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## Consultation Response

### RTS on Prudent Valuation

15 April 2024

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Banking Authority's paper on Amending Draft Regulatory Technical Standards ('RTS') on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013 (EBA/CP/2024/01).

We summarise below our response to the consultation. Our detailed answers to the individual questions raised are included as Appendix 1 to this letter and a list of points where we are requesting clarification are included as Appendix 2.

#### Executive Summary

We welcome the proposed framework for 'extraordinary circumstances' for prudent valuation, including the conditions for determining the presence of extraordinary circumstances, and rules for the calculation of AVAs under those circumstances.

We note however, that the remainder of the consultation is on the EBA's own initiative and goes beyond the scope of the mandate as prescribed in CRR Article 34 subparagraph 4 of the prospective CRR3 proposals, and as listed in the EBA's roadmap for strengthening the prudential framework<sup>1</sup>. The expanded scope of the RTS gives rise to concerns that the level 2 proposals appear to go beyond the mandate of the level 1 amendments proposed in the CRR3 package, and introduce an unwarranted level of conservatism, both in calibration and in operational terms. For instance, the hypothetical benefit of an increase in the alpha factor in the proposed extraordinary circumstances framework is undermined by the significant and conceptually debatable reduction of scope of AVAs to which it would apply under normal circumstances, mostly due to a larger fall-back scope and the opposition between VRT and diversification application.

We have concerns that some of the proposed changes do not meet the objective of ensuring a more harmonised application of the RTS. The new RTS leaves many points open to interpretation, which could result in significant differences in implementation. This could be solved by incorporating clearer definitions and providing detailed guidance with examples. We would recommend that the EBA consider the creation of industry led working groups to produce suggested guidance for specific topics.

Our view is that the overall impact of these proposed changes to the RTS are unduly conservative and are likely to take Prudent Valuation far beyond a 90% confidence level as indicated through the QIS analysis, in particular with regard to:

- the requirement to use the fall-back approach where independent pricing sources are either not available or are more subjective and the resulting calculation of the fall-back approach, particularly for derivatives.
- the requirement for an eligible accounting fair value adjustment to be included in fair value for the diversification benefit to be applied for that AVA, especially with respect to MPU and its potential override of accounting standards.

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<sup>1</sup> <https://www.eba.europa.eu/sites/default/files/2023-12/9dc534e8-8a3d-438f-88e3-bc86e623d99e/EBA%20Roadmap%20on%20strengthening%20the%20prudential%20framework%201.pdf>

- the more stringent requirements put on the VRT both with respect to the operational requirements and removal of the diversification benefit.

We have particular concerns about the amendments to the fall-back approach. The use of a percentage of notional for derivatives is rarely a relevant measure of valuation uncertainty. The changes in Annex 2(a)(i)(1) are likely to significantly increase AVAs due to institutions not taking MPU FVAs. The RTS should not be instrument specific nor prescriptive, but more principle based. We believe that institutions should be permitted to continue to use a risk-based approach for derivatives.

With respect to the regulatory implementation of sections 11 to 14 of the Basel CAP50 guidelines, we are also concerned that the new RTS would impose significant implementation costs and increased capital requirements on the European banking sector. We recommend that further consideration is given to the costs and benefits of the proposed changes.

The new RTS contains significant changes and will require an in-depth review of all the related FVA/AVA models, the market data inputs and the IPV process. We would recommend a long transition period before any changes are implemented.

## **About AFME**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global institutions as well as key regional institutions, brokers, law institutions, investors, and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

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## Appendix 1 – responses to questions

### Q1. Calculation frequency of AVAs - Article 1

**Are you able to calculate and report fair values and AVAs with a monthly frequency? If not, please describe the challenges you face with regard to a monthly calculation, and the monthly reporting of fair values and AVAs (e.g., with the COREP templates). Please make clear if those challenges arise in general or with regard to specific positions (e.g., type of instruments), whether they arise for positions assigned to the trading or non-trading book, and whether they arise for positions treated under the simplified or core approach. Please describe any simplifications and/or assumptions you would have to apply to determine fair values and AVAs on a monthly basis.**

Calculating AVAs with a monthly frequency would be operationally challenging for many of our members. The overall PVA process is time consuming and the benefits of moving to a monthly calculation are not obvious.

At the public hearing on 4 March, EBA representatives indicated that monthly CoRep reporting would only be required on request. As this is already permitted under the current RTS, we do not think any changes are necessary.

We would suggest that quarterly rather than monthly reporting is more appropriate for the following reasons:

- The volatility of AVA over time stays reasonably constant apart from exceptional cases (such as the Covid outbreak) but these can be tackled in exceptional circumstances without such strong and complex requirements.
- PVA core approach processes require the collection of a vast amount of risk and market data, numerous calibrations, it involves subsequent reviews and challenges as part of a robust governance, it needs proper commentary and finally results in multiple reporting and escalation.
- Monthly reporting cannot be done on banking book positions where valuation for accounting and prudential requirements is only required on a quarterly basis.
- The consultation paper refers to window dressing, but this would involve very short term and liquid contracts. These contracts are not subject to material valuation AVA.
- Finally, management awareness to valuation risk is already achieved through various accounting fair value adjustments that exhibit similar dynamics to AVAs, such as XVAs and bid offer FVAs; various markets volatility indicators are also indicative of potential price dispersion and provide real time information.

If any changes are made, it would be helpful to have more details of the reporting process including the proposed templates, the timelines, and the submission process.

## Q2. Data sources - Article 3

**Do you have any comments on the amendments to Article 3 in general, and specifically with regard to the threshold of ten contributors set out in paragraph 2, point (d)? If you consider a different threshold should be applied, please describe how to set it, and provide a rationale and evidence supporting your proposal.**

Our members agree that the use of consensus should be robustly back tested like any other pricing source. This should be part of a systematic pricing source accuracy, reliability, tradability and eventually observability assessment. The RTS should not be source specific as reliability assessment also applies to other sources, such as comparable analysis, evaluated pricing, broker quotes, etc.

