NOMURA

Nomura International plc

European Banking Authority (EBA) Consultation Paper

On

Draft Regulatory Technical Standards on prudent valuation under Article 105(14) of Regulation (EU) 575/2013 Capital Requirements Regulation (CRR) – EBA/CP/2013/28

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Nomura International Plc response

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Introduction

Nomura welcomes the opportunity to comment on the consultation paper (CP). The firm has also contributed to and endorses the ISDA/AFME industry response.
Nomura International plc is an international investment bank with a Japanese heritage operating in London and other offices in Europe. Our activities include:

- Trading and sales in fixed income and equity products, including related derivatives;
- Investment banking services;
- Asset and principal finance business; and
- Corporate finance and private equity.

There are a number of overarching issues which are highlighted below along with responses to the individual questions raised.

The Regulatory Technical Standards (RTS) need to recognize that judgment will be required both by institutions and by the regulators themselves. While there have been areas of significant enhancement since the Discussion paper there still seems too much reliance on formulaic prescriptive approaches. No formulaic approach can substitute for the use of supervisory judgment and understanding of how individual firms operate in relation to valuations.

There appear to be many areas of overlap between this CP and other areas of regulatory capital requirements already in existence and being developed internationally. Within the regulatory capital calculations for an institution there currently exist many capital add-ons by means of multipliers or additional calculations in both Pillar 1 and Pillar 2 along with other proposals currently being discussed by regulators such as the Fundamental Review of the Trading Book. Nomura recommends that the EBA consider its overall approach to minimize the occurrence of such overlaps/double-counting in conjunction with the Basel Committee and ensures that the RTS is written to allow offsets where such overlaps do exist. We also recommend the inclusion of an offset for the tax liability reductions that would be achieved if the prudent values were to replace fair values.

As detailed in the responses below we feel that the 100 day volatility test within articles 8 and 9 is inappropriate and is based on flawed mathematics. In addition to being hugely burdensome to calculate individually across all curves and surfaces it requires ~99.5% correlation to succeed and so effectively allows for no netting which we don’t believe was the intention of the CP.

Nomura also feels that the ongoing monitoring within Article 20 is not an appropriate methodology for testing the appropriateness of AVA levels. The suggested approach seems to suggest that we should rely on values interpolated between the current AVA calculation date and the previous AVA calculation date as though the market moves happened linearly over time. We feel that strong daily profit and loss explain/attribution including new deal review should be capable of covering the requirement for ongoing monitoring and is in line with the objective “to limit the burden of calculation by using data … that should be readily available within institutions as the foundation of the approach”.

With regard to the Simplified Approach we suggest an alternative approach which we feel would be much simpler and explain why we feel that unrealised is not an appropriate measure of uncertainty (this also applies to Article 7).

We note that the requirements of the CP prescribe a number of calculations and monitoring approaches which are not consistent with the way banks currently monitor the valuations of their portfolios. To implement these will require significant investment. As discussed elsewhere the ratio of last 100 days volatility test within Articles 8 and 9 and the ongoing monitoring tool within Article 20 would add significant costs without benefit. Setting these aside Nomura and other institutions would still require significant time to be able to design, test and implement the system enhancements which will be required to satisfy the requirements of the final RTS when issued.
If the final RTS is issued in April 2014 we do not feel that there will be sufficient time to fully implement the requirements by 1 January 2015.

Responses to the Consultation Paper 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.

In general Nomura feels the items in the list are reasonable. However we also noted that Article 3 paragraph 3 states "alternative methods and sources of information shall be considered, including all of the following". This would appear to stipulate they all must be used all the time, which we feel isn't practical.
We therefore don't agree that they all have to be considered in each case. For instance, natural bounds should not have to be calculated and considered in each and every case that one is available. Equally, does every trade have to be calculated using correlations of +/-1 and every long option have to be considered with a volatility of zero?

