

EBA/CP/ 2024/01
(EBA Consultation on Regulatory Technical
Standards on prudent valuation)

Version: 16 April, 2024

Deadline: 16 April, 2024

EBA Consultation on Regulatory Technical Standards on prudent valuation

General considerations

The BSG welcomes the opportunity to provide an opinion on the consultation paper on targeted amendments to the Regulatory Technical Standards (RTS) on prudent valuation (hereinafter 'PruVal'), amending Commission Delegated Regulation (EU) 2016/101 setting out requirements for the prudent valuation of fair-valued financial instruments, which was developed in accordance with the mandate set out in Article 105(14) of Regulation (EU) No 575/2013 (CRR). Furthermore, the BSG strongly welcomes the EBA's decision to include the impact assessment of the proposed changes in this year's QIS, which will be an important input to final decisions on the draft RTS alongside consultation responses. The BSG notes that the PruVal section of the QIS doesn't feed into the Basel 3 impact but would effectively change the baseline for the assessment of Basel 3 impact by potentially recalibrating the effect of previous reforms.

The BSG recalls that the original purpose of the PruVal framework is to address valuation uncertainty in the calculation of capital requirements, particularly those which are hard to value because of the lack of observable market prices. International standards for PruVal were set out in the Basel II framework,¹ which specified that the guidance given there reflected minimum standards for a prudent valuation framework, that supervisors should assess banks' consistency with the guidance, and that it was a factor that should inform banks' assessment of whether a valuation adjustment of less liquid positions for regulatory (but not financial reporting) purposes under CAP 50.11-50.14. CAP 50.11-50.14 require banks also to consider additional risks, such as the possibility that risks associated with incorrect valuation methodology and incorrect calibration parameters in a valuation model have not been fully captured in relation to complex products.

In the EU, the concept of PruVal was first introduced in 2013 with the CRR and subsequently completed with the Commission Delegated Regulation (EU) 2016/101. Despite being more granular and prescriptive than the Basel 'guidance', the principles underpinning the framework introduced by the

¹ [CAP 50 – Prudent Valuation Guidance](#), BIS.org

EU co-legislators in 2013 (as subsequently finalized with the RTS) were largely consistent with the global standards.

The BSG notes that most of the proposed targeted amendments are meant to address “implementation issues” which competent authorities have observed since the adoption of Commission Delegated Regulation in the EU (11 questions out of 12). Only 1 question is meant to amend Commission Delegated Regulation (EU) 2016/101 considering the new CRR3 mandate in Article 34 requesting the EBA to specify the conditions to determine the presence of extraordinary circumstances for the purposes of reducing the total aggregated additional valuation adjustments (hereinafter ‘AVAs’).

In particular, the revised PruVal framework extends the scope of the ‘fallback approach’ (based on the same fixed percentages of notionals across institutions). This fall-back approach – not explicitly foreseen by the Basel framework and originally expected by the EBA to “*only be necessary on a very small number of positions (p. 62)*”² – has been significantly broadened out to capture all products with no independent pricing sources available or with no IPV adjustment posted.

The BSG recognizes that a careful balance is needed between enabling firms to take responsibility for their individual valuation judgements within the framework and providing sufficient consistency and prudence in capital calculations. For some members, the proposed scope of the fallback approach may jeopardize the risk-based nature of the PruVal process, which, they consider, must by definition be assessed on an institution-by-institution basis. They are concerned that the revised PruVal framework is introducing a minimum capital deduction for a significant portion of positions without even considering the real ‘valuation uncertainty’ and portfolio composition. Others see the proposed approach as consistent with the existing Basel indication that, “when marking to model, an extra degree of conservatism is appropriate”,³ and stated Basel expectation that valuation adjustments are considered for positions individually, and not on a portfolio basis.⁴ Both groups of BSG members agree that if EBA does decide to pursue this approach, its commitment to review the calibration of the factors applied under the fallback approach is welcome.