The threshold of ten contributors in consensus data seems arbitrary and is not justified. Valuation inputs with committed broker quotes can have few participants to a consensus that provide less added value. Conversely, valuation inputs in one-way markets (all institutions are exposed in the same direction facing customer and no risk reduction market exist) may have large consensus service participation as many institutions need an independent value with no alternative to consensus services.

Due to the intrinsic features of some financial products and their reference markets, it is important to highlight that in many cases consensus data are contributed by less than ten contributors. This means that a significant part of AVAs would be formulaically computed under the expert-based approach and, considering that under the revised framework, the application of expert-based approach has direct and indirect impacts, this approach would bring to a potentially significant increase in AVAs.

The threshold creates a wrong incentive for consensus providers to look for less active market participants to increase the number of contributors. It is also anti-competitive as it would favor established consensus services at the expense of emerging services and could deter new entrants from entering the market. Conversely, it might create a wrong incentive for consensus services to aggressively look for a tenth contributor which may just deteriorate the quality of the service.

Evaluating the data providers holistically and taking the best reflection of the market (supported by specialist services for specific products) is a far more viable approach, than evaluating any service that could provide ten consensus contributors for any position the bank holds. The regulation should be clear that a single consensus service (that which has been deemed to best meet the needs of the institution) can be compliant, rather than a blended approach considering all viable services (this risks cherry picking and is operationally complex).

In line with industry practice, back testing of market data is outsourced to third parties. The draft RTS would indicate that back testing would have to be carried out in-house to be able to consider the results of the back testing, which would make the vast majority of AVAs expert based. We would recommend that the text should be amended to permit outsourcing.

We have concerns about the sources of market data listed in Article 3. Common data sources such as data vendors, security pricing vendors (e.g. BVAL) and clearing levels do not appear to be included, and we would be grateful for clarification as to whether these can be used.

We are also concerned that a prescriptive list of data sources could preclude any future market development or innovation. We consider the previous wording of 'including where relevant...' is more appropriate for the

varied trading inventory held by regulated entities. We also request that ‘the identification of natural bounds to the value of an instrument’ is included in paragraph 2 as well as paragraph 3, as this is an entirely reasonable threshold to use in a prudent valuation calculation.

Article 3 paragraph 1 requires that, “Institutions shall use at least the same range of market data as a basis for calculating the AVAs, as they use in the IPV process, provided that the market data meet the requirements set out in this Article.” To avoid the confusion with the recency requirement for AVA data per Article 3a, assuming IPV intends to use the best quality data source (rather a range with old data), we request that the wording is changed to “institutions shall use at least the same source of market data as a basis for calculating the AVA, as they use in the IPV process.”

### **Q3. Data requirements - Article 3a**

**Do you have any comments with regard to the requirements proposed in Article 3a? If you consider that some of those requirements should be adjusted, please describe how you would revise them in order to meet the policy objectives that the proposed amendments try to achieve and provide the rationale supporting your proposal.**

The limitation on using data within one month of the calculation date, whilst understandable, is arbitrary.

It is right that the valuation must be based on recent data reflecting the state of the market as of the reporting date. However, when measuring confidence interval for uncertainty, an historical approach is often necessary to build a relevant distribution. Data over one month old may be needed to build distributions with sufficient data, provided that the distribution obtained is a fair representation of the uncertainty as of the reporting date. Conversely, for more liquid instruments, data from 30 days earlier is of limited relevance. Judgement in the choice of suitable data is required to make informed decisions and reliably assess a prudent valuation.

We would recommend the following changes:

- The wording in Article 3a paragraph 3 should be changed to a positive approach i.e. “demonstrate there are sufficient and reliable market data sources to calculate AVAs under range-based approach,” as this will be easier to demonstrate in practice.
- Transaction pricing data above 1 month in “Data Range” approaches should be permitted, with clear argumentation and necessary adjustment if market conditions at reporting date are materially different.

### **Q4. Threshold calculation - Article 4**

**Do you agree with the proposed amendment to capture valuation risks stemming from fair-valued back-to-back derivative transactions and SFTs? Do you agree that this would restore alignment with the treatment under the core approach? If not, please describe how you would suggest revising the amendment providing any rationale and supporting evidence.**

Our members agree with the proposed amendment.

#### **Q5. Fall-back approach - Article 7**

**Do you agree with the proposed amendments to the calibration of the fall-back approach? If you consider that a different range of percentages should be considered, or that the AVAs under the fall-back approach should be calculated in a different manner, please suggest a range or a methodology, as applicable, and provide a rationale and evidence supporting your proposal.**

#### **Q6. Fall-back approach - Article 7**

**Do you have any comments in relation to the positions proposed to be subject to the fall-back approach? If you consider a different treatment should be applied to these positions, please describe how you would treat them in order to meet the intended policy objectives and provide the rationale and any evidence supporting your proposal.**

Our members have considerable concerns with the proposed amendments to the fall-back approach.

The use of a percentage of notional for derivatives, especially the most complex ones that may be subject to the fall-back approach is rarely a relevant measure of valuation uncertainty. A binary % based charge on untested/illiquid IPV cash positions seems a rudimentary and backward step. Existing methodologies look at more relevant measures (e.g. for cash positions the relevant region / rating sector spreads or peer debt etc) and would provide a better assessment of PVA. Additionally, derivative positions are decomposed into risk factors which add another layer of complexity of bifurcation of liquid vs illiquid.

This is illustrated by the following examples:

- A derivative with a notional of 10 and a “leverage” or “multiplier” of 1,000,000 will have the equivalent pay-off as a derivative with a notional of 10,000,000. However, these two trades would attract very different prudent valuation AVAs under the fall-back approach.
- Delta on an ATM option is approximately half that on a swap for the same notional, while an equivalent OTM option may have close to zero delta. The fall-back AVA will be influenced more by portfolio composition than by valuation exposure.

