European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ, United Kingdom
DP-2012-03@eba.europa.eu

Brussels, 11 January 2013
VH/LD/B2/13-004

Discussion Paper: *"Draft Regulatory Technical Standards on Prudent Valuation"*

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the EBA's Discussion Paper on *"Draft Regulatory Technical Standards on Prudent Valuation"*. We highly appreciate this process of gathering preliminary industry views on the topic.

Please find our remarks on the following pages.

We will remain at your disposal,

Yours sincerely,

Hervé Guider
General Manager

Volker Heegemann
Head of Legal Department

GENERAL REMARKS

EACB appreciates that the EBA is gathering preliminary views on this topic and has launched a dialogue with the industry representatives.

Scope of application

Article 100 of the CRR of the Commission's original proposal from 20th July 2011 refers only to the prudent valuation for the trading book, while Recital (45) of the Presidency Compromise text of May 2012 extends prudent valuation requirement to all fair valued positions. However, in the CRR from 11 May 2012, article 100 remains part of Chapter 3 "Trading Book". It seems that there is a regulatory view, with respect to additional valuation adjustment (AVA), that the fair value is not necessarily always a prudent value. However, in the CRR and in the discussion paper it is not explained why the two are different and why article 100 is still part of Chapter 3.

Including other positions than trading book positions, would lead to additional accounting complexity. Institutions that have considered or are considering the fair value option above fair value hedge accounting under IAS 39 could be negatively affected from a regulatory capital point of view. Furthermore, institutions that use other GAAP can benefit from other accounting options than fair value accounting to overcome accounting mismatch between fair value and accrual accounting.

Confidence intervals

The suggested application of a confidence interval is posing particular challenges and seems to be in contradiction with the text of CRR. The application of a confidence level for the prudent valuation (especially in light of examples in Annex 1 and 2 of the discussion paper) means that all fair value positions will not be viewed at expected value but rather at a stressed value (taking into consideration unexpected losses). The CRR text does not explicitly refer to such a confidence intervals nor to stressed values.

Moreover, especially for positions that could be most relevant for the prudent valuation – rarely traded assets – banks will not be able to show that a certain value falls within a predetermined confidence interval. Thus, from a practical point of view, we do not believe the application of confidence interval is appropriate.

Accounting considerations

After the drafting of the CRR text on article 31 and 100, other regulatory developments have taken place, especially the endorsement of IFRS 13, which covers many of the risks addressed by those articles. Nevertheless, the article 100 and 31 have remained unchanged failing to reflect the already more prudent rules for the banking industry.

As of 1 January 2013, IFRS 13 'Fair Value Measurement' is effective. Banks have already developed systems to comply with IFRS 13 requirements. IFRS 13 requires that institutions estimate as best as possible the prices at which the positions they hold could be sold in orderly transactions, based on current information and conditions. It provides a detailed description on how fair valuation has to be applied and includes a fair value hierarchy. The new standard requires institutions to make more use of information that other market participants use (e.g. market observable credit spreads). More importantly, IFRS 13 also give guidance on how to act when measuring the fair value when the level of activity of financial markets has significantly decreased. IFRS 13 fair value hierarchy provides information about uncertainty of fair values which is quantified by IFRS 7.40 / IFRS 13.93 (h) sensitivity analyses, especially for level 3 instruments where the rage of different market rates is expected to be largest.

This change in the accounting standards will, to a large extent, fulfil the objective of a prudent valuation as set out in article 100 of the CRR. It is unclear when and why additional valuation adjustments are necessary, for fair values compliant with IFRS 13. Therefore, we do not see any additional benefits for the proposed prudent valuation requirements. Furthermore, the differences between the prudent value and the fair value and the factors which contribute to such differences are not explained. In our view, in case additional guidance is needed, it should only be provided for entity specific information not covered by IFRS 13, like the amount of the entity's holding in a financial instrument when assessed against the total market size of that particular instrument. However, risks which are not reflected in fair values should be, as much as possible, treated in the framework of the relevant risk type and not mixed with additional valuation adjustments.

The fair valuation basis for IFRS purposes should be used also for capital requirement purposes. The introduction of another "prudent" fair value does not necessarily enhance reliability for financial statements and promote market confidence. Having two differently designed values (prudent and fair value) might lead to uncertainties and confusion. In addition two different values for the same position will lead to quite complex risk-return analysis, and, as a result, it will significantly complicate risk management. Indeed, this could become a problem for regulators and investors alike.

