Standard Chartered

10 January 2013

EBA
Via e-mail: EBA-DP-2012-03@eba.europa.eu

Dear Sir/Madam

Response to the EBA Discussion Paper on Draft Regulatory Technical Standards on Prudent Valuation under Article 100 of the Draft Capital Requirements Regulation (EBA DP/2012/03)

Standard Chartered is pleased to have the opportunity to comment on the European Banking Authority (EBA) discussion paper on Draft Regulatory Technical Standards (RTS) on prudent valuation.

Standard Chartered welcomes the harmonisation of prudent valuation standards to address valuation uncertainties for the fair value book. While we agree largely with the proposed calculation approach of additional valuation adjustments (AVAs), we view that the EBA could adopt a more balanced approach in the RTS. In particular, we urge the EBA to consider the following in the RTS:

- **We would like to emphasise our view that the prudent valuation standards should focus on addressing material valuation uncertainties, which arise predominantly from complex and illiquid instruments or concentrated positions. The EBA should be mindful not to recommend contradictory or overly onerous rules in the RTS which will undermine institutions' ability to provide useful solutions in liquid instruments.** The view that valuation issues during the credit crisis arose primarily from complex and illiquid instruments is also echoed by the Basel Committee on Banking Supervision[1].

- **We are of the view that the proposed testing approach for prudence of valuation is challenging to implement and has limited usefulness across products or markets.** We recommend an alternative view of testing for prudence of valuation, detailed in our response below.

- **Institutions will benefit if the RTS includes a simplified standard approach for aggregation and diversification**. We believe that the drivers of valuation uncertainties are largely similar for any institution with the same risk positions. A simplified standard approach will therefore promote a consistent playing field.

[1] Bank for International Settlements, Supervisory guidance for assessing banks' financial instrument fair value practices, April 2009.

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- **The RTS should include the potential tax liability deductions that would occur on the balance sheet if valuations were more prudent in AVA calculations.** Including potential tax liability deductions in AVA calculations maintains consistency with the exit price concept.

- **The RTS should permit offsets against AVAs for overlaps with other Pillar 1 capital requirements.** The RTS should be more principles based, in order to be flexible to future developments at a time when capital rules are still evolving. The EBA should be cognizant of the dangers of over-capitalisation for conservative institutions when offsets are not allowed as a blanket prohibition.

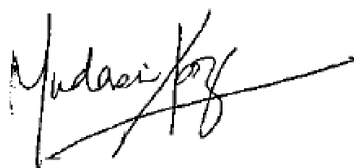
- **The RTS should not prescribe a confidence level of 95% across products and markets.** A prescribed confidence level across products and markets can be misleading and inadvertently increase valuation uncertainty, which is detailed in our response below.

- **Institutions should be given sufficient time to implement the requirements after the publication of the final standards**. Phasing in of requirements (at least six months) would be helpful.

Please find attached our detailed response to the questions raised in the discussion paper.

Standard Chartered recognizes the significant amount of work that has been performed by the EBA working group on prudent valuation. We look forward to engaging with the EBA on the topic of prudent valuation and other areas of CRR implementation. We would be happy to discuss further details with you if you have any comments.

Yours faithfully,



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Head of Valuation Control

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RESPONSES TO QUESTIONS

SCOPE OF THE REQUIREMENTS

Q1: 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 consideration of a proportionality threshold. A proportionality threshold ensures that the materiality of AVAs is put in perspective.

The EBA may wish to consider introducing a proportionality threshold after institutions assess prudent value. A proportionality threshold after the assessment of prudent value is less subjective than a proportionality threshold before the assessment of prudent value, as the size of the AVAs would not be known otherwise. An institution with insignificant AVAs relative to its capital base might not be required to deduct AVAs from common equity tier one capital.

PROCESS TO CALCULATE AVAS

Q2. 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.

We agree with the EBA that prudent value should be based on the exit price of the position. This is a practical approach which will reduce divergence between financial reporting and capital reporting requirements. This approach will aid investors in assessing an institution's financial health, given their heavy reliance on regulatory capital ratios.

In addition, we agree that the exit price used as the basis of prudent value need not be based on an instantaneous sale. The exit price should take into account the normal marketing period taken by an institution to exit the position before the reporting date. This normal marketing period, which would vary between products and instruments, is necessary for any market player to obtain sufficient number of bids from potential counterparties before a trading decision is made. For example, a market player would expect a shorter marketing period in disposing of its listed equity share holdings (not concentrated) as compared to its unlisted equity share holdings. If prudent value were based on an instantaneous sale, stress conditions would be implied. Prudent value should be based on valuation uncertainty at the reporting date and not distressed valuations under stress conditions, so as to avoid double counting with Stress Value-at-Risk.

