Standard Chartered

8 October 2013

EBA
Via webpage

Dear Sir/Madam

Response to the EBA Consultation Paper on Draft Regulatory Technical Standards on Prudent Valuation under Article 105(14) of Regulation (EU) 575/2013 Capital Requirements Regulation (EBA CP/2013/28)

Standard Chartered appreciates the opportunity to comment on the EBA consultation paper on the draft Regulatory Technical Standards (RTS) on prudent valuation. Standard Chartered has also contributed to and supports the ISDA and AFME industry response to this consultation paper.

Standard Chartered recognises the need to harmonise prudent valuation practices and welcomes the EBA’s efforts in formulating this RTS to provide clarity across the industry. We have a comprehensive prudent valuation framework which has been developed based on detailed discussions with the UK Prudential Regulation Authority over the last three years.

Standard Chartered is pleased that significant enhancements have been reflected in the draft RTS. These significant enhancements include:

- ***Stating the minimum standards required for valuation governance (Article 19).*** We strongly believe that these minimum standards will provide sufficient rigour and reflect best market practice. This is also consistent with the valuation governance principles implemented within Standard Chartered.

- ***Recognising diversification benefits (Article 17.3).*** We are pleased that the draft RTS recognises diversification benefits. The recognition of diversification benefit encourages prudent hedging practices and avoids the build-up of concentrated positions within each institution or across the industry.

- ***Permitting institutions to prove zero market price uncertainty (Article 8.2).*** We are of the view that the test of zero market price uncertainty is reasonable and objective. This test ensures that liquid instruments with high quality pricing inputs and immaterial valuation uncertainty will not attract unnecessary additional valuation adjustments (AVA). Excluding liquid instruments from AVA deductions incentivises institutions to continue to provide useful financial solutions in such instruments.

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On the other hand, we recommend that the EBA consider the following points of discussion. These points of discussion could be subject to further industry consultations, in order for consensus to develop around the potential resolutions. In particular, we recommend that the EBA consider the following:

- ***Incorporate a more principles based approach to take account of the evolving nature of capital computation rules.*** We recommend that the EBA adopt a more principles based approach in the RTS to take into account of the evolving nature of capital computation rules, which affect the carrying value of the same financial instrument contributing towards the institution's Common Equity Tier 1 (CET1) capital. A more principles based approach avoids pockets of inconsistency which will invalidate the purpose of levelling the playing field across institutions. For example, given the different CRDIV transition periods between AVA and unrealised gains on available-for-sale positions, the same financial instrument will have different carrying values reflected in institutions' CET1 capital for factors unrelated to prudent valuation considerations, such as whether the institution has booked a profit or loss on the same financial instrument or whether the financial instrument has been classified as held-for-trading or available-for-sale.

- ***Incorporate an adequate implementation period after issuance of the finalised RTS***. We are of the view that institutions should be given sufficient time to implement the prudent valuation requirements after issuance of the finalised RTS, as the actual system and process changes required would not be known until the issuance of the finalised RTS. The determination of AVA is a complex exercise and setting an unrealistically short timeline would backfire, leading to the undesirable effect of institutions not able to build and implement adequately reliable systems and processes for AVA reporting.

- ***Acknowledge the limitations of external market data information in developing expert based approaches where insufficient data exists***. We are pleased that the RTS allows an expert based approach where insufficient data exists for the calculation of market price uncertainty AVA and close-out costs AVA. However, we would like to highlight to the EBA that given the expert based approach is applied where insufficient data exists, the lack of comparability of available external market data points (whether in terms of reliability or relevance) should be kept in mind. Regulators should acknowledge the limitations of external market comparable data when institutions adopt expert based approaches.

- ***Allow alternative options to the prescribed method to prove granularity of valuation exposures (Articles 8.4 and 9.5).*** The prescribed method to prove granularity of valuation exposures is difficult to achieve and overly burdensome to implement. Articles 8.4 and 9.5 require institutions to maintain two sets of records marked based on fair value inputs and prudent value inputs, resulting in substantial costs of implementation. Unless alternatives to the prescribed method are allowed, institutions will incur disproportionately high AVA calculated from the most granular valuation exposures. We view that institutions should be allowed to develop alternative options based on institutions' expert opinion. Such

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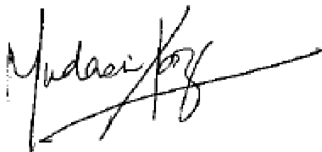
alternative options may include allowing the required proof to be provided based on a sampling approach and defining the granularity of valuation exposures based on standard market quotations.

