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Swedish Bankers' Association

POSITION PAPER

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European Banking Authority

Draft RTS on prudent valuation under Article 105(14) of CRR

The Swedish Bankers' Association supports the comments on the consultation made by the European Banking Federation, EBF. However, the specific views of the Swedish Bankers' Association are stated in this paper.

General Aspects

Compared to the previous Discussion Paper we see several improvements, especially the introduction of the Expert approach, as it acknowledges that there are areas where data is not available and judgemental considerations are needed. However, we still see far too much emphasis on quantitative methods. It will be a costly exercise and it transforms the assessment of valuation uncertainty into a quantitative exercise focused mainly on liquid positions with low uncertainty. This is not desirable, neither to the banks nor the regulators.

For small currency countries, e.g. the Nordic markets, the strong emphasis on data collecting is an extra challenge. The number of active market participants is limited and so is the set of reliable price data. It is not increasing the quality of the IPV test to include indicative prices from semi-active market players. Instead focus should be on including the best available benchmark data in the IPV control, assessing the quality of this benchmark data, and subsequently make a judgemental assessment of the uncertainty in the control.

Instruments held in the banking book, like liquidity portfolios and strategic assets in treasury departments are fair value instruments but are not trading positions. Such instruments are of a buy-and-hold nature and it seems less relevant to have these instruments included in the prudent valuation approach. This is especially obvious for liquid asset that are required to be held to comply with the Liquidity Coverage Ratio (LCR). To penalise liquidity buffers by adding CT1 deductions related to these positions would be irrational. We therefore recommend excluding banking book instruments in the RTS.

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As capital and risk measures are interconnected, there is a risk of double counting if the prudent valuation is not taken into consideration when calculating the required capital.

Capital requirements for certain instruments are already being increased through the CRD IV. The prudent valuation will further increase the CT1 charge for such instruments. It should be considered if the combined effects will become too punitive.

Given that relevant fair value adjustments, affecting CT1, are already done to comply with IFRS valuation rules, and that additional increased capital requirements are on its way for instruments with uncertain value, it is recommended that potential additional AVA should be provided as an information item rather than a required additional deduction in CT1.

With growing concern we note that EBA's technical standards have a clear tendency to rely on increasingly complex technical specifications. It has to be stressed that complex specifications does not necessarily work better than simple rule of thumbs. The proposed core method in the EBA consultation on prudent valuation implies a heavy administrative burden without any reasonable gain in precision. Therefore, the simplified approach, without any arbitrary threshold, should be an option for all banks.

We find that the Simplified approach is too simple, as it ignores the fact that for some instruments the valuation uncertainty is higher than for others. We recommend that characteristics like e.g. Fair Value Hierarchy classification and LCR liquid assets eligibility should be considered in the Simplified approach.

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.

Banks should have the flexibility to choose the most adequate market data source. Having a number of sources in parallel is simply not feasible. It should not be compulsory to use the complete set of sources of information. If sufficient precision is achieved with a single (or a few) source it should suffice. Nevertheless, the list might be beneficial as examples to be used in the assessment.

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.
No, we do not agree with the existence of the proposed threshold. A threshold solely based on the size of the fair value assets and liabilities ignore that valuation uncertainty differs significantly across instruments, and therefore characteristics like e.g. Fair Value Hierarchy classification and LCR liquid assets eligibility should be included in the definition.

When comparing the Simplified approach with the alternative (default) approach described in Article 7, paragraph 4, it is obvious that the latter is considerably more punitive. We see no reason for having this big difference between the default approaches for small and big banks.

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.
In practice this means that all subsidiaries will have to follow the core approach. We do not agree with this. We believe the group does not need to recalculate the AVA of the given subsidiaries by applying the core approach if the simplified approach is admitted at the subsidiaries level. However, as we do not support the existence of a threshold, the question is not relevant.

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 support the idea of having a simple approach based on readily accessible accounting numbers. We believe that such a default approach should be applicable for all banks, so that they can choose to apply the simplified approach either for the whole balance sheet or for specific instruments or portfolios. To maintain the incentive for applying the core approach, we support that the simplified approach should be more punitive than the core approach.

We believe that 25% is a too high number to set for all assets, however we see the difficulties to set one single, appropriate, figure. One suggestion could be to have some kind of interval (say from 1-25%) where the appropriate level should be set after having assessed the quality of the portfolio based on for example the Fair Value Hierarchy, position size etc. The higher reliance of the values the lower the level of adjustment.

Regarding the level of 0.1% for the sum of the absolute value of on- and off-balance-sheet fair valued assets and liabilities we think that the same methodology could be applied. The simplified method may encourage banks in closing/entering new trades just to decrease unrealized p/l. Besides, the 0.1% charge on value is potentially significant for a fixed income portfolio and could threaten the business. Precise guideline on how to calculate unrealized p/l would be welcome.

