European Banking Federation

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Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of almost 4,500 banks: large and small, wholesale and retail, local and cross-border financial institutions. Together these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the European Union.

Subject : EBF response to the EBA consultation on prudent valuation

General remarks

The EBF welcomes the opportunity to share the views of the European banking industry with the European Banking Authority (EBA) on its discussion paper relating to draft regulatory technical standards (RTS) on prudent valuation under article 100 of the draft capital requirement regulation (CRR).

Firstly, a usual concern is the difference in the semantics between the prudential framework and the accounting standards. The EBF is conscious of the problems associated with the definition of the very concepts of fair value and prudent value. Although we do not support the creation of 2 fair values, in the absence of a single definition the EBF urges the EBA to consider areas where the overlap between fair value and prudent value becomes evident and to make allowance for this fact in the RTS. The potential overlapping requirements for risks that are already captured via risk weighted assets (RWA) in pillar 1 is an area that also deserves attention in the final RTS, as the risk of double counting is substantial. The current regulatory reform incorporates a range of conservative measures like stressed value-at-risk requirements that European banks are already applying within the scope of Basel 2.5.

Nevertheless, if it is not deemed possible to meet at the same time the requirements sought in the accounting standards and the prudential regulation, transparency would be essential to reconcile one with the other. For this purpose, the additional elements and changes that the concept of prudent value adds to the accounting definition of fair value as per IFRS13 should be made clear. There should be a clear explanation on the reasons why the fair value of IFRS would not work for prudential purposes.

A recurrent term in the text is the ‘true realisable value’. The RTS should clarify whether the intention is to measure an exit value in an ongoing business, i.e. a sort of fair value with a more

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conservative approach, or to measure a liquidation value under certain circumstances that does not represent the situation of a going concern business, i.e. a significant departure from the fair value.

The quantitative approach proposed in the discussion paper could lead to false sense of security. The problem with valuation uncertainty is that it is primarily caused by the lack of reliable data, and therefore difficult to quantify. There are at least three contributors to valuation uncertainty: Model, concentration and input parameter uncertainty.

The paper suggests that significant weaknesses in the risk management policies, systems and controls related to valuations relative to the standards set out in the paper should be addressed by a requirement by the competent authority for additional adjustments in Tier 1 capital. This would be a new supervisory measure not seen elsewhere. The pillar 2 of the Basel framework already foresees the supervisory review of an institution's risk management, systems and controls. Against this backdrop, it would not be appropriate to introduce such a new supervisory measure in a regulatory technical standard.

When drafting the final RTS, EBA should take into consideration the global level playing field by ensuring consistency with the practices and accounting standards of other jurisdictions.

EBF believes that the new prudent valuation adjustments can cause an additional pro-cyclical element in the regulatory capital requirements as the additional valuation adjustments will feed into the dealer prices and might be of importance notably in a crisis situation.

Specific questions

1. ***Do you believe that a proportionality threshold should be considered before requiring an institution to assess the prudent value of all fair value positions? If yes, how would you define the threshold?***

- We support the idea to introduce a proportionality threshold. It may be defined as the ratio between the fair value of the positions subject to the calculation of additional valuation adjustments (AVAs) and the common equity tier 1. It should be set at a level that ensures the exemption of the obligation to calculate AVAs which would have an immaterial effect on the capital adequacy.
- The scope of assets subject to AVA calculation should be limited. In particular:
    - Level 1 assets should be exempted.
    - Assets subject to netting and collateral agreements could also be excluded due to the offsetting of potential valuation risks in long and short positions.

2. ***Do you agree that the exit price used as the basis of prudent value does not necessarily need to be based on an instantaneous sale? If yes, provide argument to support your view.***

- Yes, we agree.
- We are of the view that the exit price based on an instantaneous sale is not meaningful for illiquid complex assets or portfolios as it could not happen in practice due to the due diligence required on the part of market participants.
- The use of an exit price if based on an instantaneous sale could make little sense for hedge positions or trades based on arbitrage considerations. Exit prices are by principle only to be used for net open positions. All positions that are hedged (offset by other positions) should instead be allowed to be priced at mid market prices. It is also our understanding that the concept of prudent value should be not based on fire sales.