- ***Allow alternative options to the prescribed ongoing monitoring method to assess valuation prudence (Article 20).*** We are of the view that the RTS need not be prescriptive in areas where established market practices are in place. Less costly and more effective alternative options (e.g. profit and loss attributions and trade reviews) than the prescribed ongoing monitoring method in Article 20 are available. In addition, the prescribed ongoing monitoring method in Article 20 is not an effective test of valuation prudence as it applies more to highly liquid positions by design and does not adequately consider market movements between quarters.

Please find attached our detailed response to the questions raised in the consultation paper. We would be happy to elaborate on any points made in our response if you require further clarifications. We look forward to participating in future consultations, including the upcoming Quantitative Impact Study (QIS), and to contribute towards the regulatory effort in establishing the industry standard for prudent valuation.

Yours faithfully,



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Head of Valuation Control

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RESPONSES TO QUESTIONS

Q1. Do you agree with the minimum list of alternative methods and sources of information defined above for expert based approaches? If not, what others could be included, or which points from the current list should be removed? State your reasons.

We generally agree with the market data types, alternative methods and sources of information listed in Articles 3.2 and 3.3. However, we suggest Articles 3.2 and 3.3 should be reworded as the current wording implies that the listed items have to be considered concurrently, regardless of relevance. Not all data sources have the same relevance or reliability, which will be dependent on market conditions, institution specific conditions and trade specific conditions. In addition, if a financial instrument is already priced at its natural bound, an institution need not consider prudent shifts to the valuation inputs. Finally, the wording of Articles 3.2 and 3.3 should leave the market data types, alternative methods and sources of information open. The markets are constantly evolving and having a definite list will not be advisable.

We propose Article 3.2 should be reworded as:

"The market data used to determine a prudent value shall *consider available and reliable data sources, including the following if relevant:*

a) Exchange prices in a liquid market;
b) Trades in the exact same or very similar instrument, either from the institution's own records or, where available, trades from across the market;
c) Tradable quotes from brokers and other market participants;
d) Consensus service data;
e) Indicative broker quotes; and/*or*
f) Counterparty collateral valuations."

We also propose Article 3.3 should be reworded as:

"For cases where an expert based approach is applied for the purpose of Articles 8 to 10, alternative methods and sources of information shall be considered, *including the following if relevant:*

a) The use of proxy data based on similar instruments for which sufficient data is available;
b) The application of prudent shifts to valuation inputs; and/*or*
c) The identification of natural bounds to the value of an instrument."

Q2. Do you agree with the introduction of a threshold below which a simplified approach can be applied to calculate AVAs? If so, do you agree that the threshold should be defined as above? State your reasons.

We agree that the introduction of a threshold is useful for the implementation of the simplified approach.

We propose the threshold should be refined by excluding off-balance sheet fair value assets and liabilities from AVA calculations. This exclusion will reduce confusion around what comprises ‘off-balance sheet’ and allow ease of implementation of the simplified approach.

Q3. Do you believe there are any practical issues with a parent institution being required to apply the ‘core approach’ to all fair value positions whilst a subsidiary is allowed to apply the simplified approach? State your reasons.

No, we do not see any practical issues.

Q4. Do you agree with the proposed simplified approach? Do you think the risk sensitiveness of the approach is appropriate? Are there alternative approaches that you believe would be more appropriate? State your reasons.

We recommend that the EBA modify the simplified approach by considering the following:

i. Remove references to “net unrealised profit” from AVA calculations.

Firstly, the inclusion of net unrealised profit in AVA calculations unduly penalises profitable institutions and favours less profitable institutions. Secondly, institutions which hold the same positions would have different AVA numbers due to different accounting basis in determining the cost of investment (LIFO, FIFO or average cost). Lastly, some institutions may manipulate the net unrealised profit number by closing off existing deals which are profitable and by entering into new deals in the same financial instrument.

ii. Remove references to “off-balance sheet fair value assets and liabilities” from AVA calculations.

As mentioned in our response to Q2, this exclusion will allow ease of implementation of the simplified approach.

iii. Introduce multipliers to balance sheet valuations of fair value positions based on accounting fair value levelling for AVA calculations.