We are of the view that the RTS should include the potential tax liability deductions that would occur on the balance sheet if valuations were more prudent in AVA calculations. The inclusion of potential tax liability deductions would maintain consistency with the concept of exit price. Tax is a major consideration by institutions when determining the exit price of a position.

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Q3. 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?

Please see response to Q2. We are of the view that the time horizon for exit should not be specified, as markets are not homogenous and different products or instruments are priced with varying time horizons for exit.

The EBA should be mindful of the dangers of specifying a shorter time horizon than intended by market participants when they enter into any transaction. A shorter time horizon than intended would imply stress conditions and curtail institutions' ability to provide financial solutions. This would consequently increase hedging costs in the markets.

Q4. 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?

We are of the view that it would not be appropriate to prescribe a specified level of confidence level in the RTS across products and markets. The concept of a specified level of confidence is difficult to implement in practice and creates a false sense of certainty. We suggest that the EBA adopt a more principles based approach and allow flexibility in determining the level of confidence for the following reasons:

- *Calculation of AVAs based on a specified level of confidence would only be feasible for vanilla products or liquid markets with abundant observable data.* Conversely, calculation of AVAs based on a specified level of confidence would not be feasible for complex products or illiquid markets with little or no observable data. These complex products or illiquid markets are more likely than vanilla products or liquid markets to have material AVAs.
- *Calculation of AVAs based on a specified level of confidence may inadvertently increase valuation uncertainty*. Some products or markets may not have abundant observable data but the few data points available could be reliable and of good quality, e.g. executable quotes from a handful of market makers. In such cases, the “true prudent value” would lie closer to fair value and in practice have minimal valuation uncertainty. Specifying the level of confidence in the RTS might inadvertently encourage smaller market players to contribute poor quality quotes towards consensus for such products and markets, increasing valuation uncertainty in the process.

Q5. 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?

Please see response to Q4.

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Q6. 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?

Please see response to Q4.

Q7. 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?

Please see response to Q4.

Q8. Should any additional possible sources of market prices be listed in the RTS?

We are of the view that the RTS should leave the possible sources of market prices open. The markets are constantly evolving and having a definite list of possible sources of market prices in the RTS will not be advisable.

Q9. Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?

We generally agree with the EBA that institutions should compute AVAs by considering various sources of market prices, including consensus spreads and available broker quotes. However, the EBA should note an important point that not all of the externally available market prices represent tradable prices at the reporting date. The institution should also consider entity specific factors in determining prudent value for its positions. For example, an institution may have different AVAs as compared to other institutions for its concentrated positions or when it has limited access to certain markets.

Q10. 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?

We are of the view that the RTS need not be prescriptive on this topic, as the suitability or availability of alternative methods or sources of data across products and markets will evolve with time. Institutions need to apply judgment in these circumstances to calculate AVAs, which should be subject to review by the regulator.

DESCRIPTION OF HOW TO CALCULATE AVAS

Q11. Are there any other indicators of large market price uncertainty which should be included?

We have no comment on this question.

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Q12. 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?

We support the overall approach to calculate AVAs, with the following caveats:

- The EBA needs to be mindful of implying stress conditions in the RTS. Concerns around stressed conditions are currently captured through mechanisms such as Stress Value-at-Risk and Liquidity Asset Buffer.
- We have reservations about using a high confidence level of 95% throughout the calculation approach of AVAs, as detailed in our response in Q4.
- Future hedging costs should not be part of future administrative costs to avoid overlap. Future hedging costs should be considered as part of closeout costs or adjustments for liquidity and concentration.
- Balance sheet substantiation controls should be assessed as part of operational risk to avoid overlap. In addition, balance sheet substantiation is not part of Article 100.

Q13. 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?

We support that institutions should be allowed to prove material/immaterial valuation uncertainty. We agree with the EBA that highly liquid products should not be subject to AVAs, except in the rare case when an institution holds a highly concentrated position. The fair value of highly liquid products should have a high degree of certainty attached to their valuation given that they are frequently traded.

We are of the view that AVAs for balance sheet substantiation and operational risk should not be included in the RTS. Capital requirements for operational risk (which would include lapses in balance sheet substantiation controls) are considered separately as part of operational risk capital and any AVAs would be immaterial.

TESTING FOR PRUDENCE OF VALUATION

Q14. 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?

We are of the view that the benefits of the proposed testing approach are minimal and do not justify the costs of implementation. The proposed testing approach is likely to be only applicable to liquid trades which are expected to have little or no valuation uncertainty.

Q15. 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?

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We believe that the RTS should not be prescriptive with respect to validation techniques. A prescriptive approach will be too restrictive as institutions have different control infrastructure setups and testing of prudence of valuation can be proven via various methods.