3. ***Should a specific time horizon for exit be set when assessing the prudent valuation? If so, how the time horizon should be set (e.g. the same time horizon for calculating Value-at-Risk (VaR), Credit Risk Capital Requirements, etc.), what should it be and how would it feed into the calculating of AVAs?***

- The process for AVAs calculation is based on a point-in-time view. It is not about historical time series analyses (observation period). In principle we understand that especially market liquidity risk considerations should be taken into account.
- No particular time horizon should be set for the purpose of calculating AVAs. It should be estimated at constant market conditions. Impact from changes in market conditions over the liquidity horizon are captured in the market risk capital framework. Furthermore, longer liquidity horizons are already taken into account for credit products under Basel 2.5 and will likely be extended in the BCBS Fundamental Review of the Trading Book (FRTB) underway.

4. ***Do you support the concept of a specified level of confidence to determine AVAs? If not, why? Are there any AVAs where the use of a specified level of confidence is not appropriate?***

- The industry does not support the use of a systematic and prescribed level of confidence to determine AVAs. While the concept of a confidence level can be valuable as guidance or a benchmark, in many cases, such concept will be neither practical nor meaningful from a statistical perspective. For instance, due to the lack of available data the confidence interval would not be relevant for exactly those parts of the book for which valuation uncertainty is greatest (e.g. illiquid level 3 type assets).

- It would make more sense to define prudent valuation qualitatively and use a confidence interval as an illustrative example of what this might mean for a liquid portfolio where data is available. The definition of prudent valuation could remain at a qualitative level stating that prudent value is the value of the position that is realizable beyond reasonable doubts within the current market conditions at the reporting date, given risk assumptions that are consistent with the fair value price. Assumptions and measures of doubt should be consistent with practitioner and regulator views of market practice or standards for such assumptions.
- In setting a confidence interval as a benchmark, the question is whether sufficient data exist at the level of confidence. Only if there are enough data points (market quotes) the idea of calculating a confidence interval makes sense from a statistical point of view. But even in this situation it is not clear why a bank is obliged to take e.g. the lowest quote out of 20 quotes. Banks have to consider the quality of market data they use. For example, when a quote is only available for a very small position, it would be more practical to use a professional or expert judgment for prudent value.
- The regulatory technical standard should strike a balance between the flexibility needed to allow for sufficient available data in all institutions and portfolios and the principle of harmonisation in order to ensure the level playing field. Nevertheless, the industry does not support the concept of a specified level of confidence.

5. ***If you support a specified level of confidence, do you support the use of a 95% level of confidence? What practical issues or inconsistencies with other parts of the CRR might arise when using this level of confidence?***

- As stated above, the industry does not support a specified level of confidence. However, only as a matter of benchmark:
    - The level of confidence for benchmark purposes should be in the range between 70% and 85% (e.g. not above one standard deviation, i.e. 84,13%). Such a confidence level would allow for a sufficiently wide sample of data.

6. ***How prescriptive do you believe the RTS should be around the number of data points that are required to calculate a 95% level of confidence without any more judgemental approach being necessary?***

- The EBF believes that any additional prescriptive provision on this issue is not helpful. The number of data points necessary may vary from case to case.
- We reiterate that in most cases a confidence level will not be possible to calculate statistically.

7. ***If you support a specified level of confidence, do you support the explicit allowance of using the level chosen as guidance for a more judgemental approach where data is lacking?***

- For mark-to-model positions for which a judgmental approach is needed we believe the concept of level of confidence as guidance or benchmark could be reliable under the abovementioned conditions.

8. ***Should any additional possible sources of market prices be listed in the RTS?***

- In the opinion of the EBF, there is no need to list additional sources of market prices in the RTS. Instead, we suggest that the guidelines display the preconditions for using different sources for collecting market prices.

9. ***Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?***

- In general, no.

10. ***Should the RTS be more prescriptive on how to use the various alternative methods or sources of data to obtain a range of plausible prices where there is insufficient observable data to determine the range by direct statistical methods? If so how?***

- Prescription would add nothing in terms of value. Judgment needs to be applied to determine the most appropriate methodologies. Regulators would be expected to review methodologies to ensure appropriateness and consistency amongst institutions.

11. ***Are there any other indicators of large market price uncertainty which should be included?***

- Not in principle. The RTS should consider the overlaps between AVA for market price uncertainty and other AVAs, like concentration and liquidity AVA or close-out costs AVA.