A fundamental issue with an instrument-based approach as opposed to a net risk approach is that once a certain number of instruments are allocated to the fall-back approach, they are in theory no longer included in the core approach, so the vanilla risk exposure in the core approach becomes totally unbalanced as the fall-back deals are missing. The resulting Close Out Cost or Market Price Uncertainty becomes meaningless. Alternatively, allocating whole portfolios to the fall-back approach will inflate the total notional artificially. Imposing fall-back on exposures which are continuously risk managed in the trading book and for which models are approved in the context of the Market Risk framework would be inappropriate.

Nothing can replace a sensitivity analysis with respect to the relevant risk factors. Some of these risk factors have boundary values (positive volatilities, correlations) that the notional based measure may not respect. A better and more appropriate measure would be to prescribe uncertainty from spread measures observed via proxies with boundary conditions.

The fact that the fall-back approach replaces all AVAs from Article 9 to 17 (including e.g. AVAs for which the scope is mainly Level 3 trades) needs further consideration. Under the proposal that an entire product falls back if just one parameter is unknown/uncertain then removing the more exotics payoffs from the computation of MPU/COC will increase materially the MPU/COC AVAs for which only the hedges/vanilla payoff will remain. This would also add significant operational risk because all the MPU and CoC AVAs calculated for the tested parameters within the position along with the other AVAs would need to be removed to accommodate the fall-back AVA.

We recommend that any fall-back should be envisioned only as a last resort when the firm is not able to gauge an appropriate level of certainty, using any sensible inference or extrapolation technique. Regulators may alternatively use the fall-back approach as a challenger model.

For non-derivatives, using a fixed percentage of MTM would ignore nuances across different markets, instruments, and counterparties. This would not level the playing field, as a fixed percentage may be aggressive for one institution but conservative for another, depending on the composition of their portfolio.

Illiquid positions requiring valuation inputs that cannot be easily calibrated to market information are those for which a valuation uncertainty measure is the most useful and Prudent value regulation aims is to achieve this. On the contrary, we think that risk sensitivity should be preserved as much as possible, according to materiality criterion and not mandatorily on single valuation inputs (e.g. IPV performed on final prices of a class of instrument types and not on each single risk factor).

We do not believe any explicit consideration should be made for unlisted equities. Various valuation techniques (e.g. comparables, DCF) already exist that are described in [IPEV Valuation Guidelines](#) and practically implemented (see [IMF Valuation of Unlisted Equity](#) ). These techniques enable the derivation of appropriate uncertainty ranges. Moreover, current RTS state that PVA should be aligned with IPV process. The proposed fall-back would contravene this principle for unlisted equities where a valuation technique is already used.

If changes are made, we would recommend that a precise definition of “unlisted equities” is provided in Article 7.3. This is because there can be many unique cases around “unlisted” especially in the trading book, for instance, securities which are subject to a temporary suspension.

## **Q7. General requirements under core approach – Articles 8**

**Are the requirements included in Article 8 clear? If you consider them to be not clear or to be particularly challenging to meet in specific circumstances, please describe the issue you encounter and how you would address it in order to meet the intended policy objectives and provide the rationale and any evidence supporting your proposal.**

Our members find the wording of this article difficult to understand and are concerned that it would lead to different interpretations by different institutions.

Article 8 paragraph 3 defines “eligible accounting fair value adjustment” to be “any adjustment to the fair value already applied by institutions in accordance with the applicable accounting standard that can be identified



as addressing the same source of valuation uncertainty as the AVA.” Annex paragraph 2 states that institutions cannot apply an aggregation factor alpha 0.5 in case Fair Value does not include “an eligible accounting fair value adjustment in accordance with Article 8 paragraph 3, and that eligible accounting fair value adjustment is commensurate with the adjustment other market participants would consider when determining the reference fair value of the positions”. These paragraphs are unclear and risk overriding existing accounting standards, specifically:

- It is impossible to obtain a quantitative consensus of the fair value adjustment other market participants would consider when determining their reference fair value. We therefore request that this provision is removed.
- Accounting rules (IFRS 13.88) already provide more flexibility of the accounting fair value adjustment, i.e. “For example, it might be necessary to include a risk adjustment when there is significant measurement uncertainty.” We recommend that the words ‘fair value’ should be replaced by ‘accounting value’ in lines 2 and 5 of paragraph 3, to avoid double counting in the way the CET1 is computed. We consider MPU FVAs to be inconsistent with the determination of fair value under IFRS and US GAAP requirements. Specifically, the primary objective of fair value measurement is to determine the price at which an orderly transaction would take place between market participants on the measurement date (i.e., an exit price). To further adjust such a price to incorporate MPU FVAs would result in a price that no longer represents fair value, but instead would be more consistent with a prudent estimate. The exit price of an item is intended to be the best estimate of a transaction price for that item, and that price should not be further adjusted solely to reflect a specific confidence level associated with any of the inputs to that valuation. This concept is consistent across US GAAP and IFRS, where an entity’s best estimates of fair value are not required to have a specified minimum degree of confidence. This concept is explicitly supported by paragraph B3.27 in the Basis for Conclusions to Chapter 3 of FASB Concepts Statement No. 8, Qualitative Characteristics of Useful Financial Information, which states “Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality.”
- The intention of introducing the conditions for applying aggregation factor alpha 0.5 seems to be driven by the absence of fair value adjustments for MPU and COC, as mentioned in explanatory note paragraphs 23-27. Therefore, we suggest clarification is provided in Annex paragraph 2 that the condition for applying aggregation factor alpha 0.5 being “Fair Value includes an eligible accounting fair value adjustment on MPU and COC in accordance with Article 8(3), ...”

Article 8 does not address the issue of offset between Day One Profit deferral (DOPD) and AVA. We understand that the offset prohibition stated by Q&A 2019\_4458 still stands but this is not justified given that DOPD and AVA can account for the same uncertainty due to unobservable valuation inputs. We refer to our previous letter dated 21 December 2023 in this regard, a copy of which is attached.