Likewise, the BSG is concerned about the lack of level playing field observed by competent authorities and noted by EBA in its consultation. We note that different approaches to tackling this problem are, in principle, possible. Some members see the proposals on fallbacks as watering down the risk-based nature of the prudential framework and are of the view that – building on the current framework and keeping in mind the fine line between prudent valuation and accounting - further guidance to competent authorities on how to challenge institutions’ calculations would strengthen the risk-based nature of the PruVal framework and achieve a much better outcome by preserving the idiosyncratic assessment of AVAs and levelling the playing field. Others consider that it is already acknowledged in international and EU standards that there may be a need for some limits on the reliance of complex risk assessments in the interests of both ensuring appropriate prudence in the initial assessment, maintaining the ability for effective scrutiny by senior management which is an essential component of a risk-based approach, and ensuring that the requirements are capable of being supervised.⁵

² [EBA-RTS-2014-06 RTS on Prudent Valuation.pdf \(europa.eu\)](#)

³ [BIS CAP 50.6](#)

⁴ [BIS CAP 50, FAQ 1](#)

⁵ See “[Finalising Basel III: Coherence, calibration and complexity](#)”, Stefan Ingves, Basel Committee Chair, 2016

In its recent CRR3/CRD6 package, the EU co-legislators raised concerns about the RWA variability across EU institutions and decided to introduce a 'backstop', the output floor. Some BSG members consider that because no concerns were raised in that context around the variability of capital deductions (Additional Valuation Adjustments, in particular), the fallback component of the proposed revision of the framework may go well beyond what was the original intention of the EU co-legislators in relation to Basel III.

The BSG also notes that CRR3 and CRD6 require the EBA to develop a comprehensive set of technical standards, guidelines and other products which are necessary to complement the actual practical implementation of the banking package in the EU. As highlighted by the EBA in its 'roadmap on strengthening the prudential framework for credit institutions'⁶, the banking package includes around 140 mandates and the BSG shares the EBA's view that *"for mandate-crowded areas which require specific skills to deliver high quality policies the EBA will face bottleneck risks such as in credit, market as well as market access and governance areas"*.

Furthermore, for non-CRR3/CRD6 deliverables which may increase capital requirements in a way that will be additive to the impacts stemming from the implementation of the banking package, some members of the BSG recommend the EBA to publish the results of the QIS by showing the impact of the final Basel 3 reforms and the revised PruVal framework separately as well as combined, to provide institutions, competent authorities and policy makers with a holistic impact on the EU banking sector. In order to avoid an overly conservative calibration of the final rules impacting the EU banking sector in 2025, they suggest to postpone the go-live of the revised PruVal framework at a later date, or introduce a staggered approach which will phase-in over a certain number of years, in line with the phasing-in foreseen by the CRRIII. . Others consider that it is important to have a robust baseline of implementation of existing Basel III standards, informed by practical supervisory experience, in relation to which to make decisions about the calibration of Basel III. Given that this RTS is meant to address supervisory concerns with the implementation of legislation already in force, they suggest that any QIS regarding this impact of this RTS should be considered separately from the impact of CRR III/CRD VI, which is still forthcoming.

For some members of the BSG, most of the proposals contained in the CP may generate a significant increase in resourcing required by institutions to carry out PruVal. Other BSG members consider that the proposals are more nuanced, with evident effort having been made to ensuring that reporting requirements are targeted rather than across-the-board, and that there should be some offsetting savings from the reduced complexity associated with the use of the fallback approach.

Furthermore, some members are concerned that the proposed CP may result in institutions changing their approach to fair value accounting processes due to the reduced diversification benefit. Other members are of the view, that the overall aim of Article 105 (1) to achieve an "appropriate degree of certainty having regard to the dynamic nature of trading book positions and non-trading book positions measured at fair value, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of trading book positions and non-trading book positions measured at fair value" justifies the EBA's approach.

⁶ [EBA CRR3/CRD6 roadmap](#)

Against this background, some members of the BSG recommend to following way forward:

1. Narrowing down the scope of the revised RTS and limit the targeted changes to i.) Article 17 to cater for the replacement of the existing Advanced Measurement Approach (AMA) in the operational risk framework, and ii.) the ‘extraordinary circumstances’ in accordance with the CRR3 mandate (new Article 19a and Article 19b);
2. Finalizing the results of the 2024 QIS to get further insights into how the proposed changes would impact EU banks’ capital position pre CRR3 go-live;
3. Re-running a QIS based on year-end 2025 metrics (i.e., post CRR3 go-live) to give banks, competent authorities and policy makers the combined impact on EU institutions.