12. ***Do you believe the approaches set out above are appropriate for each of the adjustments listed in Article 100? If not, what approaches do you believe would be more relevant?***

- The proposed approaches are in general relevant and clear enough except for the following ones:
    - The wording used for the close-out costs, *sic the methodology should be consistent with or demonstrably more prudent than the most accurate hedging of the risk available using tradable instruments taking into account liquidity*, could be interpreted as a mandatory netting at a very granular level. However in our understanding the intention was to keep consistency with the level of netting acceptable for risk management.
    - Careful attention should be paid to the area where potential overlaps could occur with the capital requirements (e.g. operational risk), in particular upon the completion of the FRTB (e.g. use of long liquidity horizons, capital add-ons for model risk, etc.).
    - Future administrative costs should be considered in the *normal course of business* and not for a full exit of a business line as suggested by the RTS wording.
    - Funding valuation adjustments is still a developing area with no existing market standard so far. Therefore, it seems premature to incorporate them into AVAs.
    - Balance sheet substantiation has no bearing with prudent valuation considerations. It is, besides, burdensome. Moreover, balance sheet substantiation should not be included since it is not a part of the scope of prudent valuation according to Article 100.10 of the draft CRR.
    - Early termination AVAs are primarily driven by client relationship and should not be material to the valuation in the *normal course of business*.

13. ***Are there any other material causes of valuation uncertainty that the RTS should describe an approach for? Or are any of the adjustments listed above not material and should not be included?***

- In the understanding of the EBF, there are no other material causes of valuation uncertainty.
- Early termination and future administrative costs should be considered immaterial. Early termination is dependent on specific client relationships and is at the sole discretion of the institution. As such it does not represent a risk or uncertainty in the valuation which

would be achievable in the market were a position to be transacted. Future administrative costs refer to incremental costs associated with managing derivative portfolios over time. Market participants who would transact such portfolios would already have operations established to manage such derivatives and hence the infrastructure in place already and therefore incremental costs would be negligible. Furthermore, such costs would be reflected in observed market bid-offer spreads and hence captured through market price uncertainty.

- No AVA should be calculated related to the effect of customer non-contractual cancellation. There is usually a possibility of transferring the associated cost to the customer or of compensating the cost with potential future income from that customer.

14. ***Do you believe that the testing approach in Annex 2 represents a useful tool to test for prudence of valuation? If not, what weaknesses make it unsuitable?***

- It is questionable that the concept of back-testing adds any value to the prudent valuation assessment. The data to adequately test would only be available for those parts of the portfolio which are most liquid and for which uncertainty is smallest (and where sufficient trade data is available we would expect it to be incorporated into the assessment of prudent value anyway). For less liquid level 2 and level 3 positions it would not be possible due to a lack of data and is therefore inappropriate.

- The testing approach is also problematic because of time differences between the price as of the end of yesterday and the real observed price on the next day (intraday trades). These differences can cause false results on the test. Generally speaking we believe that a statistical test is not useful in many situations, e.g. in a mark-to-model environment.
- It should also be noted that the stressed VaR as required by CRD III already covers this element, and would lead to a double counting of risks.

15. ***Do you believe that the RTS should be prescriptive with respect to validation techniques? If not, how do you believe that comparable levels of prudence should be ensured for the valuations across institutions? Are there other validation techniques that you believe should be detailed in the RTS?***

- The banks should have the flexibility to come up with appropriate individual solutions.

- Supervisors would be expected to review individual banks' methodologies to ensure appropriateness and consistency across the industry. Comparing levels of prudence is however challenging given the variety of financial instruments, market infrastructures, models, data sources, yield curve building and information systems used by banks.

16. ***Do you support the concept that prudent value can never be greater than fair value including fair value adjustments at both the individual position and the legal entity level? If not, what would be the reason to justify your view?***

- In general, the EBF agrees on the principle that the prudent value cannot be greater than the fair value.

17. ***Would simple aggregation better reflect your assumptions and practices or would you support the availability of a diversification benefit within the aggregation of position-level AVAs? Please explain the reasons and justification why, providing any evidence available to support your arguments.***

- The arithmetic sum of high level confidence outcomes does not reflect the risk involved as it ignores the diversification effects.
- There is broad understanding that the uncertainty at a portfolio level is less than the sum of all the individual positions. Diversification therefore should be allowed. In practice we need a realistic level of regulatory requirements which neither understate nor overstate the real diversification benefit of the bank's portfolio. In this respect, it is important to have the flexibility of using an in-house aggregation method under the supervision of the competent authorities.
- In general terms, the correlation among factors of uncertainty between models should be negligible if the risk factors that are actually considered in the market risk framework are excluded from the AVA calculation.

18. ***If you support the availability of diversification benefit, do you support creating a simplified standard approach, an example of which is shown in Annex 4? If you do, do you have alternative suggestions on how this standard approach should be specified? Are the suggested correlations in the example appropriate, if not what other values could be used?***

- We prefer an internal approach approved by the regulators. Notwithstanding this preference, a simplified standard approach should be made available to banks with small portfolios. The estimation of the diversification effect should be based on a low correlation level (nearly zero).