We also noted there is a similar issue with the use of "all" in the previous paragraph (Article 3 (2)).
The list of sources may also change over time so we wouldn't want the wording to suggest that the list is fixed and therefore inflexible to changes of sources over time.

We therefore recommend that "all of" should be deleted from the sentence.

We would propose rewording Article 3(2) as:

"The market data used to determine a prudent value shall **consider available and reliable data sources, including the following, where 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 would also propose rewording Article 3(3) as follows:

"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, where 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.

Nomura agrees with a threshold below which a Simplified approach could be used. We also feel that restricting the threshold to on-balance sheet fair-valued assets only will make the test much simpler requiring as a result only a simple review of the financial statements.

However, the concept of inclusion of off-balance sheet items at fair value seems to overcomplicate matters and is therefore potentially confusing. We are struggling to understand what would be required here as we generally only calculate the fair value of items where the fair value is recognised on-balance sheet, for instance commitments may be thought of as "off balance sheet", however where they are fair-valued, the fair-value is recognised on the

balance sheet. We also feel the inclusion of liabilities in the threshold is not beneficial and seems to be not in line with the scope in Article 34 of the CRR which mentions only assets.

We would also recommend the threshold takes into account multipliers for different levels of the Fair Value Hierarchy (FVH) with multipliers of 0 for those in Level 1 of the FVH, 1 for those in Level 2 and a higher multiple for those in Level 3. In order to avoid an issue where the RTS references GAAP which may be subject to future change, the wording for the definitions of the FVH taken from GAAP could we feel also be included within the RTS. The utilisation of the FVH would "utilise information that should be readily available within institutions as the foundation of the approach" similar to the aim with the Core Approach. For institutions preparing financials where the local GAAP does not require FVH classification they could instead utilise the simple balance sheet fair value with a single multiplier.

We would also suggest that the EBA and Competent Authorities could quite easily utilise the disclosures within the existing financial statements of institutions in order to calibrate acceptable multiples and balances for use in this methodology.

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.

We do not believe this will cause an issue over and above the general practical issues of implementation which financial institutions implementing the Core Approach would have.

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.

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)?

Given they are related we will answer Questions 4 & 5 together.

As with our response to Question 2, we feel the Simplified approach could be applied solely to on-balance sheet fair valued assets. We also feel that having different multipliers for different Fair Value Hierarchy levels would be beneficial with 0 for Level 1 and differing levels for Level 2 and 3.

We do not feel that an additional charge based on unrealised profit is reasonable. We believe, if adopted, it would give rise to far too much inconsistency as financial institutions holding identical positions would incur different charges depending on when they took on that position, the direction the position they held (a buyer of a position that is now in the money would be charged but the seller on the other side of the trade would not) and whether they use FIFO, LIFO or average cost. For these reasons we do not believe that unrealised profit is an appropriate measure of valuation uncertainty.

Additionally from a practical perspective, unrealised profits and losses are typically not stored within the institution's systems since they are generally not required for financial statement disclosure purposes and therefore to build systems to calculate and retain them would represent an unnecessary cost to such institutions.

As already mentioned in our response to Question 3, the EBA could review the financial statements of financial institutions in order to calibrate what the appropriate multipliers would be, bearing in mind that the current proposed 0.1% of Balance sheet would be a maximum of €15 Million with a €15 Billion threshold. For the

institutions preparing financial statements where the local GAAP does not require FVH classification they could instead use the simple applicable balance sheet fair value with a single multiplier (for instance, 0.1%).

Q6. Do you agree with the approach defined above to calculate an AVA where the approaches in Article 8 and 9 are not possible for a valuation exposure? If not, what other approach could be prescribed? Explain your reasoning.