Level 1 positions may have a zero multiplier and level 2/3 positions may have a non-zero multiplier. Level 3 positions may also have a higher non-zero multiplier than Level 2 positions as Level 3 positions are generally traded in inactive markets and have unobservable pricing inputs which are significant to the position’s overall valuation. For institutions where the local GAAP does not require fair value levelling, a common multiplier (e.g. 0.1% of sum of absolute value of fair value assets and liabilities) may be introduced.

Q5. Could a differentiated treatment for some asset/liability classes be considered, for example with regard to their liquidity? Please state the pros and cons of such a differentiation. How would you define the degree of liquidity of an asset/liability class (e.g. fair value hierarchy, eligibility for the LCR, other)?

Please see our response to Q4.

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We are of the view that a differentiated treatment may be considered by excluding Level 1 positions from AVA calculations. Such an approach utilises readily available information and keeps the simplified approach less complex to implement for institutions with smaller fair value positions.

Q6. Do you agree with the approach defined above to calculate an AVA where the approaches in Article 8 and 16 are not possible for a valuation exposure? If not, what other approach could be prescribed? Explain your reasoning.

We recognise that the intent of Article 7.4 is to impose punitive measures on institutions which have not implemented prudent valuation approaches considered acceptable to the regulators. However we strongly recommend that the EBA consider the following amendments to avoid unintended outcomes:

i. Remove references to "net unrealised profit" from AVA calculations

As detailed in our response to Q4, the inclusion of net unrealised profit in Article 7.4 is not sufficiently robust and will create undesirable consequences.

ii. Phase in an adequate implementation period

We urge the EBA to allow an adequate implementation period for institutions to implement the prudent valuation requirements after the issuance of the finalised RTS, as the actual system and process changes required would not be known until the issuance of the finalised RTS. The determination of AVA is a complex exercise. Setting an unrealistically short timeline would backfire and lead to the undesirable effect of institutions not able to build and implement adequately reliable systems and processes for AVA reporting.

Q7. Do you agree with the approaches defined above to calculate AVAs for market price uncertainty, close-out costs, and unearned credit spreads? If not, what other approach could be prescribed? State your reasons.

We support the overall approach to calculate AVAs for market price uncertainty, close-out costs and unearned credit spreads, with the following specific comments:

i. Zero Market Price Uncertainty AVA (Article 8.2)

We are pleased that the EBA is taking a balanced view in Article 8.2, by allowing institutions to exclude a position from market price uncertainty AVA calculations where the position is proved to have zero market price uncertainty. We share the EBA's view that the proposed tests of a liquid two-way market and materiality of valuation uncertainty from market data sources would reasonably demonstrate zero market price uncertainty.

ii. Granularity of Valuation Exposures (Articles 8.4b, 8.4c, 9.5b and 9.5c)

We are of the view that the requirements of the above articles to prove granularity of valuation exposures are too complex operationally and have limited benefits which would not justify the significant costs of implementation. We recommend that the EBA consider

alternatives by allowing institutions to either formulate their own methods to prove granularity of valuation exposures or provide the prescribed proof of granularity of valuation exposures based on a sampling approach.

iii. Zero Close-out Costs AVA (Article 9.2)

Close-out costs AVA should be required only when market price uncertainty AVA has been calculated based on exit price. We suggest the wording of Article 9.2 should be amended as follows:
"When an institution has calculated a market price uncertainty AVA for a valuation exposure based on *exit price*, the close-out cost AVA may be assessed to have zero value."

In addition, we suggest that the article incorporates an option for institutions to consider direct exit price of the portfolio, i.e. costs of selling the portfolio to another market participant, in addition to using bid offer spreads for valuation inputs in assessing close-out costs AVA. This will reflect the realities of the options available to institutions in the event that an institution decides to exit its portfolio.

iv. Expert Based Approaches (Article 8.5b and 9.6b)

We would like to highlight to the EBA that as the expert based approach is applied where insufficient data exists, the relevance and reliability of available but less comparable external market data information would be questionable. Regulators should acknowledge the limited usefulness of external market data information, given that the expert based approach is applied under circumstances of data insufficiency.

Q8. Do you agree with the approaches defined in Articles 11 to 16 to calculate the various categories of AVAs? If not, what other approach could be prescribed for each AVA? State your reasons.

We support the overall approach to calculate AVA from Articles 11 to 16, with the following specific comments:

i. Model Risks AVA (Article 11)

We generally agree with the draft article.

ii. Concentrated Positions AVA (Article 12)

We generally agree with the draft article with the proposed minor amendments:

- *Remove references to "typical daily trading volume of the institution".* An institution's ability to close out the valuation exposure is not reflected by its typical daily trading volume. An institution may choose not to trade certain positions on a daily basis for various reasons other than its inability to trade in the market.