Other members of the BSG believe that the EBA should stay the course and finalize the draft RTS in its current form. These members consider that it is valuable to consider where lessons need to be learned from the experience of implementation in fine-tuning technical standards.

Moreover, should the EBA decide to submit the draft RTS without removing limiting the scope of the ‘fallback approach’, the BSG recommends that EBA consider whether there is a case to change the treatment of AVAs under the EU-wide Stress Test in the light of the potential increases to certain AVAs under the revised framework.

In addition, some members of the BSG would like to highlight that the consolidated application of the RTS raises an issue for subsidiaries in emerging markets. The new requirement to have at least 10 contributors does not consider emerging markets where capital markets are not as developed as in the EU. The RTS should consider this situation in order not to penalize the development of emerging markets capital markets where EU banks subsidiaries are relevant players, by imposing reporting obligation and validation for a significant portion of exposures under fair values in those countries. EU regulation should be mindful of extraterritorial impacts, especially on emerging economies. In those members’ view, consideration should be given to whether the calibration of the reporting component of the requirement needs to be adapted in such situations. This aspect should also be considered for European Union countries that lack well-developed capital markets.

Finally, the BSG welcomes the EBA’s decision not to include specific provisions on the treatment of environmental and social risks, as the PruVal framework will mechanically capture these once there is concrete evidence that these factors influence the valuation uncertainty.

The following paragraphs set out additional technical considerations on some of the proposals contained in the consultation paper.

Comments on specific amendment proposals to the Regulatory Technical Standards

Proposed amendments to Article 1 Delegated Regulation (EU) 2016/101

While the BSG supports the EBA decision not to include a mandatory requirement in the RTS for the calculation of monthly AVAs, some members of the BSG are also of the view that the requirement to calculate AVAs with a monthly frequency upon request by the competent authority may generate an

unjustified uptick in resources required to carry out PruVal. Furthermore, additional clarification seems to be needed as to whether there is an existing applicable reporting requirement, or a new requirement intended, as the amendments to Article 1 formally just imposes a 'monthly calculation' requirement, though Q1 of the CP asks respondents to opine on the challenges to "calculate and report AVAs on a monthly basis". For some BSG members, the cost/benefit of moving to a monthly calculation is not obvious. Furthermore, they point out that, for banking book positions, valuations are only available on a quarterly basis, implying that a monthly calculation of the valuation uncertainty will not be possible without relying on expert judgements.

Given the supervisory powers conferred on the ECB (and on other national competent authorities via the national transpositions of Art. 104 CRD) and set out in Art. 16(2)-point (j) Regulation 1024/2013 ('SSM Regulation'), the BSG suggests the EBA to consider the proportionality of such requirement and the consistency vis-à-vis the rest of the items which determine institutions' capital ratios.

Proposed amendments to Article 3 Delegated Regulation (EU) 2016/101

Proposed changes intend to amend the hierarchy of data sources for the purposes of determining AVAs to reflect observations regarding the accuracy and reliability of data from the different sources. Certain data sources originally eligible for use in the context of the range-based approaches (i.e., broker quotes and collateral data), will only be eligible under expert-based approaches. Moreover, institutions will be able to consider 'reliable market data' only consensus service data where the number of contributors is greater than or equal to 10 and the institution has performed a valuation back-testing. Consensus service data not meeting the conditions will be considered an expert-based approach and hence subject to additional requirements for verification by an independent business unit and reporting to competent authorities.

Some members of the BSG do not support the EBA's proposal, as they consider it is unclear what benefit the proposed changes will bring. In their view, considering 'expert-based' where the number of contributors is lower than 10 is arbitrary and triggers additional reporting obligations which put an additional burden on institutions without improving the calculations being performed or strengthening the overall AVAs quantification process. In general, the proposed changes, would result in practically all current MPU and CoC AVA methodologies being classified as expert-based with a subsequent requirement to produce a large number of "independent assessment" reports every year for the competent authority. For 3a(3), how does the regulator expect institutions to prove a negative? (How do institutions demonstrate that there are no sufficient and reliable market data sources?) In those members' view the proposed threshold creates the incentive for institutions and consensus providers to seek out additional contributors who may be less active in a particular market and thereby reduce the quality of services used for IPV. In general, those members believe that the market data changes will result in a considerable increase in reporting without any discernible improvement to accuracy of AVAs. Back testing criteria should be used rather than the number of participants. Therefore, some members of the BSG recommend not to amend Article 3 and to delete the new Article 3a.