We find it problematic that the AVA is based on unrealised profit since inception. This implies that the AVAs differ for identical instruments if they were not purchased at the same time. Especially for instruments traded in active markets this approach seems unjustified and very punitive.

Also, there might be a risk for overlapping between the prudent valuation framework and the Discussion Paper on Technical Advice on possible treatments of unrealised gains measured at fair value. EBA should take this into account.

Q5. Could a differentiated treatment for some asset/liability classes be considered, for example having 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)?
Yes. We believe that there are big differences between valuation uncertainty on e.g. Level 1 and Level 3 instruments, and we support that these differences are reflected in the Simplified and core approaches. Both the Fair Value Hierarchy classification and eligibility for the LCR are relevant features to include in the considerations.

One possibility is to introduce weights so that liquid positions have a low weight (perhaps even zero) and less liquid positions would have a higher weight.

Q6. Do you agree with the approach defined above to calculate an AVA where the approaches in Articles 8 to 16 are not possible for a valuation exposure? If not, what other approach could be prescribed? State your reasons.
As mentioned above we support that there is this default approach, which is less complicated than the Core approach. However, the proposed approach is extremely capital demanding. As mentioned above we see no justification of such a big difference between the default approaches for small and big banks respectively.

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.
As mentioned in our introductory remarks this very quantitative approach requires a large amount of data, which is problematic for banks operating in small currency countries. The number of active market players is small. Extending the number of prices in the IPV test to e.g. 10 would compromise the quality of the prices used. We put great emphasis on the quality of the benchmark data used in the verification rather than gathering as many prices as possible from less reliable sources. We welcome the so called expert approach, although we do foresee some challenges.

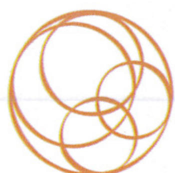
The quantitative approach will be costly to run and will result in limited AVAs for most liquid instruments. We do not see a reasonable balance between cost and the resulting small AVAs for many instruments, and we therefore suggest simplifying the quantitative models where possible.

We also would like to ask for clarification on the exact definition of market price uncertainty and its potential overlap with close-out costs.
We see it as important that EBA clarifies the difference (if any) between the AVA for unearned credit spreads and the CVA (Credit Values Adjustments) performed under IFRS13.

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 agree the AVAs described in Articles 11, 12 and 13 are important contributors to valuation uncertainty, and therefore their impact should be estimated, whereas we can see little justification of Articles 14, 15 and 16.

Collecting volume data for the quantitative approach on concentrated positions will be problematic as many instruments do not have objective volume figures easily available. Also, historical volume does not necessarily correspond to potential trading sizes. We recommend a less specific wording on the calculation to give room for more qualitative assessments.

The definition of the Future administrative costs AVA is very unclear. If the objective is to estimate the cost of running a fully hedged portfolio containing positions where exit prices are not available, this should be clearly stated. Otherwise, if this AVA is applicable to e.g. the whole derivatives portfolio then the rationale is lacking. On a going concern basis banks would never close down all contracts and, hence, these



complementary close-out costs will never materialise. We therefore recommend excluding this AVA.

Also for the Early termination AVA the definition is rather unclear. If this is aiming at situations where discounts are given to clients in distress this should be clearly stated. In such cases, the valuation will already be reduced due to the increased CVA. If additional discounts are given this could be in order to prevent an even bigger loss in the near future, i.e. it is a market/counterparty risk issue and not as such related to valuation uncertainty. In general, it is difficult to see the connection between this AVA and valuation uncertainty. We therefore recommend excluding also this AVA.

Justification of the last AVA, Operational risk AVA, is also difficult to see. Banks are already holding capital for operational risk, including the operational risk in the valuation process.

Q9. Are there cases where the above AVAs may have a zero value that could be defined in the RTS? If yes, please specify.
No specific answer.

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.
The diversification factor is arbitrary, defeating the purpose of a precise close-out costs / price uncertainty estimate. Flexibility should be left to banks to estimate the relevant aggregation methods as long as they can motivate their methodology.

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.
Yes.

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.

Partially, we would like to avoid the administrative burden associated with trade level reporting and recording of own traded prices. However we agree with the need to document the whole process in an auditable way.

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 believe that it is important that the RTS is similar to how valuation uncertainty is perceived in banks. Therefore it is important that the calculation of the AVAs should be an integrated part of the valuation process. As mentioned above we find it hard to see the connection to valuation uncertainty for some of the category AVAs. Furthermore, the worked example in the RTS shows that by optimising your AVA calculation you can minimise your valuation uncertainty. This has no basis in reality. Furthermore, it adds unnecessary complexity to the calculation and reduces the transparency in the set-up. Consequently, comparison across banks will be very difficult.

SWEDISH BANKERS' ASSOCIATION

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