- *Rephrase Article 12.2 to allow flexibility in determining the prudent exit period across asset classes.* The current wording of Article 12.2 implies that volatility

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of the valuation input, volatility of bid offer spread and the impact of the hypothetical exit strategy on market prices should be considered concurrently in determining the prudent exit period, which need not be the case for all trades.

- *Introduce different holding periods for trading book and banking book positions.* We agree that trading book positions may have a ten day holding period which is consistent with Article 365 of Regulation (EU) 575/2013. However, we view that banking book positions should have a longer holding period of one year due to the different nature of banking book positions and to be consistent with current capital computation requirements for the banking book. The EBA needs to be mindful of the dangers of specifying a shorter time horizon than market participants intended when they enter into such transactions. A shorter time horizon would imply stress conditions and curtail institutions' ability to provide financial solutions. This would consequently create a looping effect and increase hedging costs in the markets.

iii. Investing and Funding Costs AVA (Article 13)

We propose a slight amendment to Article 13.2 to emphasise that investing and funding costs AVA should be calculated based on expected contractual lifetime and not contractual maturity date of derivative trades: "Institutions shall estimate the AVA by including the expected funding costs and benefits over the *expected* contractual lifetime of each derivative trade which is not strongly collateralised".

iv. Future Administrative Costs AVA (Article 14)

We suggest that the article incorporates an option for institutions to consider the costs of selling the portfolio to another market participant, in addition to the costs of managing the portfolio over the expected life of the valuation exposures for which a direct exit price is not applied for close-out costs AVA. This will reflect the realities of the options available to institutions in the event that an institution decides to exit its portfolio.

v. Early Termination AVA (Article 15)

We generally agree with the draft article.

vi. Operational Risks AVA (Article 16)

As we have iterated in our response to the discussion paper on prudent valuation, we view that this article is a duplication of operational risk capital. We view that the current operational risk capital computation rules and its related add-ons have covered any operational risk aspects (including those arising from balance sheet substantiation controls and legal disputes) related to fair value positions. In addition, it is not best practice that any "at risk" valuation amount identified through the balance sheet substantiation or legal dispute assessments should be reflected as a CET1 capital deduction, as such "at risk" valuation amount should be reflected directly in shareholders' equity.

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Q9. Are there cases where the above AVAs may have a zero value that could be defined in the RTS? If yes, please specify.

Given the evolving nature of capital rules, we view that the RTS should not specify an exhaustive list of AVAs with zero value. In addition, institutions should be allowed to prove to the regulator if AVA is determined to be zero for any AVA category.

Q10. Do you agree with the approach defined above for the aggregation of valuation exposure level AVAs within the market price uncertainty and close-out cost AVA categories? If not, what other approach could be prescribed? State your reasons.

We agree with the proposed aggregation method as it is simple and straightforward to apply.

Q11. Do you agree that category level AVAs described in Articles 11 to 16 within the core approach should be aggregated as a simple sum? If not, what other approach could be prescribed? State your reasons.

Please see our response to Q10.

Q12. Do you agree with the requirement for institutions using the core approach to implement the above ongoing monitoring tool as an indicator of the adequacy of data sources of valuation inputs used to calculate the AVAs described in Articles 8 to 10? If not, what other approach could be prescribed? State your reasons.

We see the rationale behind ongoing monitoring of valuation prudence, but we view that the proposed method in Article 20 is too prescriptive without considering other available methods to prove valuation prudence. The interpolation method proposed in Article 20.3 is also unlikely to shed light on whether the institution's implemented prudent valuation framework is sufficiently prudent by not adequately considering market movements between quarterly reporting dates. Given that the proposed testing approach is likely to be applicable to liquid trades with little or no valuation uncertainty, we believe that the costs of implementation of Article 20 will far exceed its benefits.

We view that alternative validation tests (e.g. trade reviews and profit and loss attribution) which are well developed in the market are more effective ongoing monitoring tools.

Q13. Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?

We are supportive of the consultation and generally agree with the benefits raised with suggestions for minor amendments, except for the following which we view would have excessive costs of implementation which would not justify the minimal benefits:

i. Granularity of Valuation Buckets (Articles 8.4 and 9.5)

ii. Ongoing Monitoring (Article 20).