Morgan Stanley

European Banking Authority
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Re: EBA/CP/2013/28

Dear Sir/Madam,

Detailed below are our comments on the Consultation Paper, on Draft Regulatory Technical Standards (RTS) on prudent valuation under Article 105(14) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR).

General Comments / Overview

We agree that firms bear valuation risk against which it is appropriate to hold capital. While we welcome the amendments made to the draft RTS following consultation on the previous Discussion Paper (DP), we believe that the RTS as outlined in the Consultation Paper (CP) still fails to sufficiently recognise that valuation is a judgement which is frequently made based on limited data availability. As such, the proposed prudent valuation framework does not achieve the objectives as set out in the CP and requires a number of enhancements that should be addressed prior to finalisation of the RTS. Specifically:

a. The RTS remains overly prescriptive, and does not allow for institutions and their supervisory regulators to make appropriate judgements of valuation risk and prioritisation of resources.
    i.   The ongoing monitoring requirements set out in Article 20 of the CP remain extremely onerous, fail to take in to account existing internal controls and, as set out in our response to question 12, output minimal useful information.
    ii. The requirements for reducing the granularity of model inputs prescribe an historical P&L volatility test which is onerous to implement, set an unreasonably high threshold to satisfy, and fail to take in to account existing internal controls, as set out in our response to question 7.
    iii. The framework for calculating the Market Price Uncertainty AVA has been designed to lead to a risk based methodology in the majority of cases rather than considering the issues in utilising a more accurate revaluation methodology, as set out in our response to question 7.

b. We welcome the 50% diversification benefit specified for the Market Price Uncertainty and Close-Out Costs AVAs. As set out in our response to question 10 there is a significant overlap between Market Price Uncertainty and Model Risk and therefore to ensure consistency the diversification benefit should be extend to incorporate Model Risk.

c. We also welcome the reduction in the confidence level required to 90%, however this level remains too high and impractical to implement.
    i.   Finding the 90% confidence interval from <10 data points requires extrapolation and therefore results in more subjectivity and judgment being applied rather than less.
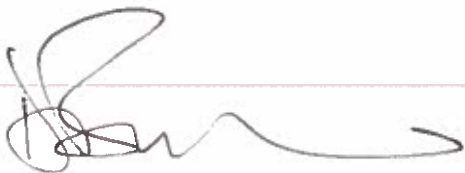   ii. A 90% confidence level places undue reliance on outliers within data sources such as consensus services.

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      iii.   The higher the threshold, the greater the increase in pro-cyclicality of capital.

   d.   We recommend using one standard deviation (equivalent to a confidence level of 84%) because:

      i.   This would significantly reduce the operational risk and implementation costs since one standard deviation is generally already used in institutions' independent price verification (IPV) process.

      ii.   84% reflects a reasonable range of uncertainty.

      iii.   This confidence level would maintain the benefits of understanding a range around an institution's fair value marks.

      iv.   The absolute confidence level chosen is not necessarily the most important input; also of importance are the data points chosen, the distribution chosen, etc. Aligning this with IPV would ensure consistency of approach across regulatory and accounting frameworks.

   e.   The nature of the draft RTS are such that the capital requirements are pro-cyclical, requiring additional capital as market conditions worsen and valuation uncertainty increases.

We have also contributed to the industry response submitted jointly by AFME and ISDA, and are supportive of the themes and points made in that response.

We have included our responses to the specific questions asked in the CP in appendix A. Should you wish to discussed these further, please do not hesitate to contact me.

Yours faithfully,

David Buckley
Chief Financial Officer
Morgan Stanley, EMEA

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Appendix A: Responses to Specific 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.

The minimum list of alternative methods and sources of information defined in both paragraphs 2 and 3 appears reasonable. However, the wording of Article 3 appears to stipulate that all of the data sources in each paragraph must be used for every product.

