POSITION PAPER

ESBG Draft Response to the EBA on the EBA CP on prudent valuation under Article 105(14) of the CRR

October 2013

ESBG

Position on the EBA Consultation Paper on prudent valuation under Article 105(14) of Regulation (EU) 575/2013 (Capital Requirements Regulation - CRR) (EBA/CP/2013/28)

The ESBG is grateful for the opportunity to provide input to the current consultation paper and hope that the responses outlined below will aid the EBA in its future development of the proposed RTS.

General Statements

We appreciate the positive amendments made based on the preliminary views expressed in the Discussion Paper. We particularly agree with the reduction of the confidence level from 95 to 90%. We also welcome the simplified approach as an alternative to the more sophisticated core approach.

We have nevertheless got some concerns regarding the calculation of the simplified approach. Using unrealised gains as a basis for the Additional Value Adjustment (AVA) leads to a double correction in light of the current EBA discussion paper on possible treatments of unrealised gains measured at fair value under Article 80 of the CRR (EBA/DP/2013/03). If unrealised gains are to be used as an input to the AVA calculation we ask that the specific applied percentage is reduced and the percentage of the aggregate absolute value of fair valued positions held by the institution is instead increased as this would reduce volatility

Regarding the core approach we would like to emphasise that this approach is extremely demanding with respect to methodological-, IT-, implementation- and validation efforts. The very quantitative approach requires a large amount of data, which is problematic in small currency countries, e.g. the Nordic, Central and Eastern European markets, where the number of active market players is limited and so is the set of reliable price data. Some of our members are therefore unable to apply the example RTS for their prudent value calculations. ESBG propose that each bank should choose which method to use – simplified or core approach – as is the case of capital requirements in Pillar 1.

These RTS are based on Article 105 (14) CRR, which mandates the EBA to specify the conditions according to which the requirements of Article 105 shall be applied for the purposes of paragraph 1. As paragraph 1 sets out the requirements for prudent valuation exclusively for trading book positions the mandate of the EBA is limited. Even if Article 34 CRR references Article 105, embracing banking book positions in these RTS would exceed the EBA's mandate as defined in Article 105 (14) CRR.

We would consequently argue for the exclusion of banking book items from the prudent valuation requirements. In addition we plead to exclude own debt from the prudent valuation requirement for two reasons:

- There is no intent of trading own debt.
- Own debt is already prudently valued.

The current RTS does not align with IFRS 13 (effective from 1st January 2013), in particular with regards to the three level hierarchy of fair valued assets. The term "exit price" is a basis for definition of fair value in IFRS 13. It is also the basis for the assessment of a prudent value which is based on a "realisable exit price". Referring to IFRS 13 we believe that level 1 and 2 in the fair value hierarchy should be excluded from AVA as level 1 is defined as quoted prices and level 2 is based on observable market data. Both levels require active markets.

Level 3 inputs are defined as unobservable inputs for the asset or liability. [IFRS 13:86]. We therefore believe that an AVA calculation should only be required for Level 3 instruments

1. **Prudent Valuation according to Article 105 (14) vs. IFRS:**

Firstly it should be mentioned that Article 105 (14) CRR in connection with Article 34 CRR exclusively refers to treatment under IFRS. We therefore ask for clarification regarding the expected prudent valuation approach to be used when other accounting principles e.g. national GAAPs apply to an entity and how the differences between different accounting principles could be measured and observed.

Secondly we want to point out that prudent valuation is not within the scope of the global framework issued by the BCBS in 2011. We therefore question the use of a prudent valuation approach for banks and banking groups within the EU as part of pillar 1 as it does not appear to correspond to the idea of a global level playing field.

Finally we want to emphasise that differences between an accounting treatment and a prudential treatment further complicates a reconciliation between the balance sheet and own funds within an entity's disclosures and would contribute to additional difficulties when interpreting the financial statements.

2. **Prudent Valuation vs. treatment of unrealised gains:**

We want to express some concerns regarding the double-counting resulting from the simultaneous application of the prudent valuation approach and the treatment of unrealised gains.

Article 468 CRR states that unrealised gains are not available within own funds during 2014. It is also a requirement to fully or at least partially exclude unrealised gains during the years 2015-2017 based on the transitional provisions in Article 468 CRR, depending on the transitional provisions to be defined by the local competent authority. We ask that any double-counting during the transitional period is avoided.

We believe that both the prudent valuation and the prudential filter on unrealised gains should be covered by provision clearly defining how interdependencies should be considered and how double-counting is avoided. Applying the prudent valuation principles under Article 105 of the CRR exclusively to trading book positions while applying the treatment of unrealised gains to banking book positions would avoid double counting and would at the same time be more consistent with the wording of Article 105.

We strongly believe that due to the full exclusion, at least in 2014, of unrealised gains neither prudent valuation nor the requirements within Article 80(4) CRR should be required before 2015.

3. **Questions regarding consideration of prudent valuation in other requirements defined within the CRR:**

As prudent valuation will impact other topics covered by the CRR we want to highlight that a further need for clarification is required regarding the following issues:

- How to consider prudent valuation in the calculation of eligible minority interest?
- Which approach should be used for determination of eligible minority interest in case the simplified approach is used at a solo-level and the core-approach is applied at group-level?
- Will prudent valuation adjustments affect the calculation of the leverage ratio?

