Brussels, 08 October 2013

EACB Comments on EBA draft RTS on Prudent Valuation

A. GENERAL REMARKS

Transition period

In general, we believe that the EBA should allow for the inclusion of a sufficient transitional period for the implementation of the complex procedures set forth the regulation.

Longer holding periods

Article 105 CRR requires that the prudent valuation of fair value positions in the trading book should take into account the dynamic nature of trading book positions. On the other hand, Article 34 CRR requires institutions to apply the requirements of Article 105 to all their assets measured at fair value, when calculating the amount of their own funds in order to deduct from CET1 capital the amount of any additional value adjustments necessary. This determines the inclusion in the scope of the standard of any category of instruments held at fair value, also those not intended for trading (assets) or redemption (liabilities), such as "Available For Sale" assets and assets and liabilities held at the "fair value option". Therefore, the methodology and the criteria proposed in the draft RTS, are not only limited for positions with short holding periods, for which they have been designed for. Therefore some adjustments to take into account also longer holding period positions would be required.

Fair valued liabilities

Moreover we believe that the methodology set forth in the draft RTS is clearly focused on asset positions, while it lacks guidance on how to identify and address AVAs that are specific for fair valued liabilities. Some additions in this sense are welcome.

Threshold for valuation inputs hierarchy

The draft standard does not specify any materiality threshold to be considered in order to provide a rank of the valuation inputs proposed. We suggest that a framework analogous to the schemes outlined by the IFRS could be adopted. Such a tool would result, indeed, extremely useful when different inputs are available.

SCOPE OF THE STANDARD

Strategic holdings

Some equity instruments classified in the "available for sale" category for accounting purposes should be excluded from the scope of this RTS. However, the exemption from the scope should be limited to instruments fulfilling two conditions:

- They constitute equity holding of entities which are included in the prudential perimeter at Group level
- They are held for purposes other than generating investment returns ("'strategic investment").

When IFRS 9 enters into effect, these instruments would generally be classified in the "fair value through OCI" category (for equity instruments). This category prohibits recycling of gains and losses into profit or loss when an equity instrument is derecognised. Accordingly, this category will generally be dedicated to "strategic investment" and is not aimed at being sold. This exemption would be particularly appropriate for the holding of cooperative banks in their central body which they are affiliated to.

More generally we believe that EBA should explicitly exclude from the prudent valuation scope any amount filtered for the calculation of regulatory capital (as it is mentioned for the calculation of the simplified approach, page 14 "explanatory text").

LOCOM treatment under national standards

The discussion paper EBA/DP/2012/03 specifically mentioned in a footnote in Paragraph 4.1 that "The EBA's preliminary view is that the RTS will not apply when the valuation basis is lower of cost or market (LOCOM) as applicable in the relevant accounting framework." Our view is that such clarification should be included in a similar form also in the RTS.

National requirements

We believe that it should be generally stated that the requirements of the standard should not be treated as additional requirements duplicating rules already existing at a national level. For example, haircuts for risk positions may already be taken into account by the national accounting legislation (national GAAPs), as, for instance, by the German Commercial Code (340e paragraph 3 HGB). These prudential haircuts do not correspond exactly to the valuation adjustments as defined in the CRR. The German law also foresees that, on a yearly basis, the funds for general banking risks must be increased by at least the 10% of the net income from the trading portfolio (340e paragraph 4 HGB). The risk reductions for trading book positions held at fair value are measured regularly in the amount of VAR in accordance with German commercial law. As this prudential measure plays the role of a risk premium to account for the uncertainty in the realization of net trading income, it can be seen having a similar goal with valuation adjustments proposed in the regulation. In this case, AVAs should be calculated only on the excess amounts not considered in the haircut, thus avoiding double counting.

B. ANSWERS TO SPECIFIC QUESTIONS

Question 1:
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.

Article 3 paragraph 1 requires institutions that calculate AVAs based on market data to use the same market data as in the independent price verification (IPV) process as from Article 105(8) CRR. It has to be considered, however, that the IPV process is implemented only by institutions with intensive trade activities. Thus, such processes do not exist in all banks, especially not in smaller and retail oriented banks, such as many cooperative banks. While we see that the design of the regulation is based on the IPV process, such approach should not completely determine all elements, but rather leave and allow for some further specifications.