Article 8 paragraph 5 states “For the determination of the AVAs, ..., institutions shall use the same pricing models that they use to determine the changes in the value of positions reported in their financial statements. If sensitivities are used in the determination of AVAs, they shall be based on those models.” We would like to point out the cases where end-of-day valuation is based on third party pricing model whereas sensitivities that are used for market risk and AVA calculations are produced by internal models. For example, end-of-day valuation for the multi-callable bonds is based on Bloomberg prices, while credit risk sensitivities are not provided by the same vendor, but generated from validated internal models. Therefore, we suggest ECB consider adding the words ‘or on validated sensitivity models for end-of-day risk calculations’ to the last



sentence. We would also propose the introduction of materiality considerations given the balance between complexity of the computation and the impacts.

Article 8 paragraph 7 states “Where institutions apply a sensitivity-based approach ..., institutions shall be able to demonstrate to the competent authority that the sensitivities used in the computation provide an accurate representation of the actual profit and loss, including convexity and cross-order effects”, we would highlight that modeling sensitivity-based Convexity and Cross-effect MPU/COC AVA is not feasible due to the unavailability of such market data. We recommend that clarification is provided of the exact requirements here, and we would also point out that even with a full revaluation approach, not all cross-order effects can be covered.

We therefore request that this requirement be removed.

#### **Q8. MPU, CoC and MR – Articles 9, 10, 11**

**Do you have any comments with regard to the amendments to Article 9, 10 and 11? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

Our members welcome the possibility of reducing the number of paragraphs. However, as currently drafted, these articles have become much more complex and are likely to result in differences of interpretation among institutions contrary to the objective of the RTS. We recommend that the EBA should consider the creation of industry led working groups to draft appropriate guidance.

The proposal fundamentally contradicts the letter and the spirit of the diversification benefit, as previously elaborated by the EBA in paragraphs 60 and 61 of the EBA discussion paper on prudent valuation:

- “The principle of allowing for a diversification benefit is based on the theory that an institution with many small valuation uncertainties may face a very different total valuation uncertainty when compared to an institution with one large valuation uncertainty”
- “Any diversification benefit should in any case only apply to certain AVAs as some relate to uncertainty around the fair value of individual positions which could be positive or negative (and which would not all be expected to be at the bottom of the range of plausible values at the same time) while others relate to reserves that are required for particular reasons that are only negative.”

We do not believe that the diversification benefit should be adjusted to account for any flaw in methodologies.

We therefore do not see the purpose of removing the alpha factor when using the Variance Ratio Test (“VRT”), as there is no overlapping between the effects, because they represent different aspects (the VRT addresses the overlapping of adjustment in highly correlated risk factors, versus the diversification effect which addresses the overlapping of AVA adjustment in a portfolio with enough granularity due to these being diversified enough, this is, uncorrelated in greater terms).

Article 9 paragraph 4 states that institutions may calculate the individual market price uncertainty AVAs based on a reduced set of parameters. For certain valuation inputs (e.g., EURO STOXX vega) institutions need to identify ex ante which strike-maturity combinations are contributed by more than ten contributors and are back-tested and then apply the VRT to a reduced set of parameters including only this type of combinations. We believe that this requirement, in addition to the new stricter requirements for the range-based approach, limits too much the VRT application.

Article 9 paragraph 4(a) does not define tradable instruments. Articles 9 and 11 indicate that the exposure should be mapped to tradeable instruments, and it is not clear where the expert-based or the fall-back approach can be applied. In cases where observability is low, mapping the whole exposure only to tradeable instruments is not methodologically sound and it is not aligned with the main purpose of the regulation of hedging the risk.

We have concerns about the proposed VRT calculations. Calculating MPU on a matrix input by matrix input basis does not account for the very high correlation that will exist between each input which reduces valuation uncertainty.

Articles 9 & 10 paragraphs 4 confirm that the application of the VRT remains optional if valuation inputs are mapped to a “set of market tradable instruments”. “Market tradable instruments” is further referenced in the VRT conditions but is not defined. We suggest a matrix of tradeable instruments at the valuation exposure level is defined in the RTS for each risk factor type, which would align to the Assessment of Modellability of Risk Factors per FRTB article 325be paragraph 9.

In Article 9 paragraph 8, it is reasonable to estimate the magnitude of the change in the individual market price uncertainty AVAs resulting from the use of a reduced set of parameters. However, in our view it is not necessary to explain the drivers of reduction, since it is the result of the VRT, nor to send a report containing this assessment, but producing evidence of the VRT.

In Article 9 paragraph 9, it is not clear how to prove that the level of certainty of the prudent value estimated under the expert-based approach is equivalent to that targeted under the range-based approach. We suggest removing this part or replace with a more feasible consistency check of this approach, such as using other available valuations like those coming from the collateral management process and corresponding controls on the valuation differences with counterparties. Moreover, it should not be necessary to include a margin of conservatism in the determination of the expert base estimate since it is already addressed by not applying the VRT.

We propose an additional consideration on articles 9 and 10: including a paragraph about valuation inputs on different risk factors that are part of hedging strategies. The sensitivity to such valuation inputs must be jointly considered, in accordance with trading logics and best practices, such as IFRS 13 principles and monitoring of sensitivity limits of Trading Book exposures.

The P&L requirement in the VRT is too constraining for the second order sensitivities and sensitivities generated by valuation adjustments. We would propose keeping constant risk over the past 100 days.

Article 9 Paragraph 11 adds a granular level of reporting for MPU/CoC for top 10 drivers etc. along with documentation. This would increase our members operational burden for little benefit. We would recommend that this should be provided only upon request.

## **Q9. UCS - Article 12**

**Do you have any comments with regard to the amendments to Article 12? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

The changes to the calculation of AVA UCS will add a lot of operational effort and methodological difficulties, while the impact on the AVA would be very limited. Therefore, we suggest allowing institutions to use materiality thresholds based on CVA amount or CVA sensitivity to the credit curve.