19. ***If you support the availability of diversification benefit, do you support allowing an in-house approach which should be subject to approval by the regulator, an example of which is shown in Annex 4?***

- An in-house approach allows the bank to tailor the approach to its specific portfolio to arrive at a number which is meaningful for internal management reporting as well as external regulator reporting.

20. ***Would you agree that offsets against AVAs for overlaps with other Pillar 1 capital requirements should not be permitted? If not, what offsets might be appropriate and under what conditions might they be allowed (e.g. individually assessed by the institution and agreed with the regulator rather than specified in the RTS)?***

- The estimation of AVAs should avoid overlapping requirements. We consider that the AVAs proposal double counts risks that are already considered under the market risk and operational risk frameworks, as follows:
    - Overlaps between the AVAs and the market risk capital charges in the current regulatory framework:

      There is a clear overlap between the AVA calculation proposed in the document and the market risk capital charge calculation under the current prudential regulation. The market risk capital charge includes an overly conservative estimation of the economic impact associated with changes in the underlying risk factors of a position (confidence level of 99% and holding period of 10 days). In the view of the EBF, the confidence level and the holding period already capture the uncertainty related to the spot pricing.

      In addition, the current regulatory framework considers these risks under normal and stressed conditions. Indeed, the proposed future regulatory framework has modified this treatment in order to solve the existing overlapping.
    - Overlaps between the AVAs and the market risk capital charges in the proposed future regulatory framework:

      The Basel Committee has launched a public consultation regarding the revision of the market risk framework. There is an overlap between the AVA calculation proposed in the document and the Basel Committee proposal as it stands in the consultative paper launched in the second half of 2012. Under the proposed market risk framework, the risk factors that cannot be modelled for regulatory purposes should be capitalised under a stress scenario. In turn, the AVA calculation is also considering the same underlying risk factors under the confidence level.

As for liquidity risk and concentration risk, they are also being considered under both frameworks.

In view of the significant overlaps, the EBF would propose that the RTS on AVA calculation be postponed and finalised in the light of the final revision of the FRTB.

- Overlaps between the AVAs and the pillar 1 capital requirements:

  Significant overlaps between AVAs and other pillar 1 capital requirements could arise if the latter are determined with reference to the fair value calculated in accordance with the accounting standards. For example, in the case of credit valuation adjustments (CVA), according to the accounting rule the fair value of the position is calculated net of the expected loss and the CVA capital requirement covers the unexpected loss. If an AVA imposes a deduction related to CVA, in addition to those considered in the fair value, a problem of double counting arises. In this case, offsetting the AVAs should be permitted (for example, the EAD for the purpose of the CVA requirements could be determined with reference to the prudent value). The same problem would arise whenever the requested AVAs are related to a source of valuation uncertainty for which a pillar 1 capital requirement exists.

- Overlaps between the AVAs and the operational risk capital charges:

  There is as well an overlap between the AVA calculation proposed in the document and the operational risk internal model capital charge calculation under the current prudential regulation. Entities using an internal modeling approach for operational risk should be exempted of this AVA calculation.

21. ***Do you believe the above requirements are appropriate? If not, what other requirements could be necessary and what requirements stated above are considered not to be relevant?***

- We find the requirements stated under documentation, system and controls and reporting requirements to be very burdensome even though many procedures already should be covered in existing processes.

- Banks' management should be entitled to define its own control framework that would thereafter be reviewed, challenged and changed if need be by the supervisor.

22. ***What would be the sources of costs and benefits of requiring (a) the implementation of a unique AVA methodology and (b) a consistent format for reporting AVA? Do you agree that the benefits of such requirements outweigh the costs associated with them?***

- Regarding the AVA methodology, the calculation procedures described in the document, in particular the model risk AVA estimation process, are really time consuming and very resource demanding. The highly prescriptive nature of the methodologies is such that the operational cost associated with the implementation is very high even for banks that already have solid valuation frameworks and a long tradition of prudent valuation.

  The calculation frequency should be reduced. We propose a quarterly basis.

- As to the format for reporting, a one-size-fits-all format would not be appropriate. Internal reporting formats should remain a matter for the institutions to define themselves. They are developed to fit the needs of the individual institution and should be consistent with the systems and controls within the individual institution.

23. ***If you agree with a reporting form being introduced, could you please provide a suggested template?***

- If there is a standardised form, coordination with the existing national templates would be appreciated.
