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Deutsche Bank's response to the European Banking Authority's (EBA) Consultation Paper on the draft regulatory technical standards on the sequential implementation of the IRB Approach and permanent partial use under the Standardised Approach.

Dear Mr. Farkas,

Deutsche Bank (DB) welcomes the opportunity to comment on the EBA's consultation paper (CP) on the draft regulatory technical standards related to the sequential implementation of the Internal Ratings Based (IRB) Approach and permanent partial use under the Standardised Approach (SA). We agree there should be consistency in the sequential implementation process of the IRB Approach led by competent national authorities.

We support the provisions in the Capital Requirements Regulation (CRR), which grant competent national authorities the authority to determine the time period over which an institution shall be required to implement the IRB Approach, based on the nature and scale of the activities of the institution.

DB's key concern relates to the maximum level of exposures permanently allowed under the SA for "non-significant business units and immaterial" exposure classes. As explained in more detail in our response to question 3 of the draft RTS, there are a number of exposures for which no internally approved IRB Approach models are used or which benefit from specific exemptions. However, in line with developed practices over time, certain national competent authorities have permitted institutions to treat these exposures under the IRB Approach, since they can be categorised as non-significant or immaterial (for instance exposures from expiring business units and exposures for which a transitional exemption may apply due to acquisitions / new business units or new product types). For these reasons, these exposures are excluded from the calculation

of the maximum levels of exposures for the use of the SA. We would suggest for the EBA to include these exposures in the definition of the set of relevant exposures under the draft RTS. Additionally, we would propose that the institution and the competent national authority establish a plan if necessary detailing how to include these positions in the IRB Approach within a reasonable timeframe.

Please see the Annex for more detailed and technical comments that we would like to have taken into consideration.

Please do not hesitate to let us know if you have questions about any of the points or if there are any issues related to this topic which you would wish to discuss further.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy

ANNEX I: Responses to specific questions

Question 1: Do you agree with the proposed draft RTS regarding the sequential application of the IRB Approach?

DB supports the provisions in Article 148(2) of the CRR, which state that the competent authorities shall determine the time period over which an institution and any parent undertaking and its subsidiaries shall be required to implement the IRB Approach for all exposures, based on the nature and scale of the activities of the institution, or any parent undertaking and its subsidiaries, as well as the number and nature of rating systems to be implemented. To respond to the question, we agree with the 50% threshold that needs be fulfilled throughout the implementation of the sequential roll-out plan, as stated in Article 4(2) of the draft RTS.

Question 2: Do you agree with the proposed draft RTS regarding permanent partial use of the Standardised Approach (SA) for the exposures specified in Article 150(1) (a) and (b) of the CRR?

We generally agree with the proposals related to the exposures contained in the IRB Approach exposure classes 'central governments / central banks' or 'institutions', where the number of material counterparties is limited and it would be unduly burdensome for the institution to implement a rating system for these counterparties. However, we would like to highlight that under current regulatory practice, there are additional types of exposures, where similar conditions are considered to be fulfilled without providing any evidence, including exposures to German churches or religious communities with the legal form of a public-law corporation and which levies taxes or shares in the tax revenue of tax-levying church corporations at public law[1]. In our view, these exposures should be included in the definition, as these types of exposures will always fulfil the condition of 'limited number of material counterparties'. We would propose that the RTS give national competent authorities the flexibility to consider these conditions for certain type of exposures as being fulfilled.

Question 3: Do you agree with the proposed draft RTS regarding permanent partial use of the SA for the exposures specified in Article 150(1)(c) of the CRR? Which of the two alternative proposals presented in the impact assessment section under 'Technical options considered' do you prefer?

As highlighted earlier in this response, we propose a different definition of 'set of relevant exposures' than what is stated in Article 1(3) of the draft RTS. In order to achieve the goal of adequately measuring non-significant business units and immaterial exposures that count for the proposed 8% according to Article 3 of the draft RTS, all exposures that could be treated under the

[1] Article 140 of the Basic Law in conjunction with Article 137 (6) of the Weimar Imperial Constitution of 11 August 1919

IRB Approach without using approved internal models (e.g. other non credit-obligations) or exposures for which a specific reason exists why the IRB Approach is not used must be excluded from the population of this coverage ratio.

Through the application of the national competent authority's approach to the roll-out of the IRB Approach over a period of time, additional exemptions from the relevant population of exposures are allowed for reasons of non-significance or immateriality, which are currently not listed in the EBA proposal. For example, exposures from expiring business units are exempt as these are only temporary and it would be unduly burdensome to apply an IRB Approach rating system to those positions, since these will expire in the near future. In addition, if a new business unit is acquired, these exposures should be temporarily exempted as it would be not possible to require that the internal model must be immediately applied to those positions. We would suggest for the institution and the competent authority to establish a plan if and how to include these positions in the IRB Approach within a reasonable timeframe.

