you agree with the requirement for institutions using the core approach to implement the above ongoing monitoring tool as an indicator of the adequacy of data sources of valuation inputs used to calculate the AVAs described in Articles 8 to 10? If not, what other approach could be prescribed? State your reasons.

The approach as detailed offers minimal benefit in return for the material operational expense that would be incurred. As a result, we propose that a more stream-lined approach which leverages existing industry-wide processes be considered.

Question 13: Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?

As detailed in our previous responses, we believe that there are areas within the consultation paper that would lead to a material increase in operational expenses without discernible benefits.

In particular we would propose that a review of requirements such as life-to-date unrealised P&L, the 100 days volatility measures and prescribed monitoring tools be revisited.