Overview of consultation 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 ask that the "natural bound of an instrument" as stated in Article 3(3) c is defined.

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.

All institutions should be allowed the option of the core or the simplified approach. As there are certain incentives for applying the core approach we believe that institutions who are able to meet the administrative burdens and costs should have the opportunity to do so. We do not however believe that the mandatory application of an approach is an appropriate requirement.

It should also be clarified, that in the case where the core approach is used at parent level and the simplified approach is applied within its subsidiaries, the parent institution should be allowed to aggregate the data using 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.

We support the idea that subsidiaries are allowed to use the simplified approach for their local reporting. Differences in the amount of AVA can however be substantial. If the subsidiary has a high positive P&L the simplified approach may lead to a much higher AVA than the core approach.

The core approach does not have to be applicable for the subsidiary for consolidation. We propose to solve this as follows: Each bank within the group should be allowed to choose the method of AVA calculation based on its own preference, not based on a threshold or based on the method chosen by the parent company. The consolidation would as a result contain both simplified and core approach results.

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.

In principal we agree with a simplified approach, although it is imperative that double-counting is avoided. The disadvantage for institutions with a high amount of unrealised gains would otherwise be substantial. Reducing the percentage from 25% and instead increasing the percentage of the overall fair valued assets and liabilities appears to be a less volatile alternative.

We do not understand the rationale for using unrealised profit as the basis for the calculation. It implies that instruments whose fair value has decreased since their initial valuation actually lower the AVA costs (and vice versa, instruments with increasing FV increase AVA costs). In reality, there is no reason to believe that the types of risk covered by this regulation have any connection to the upside/downside development of fair value of any individual instrument. As a result we believe that increasing the weight of the total net value of FV priced instruments is a superior approach. This may additionally make the AVA provisions less volatile and unpredictable given the size of the portfolio.

If we consider the P&L as a source for AVA calculation, we believe that it would be more accurate to consider net realised profits and losses rather than only net realised profits.

In case the parameters used for calculation (25% and 0.1%) are outputs from a calibration exercise we think the RTS should describe how they were derived.

Also, there might be a risk of an overlap 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 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)?

Instruments held in the banking book, like liquidity portfolios and strategic assets in treasury departments might be 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 assets that are required to be held to comply with the LCR requirements. To penalise liquidity buffers by adding CET1 deductions related to these positions would be irrational. We therefore recommend excluding banking book instruments in the RTS.

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.

ESBG support an exclusion of instruments which are held for liquidity purposes as the majority of those assets are central bank eligible. Government bonds in particular should be excluded from the prudent valuation regime. Furthermore we would exclude own issues as, especially in times of crisis, liabilities buy-back levels typically decrease and we thus see no need for an immediate early termination of own issues.

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.

No we do not agree as the provisions do not appear consistent from a systematic point of view.

This approach would result in an extremely high AVA. If institutions are unable to calculate single valuation exposures they should use a percentage of the aggregate absolute value of fair valued positions. This percentage could for example be retrieved from other banks who are capable of calculating the AVA figure. The current approach described in Section 3 Article 7 is excessively strict in our opinion. We would propose to instead consider the simplified approach, possibly with an appropriate add-on.

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.

In principle the calculation is understandable, although there is risk of possible double-counting. Continuous and regular calculation will require substantial methodological, implementation, IT and validation efforts. As mentioned in our introductory remarks the very quantitative approach requires a large amount of data, which is problematic for banks operating in small currency countries. We believe that the application of already available tools, e.g. the VaR approach or the Bloomberg/Reuters scores for market depth should be considered.

We would also like to point out that the source of uncertainty mentioned in Article 10 would already be covered by the Credit Valuation Adjustment (CVA). Additionally we ask for clarification on the definition of market price uncertainty and its potential overlap with close-out costs.

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.

For concentrated positions the information on the liquidity of a certain instrument is not always available. The articles are very general and there is not much to comment on. We would especially request that Article 13 regarding the Investing and Funding AVA is further elaborated). It is not obvious to us why nor how administrative costs should be included in the AVA.

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

i. We propose to set AVA equal to 0 in case the asset is classified as Level 1 or Level 2 according to the IFRS Fair Value hierarchy.
ii. We propose to set administrative cost AVAs equal to 0 for very standardised and liquid Instruments.

The capital requirements for Operational Risk are already met, independent from the AVAs.

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 welcome the possibility to reduce the aggregated total amount of AVA to 50 %.

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.

A precise answer cannot be delivered without knowing the exact methodology for the calculation of individual components. We do however believe that a simple sum may lead to double counting and should be avoided.

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.

This will depend on whether the core approach will be extended to each subsidiary of a parent institution using the core approach or if the parent institution will have the possibility to aggregate data calculated on basis of the simplified approach (see Question 2). Otherwise the implementation costs would be substantial.

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?

N/A

About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,470 billion, non-bank deposits of €3,400 billion and non-bank loans of €4,000 billion (31 December 2010). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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