We are of the view that comparable levels of prudence can be achieved if the RTS adopts a more principles based approach. The RTS can state the minimum standards of the validation tests:

- The types of validation tests
- The frequency of validation tests
- The thresholds of validation tests to facilitate reporting of breaches

We propose that the following validation tests be considered for testing of prudence of valuation. We are of the view that these validation tests to be well developed in the market and could be implemented by any institution.

Validation Test	Frequency	Thresholds
Compare close-out values and prudent values of transactions with significant exit PnLs* (PnL exceeding a certain value on an absolute basis) for the last one year.	Quarterly	Percentage, dollar amount or number of transactions where prudent values are less prudent than close-out values. The threshold should vary according to the size and number of transactions with significant exit PnLs.
Compare day one transacted values and prudent values of transactions with significant day one PnLs* (PnL exceeding a certain value on an absolute basis) for the last one year.	Quarterly	Percentage, dollar amount or number of transactions where prudent values are less prudent than day one transacted values. The threshold should vary according to the size and number of transactions with significant day one PnLs.
Analysis of profit and loss versus risk factors	Daily	The number of days where unexplained PnL exceeds a certain percentage or dollar threshold when compared to total PnL. The threshold should vary according to the size of the position or portfolio.
Price testing of output prices for existing positions, wherever possible.	Monthly	Threshold for price testing variance to vary according to size of the position or portfolio.
Price testing of input prices for existing positions, if price testing of output prices are not possible.	Monthly	Threshold for price testing variance to vary according to size of the position or portfolio.

*We are of the view that testing for transactions with insignificant exit or day one PnLs is challenging to implement and would have limited benefits.

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AGGREGATION OF VALUATION ADJUSTMENTS

Q16. 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?

We have no comment on this question.

Q17. 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

We are of the view that institutions should be allowed to include diversification benefit when aggregating AVAs. A simple summation of AVAs at the position level, i.e. implying that both long and short positions move adversely, is overly punitive and unrealistic.

We illustrate our point using the following example. Assume that an institution has two positions – long credit default swap and long corporate bond – each referenced to the same issuer. The prudent value is assessed on a position level, where:

- the prudent value of the credit default swap is based on the lowest credit spread quoted in the market by Bank X.
- the prudent value of the corporate bond is based on the lowest bond price quoted in the market by Bank Y.

In practice, a deterioration of issuer credit will give rise to gains in the long credit default swap position, which will at least partially offset the losses in the long corporate bond position. If no diversification benefit is allowed, the total prudent value of these two positions would have been lower than the “true prudent value”.

The institution should enjoy diversification benefits and not be penalised by the different issuer credit assumptions between market participants. Otherwise, the institution will be discouraged from hedging, which contradicts the promotion of prudent practices.

Q18. 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 welcome the inclusion of a simplified standard approach that is risk based and which provides more clarity in terms of the correlation factors to be used in the RTS.

As institutions are likely to have common sources of valuation uncertainties, simple rules of thumb may be more useful than sophisticated in-house models. A simplified standard approach will also have the benefit of leveling the playing field for smaller banks with valuation uncertainties spread across many positions.

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Q19. 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?

Regulators should be allowed to approve advanced customised diversification methods in the case that the simplified standard approach is less appropriate for the institution.

OFFSETS TO AVAS WHEN CALCULATING THE ADJUSTMENT TO COMMON EQUITY TIER 1 CAPITAL

Q20. 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)?

We are of the view that the RTS should permit offsets against AVAs for overlaps with other Pillar 1 capital requirements. The EBA needs to be cognizant of the dangers of over-capitalisation for conservative institutions when offsets are not allowed. As capital rules are still evolving, we also caution against specifying an exhaustive list of offsets in the RTS which will reduce flexibility. Institutions should be allowed to assess the possible offsets which will be agreed with the regulator.

DOCUMENTATION, SYSTEMS AND CONTROLS REQUIREMENTS

Q21. 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 agree that institutions with significant control weaknesses should be subject to additional AVAs. Likewise, institutions with strong control systems which reduce concerns around valuation should be subject to less AVAs.

The EBA may consider including a scoring system for regulators to assess adequacy of prudent valuation controls in each institution. For example, if institutions adjust all price testing variances found from good quality pricing sources, especially for derivatives, concerns around reliable and prudent valuations will be addressed to a great extent.

REPORTING REQUIREMENTS

Q22. 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?

We have no comment on this question.

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Q23. If you agree with a reporting form being introduced, could you please provide a suggested template?

We agree that the EBA prescribe a standardised reporting form. We recommend that the EBA considers the format of the regulatory prudent valuation return reporting format prescribed by the Financial Services Authority (FSA)[2].

[2] The Financial Services Authority, Policy Statement PS12/7 on Regulatory Prudent Valuation Return, May 2012.