European Association of Public Banks

– European Association of Public Banks and Funding Agencies AISBL –

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EAPB opinion on the discussion paper "relating to Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR)" (EBA/DP/2012/03)

Dear Sir or Madam,

The European Association of Public Banks (EAPB) is pleased to comment on the EBA discussion paper "Relating to Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR)". The EAPB welcomes the publication of the draft standards. However, we believe that the ideas would lead to huge efforts which are not appropriate given the little added value of the measures. Moreover, some of the required costs and risks which should be covered in the AVAs are already covered in the fair value approach (e.g. bid/ask spreads). It is important that the EBA makes clear where the prudent valuation deviates from the fair value under IFRS 13 and to what extent the risks are not already captured through the risk weighted assets.

In the following, the EAPB addresses a selective number of the questions in order to highlight its main concerns. Of particular importance for our members is question 4.

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 introduction of a (de minimis) threshold. We also support the intention of the EBA to introduce an a priori rule that does not require the affected institutions to calculate valuation adjustments right from the beginning. For the structure of the de minimis threshold we suggest to direct the ratio of fair value positions to the institution's total assets or capital. In order to have a relevant threshold, the scope of assets subject to AVA calculation should be limited. In particular assets, which are part of the High Quality Liquid Assets (HQLA) and assets which are valued at fair value in order to avoid accounting mismatches should be excluded. It is important that the threshold can be easily determined by the institution and that it can be quickly calculated. It should not lead to any additional complexity.

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?

In our opinion, caution should be applied in the determination of a level of confidence. In any case, such a statistical approach should only be applied if corresponding data is available. It is, moreover, indispensable to have sound conceptual reasons at hand which clarify why the worst quotes should be used for the quantile estimate of the market price uncertainty on a confidence level basis. The selling institution will usually select the highest offered price among the various prices quoted by possible counterparties (with allowance for their liquidity) and conclude the transaction at that price. Therefore, it is not plausible to apply the same probabilities for all the available quotes. In addition, with respect to the quality of the models it can be assumed that the values at the lower end are of a poorer quality than those in the centre of the distribution. Hence, we object the quantile concept for determining AVAs even if there is sufficient market data available. A "best available estimations" approach should be applied instead.

Furthermore, in almost all cases it is expected that the level of confidence will not be able to be calculated due to a lack of data since a statistical process only supplies robust results if there is a sufficient data basis for the calculation. Where there is an inadequate data basis we see the problem of a large estimation error in the determination of AVAs, which would lead to an unjustified fluctuation in measuring the risk. Hence, it would also result in an inappropriate accuracy for the affected institution, the supervisory agency and third parties which could not be corroborated due to the lack of data (for example, we fail to understand how a statistical procedure can be expected to deliver a reliable 95% interval with only 15 data points). In this context, it should also be borne in mind that the industry lacks sufficient experience for determining valuation adjustments.

Particularly in case of a quantile estimate based on expert opinions for market-to-model positions we fear unreasonable and too high safety loadings. In addition, we see a risk that various banks – even with the consent of their supervisors – will come to very different estimations. That would thwart consistent European regulation. In our opinion, AVAs which reflect uncertainties in valuation should be largest in illiquid markets. However, precisely in those cases, a reliable estimation of a large quantile will not be possible due to a lack of data. In addition, expert-based distribution functions cannot be drawn up for certain AVAs. This includes, for example, model uncertainties.

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

If the EBA does not wish to fully dispense with the definition of a level of confidence, we explicitly favour that a lower level of not more that 75 – 80% will be applied. This would also alleviate the problem discussed under question 4. In return, an aggregation approach that

allows for diversification is perhaps not needed, provided that potential overlaps between individual criteria could be ruled out (please see also our remarks on aggregation).

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?

In our opinion, it should be left to the institution to decide on the positions for which they can and want to carry out a statistical calculation of the valuation adjustments. The necessary number of data points can vary from instrument to instrument, and hence the institution would have to justify the decision it has taken. In this case, other factors could then be included for case-by-case decisions. Likewise, the institution should also be permitted to demonstrate that no valuation adjustments at all are needed. For example, certain OTC derivatives tend to have narrower bid/ask spreads than certain exchange-traded products. Here it should be possible to forego a mark-down for closing costs.

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?

As already discussed, quantile rules should be avoided in general.

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

We do not welcome this idea. Every description of how to use certain data sources entails a risk of distortion. Such distortions can pose a danger in practice.

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?