Taking into consideration the CRR framework

As previously mentioned, only risks that are not reflected in the fair value calculation in accordance with IFRS 13 should be considered. However, the risk factors not reflected in the fair value should be treated together with the respective risk type in accordance with CRR and not as additional value adjustments. Operational risks, concentration risk and model risks are treated in the capital framework. Unearned credit spreads are appropriately treated by the CVA capital requirement. These should not be addressed as a deviation from fair values. Moreover, some of the risks are already covered by capital requirements. Considering them for the purpose of prudent valuation would lead to a double counting of such risks.

Proportionality and Relevance of Measures for Strengthening the Resilience of EU Financial System

A detailed and far reaching standard will result in burdensome requirements that might bring little added value to strengthening the resilience of EU financial system. The regulatory requirements now being discussed are a response to specific irregularities at comparatively few distinct institutions. Such specific irregularities seem to have appeared in the case of a certain business model or structure. Hence, applying the new requirements to all institutions in the same way does not seem to be the best approach.

Additionally, smaller institutions using fair valuation under the relevant accounting framework may not the have human resources, the modelling expertise and/or the amount of data required for the calculation of AVAs. This is particularly relevant for institutions applying the standardised approach for the calculation of the capital requirement for market risks, or simple models to calculate the value adjustments on positions outside the trading book. The appropriate development of a prudent valuation model, as suggested in the discussion paper, would be too costly for such institutions, especially when most of their positions are Level 1 according to the fair value hierarchy. Moreover, it might lead only to insignificant changes as compared to the fair value determined in accordance with IFRS 13.

Therefore, we propose that the prudent value should be based on the fair value definition of IFRS 13 and basic requirements related to such value. Any value adjustments should rather be due to either entity specific items or due to a gap between national accounting and IFRS, rather than having a separate methodology of calculating such adjustments. A proportionality principle should be considered and also appropriate exemptions for certain types of assets. The proportionality principle could be aimed at institutions with small trading book business, subject to the derogation for calculation of market risk of article 89(1) CRR and to all non-material portfolios of less than 1% of institution’s total asset.

EACB would like to draw your attention to the case of fair value option according to IAS 39 9(b)(i). Some institutions use the fair value option according to IAS 39 9(b)(i) in order to reduce accounting mismatches that would otherwise occur. This is for example the case of Danish mortgage banks where non-traded mortgage loans are designated at fair value in order to exactly match the accounting value of the bonds that fund the loans exclusively. Consistent with article 30 (b) of CRR, additional value adjustments do not alter the own funds of these institutions, as the prudent value adjustments apply to both sides on the balance sheet, while changes in own credit standing of the institution are not included. In this way any additional value adjustments on the assets will be offset by a corresponding additional value adjustment on the liabilities.

Taking into consideration the proposal of High-level Expert Group

We also refer to the proposal by the High-level Expert Group to the Europe Commission to assign proprietary trading and other high risk trading activities into a separate legal entity if the activities amount to a significant share of the bank’s business. In case this proposal will be followed up by the European Commission, it would be necessary to reconsider its impact on article 100 of the CRR.

ANSWERS TO SPECIFIC QUESTIONS

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?

I. Proportionality Thresholds

The principle of proportionality should indeed be appropriately reflected, taking into consideration the nature, scale and complexity of the business. This could help determine whether there is a supervisory relevant risk that can be effectively countered by means of additional value adjustment to the fair values.

1. Thresholds for Smaller Banks to Establish a Prudent Value

Small institutions, have regionally focussed traditional deposit taking and SME lending business models and the size of such risks is not significant. Thus, the relevance for strengthening the financial resilience by applying the prudent valuation requirements to such small banks is very limited.

Calculating prudent value adjustments in the case of small banks with relatively small amounts of assets measured at fair value brings little added value to the supervisor's objective, while being complex and difficult for those small institutions. The minimum elements required for AVAs require substantial new data collection systems, controls, procedures and costs of IT system changes. Small banks usually use the standardised approach for market risks and may not have the modelling expertise and/or the data required for the calculation of the described modelling techniques. The benefits of such efforts are insignificant in case of small banks that normally do not have trading books and have little assets in their books that will need an additional correction to the fair value.

Therefore we propose a waiver for banks which are also subject to the derogation for trading books business according to article 89(1) CRR with "the size of their on- and off-balance-sheet trading-book business meeting the following conditions:

(a) is normally less than 5% of the total assets and €15 million;
(b) never exceeds 6% of total assets and €20 million."