Furthermore, trade exposures and default fund contributions to a central counterparty should be exempt as these positions are subject to specific rules promulgated in a CRR chapter outside the SA and IRB Approach rules (see Article 107(2) of CRR).

Additionally, DB may also recognise IRB Approach exposures in the population for the degree of coverage if an approved IRB rating model is used for them (e.g. IRB Approach equity portfolios subject to the internal models approach or the PD/LGD model).

Thus, we would propose to amend the definition of 'relevant exposures' to include the following additional exemptions:

- Securitisation exposures, since the treatment of IRB Approach for these exposures is also possible without using an internally approved model, but by applying the Ratings Based Method based on external ratings.
- Exposures incurred by a collective investment undertaking (CIU), as these can be classified as 'IRB Approach positions' even though their treatment is not based on an approved internal model by using the flat IRB risk weight of 370% for equity exposures.
- Other non credit-obligation assets as those positions receive a flat 100% risk weight and are not treated under an approved internal model.
- Trade exposures and default fund contributions to a central counterparty as these positions are subject to specific rules laid down in a CRR chapter outside the SA and IRB Approach rules (see Article 107(2) CRR).
- Exposures from expiring business units as these are only temporary and it would be unduly burdensome to apply an IRB Approach rating system to those positions since they will expire in the near future.

- Exposures from an existing business for a non-expiring business unit that are principally in scope of an approved IRB Approach rating model, but where the institution demonstrated to the competent authority that the application of this rating system would currently be unduly burdensome for this particular business unit. New exposures from a non-expiring business unit must be treated under the approved IRB Approach rating model, but exposures that have already existed prior to the approval of a new rating system should be exempted if it is unduly burdensome to treat them with the new approved IRB Approach model.
- Exposure types for which a transitional exemption may apply (e.g. the acquisition / set up of a new business unit or the beginning of providing new types of exposures if the institution has established a plan to include these positions in the IRB Approach within a reasonable timeframe). If, for example, a new business unit is acquired or a business is already in a transition process, these exposures should be temporarily exempted as this would not be possible to require that the internal model must be immediately applied to those positions as, for example, the applicable IT systems and processes are not set up for the newly acquired portfolio. If an institution starts making business with new types of exposures, it is also not possible to immediately develop a new IRB rating model as the institution must collect the new data in accordance with the required length of data history (principally five years for PD and seven year for LGD, see Articles 180 and 181 CRR). Instead, the institution and the competent authority should establish a plan when and how to include these positions in the IRB Approach within a reasonable timeframe.

However, an institution may additionally recognise the following IRB Approach exposures in the population for the degree of coverage if an approved IRB Approach rating model is used for them as this is justified by the effort to capture these positions under an approved IRB Approach rating system:

- IRB Approach equity portfolios subject to the internal models approach or the PD/LGD model as for these exposures an internal model is employed.
- IRB Approach securitisation positions for which the institution uses either the 'Supervisory Formula Approach' (SFA)[2] or the 'Internal Assessment Approach' (IAA) as these positions are indeed subject to an approved internal model.
- Exposures incurred by a CIU transaction for which the IRB Approach risk weights are used in the look-through approach as these positions are treated under an approved internal model.

[2] When using the SFA, only those parts of the underlying portfolio for which an approved IRB Approach model is used can be treated as IRB Approach positions for the coverage ratio, the remainder is treated as SA positions.

Looking at the two options discussed in the explanatory box starting on page 19 of the RTS, we believe that both options are somewhat complex. With regards to proposal 1, the comparison between the SA and IRB Approach capital requirements might be challenging if there is no suitable IRB Approach rating system available for these exposures, which means the IRB Approach capital requirements cannot be estimated. Proposal 2 seems also quite complex, but acknowledges our points made earlier related under question 3. We find it crucial that the population of the coverage ratio is well defined (as proposed above). This ensures that IRB Approach exposures with a fixed IRB risk weights are excluded from the coverage ratio, but other exposures for which a more risk sensitive approach is used can, instead, be included (e.g. equity exposures subject to PD/LGD model).

