European Banking Federation

Brussels, 8 October 2013

Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of almost 4,500 banks: large and small, wholesale and retail, local and cross-border financial institutions. Together these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the European Union.

Subject : EBF response to the EBA consultation on prudent valuation under article 105(14) of CRR

General remarks

The EBF welcomes the opportunity to participate in this consultation on draft regulatory standards that follows the discussion paper launched last year to which the EBF submitted a response on January 2013.

The EBF notes many areas of positive developments in the guidance provided in the consultation paper, in particular the recognition of a diversification factor of 50% as a standard measure and the fact that liquidity risk is excluded from the category of adjustments to be done for AVA computation.

As regards the current draft RTS, the main concern lies with the **definition of scope**. EBF members have serious concerns as to the impact that such a wide scope as *all items at fair value* would have in operational terms and in the capital requirements of banks.

The EBF defends that instruments of own funds and own debt should be excluded from prudent valuation as there is no intent of trading. Furthermore, we would urge the EBA to consider the combined effect of the prudent valuation proposed in this consultative paper and the discussion paper on possible treatments of unrealised gains measured at fair value under Article 80 of the Capital Requirements Regulation (CRR) in order to avoid double deduction from own funds.

The EBF calls for clarification of the scope and would argue that it would make more sense that the scope of prudential valuation be limited to the trading book. The EBF observes that trading book is the scope envisaged in the Capital Requirements Regulation (CRR), article 105, while article 35 could be considered as an emphasis.

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Should the EBA determine that this is not the CRR intention, the EBF would argue that the RTS should clarify that article 35 relates to financial instruments in the accounting sense, and include specific provisions for non-trading exposures. In particular, we draw the EBA attention to the following issues:

- The instruments used as hedges, notably of interest rate risk, of loans and receivables in the banking book are not intended for immediate realization or necessarily available for such realization. It is our view that while estimating a close out cost for these instruments in isolation makes little economic sense, the inclusion of the hedged component's fair value in the scope of Prudent Valuation goes beyond the scope of articles 35 and 105, and does not correspond to realistic close out scenario. This ambiguity calls at least for clarification of the CRR intention with regard to derivatives used as interest rate hedge of loans and receivables portfolios,
- In application of IFRS13, EU banks are required to factor their own credit risk when measuring the fair value of derivatives and of own debt designated at fair value. The article 33 of the CRR states that the gains and losses arising from changes of own credit risk should be deducted from the own funds. Therefore, we believe that the RTS should also explicitly exclude these from the scope of prudent valuation framework. The EBF would argue that own credit risk, as a risk factor, should be scoped out of the RTS.
- In the view of the same article 33, we believe that EBA should explicitly clarify that cash flow hedges targeted by the prudential filter in paragraph 1 (a) are also scoped out.
- Assets that are deducted from own funds according to articles 36, 56 and 66 of the CRR should be scoped out of prudential valuation. Including such assets within the scope of prudential valuation would clearly amount to double counting of deductions.
- Finally, we would argue that the application of the prudent valuation requirements should be aligned with the phasing of the prudential filter related to the AFS portfolio. The EBF would argue that the simplest approach is to exempt the AFS portfolios during the phasing period.

As to the trading book positions, the EBF would welcome further simplification with regard to the zero AVA provisions. The EBF argues that instruments that are eligible liquid assets and are classified as level 1 in the accounting fair value hierarchy should be assigned zero market price uncertainty AVA and zero close out cost AVA. The EBF further suggests that instruments traded in exchanges, and meeting the requirements of article 338 of the CRR should attract zero Close out cost AVA with no further documentation of the 90% confidence interval (art 9.3 of the RTS).

The EBF also has significant concerns with the back-testing requirements within Article 8 paragraph 4 (b) and Article 9 paragraph 5 (b) which we do not believe will achieve consistency in risk aggregation across the industry. The reasons why it is not believed that these paragraphs

would lead to consistent reduction in parameters is that the calculation is dependent upon an institution's position at the point in time that the ratio is calculated. The guidance as currently drafted would also enable institutions to select any reduced set of parameters that pass the stipulated test in order to optimise their uncertainty calculations, even where this is not reflective of the market structure or risk management practices. In addition, we also believe this guidance to be extremely onerous given that detailed calculations would need to be performed for each set of parameters each period.

Regarding the timing, it is important to note that it could take at least 9 to 12 months for banks to upgrade their internal control frameworks. This entails implementing and upgrading valuation policies and price test departments and the IT infrastructure that should support the process proposed. As IT applications can only be designed using detailed and specific instructions, the analysis of the upgrade can only start the moment the final RTS is available. After the RTS is available banks need to study it, discuss it with IT developers who need to convert it into IT specifications and finally it needs to be programmed and tested. This process will last at least 9 to 12 months. Consequently, we advise EBA to include in its RTS that banks will have maximum 12 months to fully implement the requirements and how to cope with prudent valuation as from 1 January 2014 before it has been fully implemented.