2. Thresholds for Non-Material Portfolios

Non-material portfolios of certain assets of less than 1% of institution's total asset should also be exempted from application of the prudent valuation. An impact study on the appropriateness of the level of such threshold for non material portfolios could be foreseen.

II. Additional Proportionality Considerations

Furthermore, we would like to propose way of applying the proportionality criteria in the following contexts:

1. IFRS Banks

As mentioned in the general comments the IFRS 13, to a large extent, already fulfils the objective of a prudent valuation. In the case of IFRS banks, additional requirements could be foreseen only for entity specific information not covered by IFRS 13, such as for example the amount of the entity's holding in a financial instrument when assessed against the total market size of that particular instrument. This is not foreseen in the accounting standard which uses the unit of account and values each instrument individually.

However, entity specific risks which are not reflected in fair values should be, as much as possible, treated in the framework of the relevant risk type and not mixed with additional valuation adjustments.

2. Non-IFRS Banks

For banks using the national GAAP, the standards should take into consideration the already existing national rules. In some countries there are national rules in place which in some cases could be considered as an even more prudent concept than the EBA proposal.

- EACB appreciates that the EBA standards are not applicable to assets for which the valuation basis is the lower of cost or market (LOCOM);
- In case fair value is applied and in case of material portfolios for a bank that doesn't qualify for the above proposed waiver, a fair prudent definition needs set which takes into consideration the nature, scale and complexity of the business. Therefore, we propose that the prudent value in this case should be roughly based on the fair value definition of IFRS 13 and basic requirements related to such value. Any value adjustments should only be due to a material gap between national accounting and the proposed definition, rather than having a separate methodology of calculating such adjustments.

However, these adjustments should only be calculated for items that are not already covered in the framework of capital requirements. Moreover, in case of small banks using national GAAP, the additional requirements for valuation should be less frequent, reflecting the nature, scale and complexity of the business.

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.

The exit price should indeed not be based on an instantaneous sale. This would be in line with the exit price definition of IFRS 13 as well. IFRS 13.24 requires the use of the exit price as a basis for fair value.

During the most recent crisis, we experienced that, when markets are stressed, valuations are not representative due to a lack of liquidity. However, after the first shock, market prices tend to recover quickly, with the exception of positions that were affected by a significant increase in credit risk.

Taking into consideration an instantaneous sale could lead to short-termism and possibly accentuate a fall in value of an asset and cause an additional pro-cyclical element in financial markets due to regulatory capital requirements.

Moreover, a price based on an instantaneous sale is a liquidation view on fair value portfolios. In our view this is not supported by the CRR wording.

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?

The EBA should not set a specific time horizon, given the diversity of financial instruments and development of financial markets. Moreover, a timeframe for determination of the value could suggest a forced sale (instantaneous sale) which is a liquidation value rather than a usual price for closing a position. The value should rather reflect the approach of IFRS 13 where the exit price is determined at the measurement date but does not mean that the position is closed. The objective of supervisors in this case could better be achieved in the assessment of the market risk capital requirement where the illiquidity of a position is already reflected. The institution's internal risk management system should be reflected in this case, taking into consideration the individual ability to react (for example market access, decision channels). Authorities evaluate the effectiveness of the internal risk management systems during the Pillar 2 assessment (CRD IV implementation/ Basel II).

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?

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?

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?

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?

Q4 - Q7:

EACB does not support the use of a specified confidence level to determine AVA, as it seems impractical. Normally, there isn't a vast range of quotes or possible market values available. Therefore, the size of the sample which also depends on the size of the market may not be large enough to interpret and validate the confidence level or be insufficient to perform a statistical analysis.

Moreover, the uncertainty is particularly high for financial trading positions that are traded in markets that are not sufficiently liquid or transparent. When there is a confidence level set, it will be hard for institutions to demonstrate that, for certain valuations, the estimated value is falling within the confidence level.

The application of a confidence level (especially in light of examples in Annex 1 and 2 of the discussion paper) means that all fair value positions will not be viewed at expected value but rather at a stressed value (taking into consideration unexpected losses). This is in our view inconsistent with CRR text which does not explicitly refer to such a confidence intervals nor to stressed values.

If, contrary to our proposal, the RTS will specify a confidence level, judgemental approaches could therefore be more appropriate. However, judgemental approaches will lead to different methods being used in practice. These reduce comparability among banks. Therefore, some guidance to judgemental approaches could be useful and also some examples on how to do the validation. Additionally, an impact assessment could also be appropriate to reflect what will be the cost, effect on comparability and whether the methodology could actually fulfil the objective of supervisors.