However, we agree with the general principle that 8% as a quantitative threshold is too low and therefore we propose the following alternative:

- The term ‘set of relevant exposures’ must be defined as described above.
- The limit of 8% should be adjusted to 10% in order to give the institutions more flexibility around the development of IRB rating systems, which is unduly burdensome for small portfolios. In addition, a clear, consistent and reliable requirement ensures a level playing field and gives clear guidance for institutions about how much exposure can be treated under the SA without negotiating with the competent authority.
- The ratio should only be defined in terms of total exposure value and not relating to the total risk-weighted exposure amount. The ratio based on total risk-weighted exposure amount is very volatile and – to a large extent – not controllable by the institution itself as the risk-weighted exposure amounts fluctuate based on the external or internal rating, i.e. based on the creditworthiness of the counterparty. This means that if the creditworthiness of the SA counterparty deteriorates, the utilisation of the SA limit goes up while the ratio on exposure value remains stable. In addition, the riskier the IRB Approach position is, i.e. the higher the IRB risk weight is, the ‘better’ it is for the coverage ratio based on risk-weighted exposure amounts. Furthermore, the application of credit risk mitigation techniques under the IRB Approach would lead to lower risk-weighted exposure amounts under the IRB Approach and hence have negative implications for the coverage ratio based on risk-weighted exposure amounts. For the reasons stated above, we believe that the coverage ratio should only look at the exposure value to avoid setting wrong incentives.

- Lastly, we would highlight the potential impact of foreign exchange fluctuations on both the Risk Weighted Assets (RWA) calculation, as well as potentially on the calculation of the coverage ratio[3]. This effect needs to be taken into consideration in the draft RTS.

Question 4: Do you agree with the quantitative thresholds proposed in Articles 2(1), 3 and 4(2) of these draft RTS? If not, what thresholds do you consider more suitable?

DB generally agrees with the quantitative thresholds proposed in Article 2(1) of the draft RTS. However, if we look at institutions which are developing IRB Approach rating systems and do not have approved internal models in place for the exposure classes 'central governments / central banks' and 'institutions', these institutions could exempt up to 24%[4] of the relevant exposures from the IRB Approach whereas institutions which have already developed rating systems for most of its entire portfolio can only exempt 8% of the relevant exposures as they cannot make use of Article 150(1) (a) and (b) in the CRR. Therefore it is even more important for banks that have already implemented the IRB Approach that the definition of 'relevant exposures' is amended and that the quantitative threshold for the 'immaterial and non-significant exposures', as proposed in Article 3 of the draft RTS, will be adjusted to 10% based on the exposure value (see our response to question 3). As for Article 4(2) of the draft RTS, DB agrees with the threshold of 50% which must be fulfilled throughout the implementation of the sequential roll out plan.

Question 5: Do you think that separate quantitative thresholds should apply for application of these draft RTS on an individual and on a consolidated basis? Which of the two alternative proposals presented in the impact assessment section under 'Technical options considered' do you prefer?

In our opinion, the same quantitative thresholds should apply on a consolidated basis, especially in the event that solo entities transitioning or being integrated into a group entity which has been approved as an IRB Approach institution. However, if the competent authority has waived the application of the prudential requirements on an individual basis in accordance with Article 7 of the CRR, the quantitative thresholds of this draft RTS should not be applicable on an individual level. We believe that the proper definition of the term 'set of relevant exposures' – as suggested in our response to question 3 – is sufficient to accommodate the specific circumstances on the individual level (e.g. larger proportion of expiring business units on the individual level compared to the consolidated level).

[3] Even though the effect on the coverage ratio is hard to specify, since currently our systems do not produce an impact number on the Advance Approach, Standard Approach nor do they include all exceptions. However, for July the FX RWA effect was approx. 2.6bn and for August, the FX RWA effect was approximately 1.5bn.

[4] The proposed rules allow up to 24% of the set of (IRB Approach) eligible exposures to be exempted from IRB treatment under Article 150(1)(a) to (c) of the CRR (not cumulatively, but 8% under each one).

Question 6: Do you agree with our analysis of the impact of the proposals in this Consultation Paper? If not, can you provide any evidence or data that would explain why you disagree or which might assist our analysis of the possible impact of the proposals?

In our view, this proposal would have a significant impact on financial institutions given the narrow definition of the exposures eligible for exclusion for the calculation under the IRB Approach. If the definition of 'set of relevant exposures' remains as it is currently proposed in Article 1 (3) of the draft RTS, our internal impact analysis shows that our current percentage based on risk-weighted exposure amounts under the domestic rules for the immaterial and non-significant exposures could almost double and would therefore be above the 8% limit as proposed by Article 3 of the draft RTS. Since DB currently fulfils the coverage ratio under the domestic regulation, there could be challenges fulfilling the 8% limit based on the risk-weighted exposure amounts for the 'immaterial and non-significant exposures' as proposed in Article 3 of the draft RTS. As a consequence, we would have to develop internal models for types of exposures where it is unduly burdensome and not reasonable, e.g. for expiring business units. Therefore we ask for your consideration of our response to question 3.