We note that the scope of CVA has been increased regarding Fair Value Securities Financing Transactions (SFT). FV CVA is not relevant when trading SFTs and no accounting adjustments for CVA are applicable. This is inconsistent with other capital measures, for example FRTB CVA allows for the exemption of FV SFTs subject to a materiality, US NPR exempts all SFTs, and the UK PRA significantly limits the scope. We suggest that this requirement be removed.

Article 12 states that 'SFTs' should be considered in UCS. The Explanatory Text states that SFTs should be considered in UCS 'Only where CVA is recorded for those instruments.' To avoid ambiguity, we would like the core text of Article 12 to clarify that SFTs should be considered 'only where accounting CVA is recorded for those instruments'. In case the interpretation of the above is that all SFTs, regardless of the CVA treatment should be incorporated (as indicated at the Public Hearing call), the wording should clarify that only SFTs with recourse to the counterparty should be considered (as opposed to non-recourse SFTs).

The requirement in Article 12 3(b) to include CVA correlations introduces operational burdens due to the prescribed granularity of application, without a necessarily meaningful change in outcomes. We recommend that this requirement be removed.

In article 12 paragraph 4, the requirement to set the margin period of risk ('MPOR') to be equal or greater than that employed for the purposes of determining the own funds requirements for CVA risk may create a double count of capital requirement. If there is a default, there is indeed a value slippage risk leading to insufficient collateral posted leading to a real counterparty risk. However, at the current date when default has not materialised, valuation is about the purchasing price offered by a willing market participant. Default risk is rarely considered in the interbank market for fully collateralised derivatives or SFT. We also think there is possibility of double counting as arguably the MPOR increase employed in own funds is already going above fair value to stressed capital which is already taken. We suggest that the MPOR concentration be replaced with Margin frequency + 10 days for all.

## **Q10. CP and FAC - Articles 14, 15**

**Do you have any comments with regard to the amendments to Article 14 and 15? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

We have the following comments on the amendments to Article 14:

The use of the liquidity horizon set by article 325 bd CRR, under which no concentrated position AVA is required, is a welcome amendment that compensates for increased market risk charge when the liquidity horizon is longer for less liquid risk factors and avoid double counts. This amendment is consistent with the [2013 EBA CP on prudent valuation](#) that stated “*Concentrated positions AVA is only required where the prudent exit period exceeds the time horizon for the market risk measure used to calculate own funds requirements as defined in Article 365 of Regulation (EU) 575/2013.*”

The RTS requirement of the use of Liquidity Horizons per article 325bd of Regulation (EU) No 575/2013 for Concentration AVA refers to Table 2 in the article. However, in article 325bd a formula is referring to the calculation of partial expected shortfall measures in accordance with Article 325bc for FX and Commodity, but it is not clear as to whether this is optional or mandatory. We request that further clarity is provided over the determination of the Liquidity Horizon, for example with direct reference to Table 2 (only) or transferring relevant text into the Prudent Valuation RTS.

We do not think the inclusion of the volatility of the bid-offer spread is necessary. The COC AVA is already capturing the 90-centile bid offer charge including for the concentrated position, so this seems like a double count. The mid volatility is appropriate as it impacts the market movement. We do believe it is appropriate to take the 90-centile measure of volatility.

We have the following comments on the amendments to Article 15:

These amendments will result in additional charges even if back testing of PruVal charges is successful. We suggest that this requirement be removed if PruVal has been successfully back tested.

The discount rate is disconnected from cost of capital. We suggest discount rate should be linked to the cost of equity of the institution.

The amendment to Article 15 introduces four extremely stringent conditions for the computation of the future administrative costs AVA which are based on principles regarding the uncertainty of the valuation inputs, illiquidity of positions and existence and feasibility of dynamic hedging strategies. We do not think these are necessary as we observe a double counting of prudential requirements for FAC AVA that are already considered in the computation of MPU, CoC, Model Risk and Concentrated Positions AVAs. In our opinion, only positions that are hard to liquidate because of the existence of legal or regulatory hurdles that prevent the institution from exiting the positions should be subject to future administrative costs AVA.

We also note that condition b) does not provide a definition of tradable instrument. Please note that the fact the exposure cannot be mapped to tradable instruments does not imply additional future administrative costs since there are market practices that provide guidelines in the valuation process. Condition b) tries to assess the uncertainty related to the potential existence of a range of different valuation techniques that are used by market participants to value bespoke and tailor-made contracts. This requirement is already considered when computing the Model Risk AVA.

For these reasons, we suggest the draft RTS should specify that the FAC AVA is an incremental AVA to the MPU, CoC, Model Risk and Concentrated Positions AVAs where there are obstacles to exiting the valuation exposure

(e.g., valuation exposures requiring client consent; valuation exposures with a tailored legal set-up; valuation exposures subject to regulatory holding hurdles).

#### **Q11. Extraordinary circumstances - Articles 19a, 19b**

**Do you agree with the requirements set out in Article 19a and Article 19b? If you do not agree, please describe how you would suggest revising those Articles and address the mandate on extraordinary circumstances outlined in Article 34 CRR. When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.**

Our members agree with the requirements set out in Article 19a and Article 19b. Considering extraordinary circumstances with a mechanism to avoid a pro-cyclical effect of AVA is a welcome addition. The use of the aggregation factor alpha is efficient.

Article 19a provides examples of market factors to consider triggering the state of “extraordinary circumstances”. We agree that there should not be an automatic trigger from quantitative factors as no pre-set criteria will ever account for all cases and an element of human judgement is required.

The regulation does not state who makes the ultimate decision of declaring the state of “extraordinary circumstances,” and we suggest that this point is clarified.

#### **Q12. Aggregation factor for UCS - Annex**

**Which of the two options presented do you consider more appropriate for the purposes of addressing concentration of UCS AVAs? When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.**

Our members have concerns about both options, and we would therefore recommend that neither option is adopted.