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

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

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?

Q8 – Q10:

The implementation of IFRS 13 will already enhance the use of external data sources, like, for example, the use of market observable credit spreads. Also it will already enhance the amount of description, especially in the case when the level of activity/volumes of the financial markets have significantly decreased.

We don’t think there is the need for additional price sources or description on how to use them in the case of banks using IFRS. The additional benefits of employing prudent valuation seem to be immaterial, especially in the case of banks using IFRS.

In the case of smaller banks using national GAAP, some general criteria and restrictions for using the alternative methods would be useful and should be part of the technical standards in order to avoid any mistreatment and misunderstandings.

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

In response to this question, we would like to remind that the natural indicators of market uncertainty would be high historical volatility, low trading volume, and wide bid-offer spread which are already reflected.

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?

Double counting should be avoided as much as possible. Unearned credit spreads are appropriately treated by the CVA capital requirement. Since the calculation of the CVA capital requirement is mandatory for all institutions, it should not be additionally reflected in an AVA.

In addition, potential operational risk events are covered by a separate capital requirement. In case necessary, supervisors could consider to define a higher capital requirement for operational risks, instead requesting the calculation of AVAs for operational risk. In this way overlaps and complex offsetting is also avoided.

A quantitative example for AVAs calculation could be useful to clarify any approach proposed.

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?

The described adjustment for investing and funding costs is conceptually difficult to implement. Moreover, it is unclear why funding costs should be considered for the prudent valuation. For positions that are valued at fair value and are funded by fair value positions, the funding costs are already included in equity (as result for the period). For fair value positions that are funded by positions at amortized cost, the accrued interest cost are already in equity and therefore included in the valuation.

The investing and funding costs adjustment should be limited to collateralised derivatives concluded with non-professional counterparts. However, it should be taken into account that the pricing of derivatives with these counterparts normally includes a mark-up to cover for funding cost, that should be reserved for.

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?

In practice, valuation uncertainties under IFRS or GAAP are the highest for instruments that are rarely traded. Thus, determining the appropriate price for a subsequent sale as proposed in the discussion paper is largely hypothetical and hardly feasible. Moreover, the proposed testing is a rather complicated methodology. EACB does not support a complex validation of the AVA.

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?

Given the wide variety of financial instruments, market infrastructures, models, data sources, yield curve building, IT applications, banks have developed their own systems and methodologies. Thus, we believe it is not feasible to have very prescriptive RTS. However, principles and general guidance and examples for validation of AVA should be provided.

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?

As currently drafted, the prudent value is intended to counteract uncertainties about the true value of positions. This is necessary to avoid sudden losses due to a drop in value of positions in times when the markets experience dramatic reductions in liquidity. Thus the prudent value should not be higher than the fair value, including fair value adjustments at both individual position and legal entity.

Q17:
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.

Q18:
If simple aggregation better reflect your assumptions and practices or would 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?

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?

Q17 – Q19:

To some extent a simple aggregation might be appropriate, as correlations between prices for financial instruments in stressed market conditions tend to increase. Nevertheless, we believe that the diversification benefits should be taken into account for the portfolios that the institution manages as a unit.

In case diversification is considered, we suggest allowing for an in-house approach and a simplified standardised approach for institutions unable to reliably quantify the diversification benefit.

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)?

In principle, the design of the requirements should avoid overlaps with other capital requirements as an offset is difficult to assess and implement. Subtracting additional prudent valuation adjustments from equity, for risks that are already covered under regulatory capital calculation for trading books or operational risk, leads to double counting and is inconsistent with the Basel III framework. Therefore, we support the view that AVAs should be aimed only at risks that are not treated elsewhere in the capital framework.

In case it is not possible avoiding overlaps, offsetting should be allowed.

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?

In view of this question, we remind that the proportional treatment should be taken into account.

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?

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

Q22 - Q23:

In principle, it seems sensible to stipulate a particular format, as appropriate instructions and Q&A possibilities help a better understanding of the framework. However, in practice, it might turn out that having a unique AVA methodology and reporting format might be unrealistic. In any case, it is too early, to define such a template, as there are many issues that need to be clarified and finalised.

In case a single format is followed, it is important, that it incorporates sufficient flexibility to allow taking into consideration different circumstances of institutions.