The wording should be clarified to remove reference to "all of" in paragraph 2. Alternatively, the wording could be amended to require that all sources be considered as opposed to used:

"2. In determining a prudent value a full range of available and reliable data sources shall be considered including all of the following:

    (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
    (f)   Counterparty collateral valuations."

This wording would be consistent with the standard practice for internal IPV processes, thus achieving the objective of utilising existing IPV processes as much as possible. The risk otherwise would be that institutions are forced to include sources that they know are unreliable when determining prudent valuation.

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 with a threshold being applied below which the simplified approach may be used. The threshold as defined is overly simplistic since:

- An entity with €14 billion fair valued exotic and illiquid products with significant valuation uncertainty would be able to use the simplified approach.
- An entity with €16 billion of G7 government debt would be required to use the core approach.

Therefore, we propose that the threshold be a function of Fair Value Measurement levels, with multipliers applied to the sum of the absolute value of relevant assets and liabilities within each level to ensure that the threshold effectively decreases as unobservability and valuation risk increase. For example, a multiplier of zero could be applied to level 1, a multiplier of 1 for level 2, and a higher multiplier for level 3. The multipliers could easily be calibrated by the EBA and Competent Authorities based on the existing financial statements of each institution.

Further, clarification is required as to the inclusion of off-balance-sheet fair valued assets and liabilities within the threshold calculation since anything fair valued is recognised on balance sheet.

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 that this would create any practical issues.

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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.

See answer for Q5.

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)?

This answer relates to both questions 4 and 5.

We do not believe that unrealised profit represents a reasonable measure to include in the calculation of the AVA since it does not represent a measure of valuation risk. Instead incorporating this measure would assign a different AVA to a given instrument depending on when the instrument was bought which would create inconsistencies across institutions.

We propose a measure purely derived from the sum of the absolute value of relevant assets and liabilities, potentially also linked to the Fair Value Measurement level approach described for Q2.

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.

The approach specified would potentially be punitive, however we understand that this is intended to encourage institutions to utilise expert based approaches as far as possible in calculating these AVAs.

Taking in to account the same point as raised for Q5 in relation to unrealised profit we propose that the AVA in this situation be calculated purely as a function of the absolute value of relevant assets and liabilities, with the % applied determined by the EBA.

Q7: Do you agree with the approached 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 understand the intent of the approach defined for Market Price Uncertainty, Close Out Costs and Unearned Credit Spreads however we believe the approaches as currently written could lead to widely different interpretations and could potentially lead to inconsistently calculated Prudent Valuation.

Specific points and suggested amendments are as follows:

Granularity of Input Parameters (Article 8 para 4(b) and Article 9 para 5(b))
The draft rules try to ensure a consistent approach across institutions in reducing the granularity of risk. However, this assumes that the initial granularity marked by each institution for the same valuation input is the same, which is generally not the case. In order to address the potential inconsistency it should be made explicitly clear in the regulations that uncertainty due to interpolation and extrapolation of model inputs should either be included as part of Market Price Uncertainty or Model Risk.

Market Tradable Instruments (Article 8 para 4(b) and Article 9 para 5(b))
The term "market tradable instrument" is not defined within the regulations. A definition should be provided in the final regulations.

Reducing Granularity of Parameters (Article 8 para 4(b) and Article 9 para 5(b))
Based on our analysis the 100 trading day historical P&L volatility rule specified for reducing the granularity of inputs:

- does not set a reasonable threshold to determine an acceptable reduction in granularity.
- would fail to permit a number of reductions in granularity which would exhibit very similar valuation characteristics to the unreduced granularity.
- would permit some reductions in granularity which would not achieve the overall objective of reduced granularity generating a valuation consistent with unreduced granularity.

These are demonstrated in the examples below. Additionally the calculation methodology is time consuming and resource intensive to implement, requiring multiple calculations for each model input in order to assess which reduction in granularity satisfies the rules. This is not consistent with the stated objective of utilising existing IPV processes.