Option 1 suggests a binary cliff mechanism for the whole portfolio based on one counterparty, which does not measure the overall concentration of the portfolio but rather just one counterparty's overall AVA. It isolates counterparties whose AVA clearly dominate those of the other counterparties if there is a large number of counterparties (well above ten) but is not a proof of concentration in absolute terms. If this option is adopted, we would recommend adjusting the alpha factor to zero for only counterparties that are deemed concentrated. This could be quantitatively measured such as the one proposed in option 1, i.e., for those counterparties only where  $UCS\ AVA > a\ fixed\ percentage\ (e.g.\ 10\%)\ of\ Total\ UCS\ AVA$ .

Option 2 appears simple to implement but is arbitrary as being part of the five largest UCS AVA has no relationship with concentration. The five counterparties may simply have a slightly larger AVA than others. It is not appropriate for a fully diversified portfolio with no concentration risk.

More fundamentally, both option 1 and 2 subjectively measure “inner” concentration and are irrelevant from a valuation perspective, be it accounting, regulatory or in a resolution context. Market participants/valuers would not factor in these metrics when pricing individual or aggregated XVA exposures not to mention that 10% threshold/5 most significant counterparts appear arbitrary.

### **Q13. Annex**

**Do you have any comments with regard to the amendments introduced in the Annex? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

Our members disagree about the rationale leading to the removal of the method 2 of aggregation. Contrary to method 1, method 2 leads to a CET1 level independent from the choice of Fair value methodology and level of conservativeness embedded in Fair value. Method 2 relies on a precise definition of the Expected Value (EV) that is insufficiently defined in the current framework for CoC (expected exit cost for Prudent value vs principal market exit cost for Fair value). However, for MPU and Model Risk, expected value is clearly defined as the value obtained with valuation models without conservative layer (valuation theory defines the value as the expectation of future cashflows).

With the use of method 1, the effect well explained in figure 1 page 9 of the consultation paper (impact of absence of fair value adjustment) leads the revised framework to propose a form of penalty ( $\alpha = 0$ ) when fair value adjustments are deemed insufficient (defined as ‘not commensurate with the adjustment other market participants would consider when determining the reference fair value’). This may lead to inconclusive challenges by the supervisory authority as to whether fair value adjustments are insufficient as there are no objective criteria for this. Setting an appropriate level of EV in method 2 with more regulatory guidance would lead to better EU level playing field in the determination of CET1 without the need to challenge each firm’s accounting practice with subjective judgement. Again, the diversification benefit has been designed to account for the structural de-correlation between uncertainties across all sources and when measured at a conservative confidence level. There is no theoretical rationale for adjusting it to offset various flaws or bias in the FVA or PVA framework.

Regarding the need to reintegrate unadjusted IPV difference into the CET1 measure through the AVA, we can understand the logic but there are 2 elements to consider: 1) If IPV is not adjusted because the independent source is not proven to be more reliable than the trader marking, there is no more reason to adjust CET1 than fair value apart from recognising that this is a source of uncertainty that should benefit from diversification benefit; 2) Only considering the negative unadjusted IPV differences may lead to a large negative adjustments as even if these differences are a form of valuation noise, the cumulative negative noise may be important when the total noise is not. The cumulative negative IPV would be also dependent on the granularity at which the IPV is performed /recorded.

We recommend that the hypothetical portfolio exercise for IMA benchmarking be expanded to assess consistency in FVA and PVA calibration across institutions.



The Annex should precise that the alpha values of 0.5 or 0 should only apply in normal circumstance when the condition of article 19a and 19b are not triggered (extraordinary circumstances). The conditions for setting alpha = 0 should be set in the RTS articles themselves and the annex should only contain the aggregation formula as it is the case in the current framework.

The Annex stipulates that only aggressive (i.e. "would result in a more conservative valuation") unadjusted IPV differences receive zero Diversification Factor. This will lead to asymmetric capital treatment depending on whether an institution makes a capital adjustment via the IPV process or via the Prudent Valuation process. The institution that adjusts through IPV will record both aggressive and conservative adjustments (irrespective of the granularity which the adjustment is posted). However, the institution that records the same IPV variances as unadjusted will receive zero Diversification Factor only on the aggressive IPV variance with no offset for conservative variances. This can lead to materially different capital positions which is contrary to the goal of achieving a level playing field irrespective of whether a bank chose to capitalise through IPV or Prudent Valuation. We would therefore propose that the definition of "Unadjusted IPV" is further extended to stipulate that the granularity at which the Unadjusted IPV amount is measured should be consistent with the granularity at which the institution records IPV adjustments and hence may include offsetting positive amounts (with the net amount capped at zero to not be capital additive), such that the goal is to produce the same net capital deduction for IPV adjustments irrespective of whether it is capitalised through AVA or IPV. It is also not clear at what level the variance should be considered, i.e. position-by-position or on a net basis.

Among the requirements to be met to apply an "alpha" factor equal to 0.5 we suggest deleting:

- the need to demonstrate that eligible accounting fair value adjustment is commensurate with the adjustment other market participants would consider when determining the reference fair value of the position, since this is already required by accounting principles (IFRS 13), and it is difficult to support these statements with evidences (e.g. institutions are not required to disclose this kind of information);
- the requirement related to the reduction of parameters, considering that this option is applicable only in extremely specific cases and it is subject to several requirements that are aimed at ensuring that combinations used are the most liquid ones and do not affect the ability of the institutions to close the position.

#### **Q14. Other comments**

**Do you have any other comments on this consultation paper? If you do not agree with any of the proposed requirements, please describe how you would adjust or design them in order to meet the policy objectives that the proposals try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

There is a double counting of the operational risk RWA on valuation, as the full AMA risk is replaced by the Standard Approach of Operational risk. Adding another dedicated Operational risk charge (on a subjective level of 5%) will duplicate what was earlier in AMA and now in the Standard Approach.

## **Appendix 2 – points for clarification**

We would appreciate clarification of the following points:

### **Q1. Calculation frequency of AVAs - Article 1**

1. Under what circumstances could the competent authority request monthly PruVal runs?
2. Would this be on a per institution basis?
3. How much notice would institutions expect?
4. Would the provision of monthly AVAs would this be permanent or for a specific period?