We believe that this approach, if adopted, would be potentially extremely punitive. It may well be that this was intentional, in order that institutions will endeavor to find an alternative acceptable approach and avoid this punitive charge however we would note that:

- It will take some time for institutions to implement the required processes across all their positions;
- The use of net unrealized profits suffers from the same shortfalls as mentioned in our response to Questions 4 & 5 above;
- The charge in Article 7 is highly procyclical and if at some future point in time a market moves to a state of dislocation where there is not a way of estimating the charge (even for a short period of time that crosses a calculation date for example due to an event such as a US government default) then the 10% of notional charge could be extremely damaging and with $1 Billion of capital required per $10 Billion of gross notional could escalate in size very quickly;
- We would emphasise that the future potential impact of Article 7 cannot be calculated in advance, which renders it a highly suspect and potentially damaging piece of regulation;
- While recognising that it is to be used for a different purpose, we would like to point out that the charge of 25% relating to balance sheet market value is 250 times as large as that proposed under the simplified method
- From a practical perspective, assuming that a more appropriate/viable alternative calculation is reached and ultimately agreed, there will of course need to be sufficient implementation time after issuance of the final RTS or a potential reasonable phase-in timeline of the amended approach to be taken as part of the implementation of Article 7.

Nomura would be happy to work with the industry, the EBA and the relevant Competent Authorities to develop an alternative methodology and suitable alternative wording for this fallback calculation

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.

The overall methodologies for the calculations should make clear that for market price uncertainty, we are not expected to come up with a curve or surface that has discontinuities and which reflects a “Frankenstein”curve as a result of taking high levels at points with short exposure and low levels at points with long exposure **(see below the illustration taken from the example in Section 5.1 of the Consultation Paper)**. The curve or surface used needs to be a realistic curve or surface and could for example be constructed by utilising the available curves/surfaces in their entirety. The example at the back of the Consultation Paper also does not suggest this as a potential method despite discussions with various Competent Authorities showing that they believe it to be acceptable.

Additionally the backtesting within Article 8 paragraph 4 (b) and Article 9 paragraph 5 (b) we feel is inappropriate. We would note that while the intention of selecting a ratio of 0.1 between the two volatilities seems superficially linked to the concept of 90% certainty, this hasn’t been fully thought through. In order to achieve the ratio of 0.1 for volatilities (which is the square root of the variance), this means achieving a ratio of the variances of 0.01 which implies a correlation between the reduced and unreduced valuation input P&L’s of 99.5%.
In addition while being overly complicated for simple curves, in our view it is practically impossible for many volatility surfaces and would be a huge burden. Discussions with individuals at the national Competent Authorities

indicated that the test wouldn't be expected to be performed as written which adds further to the argument concerning its recognised impracticality.
This will cause potential issues with the reliability of the numbers calculated within the QIS, as discussed earlier.

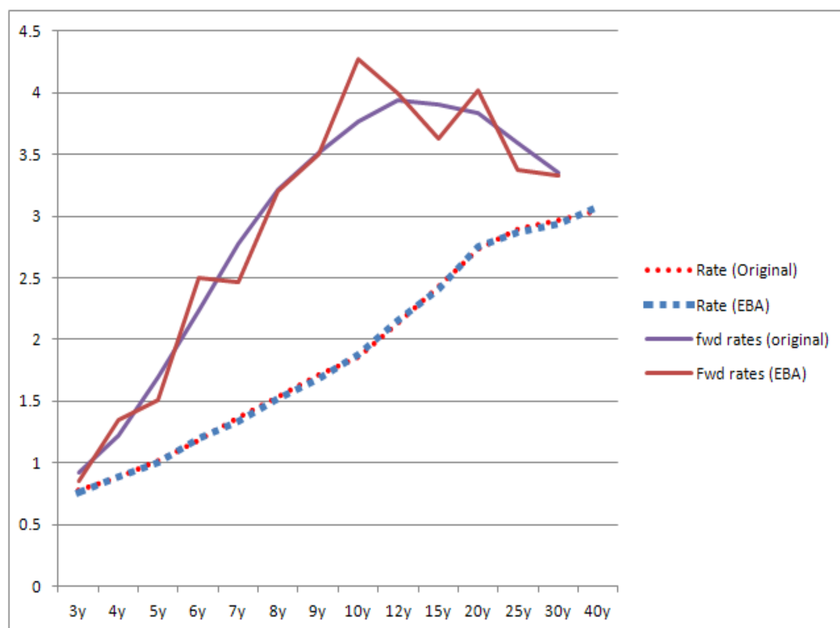
With regard to certain other amendments we feel that:

