

Submitted by e-mail to [EBA-DP-2012-03@eba.europa.eu](mailto:EBA-DP-2012-03@eba.europa.eu)

11 January 2013

Dear Sir/Madam,

Response to Discussion Paper Relating to Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR)

Deloitte LLP welcomes the opportunity to comment on the European Banking Authority (EBA) Discussion Paper (DP) on Draft Regulatory Technical Standards on prudent valuation, under article 100 of the draft Capital Requirements Regulation (CRR) ("EBA/DP/2012/03").

In responding to EBA/DP/2012/03, Deloitte LLP has sought views from Deloitte member firms in Germany, Deloitte & Touche Wirtschaftsprüfungsgesellschaft GmbH and France, Deloitte SA, which have been incorporated into this submission.

If you would like to discuss further any of these issues, please contact me on +44 207 303 8991 or Jim Leonard on +44 207 303 5948 or David Roberts on +44 207 303 7117.

Yours faithfully



Tom Millar

Partner  
Deloitte LLP

## EXECUTIVE SUMMARY

The primary objective of fair value measurement in accordance with International Financial Reporting Standards is the provision of an unbiased, neutral view of the firm to stakeholders. We recognise that this may differ from the objectives of prudent valuation as required for regulatory capital purposes and agree that this difference in valuation basis is best dealt with through a prudential filter such as the proposed prudent valuation adjustment.

In order to avoid any undermining of the financial statements, we believe that the Regulatory Technical Standards should clearly articulate how the “prudent valuation” basis differs from IFRS. If regulatory valuations are misinterpreted as being more reliable due to the higher level of confidence required, rather than it being understood that they are prepared for different purposes, this may have an overall detrimental impact on the perception of financial reporting of firms.

We are concerned that the DP as drafted does not clearly articulate the differences between the two valuation bases<sup>1</sup> and additionally, uses terms that are defined and recognised in accounting standards, such as ‘exit price’, in a different sense, which could lead to confusion. Additional work is required by the EBA to define their intended valuation basis and to clarify certain statements in the DP, for example ‘... should reflect exit prices at which the institution can transact within the time horizon for capital purposes’. In particular, it is unclear where the EBA intend this exit price to fall in a range from an instantaneous liquidation to the orderly disposal under the going concern principle required by accounting standards. We would expect the regulatory exit price to fall in between these two points and believe that further work is required to define exactly where this point is.

The majority of a firm’s valuation uncertainty typically resides in positions where there is little, or no, trading in similar positions. We therefore believe that the use of a confidence-interval-based approach is not relevant or helpful in such a case. We recognise that this may serve as a useful tool to help define how the prudent valuation may be different from the fair valuation for accounting purposes, but feel it should not be used as the fundamental basis for the calculation.

The paper helpfully sets out certain Additional Valuation Adjustments (“AVAs”) which must be considered when calculating the prudent valuation adjustment by individual firms, for example, unearned credit spreads and close-out costs, which can typically be the source of some of the greatest uncertainty. However, the paper does not go as far as prescribing, or even providing examples of, how a ‘conservative’ prudent valuation adjustment may typically be calculated. If one of the EBA’s objectives is to increase consistency in valuation between firms and reduce some of the perceived inconsistency permitted by accounting standards, this would suggest more prescriptive requirements may be necessary for regulatory purposes.

However, while we recognise that methods applied by firms to determine fair value in line with generally accepted accounting principles can produce varied results, we continue to have some reservations about a fully prescribed valuation approach based on overly detailed rules for financial statements and capital returns. The illiquidity of certain instruments means that differences in valuation are likely to remain as there will be real differences in each firm’s market access and their ability to exit these positions. Valuation measures also may range in subjectivity based on data available to each individual market participant.

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<sup>1</sup> As a consequence the paper does not identify clearly the adjustments that would already be considered by banks in the assessment of FV accounting measurements. For example, unearned credit spreads, model risk, and market price uncertainty are already part of IFRS 13 FV measurement principles; however, adjustments for operational costs, early termination penalties, future administrative costs, concentration and liquidation costs are typically not.

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Moreover, attempts to standardise capital adjustments for additional valuation prudence will not provide immediate consistency and comparability, as the underlying data around valuation uncertainty will still be measured and evaluated using a range of subjective parameters and techniques. Only after detailed assessments on specific asset types, parameters and models can reasonable observations across the industry be presented. As such, this continues to be an iterative journey of discovery and examination with each firm and the industry as a whole.

For example, there is a wide range of views and practices in regard to the calculation of unearned credit spreads across Europe, which is likely to lead to materially different AVAs being calculated and inconsistent prudent valuation adjustments.