### **Q5-6. Fall-back approach - Article 7**

5. Does the fall-back approach apply to the valuation positions consisting of unlisted equities in the banking book?
6. In the QIS EU PruVal template, Panel B.1. positions under the fallback approach, “unlisted equities” is categorised as “instruments other than derivatives under the fall-back approach.” Does Article 7.3 only refer to unlisted equity securities, rather than derivatives with unlisted equity underlyings?
7. In Article 7.3.b. can the fall-back approach be diversified?
8. In Article 7.3.b. must a valuation adjustment be taken, or simply must sufficient observability exist to allow for a valuation adjustment to be considered?
9. Is Article 7.3.b. limited to only positions that are untested in the IPV process and not those that are tested to "subjective" pricing sources for which an IPV difference is estimated and recorded?

### **Q7. General requirements under core approach – Articles 8**

10. Are the requirements regarding the calibration of the models to the most recent observable prices on a quarterly basis applicable to models used to compute fair value adjustments for missing risk factors?

### **Q8. MPU, CoC and MR – Articles 9, 10, 11**

11. Is the use of the VRT subject to the data requirements of Article 3(2) (as written in the CP) or also the requirements of article 3a?
12. The projection from tenors without tradable instruments to tenors with tradable instruments is not clear enough. E.g., Can we project long and short dated tenors to the last tradable tenors (e.g., 15-30 years to 15-year tenor)?

## Q9. UCS - Article 12

13. In article 12 paragraph 3, is it expected that prudent expected exposure profiles are regenerated?
14. On the potential application of the fall-back approach for any instrument where any of the paragraphs of the UCS AVA are not liquid enough, does this imply that the rest of the AVAs should be calculated by means of core approach for the same instrument?

## Q10. CP and FAC - Articles 14, 15

15. How is concentration AVA computed when no volume is observed (or an extremely limited volume) suggesting that the exit period is very long?
16. CRR2 Article 325bd requires institutions to map each risk factor assigned to the trading desk for which they have been granted permission as referred to in Article 325az(2), i.e., FRTB IMA models, and prescribes the liquidity horizons for the risk factors. Should these liquidity horizons be considered for CP AVA only by institutions adopting FRTB SA?
17. The reference to the trading desk liquidity horizon seems to suggest that the prudent exit period is only relevant to trading book positions. Are the requirements in this article also applicable to fair value positions in the banking book, such as the fair value interest rate and equity positions in the banking book which are not capitalised under FRTB market risk framework?
18. As cut-off levels of prudent exit period are aligned with the liquidity horizon prescribed by IMA VaR/Expected Shortfall models for market risk capital, should the CP AVA charge be interpreted as an additional charge beyond these liquidation periods, which are not covered by VaR or Expected Shortfall when the prudent exit periods are longer? In that case, should the main driver of the charge be the market price movement of instruments/valuation inputs as in the VaR or Expected Shortfall model and not bid-offer spreads as required in Article 14.1.(c) “where the prudent exit period exceeds ..., they shall estimate an AVA taking into account the volatility of the valuation input, the volatility of the bid-offer spread and the impact of the hypothetical exit strategy on market prices”?
19. Article 14 refers to the identification and AVA calculation for concentrated valuation positions, amended Article 15 requires future administrative costs AVA for a valuation exposure where the individual MPU, COC and Concentrated Positions AVAs do not imply fully exiting the exposure. Should the identification of concentrated positions be aligned with the exit scenarios, where, in case of derivatives, additional hedges corresponding to net valuation exposures to close out the relevant valuation positions shall be assessed?
20. Article 15 Paragraph 1 (a) is extremely ambiguous and vague. How can institutions demonstrate that MPU, CoC and Concentrated Positions AVAs already imply fully exiting the exposure (i.e., back-testing: exit prices vs  $APVA = \alpha \cdot (FV - PV)$  or other methods)? Why can MoRi AVA not also be considered in this regard?

21. Does the condition in Article 15 Paragraphs 1 (a) the individual MPU, COC and Concentration AVA imply fully exiting the exposure met if a valuation position is hedged / flattened in a way such that future dynamic hedging is not required?

22. For Article 15 Paragraph 1 (b), can valuation exposure be mapped to valuation input?

**Q10. Implications for the EBA stress tests**

23. If the final RTS results in a significant change to the baseline AVAs, this should be taken into account in the stress calibration.

- In the 2023 EBA Stress Test, reserves and AVAs were stressed by very large amounts:
- Level 1: 209%, Level 2: 384%, Level 3: 465%.
- During recent crisis periods (e.g., Covid or Russia/Ukraine), banks have observed reserves / AVA increases which are approx. one order of magnitude lower than the EBA prescribed shock factors.

Reserves / AVA increase <sup>1)</sup>	Covid	Russia / Ukraine	Crisis Period Average	Crisis Period Worst of
Bank 1	32%	24%	28%	32%
Bank 2	33%	29%	31%	33%
Bank 3	51%	17%	34%	51%
Average across Banks	39%	23%	31%	
Worst of Banks	51%	29%		51%

<sup>1)</sup> based on internal analysis from three EBA ST participating banks

- Also, in both crisis periods, reserves and AVAs reverted to pre-crisis levels within 6-9 months.

Is the EBA going to re-adjust the shock calibrations for the forthcoming EBA stress tests for AVAs, based on the changes made to this RTS?

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21 December 2023

Dear Mr.Overby,

### **Prudent Valuation – Day One Profit Deferral issue**

The Association for Financial Markets in Europe (AFME) is writing to highlight a significant issue arising from the EBA's current guidance on the offset of Additional Value Adjustments (AVA) against Day One Profits deferral, which results in a double counting of valuation uncertainties in our members capital.<sup>1</sup> We understand that consideration is being given to revising the 2016 RTS. This is therefore an appropriate opportunity for the EBA to address the issue.