Paragraph 2 extends the market data to be used to "a full range of available and reliable data sources", listing among others: the exchange prices in a liquid market, consensus service data, indicative broker quotes etc. The wording seems to imply that the valuation input should take in consideration all the data sources listed. We think that such an obligation would be overly burdensome. The list should rather be seen as a waterfall of possible data sources. Using a reliable data source shall be sufficient without recurring also to less reliable sources. In our opinion in case of use of cash prices, as from consensus service data or broker quotes, such approach would be inappropriate. Moreover, even taking in consideration only all the "reliable" sources would require effort, create redundancies in the data, and generate costs, without improving the quality of the results. The integration of all data sources and the participation to consensus pricing services would lead to a significant additional burden of both material and labour costs, also to face the management of such a mass of data. In our view the definition of paragraph 2 poses some problems and should be reworded.

In conclusion we advocate greater flexibility taking into account the proportionality principle for the selection of information sources. Moreover, the test for the adequacy of the sources used by the bank is already in practice in the context of the audit run by the independent auditors.

Question 2:
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.

In our view, the threshold proposed[1] in the draft RTS is be too low for small and medium sized institutions with fair value portfolios that could well be above such limit. On the other hand such institutions may face great difficulties to implement the *core approach*, within the 20 days of the entry into force of the regulation, and may have to sustain high costs and effort.

Question 3:
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 appreciate the proposal of a simplified approach, yet we believe that it poses some issues to be addressed

[1] The sum of the absolute value of on- and off- balance sheet fair valued assets and liabilities shall be equal to or smaller than 15 billion Euros.

Firstly we point out that if parent institutions compute AVAs on the basis of a different methodology than the one used for their subsidiaries, this would require a double computation and a subsequent heavy operating burden. We believe that the RTS should shed some clarity on the possibility to net exposures between different legal entities and then focus on how the resulting AVAs can be split among the entities contributing to the exposure. Therefore, we believe that the two methods must be mutually exclusive: if a subsidiary uses the simplified approach, then the perimeter of that subsidiary must be excluded from the application of the core method.

In the problem definition paragraph of section 5.2, note 3., it is reported that, according to the European Commission, more advanced calculation techniques are needed for the valuation of complex and illiquid products. The presence of such positions is not linked to the total amount of positions held at fair value. Therefore, there should generally be no need for a threshold and the simplified approach should be open to all institutions not holding such complex and illiquid assets and liabilities. Moreover, since IFRS requires measuring assets at fair value even if not available for sale, the threshold should be higher.

We also ask to clarify the compliance with the threshold. The wording suggests (Article 4(1)) that the absolute value of assets and liabilities is to be added for this purpose. We suggest to clarify that positions that can be offset against another should not be included. Furthermore, hedged positions (secured transactions/hedging) should not be included in the calculation of the threshold either.

For the calculation of AVA (Article 5(a)) the 25% of the net unrealised profit refers only to financial instruments "held" at fair value. In our view only assets (in particular, to determine the threshold value of 15 billion) should be considered.

Positions whose fair value is provided by an active market should be exempted from valuation discounts. For institutions reporting under national GAAP, this can be addressed assigning a zero AVA to positions that fulfil the requirement of a tradable price determined on a two-way market, as defined in Article 338 CRR; institutions that report under IFRS may apply a zero AVA to Level 1 IFRS Fair Value Hierarchy positions, and Level 2 positions (provided that evidence of a tradable price on a two-way market is given). In our view, such form of a relief is to be created since many of the reasons that call for valuation adjustments do not apply to these positions: their fair value is, indeed, constantly updated and assessed by the market itself and the active market grants sufficient liquidity to exclude, for example, close out costs.

Question 4:
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.

Firstly, we would like to welcome implementation of the proportionality principle, allowing smaller institutions with limited exposure to fair value positions to apply a simplified approach for the calculation of AVAs.