The data basis in the discussion paper is already sufficiently prescriptive. Rather than to extend the list, we would favour transferring responsibility to the individual institution. This can then apply to sources suitable for the specific product.

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

The "bid-offer-width" could be included in the analysis.

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?

We do not believe that this is a useful tool. A test based solely on the number of "prudent valuations" compared with "imprudent valuations" ignores the magnitude of the "imprudent

valuations". Since the discussion paper already admits that AVAs cannot be statistically calculated for many instruments, we see no additional value in a statistical review of those expert-based estimations. At the same time, it makes little sense to demand a test solely for the statistically calculated values. We assume that even without explicit back-testing a qualitatively good best practice will emerge from the oversight by the supervisory agency and auditors. Since, as argued above, neither the benefit nor the practicability of this additional complexity layer is apparent, we believe that the test approach is not necessary.

In practice, however, the determination of AVAs often has evidence at the portfolio level but not at the level of individual transactions. In our opinion, the determination of AVAs at the portfolio level is acceptable in principle, but leads to problems in the testing approach. If no AVA is assigned to an individual transaction a priori, it will be hardly possible in practice to determine the "ex-ante change in value" for a transaction. Under the proposed system, this would require the portfolio's AVAs to be determined with and without the actual transaction. This requires too huge an effort.

In the proposed test approach, the prior day price is to be compared with the actually traded price and is then to be compared with the valuation adjustment. We do not believe that this approach should be used as the standard procedure because the comparison does not contain any particular information. Due to the time lags, market changes cause "market contamination". In addition, the circumstances that apply when an institution sells a position are different for each transaction. A plain-vanilla test approach would not be beneficial to achieve the goal.

Institutions face an exorbitant effort when using the proposed test approach. Since all marked-to-model positions ought to be included it would, for example, also have to be applied for swaps with non-standardised maturities. Re-evaluating all those positions, some of them a hundred times, would be beyond the capacity of many institutions.

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?

As in other areas, the RTS should be sufficiently prescriptive so as to avoid misunderstandings and impractical requirements. We believe that the trade-off between the necessary requirements and sufficiently taking into account the institutions' individuality is a problem which calls for a practicable solution. On the one hand, achieving comparability across institution boundaries requires the definition of a minimum level of clear requirements and procedures by the supervisory bodies. On the other hand, the particular characteristics of the institutions and their scale of trading activities have to be kept in mind in order to find individually reasonable solutions.

17. 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.

Diversification effects of AVAs relating to the position should undoubtedly be permitted. Many of the individual causes stated contain either substantial overlaps (e.g. market price uncertainty and model risk) or are uncorrelated (e.g. model risk and concentration risk). We assume that the discussion paper already implies that institutions can take such overlaps into consideration during their calculations.

The definition of a supervisory standard procedure for aggregating AVAs seems most compatible with the EBA's goal of achieving a "level playing field". This would help the institutions to save the effort for deriving, demonstrating and documenting the applied methodology. Institutions should nevertheless be permitted to apply an internal method if they can demonstrate that the standard approach would result in significantly distorted values. It would undoubtedly make sense to use existing internal market risk models that have already been approved by supervisors.

The definition of a level of confidence that should apply at both the level of the individual AVA components and the overall AVA of a position does however raise certain questions. A simple aggregation of individual AVAs to a 95% level of confidence would lead to an unreasonably high AVA for the overall position if the diversification is not considered. An aggregation approach allowing for diversification could, in an ideal situation, avoid this problem. In practice, however, it may be impossible to prove the appropriateness of such an approach from the content perspective. Here, we fear that there will be a considerable additional effort which brings little added value for the content aspect. Therefore, we refer to our suggestion above which says that a level of confidence of 75 to 80% should be applied, and advice a simple summation on that basis. We believe that this is a significant trade-off; in particular against the background that aggregation with diversification would hardly prove to be robust and thus presumably lead to a significant portion of "arbitrariness".

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)?

In principle, the aim should be to define regulatory requirements in such a way that there are no overlaps. Where there are clear overlaps, offsetting should be possible. I would be even better to drop AVA requirements e.g. for "unearned credit spreads" and "operational risk". If the institution can demonstrate other overlaps, the AVAs should be reduced accordingly.

In addition, we would like to point out that AVAs can also have an impact on pillar II. We therefore ask to make allowance for the interactions with ICAAP.

The European Association of Public Banks (EAPB) directly and indirectly represents about 100 public banks from nearly all European countries, with a total market share of 15%. The EAPB represents promotional banks, financial agencies, export financing institutions and other public banks with special tasks and under public control.