Example 1 – Reasonableness of Threshold
Considering hypothetical P&L scenarios where each of the reduced and unreduced P&L is distributed with identical mean and standard deviation, calculated over a 100 day period the correlation between the reduced and unreduced P&L would need to exceed 99.5% to satisfy the ratio threshold of 0.1 specified within the draft RTS.

In such a situation this implied correlation threshold is excessive. We do not believe that the intention of the rule was to set such a strict criteria, and that the intention was instead to permit a reduction in granularity consistent with a more reasonable correlation threshold.

Example 2 – Granularity Reduction
Consider a similar hypothetical scenario, where each of the reduced and unreduced P&L is distributed with identical standard deviations but significantly different means. Provided the correlation is set at or above the level identified in Example 1 of 99.5% the rule will be satisfied.

In such a case the draft RTS will therefore accept a reduction in granularity which materially changes the overall P&L, which we do not believe was the original intention behind this rule.

Proposed Alternative Approach
We propose that instead of including this test within the regulations the EBA should permit an expert based approach to bucketing, consistent with the expert based approaches permitted elsewhere for Market Price Uncertainty. This would be consistent with the stated objective of utilising existing IPV approaches by utilising existing internal controls around reduction of granularity. For example, an expert based approach could be to use a statistical test of the hypothesis that the expected difference between the daily unreduced P&L and the daily reduced P&L is zero, subject to a confidence level of 90%.

If the decision is made to continue to use a historical P&L volatility rule as currently defined, the P&L volatility ratio threshold of 0.1 should be increased to 0.5, which is consistent with the correlation level of 90% in Example 1.

Independent Review of Netting Methodology (Article 8 para 4(c) and Article 9 para 5(c))
The current wording of this paragraph can be interpreted to mean that there is a requirement for the netting methodology to be externally audited annually. Our understanding is that the intent of this paragraph is instead that the netting methodology is reviewed and validated by the IPV function annually. We propose the following alternative wording:

"Where a reduced number of parameters are used for the purpose of calculating AVAs, the determination that the above criteria are met shall be subject to review by the institution's IPV function or its equivalent of the netting methodology and validation on at least an annual basis."

Prudent Parameters for Revaluation (Article 8 para 5)
Our preference, in line with existing IPV processes, is to utilise revaluation approaches as far as possible in calculating Market Price Uncertainty. We believe that the current wording of the draft RTS is too focused on adopting a risk based approach to calculating Market Price Uncertainty and therefore does not consider sufficiently the need to create prudent model inputs for arbitrage free use in pricing models.

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The methodology required and example given for calculating a prudent set of model inputs will lead to mathematically inconsistent valuation inputs and hence unreliable Prudent Valuation calculations. For example, the interest rate curve provided as an example calculation in the Consultation Paper creates a significantly non-smooth 10 year forward curve when a realistic risk profile is applied to it that creates numerous pricing issues and could not be used for revaluation purposes.
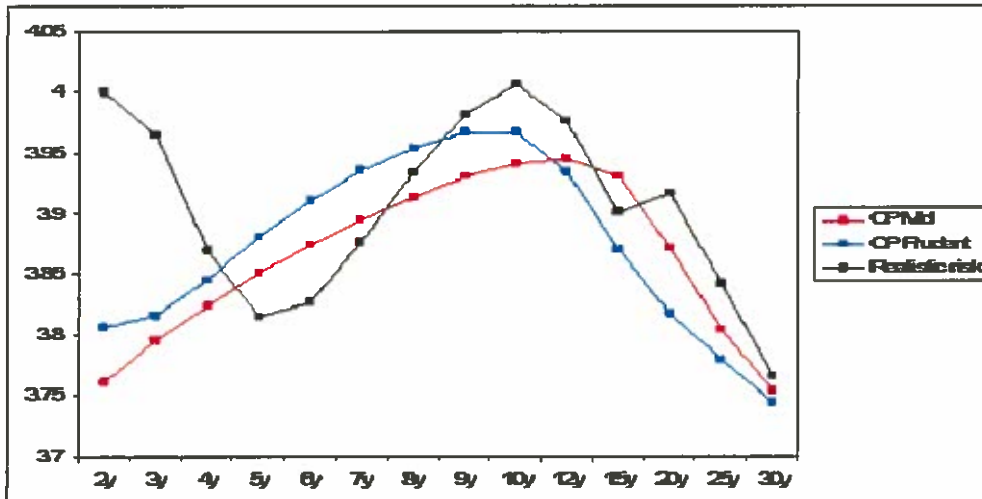
We propose that an expert based approach be permitted in generating model inputs for a revaluation approach in order that institutions can balance model requirements with the need to generate an accurate prudent value This should be made clear in the wording of the regulations.