Also, in our opinion it would be appropriate to allow institutions to decide which approaches suits best to their business model and allocated internal resources. The simplified approach should therefore be seen, and accordingly developed, as a standardised approach available to all institutions, regardless of their size. We believe, indeed, that the introduction of a widely accepted standard approach will help the local supervisory process, make the AVAs comparable among different credit institutions and contribute to a smoother change of valuation regime.

The simplified approach, on the other hand, does not account for very liquid positions, which can be, instead, assessed to have a zero AVA adjustment when applying the core approach (Articles 8(2), 9(2),(3)). It seems reasonable to apply the simplified approach to IFRS Level 3 positions or, for institutions not reporting under IFRS, to positions that do not fulfil requirements of Article 8(2)(a).

Question 5:
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)?

According to article 5 one element of the calculation of the AVAs under the simplified approach is "25% of unrealised profits on financial instruments held at fair value". However, there is no common understanding or a legislative definition of the term "unrealised profit". This may create difficulties when applying one concept to and entire trading book with a variety of instruments. Another element that may have a significant impact on the determination of the capital charge is represented by the approach taken by the institution with regards to securities management (LIFO, FIFO, average purchase price).

We believe that there should be no distinction regarding the percentage applied to unrealized profits and losses since the current proposal would enhance the effects of market volatility; moreover, we consider the percentages for deduction to be too high; they should be assessed as part of the Quantitative Impact Study (QIS).

We think that the wording "matching, offsetting assets and liabilities" (Article 5(b)) also includes hedging situations: As regards hedging transactions, we believe that neither of the transactions that are included in the hedging should be taken into consideration when calculating the AVAs and Article 5(b) should be drafted accordingly.

The simple approach should not be configured as a strict and inflexible regulation with an almost punitive effect. EBA rightly assumes that "institutions with small fair value portfolio will typically be subject to limited valuation uncertainty" (Recital 6 of draft RTS). A certain degree of sensitivity, as for the core approach, should therefore be provided.

In our opinion liquidity is an essential input to the valuation uncertainty. However for the simplified approach we would recommend to keep the algorithm rather simple, and address the liquidity of positions in an indirect way via Fair Value Hierarchy. According to the IFRS 13 Fair Value management, Level 1 of Fair Value includes positions valued with observable inputs without any adjustment, which implies high liquidity of the valuation inputs and less valuation uncertainty.

Question 6:
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 consider the back-up approach proposed in Article 7 (Section 3) as generally acceptable, however the proposed weights to calculate the AVA should be re-calibrated, as they are too high. In particular, calculating an AVA corresponding to the 10% of the notional value of the relevant financial derivative (Article 7(4)(b)) seems disproportionate, also considering that in many cases the nominal value of the instrument is only used for interest calculations. As an alternative, we propose to calculate AVAs as a percentage (e.g. 25%) of the already made fair value adjustments.

Moreover, the wording of Article 7 seems to suggest that an institution that fails to determine even an AVA category (Art. 8 to 16) for a sample of the positions being valuated, automatically qualifies for the alternative approach under Article 7. This would be an excessive measure and we believe that, in case one category of AVAs cannot be determined, a combination of the core approach and the alternative approach under Article 7 should be allowed.

Question 7:
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.

According to Article 8, for exposures showing records for tradable prices determined on a liquid market, or based on a reliable data, no material market price uncertainty can be determined and the AVA for market price uncertainty shall have a “zero” value. However, we think that it should be clarified that these requirements are always met when instruments are traded on an active markets, classifiable Level 1 according to the IFRS fair value hierarchy.

Moreover, we believe that the requirements for the reductions of parameters for market price and close-out costs uncertainty are too strict and onerous. In fact, the limiting provisions for such reductions from Articles 8 and 9 are further strengthened by Article 20.

The discussion paper EBA/DP/2012/03, when addressing the issue of AVAs’ calculation, explicitly stated in note 21 in Paragraph 4.4 that the DVA (the gain or loss on liabilities reported by the institution due to its own credit quality) should not be included in the calculation of own funds. Therefore, DVA does not need to be assessed for prudent valuation purposes. We see that such approach has not been reflected in the proposed draft RTS. Therefore we suggest that such a reference shall be provided at least in a footnote. At the same time, a similar approach should be considered for the fair value reserves related to gains or losses on cash flow hedges of financial instruments that are not valued at fair value, including projected cash flows. Such approach would be consistent with Article 33(1) CRR and avoid double counting for deduction of such items.