i. Article 8 paragraph 2 (a) should be amended to include "a tradable price or value for a valuation exposure or a price or value that can be determined from reliable data…" since "a tradable price" may be felt to exclude for instance a swap rate since it is not a price.
ii. Article 8 paragraph 4 (a) and Article 9 paragraph 5 (a) should be amended to reflect the fact that some non-derivative positions will require analysis of their inputs as opposed to their price and so should be amended to say something like "Institutions shall calculate AVAs on valuation exposures related to each valuation input used in the relevant valuation model. The valuation input may be the price of the instrument", with the word "may" replacing the word "will".
iii. Article 8 paragraph 5 (a) (1) should be amended to replace the words "exit prices" with "exit values" and the word "price" with "value" since the valuation input may not be based on a price so that it reads "For a valuation input where the range of plausible values is based on exit values, institutions shall estimate a point within the range where it is 90% confident it could exit the valuation exposure at that value or better".
iv. Similarly for Article 8 paragraph 5 (a) (2) "price" should be replaced with "value" to become "For a valuation input where the range of plausible values is created from mid values, institutions shall estimate a point within the range where it is 90% confident that the mid value it could achieve in exiting the valuation exposure would be at that value or better "
v. Article 9 we feel may need some rewording as paragraphs 2-4 do not seem to recognise the fact that the calculation of market price uncertainty in Article 8 may have been calculated on an exit basis as per Article 8 paragraph 5 (a) and so would not require further close-out costs within Article 9. Paragraph 2 only exempts this calculation where there is "firm evidence of a tradable price". The close-out costs should clearly only be required where market uncertainty has not been calculated as an exit uncertainty. Article 9 paragraph 2 should therefore be amended to read something like: "When an institution has calculated a market price uncertainty AVA for a valuation exposure based on exit values, the close-out cost AVA may be assessed to have zero value"
vi. Either Article 9 should include a section that allows full portfolio exit costs to be calculated including the future administrative cost aspect or the future administrative cost section in Article 14 should be amended to allow the calculation to reflect the future administrative costs a market participant would charge if the portfolio were being exited (please also see our response to Q 8).

Nomura would of course be happy to work with the industry, the EBA and Competent Authorities on some form of suitable alternative wording for these key AVA's.

Example of a "Frankenstein" forward curve:

This uses the FV rates and upper/lower ranges from table 1 of the example in Section 5.1 of the Consultation Paper. It can be seen that the original Fair Value swap rates "Rate (Original)" and the Prudent Value rates "Rate (EBA)" seem to correlate closely as is to be expected for swap curves. However if we analyse the impact on the forward points then what was a relatively smooth forward curve becomes very jagged and is unrealistic.
This impact could be much worse in many cases, even causing negative forward rates or volatilities that would cause model issues. We particularly wanted to illustrate the impact purely with the information that was provided within the Consultation Paper in order to demonstrate how this effect is very likely to occur with the current wording.



Please note we have increased the number of switches between long and short risk positions to better illustrate the effect

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.

Article 11 - Model Risk - This seems reasonable, however we would note that the Model Risk is closely linked with market uncertainty/closeout costs and so we feel it should be included within the aggregated AVA diversification calculations.

Article 12 – Concentrated Positions – This seems reasonable, however we would note that the typical daily trading volume of an institution often has little real bearing on whether it has a concentrated position or not since there will be numerous counterparties with which to exit their positions even when they themselves are not market makers.