Overlap Between Market Price Uncertainty and Close Out Costs (Article 8 para 5, Article 9 para 2)
As currently written there could be situations where the Market Price Uncertainty AVA is calculated to an exit price but where a Close Out Costs AVA is still required. This is because the wording of Article 8, paragraph 5(a)(1) and Article 9, paragraph 2 is inconsistent.

We do not believe that the intention is to require a non-zero Close Out Costs AVA in situations where the Market Price Uncertainty AVA has been calculated to an exit price, therefore to avoid this situation we propose the following wording for Article 9, paragraph 2:

"When an institution has calculated a market price uncertainty AVA for a valuation exposure based on exit values, the close-out costs AVA may be assessed to have zero value."

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
The definition of this AVA appears reasonable, however we note that Model risk and market price uncertainty overlap significantly (see response to Q10), therefore we believe that it should be included within the 50% diversification benefit currently defined for market price uncertainty and close out costs.

Article 12 – Concentrated positions
The definition of this AVA appears reasonable, except that the requirement to consider the typical daily trading volume of an institution should be removed since if the average daily market volume is significant there would be numerous counterparties with which to transact regardless of how often the institution trades. This would mean that there would be no difficulty in exiting the position regardless of the institution's own average daily trading volume.

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Article 13 – Investing and funding costs

The wording should be amended to state "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." This would make it explicit that the expected contractual lifetime needs to be considered rather than simply the contractual lifetime. This amendment is important as it reflects the true funding profile, including where derivatives contain either optionality or mutual early termination clauses.

Article 14 – Future administrative costs

We believe that this AVA should be removed from the RTS since it is inconsistent with the other AVAs in that it assumes that each institution is no longer a going concern. As a going concern the cost of closing out risk exposures is already covered under the Close-Out Costs AVA, therefore there should be no additional AVA required to cover Future Administrative Costs.

If Future Administrative Costs must be included in the RTS it should be made explicitly clear in the wording of paragraph 1 that this AVA is required for any valuation exposures where the close out costs AVA has been calculated to reflect the cost of flattening the risk exposure rather than exiting the entire position.

On the basis that each institution remains a going concern the wording needs to make clear that it is permissible to also consider the cost of selling the portfolio to another market participant. Potential wording would 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 as part of a complete portfolio novation to another market participant."

It should be permitted to include the incremental costs charged by a market participant in taking on the portfolio within the Close Out Costs AVA, with the wording of the Future Administrative Costs AVA amended to ensure that in such instances no further Future Administrative Costs AVA is required.

Article 15 – Early termination

The definition of this AVA appears reasonable.

Article 16 – Operational risks

The wording of this article seems unclear and open to misinterpretation. Paragraph 1 includes a requirement to assess the potential losses due to operational risk related to the valuation process, which then appears to be contradicted by Paragraphs 2 and 3 which state explicit calculation methodologies. Paragraph 3 includes an arbitrary 10% charge of other AVAs which is not based on any clear methodology.

As a more general comment Operational Risk either is already subject to the Advanced Measurement Approach or to an add-on where the Competent Authority feels it is appropriate, therefore this AVA appears to be superfluous.