Finally, for what pertains CVA we request clarification that no double counting occurs and that only the uncertainty component not already included in the CVA itself should be considered. Changes in the probability of default should not be taken into account.

Question 8:
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.

Question 9:
Are there cases where the above AVAs may have a zero value that could be defined in the RTS? If yes, please specify.

We think that the Model risk AVA (Article 11) should take a zero value. Model risk may reflect different aspects such as correlation risk, interest rate risk, recovery risk, dividend risk. Such a variety of model risks are hard to quantify in terms of AVA. This is also the case for setting up alternative appropriate models and calibration approaches, or expert estimations (as proposed in paragraphs 3 and 4).

Moreover, we would appreciate some clarifications on model calibrations "other than calibrations derived from market parameters" (Article 11(1)).

There is no consensus in the industry on a definition for funding valuation adjustments. Moreover there is a number of different approaches to account for financing costs and profits for unsecured derivatives, and in our view Article 13 does not provide a consistent perspective. Also, it is unclear how expected funding costs could be considered as part of the AVA.

Finally, we understand from Article 14 that future administrative costs are not to be taken into account into AVA (that therefore shall have a zero value) when closing costs are based on a direct exit price based on market prices. We ask for your confirmation on such interpretation.

Question 10:
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.

Question 11:
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.

The consideration of diversification effects in Article 17 is appreciated, nevertheless it seems difficult to be implemented in practice. We think that institutions should be given the possibility to calculate these on the basis of appropriate and regularly reviewed internal procedures.

Question 12:
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 do not agree with the requirement proposed.

All in all, we believe that the ongoing data quality assessment prescribed in Article 20 is very onerous and should be excluded from the RTS. The requirement to use systematically the actual prices entails a heavy system. This would require ponderous changes to enable the handling and the storage of data. If this requirement is kept, we would like to reduce the application scope by targeting only the most exotic instruments, and to delete the prescriptive methodology, leaving it up to the institutions to design the appropriate methodologies to make use of this trade data. We believe that, at its best, this test could bring value to institutions when assessing their valuation uncertainty, if restricted to an equivalent to Level 3 instruments in accounting terms.

Moreover, Article 20 paragraph 2 and 3, only refer to "reduced valuation inputs" with no further specification. Therefore, if the article is kept, we would ask to explicitly clarify that institutions that do not reduce the number of parameters used for the valuation inputs shall be exempted from the rules proposed in the article.

Moreover, we believe that paragraphs 2 and 3 should be elaborated further and provide more detail: we would welcome for example some terms' specifications in the Definitions section (Article 2), if not already specified. For example the meaning of "valuation inputs did match the contractual price" is not clear. Also the use of interpolation techniques, as outlined in Article 20(3)(c),(d), is not clear to our understanding and we ask for an illustrative example.

Question 13:
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?

In our view, a cost benefit analysis should take in consideration also the following:

- Indirect costs – ineffective management: the new increasing complexity of capital requirements calculation may lead to less effective bank management. Prudent valuation regime intends to protect the economy from hidden valuation distortion in bank's balance sheet: such a crucial role would require that it is introduced smoothly, gradually and in the consistent way. We believe that unfortunately the current draft of Technical standards does not provide clear guidelines about the calculation of AVAs.
- Indirect costs – unattractive markets: the introduction of AVAs for less liquid positions will make investment into developing and emerging markets less attractive, which could contribute to the slowdown of those economies development. Charging AVAs for complex products may also hinder the innovation on the financial markets, which could affect their economic prospects.

Finally, it appears that the proposed core approach presents some procyclical features that lead to a drain of further liquid resources towards capital reserves in conditions of liquidity distress.

EACB contacts:

Mr. Volker Heegemann – Head of Legal department

v.heegemann@eacb.coop

+32 (0)2 286 98 48

Mr. Marco Mancino – Adviser Banking Regulation

m.mancino@eacb.coop

+32 (0)2 286 98 44