Article 13 - Investing and Funding Costs - We feel the wording should be amended slightly in order to say “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”, therefore emphasising it is the expected contractual lifetime that the expected costs and benefits should be calculated over.

Article 14 - Future administrative costs - We feel that as currently drafted the wording is out of line with the objectives of the other AVA’s which are to estimate a prudent exit value. More appropriate wording we feel could therefore be: “The entity should calculate the future administrative cost adjustment taking into consideration the lower of the costs that it would incur in managing the portfolio or the incremental costs that would be charged by a market participant if they were taking on the portfolio”. We also feel that an institution should have the option to calculate these costs within Article 9 close-out costs as described in Question 7 above.

Article 15 - Early termination - The suggested wording seems reasonable, so no further comments.

Article 16 – Operational Risks - We feel that this section of the Consultation Paper is unclear and perhaps as a result, may not make sense. As we noted earlier, this should not be part of Prudent Valuation given that Operational Risk is already either subject to Advanced Measurement Approach or to an Add-On where the Competent Authority feels it’s appropriate. We would also note that the wording within the Consultation Paper appears illogical asking in paragraph 1 for certain calculations to be performed and then asking for an arbitrary charge of 10% of certain other AVA’s in paragraph 3. This arbitrary charge would lead us to conclude that the drafters agree that this AVA is not meaningful in its own right.

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

Nomura does not feel there is a need to define cases of specific zero value AVA's within the RTS as the guidance provides a meaningful principles based approach. Though not specifically requested in this question we would again highlight the slightly flawed wording within Article 9 that is mentioned within our response to Question 7. Closeout costs should clearly be zero whenever the market price uncertainty has been calculated on an exit basis and should not be limited to the sole example mentioned in Article 9.

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 are pleased that the EBA recognises the need for diversification. As discussed in the response to Question 8 we think that Model Risk is very similar to market price uncertainty and overlaps with it and so Article 11 should also be brought within this diversification benefit.

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.

As per the response to Question 10 we feel that Model Risk is very similar to market price uncertainty and so should be included within the diversification applicable to market price uncertainty and close-out costs.

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 are somewhat confused and concerned by Article 20. We do not see any benefits deriving from this proposed "Ongoing Monitoring", although we do see very material potential costs in order to build and support the required system builds. We are therefore struggling to determine that what is proposed would be achievable. We cannot for instance understand what is meant by interpolating "between estimated prudent value parameters at the previous AVA calculation date and … the current AVA calculation date". Are we for example to try to interpolate values between two dates that are three months apart as if market moves happened linearly across this time? We feel this test is a waste of resources as it gives no meaningful or useful information as was the case with the ongoing monitoring tool mentioned in the previous Discussion Paper. We would note that trading information will generally only be available for the more liquid positions with less valuation uncertainty where market movements would distort results. We feel that good daily profit & loss explain/attribution should be capable of covering the requirement for ongoing monitoring and is in line with the objective "to limit the burden of calculation by using data … that should be readily available within institutions as the foundation of the approach".

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?

Although we haven't had the opportunity to analyse in detail the costs and benefits of the Consultation Paper, we do feel that the costs related to certain proposals would far outweigh any potential benefits. These have also been discussed in the introduction and in the responses to Questions 4, 5, 6, 7 and 12.

Within the core approach we feel that the ratio of last 100 days volatility measure within Articles 8 and 9 and the ongoing monitoring tool within Article 20 will take very material amounts of resources while still not necessarily being either achievable as well as being of little or in fact no benefit.

We also feel that as mentioned in our combined response to Questions 4 and 5 the inclusion of net unrealised profit within the simplified approach (and in Article 7 of the core approach) is not appropriate as a measure of valuation uncertainty and would require costly systems upgrades since the realised and unrealised split is not typically stored and therefore retained since it is generally not required for accounting purposes.

For any questions regarding our responses please contact:

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