Regulatory authorities should recognise the need to commit to providing quantitative and qualitative benchmark information to the relevant industry participants. As recipients of this information regarding the prudent valuation measurements, regulatory authorities in their role as supervisors will have the sole ability to identify and communicate issues with compliance with standards or significant inconsistency of application between firms. As such, they will owe a duty of care to provide timely and meaningful feedback to industry participants and users of this financial information.

We have provided comments against relevant questions below, while we have not sought to provide responses to certain questions that we believe are most appropriately responded to by the banking industry.

## RESPONSES TO QUESTIONS RAISED IN THE CONSULTATION PAPER

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.

- While the term “exit price” according to IFRS implies a disposal of fair value positions as if such was “instantaneously” concluded at the reporting date it does not mean an immediate forced liquidation of all fair value positions.
- In this regard, **yes**, we believe that exit price need not be instantaneous in the meaning of a forced liquidation as:
  - It would be unlikely that a firm would need to instantaneously liquidate its entire balance sheet.
  - This measurement is likely to be difficult to quantify for large positions.
  - It is more likely to be impacted by changes in market liquidity and therefore need constant remeasurement by firms.
  - And it seems to be overly conservative.

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?

- We believe it would be helpful to establish a specific time horizon when assessing prudent valuation as this would help to distinguish the valuation from accounting valuation.
- Time horizons could be set in a variety of ways of increasing complexity. For instance, one may consider one time horizon for each Level of valuation, the time horizons to be introduced by the Fundamental Review of the Trading Book, those used under Pillar II, etc. Having said that we believe that a less complex solution would enhance transparency, and perhaps comparability and a level playing field.

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?

- No, we do not support the use of a specified confidence level to quantify an AVA for the reasons set out in the Executive Summary.
- In addition, the vast majority of valuation uncertainty relates to positions where there is little or no independent pricing information and therefore it is not possible to calculate a statistically meaningful valuation.
- For some positions, notably unearned credit spreads (CVA), even an ordinary assessment is very difficult, such that a prudent, VaR-like assessment is tremendously difficult to achieve.

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

- Yes, as we believe the definition of prudent value is not sufficiently clear from the discussion paper.
- In the absence of confidence based measures, which we believe are likely to be inappropriate due to lack of availability of information, there is limited guidance as to how the prudent valuation should be calculated.
- We think that, especially for illiquid positions, not all available data can be deemed reliable. We would therefore appreciate more guidance on how to define “plausible” prices.

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?

- Yes, we believe that as currently written, the discussion paper provides less prescriptive guidance than accounting standards and it may serve to increase inconsistency in valuation, rather than decrease it.

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

- Currently, no further such indicators have come to our attention.
- It is important to note that the presence of the factors listed is not conclusive evidence that there is large market price uncertainty, but rather that it should be considered.

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?

- We believe that the approaches are reasonable; however, more guidance may be required to ensure that they are consistently applied across all firms within the EBA's remit. For example:
  - Unearned credit spreads – more guidance may be necessary as to the range of alternative approaches that could be considered, including the impact of using current market implied probabilities of default as opposed to historic.
  - Close-out costs – further guidance and examples of appropriate netting approaches and kind of evidence required to support them may be appropriate.
  - Operational risk and balance sheet substantiation – we consider that these AVAs are less relevant to the concept of prudent valuation and appear out of place in the RTS DP and could potentially lead to double counting of other capital charges.
  - Future admin costs – guidance on the differentiation between the costs to hedge the portfolio and the costs to sell it would be beneficial. Additionally, we consider that, future administration costs can be earned by the carry of the portfolio; it remains unclear why this is an AVA.
  - Concentration and liquidity – we think that more guidance on the determination of the prudent exit period is needed as this period and the exit strategy do have a material impact on the price that can be realized.
- Irrespective of the need for further clarification, the proposed rules are complex and an alternative, simplified set of rules might be considered. That may help enhancing comparability amongst banks and reducing implementation costs. The principle based nature of proposed rules may challenge those banks that mostly apply standard approaches under capital requirements rules, for whom a prescriptive simple rule set might be a preferable option.

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 principle, if 'fair value' refers to the accounting definition, which is an unbiased estimate, then prudent value should in theory never be higher than fair value for (net) assets and never be lower for (net) liabilities.

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?

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- This list seems broadly reasonable. We believe the most important points are providing clear reconciliations between prudent value and fair value and clearly explaining the management why any adjustments taken to prudent value should not be considered for fair value.

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