We set out below the issue and our proposed solution.

#### ***Executive Summary***

- For trading and banking book positions, the EU prudential framework requires banks to reduce their Common Equity Tier 1 (CET1) to achieve an “appropriate degree of certainty” around the fair value of a position.
- Valuation uncertainties are addressed by:
  - Additional Value Adjustments (AVA) stemming from the Prudent Valuation (PruVal) of their book.
  - Further adjustments under IFRS beyond the fair value, in particular the deferral of the recognition of Day One Profits.
- Although Day One Profit deferral and PruVal address the same issue, an EBA Q&A bans any offset between the two.
- The lack of offset between Day One Profit deferral and AVA means banks have to double-count valuation uncertainties in capital.
- A review of the relevant EBA RTS is an opportunity to allow a degree of offsetting and eliminate some of the double-counting.

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<sup>1</sup> [https://www.eba.europa.eu/single-rule-book-aq/-/qna/view/publicid/2019\\_4458](https://www.eba.europa.eu/single-rule-book-aq/-/qna/view/publicid/2019_4458)

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- A prescriptive methodology can be developed and safeguards can be added to ensure that the offsetting is consistently applied across all banks and does not lead to an undue capital advantage.

***Background –PruVal and how it impacts bank capital***

- EU Banks reduce their Common Equity Tier 1 (CET1) Additional Value Adjustments (AVA) stemming from the Prudent Valuation (PruVal) of their trading and banking book positions (CRR Arts.34, 105)
- PruVal is designed to achieve an “appropriate degree of certainty” around its fair value, the methodology is laid out in a European Banking Authority (EBA) Regulatory Technical Standard (RTS) in 2016.<sup>2</sup>

***Background – PruVal, Day One Profit and other adjustments to fair value***

- When banks enter into a position, to reach the fair value with certainty, IFRS require them to:
  1. Take “fair value adjustments”, defined in IFRS and other accounting standards – the resulting value is the “fair value”.
  2. Take further adjustments beyond the fair value, in particular to defer the recognition of Day One Profits when significant parameters are not observable.
  3. The EU prudential framework then uses AVA to achieve an “appropriate degree of certainty” around the fair value of the position, catering for e.g. market price uncertainties, model risk, concentrated positions.
    - This ensures banks hold enough capital for potential losses from an exit at a lower value.
- The 2016 RTS set the threshold for “appropriate certainty” at 90% confidence level for the exit price, based on a data range of plausible values or expert-based approaches.
- The EBA RTS (Art.8(3)) clarifies that the AVA from PruVal is the excess of valuation adjustments required to achieve the prudent value over any *adjustments* applied in the *fair value* addressing same source of valuation uncertainty.
- Both the AVA and the Day One Profit deferral adjustment impact CET1 capital in excess of the fair value.
- Valuation uncertainty is addressed by:
  - Banks are required to defer the recognition of Day One Profit due to valuation uncertainty inherent in unobservable market parameters.
  - PruVal addresses a wider range of valuation uncertainties, including unobservable parameters.

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<sup>2</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0101>



- Unobservable parameters typically attract larger PruVal charges as the valuation uncertainty is higher.
- Provided the overlap between the two can be appropriately quantified and mapped, an offset is justified.

***Issue: Day One Profit Deferral ban via EBA Q&A***

- EBA Q&A 2019\_4458<sup>3</sup> refers to the EBA 2016 RTS and stipulates that Day One Profit deferral cannot be offset against AVA, because:
  - Day One Profit deferral is not a fair value adjustment.
  - Day One Profit deferral addresses *unobservable parameters* whereas AVA addresses confidence from *observed* parameters.
  - Subsequent amortisation of Day One Profit deferral balance over time can give rise to uncertain revenues.
- The Q&A fails to acknowledge that:
  - Day One Profit deferral and PruVal both address valuation uncertainty for *unobservable* parameters.
  - The disallowance of DOP reserve offset against AVA does not mitigate uncertainty which may exist in subsequent revenue recognition in line with IFRS.
- The lack of offset between Day One Profit deferral and AVA means banks have to double-count valuation uncertainties in capital.
- This leads to a valuation level considered in capital in excess of the 90% confidence level required by the 2016 RTS.

***Proposal: Allow offsetting with safeguards to eliminate some of the double-counting***

- There is no mandate to review the 2016 RTS in the latest revision of the CRR (CRR III).
  - CRR III mandates the EBA to prepare a separate RTS to define the extraordinary circumstances of market disruption, under which AVA could be reduced.
- However, it is understood that EU supervisory and regulatory authorities, including the European Central Bank (ECB) and the EBA, are considering to revise the 2016 RTS.
- This is an opportunity to amend Article 8 (3) of the 2016 RTS and allow the offset of some of the deferred Day One Profit reserves, and eliminate some of the double-counting.
- A prescriptive methodology can be developed and safeguards can be added to ensure that the offsetting is consistently applied across all EU banks and does not lead to an undue capital advantage.:

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<sup>3</sup> [https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2019\\_4458](https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2019_4458)

- Banks demonstrating their ability to map out the deferred Day One Profit reserves against the corresponding AVA for valuation uncertainty drivers that led to Day One Profit being deferred.
- Ensure amount of offset is capped by the relevant AVA.
- An amendment to Article 8(3) of the 2016 RTS that would align with the above proposal is presented below:

Article 8 (3) EBA RTS 2016

*AVAs shall be considered to be the excess of valuation adjustments required to achieve the identified prudent value, over any adjustment applied in the institution's ~~fair value~~ **accounting value** and can be identified as addressing the same source of valuation uncertainty as the AVA. Where an adjustment applied in the institution's ~~fair value~~ **accounting value** cannot be identified as addressing a specific AVA category at the level at which the relevant AVAs are calculated, that adjustment shall not be included in the calculation of AVAs.*

We would be happy to provide further information or schedule a meeting or call to discuss.

### About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors, and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA), a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

Yours sincerely,

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