Specific questions

Question 2

In the view of the EBF, the **simplified approach** should be an option for all banks and not only for banks with the sum of assets and liabilities below a certain threshold.

Overall we find the core approach for the determination of AVA to be very complex. It will require extraordinary levels of resources to implement including those necessary for the development of new data requirements. For many banks, including large banks, the resources that the core approach will consume would be disproportional to the potential gains in additional risk sensitivity associated with that approach. Our general belief, therefore, is that there should not be a threshold for determining which banks are allowed to apply the simplified approach. We believe it should be optional or at least it should be possible for banks to obtain an approval by the competent authority to use the simplified approach.

We would like to note that the proposed RTS could increase pro-cyclicality: When liquidity in financial markets decrease, the amount of AVAs increases and this weakens banks solvency capital and can lead to forced sales.

Should the EBA opt for setting some criteria, we believe that the RTS should distinguish between banks that use complex financial instruments and have large trading portfolios and

others whose fair-valued balance-sheet is mainly composed of liquid bonds subject to IFRS13 valuation hierarchy 1 and interest rate hedging instruments. A simple way of doing so would be to scope out hedging derivatives. Furthermore, liquid bonds which are subject to IFRS13 valuation hierarchy 1 or assets and liabilities that are demonstrated to contain matching, offsetting assets and liabilities should not be included in the calculation of the chosen threshold.

With regard to the chosen threshold, we believe it is extremely difficult to capture market uncertainty by using any kind of balance-sheet-based proxy but welcome the simplicity of the proposal.

In terms of scope, implementing either the core approach or simplified approach as drafted, is expected to have a significantly burdensome impact both operationally and potentially from a cost of capital perspective. The complexity of either approach is significantly onerous on medium size credit institutions.

The simplified approach should in theory be easier to implement but equally should be available as an option to all, irrespective of balance sheet size.

Finally, should the scope of prudential valuation include assets outside the trading book, some, for example smaller banks with substantial equity holdings in profitable sector owned companies, may be affected severely by the simplified approach. Therefore, we believe that the EBA should consider a transitional provision, for example by setting a cap on initial unrealised gains on individual assets outside the trading book in proportion to their current valuation of 20 % at the time the ITS enters into force.

We also understand that the final calibration will consider the quantitative impact study results.

Question 3

In application of **principle of proportionality**, this consultative paper suggests two different approaches, a simplified for small institutions and a core for others. The EBF believes that where the simplified approaches are admitted at the subsidiaries level, the group does not need to recalculate all the positions of the given subsidiaries with the core approach applicable at the group level. In the absence of this change, no subsidiary of a group would be able to opt for the simplified approach as it would impose a heavy operational burden at the group level any way and make that option void. In market risk capital approach, the use of the standard method in one entity prevents the use of the internal model for the same entity. The same logic should be applied for prudent valuation. We propose that EBA allow the aggregation of the results from the simplified approach for small subsidiaries with the results calculated with the core approach at the group level.

Question 4

The EBF considers that the unrealized net profit is not a good proxy of the valuation uncertainty, notably because of it is an asymmetric quantity and that it shows dependency to the date at which the trade took place.

Volatility in AVA is the flipside of applying the simplified approach. The volatility in the values of derivatives would be passed through to the volatility in the capital ratio. To prevent the transfer of the sheer level of volatility the percentage of the net unrealised profit of 25 % for determining AVA under the simplified approach should be removed, given that is also not a good proxy for valuation uncertainty.

Question 5

The proposed simplified method results in too much penalty in valuation adjustment for fair valued instruments consisting mainly of liquid bonds and plain vanilla derivatives, even though in these cases the market price uncertainty is non-existent. Furthermore, the EBF considers that the cost of implementing the core approach for such instruments outweighs the expected benefit.

The EBF therefore would welcome that IFRS13 valuation hierarchy 1 are either be scoped out of prudential valuation or be subject to a lower requirement. Only financial instruments at level 2 and 3 must be included in AVA-adjustments if there is disturbance of pricing according to illiquid financial markets. Also, the EBF would argue that eligibility for Liquidity Coverage Ratio (LCR) purposes should provide indication for scope out. There should be no requirement for additional prudent adjustment on assets that meet the EBA criteria for extremely high liquid and credit quality assets as these assets are already deemed to be readily and easily monetised in the period of market stress.

More clarity and consistency as to scope of coverage by the CP would be required with respect to elements of the CRR. For example, CRR article (105) notes that PVA is only applicable to the trading book whereas the CP applies to trading and banking book. Article 34 relates to assets held at fair value only, whereas the CP applies to assets and liabilities.