Therefore we propose that:

- This AVA is removed to avoid double counting existing regulatory requirements.
- Failing that, that Paragraph 1 is removed and the % in Paragraph 3 is reduced to a more reasonable level representative of historical operational risk losses relating to the valuation process, and which is reflective of the controls in place around valuation.

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

We propose that there be an exemption for all FVM level 1 positions from the AVA requirements with the exception of the concentrated positions AVA, since the valuation uncertainty on such positions is minimal

and this would permit institutions to allocate more resource to assessing valuation uncertainty on more uncertain positions.

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 that the 50% diversification benefit for Market Price Uncertainty and Close-Out Costs should be included within the standards.

Model risk should also be incorporated within this 50% diversification benefit since there is clear overlap between this and the Market Price Uncertainty AVA. To illustrate this consider the following examples for interest rate curves:

- Institution A marks their interest rate curve with 20 tenors, reflecting the mid valuation uncertainty entirely through the Market Price Uncertainty AVA.
- Institution B on the other hand marks their interest rate curve with 5 tenors, reflecting the mid valuation uncertainty for those 5 points through the Market Price Uncertainty AVA and reflecting the mid uncertainty on the interpolated and extrapolated points of the curve through the Model Risk AVA.

Institutions A and B should arrive at the same overall Prudent Valuation for their interest rate curves given identical exposure. However, Institution A receives a greater diversification benefit than Institution B as a consequence of the increased granularity of marking, and therefore Institution A would take a smaller overall Prudent Valuation charge than Institution B for an identical exposure.

This example demonstrates that institutions are incentivised without a 50% diversification on the Model Risk AVA to assign as much valuation uncertainty as possible to Market Price Uncertainty, which could lead to a misleading allocation between AVAs.

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.

In line with the response to Q10 we believe there is a strong argument for including the Model Risk AVA within the diversification benefit 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 believe that the requirement for an ongoing monitoring tool should be excluded from the final RTS for the following reasons:

- The test adds minimal value to the appropriateness of prudent parameters since:
  - Any products that trade sufficiently frequently to permit a statistically meaningful conclusion as to the appropriateness of prudent valuation from this tool will have sufficient pricing data in the market to ensure a reasonable level of confidence in the prudent valuation calculated at the next calculation, making the output of the tool irrelevant.
  - Conversely, any products where the confidence in the prudent valuation is lower since the market is illiquid will not trade in sufficient volume to give a statistically relevant conclusion from the tool.
- The requirement to interpolate between Prudent Valuation calculation dates is fundamentally flawed because of the potential for significant market movements between those dates. Any

conclusion based on interpolation will not therefore provide a meaningful analysis to refute or amend the prudent valuation parameters used at the later calculation date.

- Implementing this tool would be highly resource intensive, requiring an entire parallel prudent P&L and daily IPV process for all products to generate any meaningful results.

As such there is minimal benefit but very significant cost from the introduction of this tool.

We do however appreciate the need to utilise trading activity in an ongoing assessment of the prudent parameters. Utilising existing controls we propose that reliance should be placed on robust P&L explain and attribution controls, including the analysis of significant P&L generated on new transactions, restructures and exits.

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?

While there has not been the opportunity to quantify the impact of the proposals, it is apparent that the costs associated with certain proposals far outweigh the benefits:

Ongoing Monitoring Tool in Article 20
As highlighted in our answer to Q12 this tool would be very costly to implement with no appreciable benefit in terms of enhancing the validity of the Prudent Valuation calculation.

Historical P&L Volatility Test in Articles 8 and 9
Applying this test will require significant resources in terms of either manually running the test or making significant system upgrades. It is important to note that applying this test would not be a simple matter of comparing two levels of granularity, but instead considering numerous granularity scenarios to determine the most efficient satisfying the rule.

Additionally the impact of the proposals would be reduced if the bank is able to generate a single consolidated Prudent Valuation calculation rather than also calculating for individual legal entities.