Finally, we would propose that the EBA considers derogation on taking Funding Valuation Adjustment (FVA) as part of AVA until there is an agreed industry practice on FVA.

Question 6

As per response to question 4 above, the EBF does not believe that calculating uncertainty based on unrealised profit is reasonable and would lead to inconsistency between institutions that hold identical positions for different time periods. As such, the EBF would propose that the approach to be applied where it is not possible to follow the detailed requirements in articles 8 to 16 should

not be based on unrealised profit. The EBF notes that the % of notional and market values are already very conservative.

The EBF urges EBA to allow an adequate implementation period after the issuance of finalized RTS. The determination of AVA is a complex exercise. While in many instances, with time, institutions may be able to calculate a particular AVA, they may not be in the position to do so immediately. Where institutions cannot determine an AVA in line with Articles 8-16 given the complexity required, institutions should be allowed to update systems and procedures to meet compliance over the transitional period of the CRR in line with other new deductions to CET1 or alternatively, opt for simplified approach.

Question 7

The back-testing requirements within Article 8 paragraph 4 (b) and Article 9 paragraph 5 (b) we feel is inappropriate and will not lead to consistent application across the industry which we believe was one of the reasons for including such prescriptive guidance. The reasons why we do not believe that these paragraphs would lead to consistent reduction in parameters is that the calculation is dependent upon an institution's position at the point in time that the ratio is calculated. Institutions would be able to select any reduced set of parameters that at the time of testing meet the requirements in order to optimise their uncertainty calculations, even where this is not reflective of the market structure or risk management practices. In addition, we also believe this guidance to be extremely onerous given that detailed calculations would need to be performed for each set of parameters each period.

We would also welcome further clarification as to the following definitions:

- The difference between market price uncertainty and close out costs.
- In the context of exit scenario or time horizon, which exit would be expected to occur? Is this on a going concern basis or recovery and resolution basis? Is it based on a 1-day or a 30-day horizon?
- The 50% correlation for market price uncertainty seems overly prescriptive. Expert judgment should be considered.

- Question 8

Article 14 – Calculation of Future administrative costs AVA

In the view of the EBF, the approach set out draft RTS does not represent an estimate of a prudent exit value based on current market conditions. The EBF believe that future administrative costs AVA should be limited to the additional cost that would be expected to be

incurred if an institution were to transfer the portfolio to another market participant, for which the incremental cost would be significantly lower.

Article 16 – Calculation of Operational risks AVA

In the view of the EBF, it is important not to introduce standalone capital standards for specific elements of operation risk ahead of the Basel Committee reassessing the operational risk framework.

Question 10

As regards unrealised gains and losses on liabilities, it should be clarified that fair value changes due to changes in own credit standing are excluded as this is required by Article 33 1(b).

Question 11

In the view of the EBF, the 50% reduction in aggregated AVAs for market price uncertainty and close out costs should also be applied to model risk AVAs. For model risk, there are various potential outcomes relative to fair value some of which are positive and some are negative, and as such seems analogous to market price uncertainty.

Question 12

The **complexity** associated with the obligation to use systematically valuation exposures that are based on tradable instruments makes it costly from operational and computational perspectives especially for "exotic" instruments. In this vein, the ongoing data quality assessment process described in article 20 is unworkable and we recommend it to be deleted from the final RTS. The requirement to use systematically the actual prices entails a heavy system and process changes to enable handling the storage of data. We also note that the approach is flawed in that any form of interpolation between the two AVA dates for prudent value would not take into consideration underlying market movements between the two AVA dates. As such, any results where the transaction price falls below the interpolated prudent value is likely to be significantly distorted by the impact of market movements between the prudent valuation reporting dates. The results of such a test would thus not be meaningful in assessing appropriateness of an institutions prudent value. It should also be noted that most valuation uncertainty is associated with less liquid positions for which trading activity is generally not available in sufficient volumes to meaningfully inform the assessment of prudent value.

In particular, **back testing** is especially difficult for unrealised gains. We advise EBA to state that banks should document how they have substantiated the fair value of less liquid positions, what judgment and information was used to value positions on a portfolio basis (e.g. equity, interest rate, FX, equity options, interest rate options). This will enhance the internal controls of banks and would make more sense as it require banks to learn from their valuations.

As for the threshold, we would request that it is calculated with reference to CET1 instead of total capital.

Question 13

The EBF believes that (i) the guidance for reducing the number of input parameters in *paragraph 4* of *Article 8* and *paragraph 5* of *Article 9*; and (ii) the on-going monitoring required in *Article 20* fail the cost-benefit assessment as currently drafted. This is largely because the perceived benefits are not likely to be realised with the current flawed specification of these proposals, but also as they would be extremely onerous and costly to implement and maintain.