Other members of the BSG think that the distinction between range-based and expert approaches is comprehensible and every threshold can be questioned, but the reasoning is understandable. Those members recognize that the particular sources selected for transfer from the 'range based' to the 'expert' approaches are those where valuations could potentially be susceptible to overstatement as

a result of conflicts of interest and where second line scrutiny would consequently provide a valuable protection.

Proposed amendments to Article 7 Delegated Regulation (EU) 2016/101

The draft RTS included in this Consultation Paper propose that AVAs relating to products with no independent pricing sources available or with no IPV adjustment posted should be determined in accordance with the fallback approach.

The BSG would like to highlight that existing requirement to apply an expert-based approach encourages institutions to review in detail the valuation uncertainty of such positions and justify their AVAs.

According to the BSG, that is a valuable exercise – arguably the most useful aspect of PruVal – since products with no independent pricing sources available or with no IPV adjustment posted generate the most valuation risk to an institution.

In the view of some members of the BSG the EBA proposal to mandate the fallback approach for all such positions removes the incentives for institutions to ‘think’ about valuations and as a result, it will weaken valuation control. In addition, a clarification from the EBA on the treatment of Level 3 positions vis-à-vis the new Article 7(3), would be welcome to them. In those members’ view, a fall-back measure based on the notional value for derivatives, will result in a crude measure that will not correspond to the actual valuation risk in the related instruments, and they believe a materiality condition should be applied to determine if the position falls under the fallback approach.

Furthermore, those BSG members would like to highlight that with CRR3 the TREA associated with certain categories of unlisted equity exposures will increase substantially (up to 400% vs current 100% or 150% if classified as ‘high-risk’ in accordance with Art. 128 CRR). Some members of the BSG are of the view that a simultaneous substantial increase in TREA as well capital deductions in the form of AVAs is unduly conservative. Given lack of supporting evidence, those BSG members consider the QIS would have been the perfect tool to assess the joint impact and recommend that EBA should not amend Article 7 meanwhile. Unlisted equity valuations commonly incorporate a discount for lack of liquidity and/or marketability in line with IPEV guidelines. This is important to consider in the calibration of the fallback approach, to avoid that such assets receive a disproportionate treatment.

That said, the BSG welcomes the EBA’s decision to wait until the outcome if the QIS is available before calibrating the appropriate percentages which institutions will need to multiply by notionals. It encourages EBA to consider potential refinements to the scope of the fallback position if evidence of unintended consequences arising from the current specification emerges from the consultation and addressing these does not undermine the purpose of the intended changes in addressing the implementation challenges observed to date.

Proposed to Article 17 Delegated Regulation (EU) 2016/101

The CRR3 will introduce a new standardized approach for operational risk in the prudential framework, which replaces the existing approaches for operational risk. The current Advanced Measurement

Approach (AMA) will no longer be available to determine capital requirements for operational risk, as soon as CRR3 will apply.

The BSG supports the EBA's proposal to amend Article 17 and remove any provisions regarding the AMA, which would have no effect as soon as the CRR3 applies.

Proposed new Article 19a and Article 19b

In line with the CRR3 mandate, the proposals contained in the consultation paper specify the indicators and conditions that the EBA will use to determine the presence of extraordinary circumstances for the purposes of Prudent Valuation, as well as the reduction of the total aggregated AVAs under those circumstances.

The BSG supports the EBA's proposal.

Proposed amendments to the Annex to Delegated Regulation (EU) 2016/101

The amending RTS included in this consultation paper propose that the aggregation factor 'alpha' in the Annex of the regulation should be set to zero, *"where the amount of fair value adjustments applied for accounting purposes, and reflected in the term 'FV', is not commensurate with the risk other market participants would consider when determining the fair value of the valuation exposure"*. It is unclear to the BSG how such assessment will be performed.

Some members of the BSG would like to point out that encouraging the automatic booking of IPV adjustments means that valuation teams become the first line and effectively mark the books with trading staff taking on the role of second line [i.e. traders will "review" controller marks].

Instances where IPV is not adjusted arise precisely because there are occasions where independent sources cannot be demonstrated to be more reliable than trader marks, i.e. there is valuation uncertainty. Such instances trigger valuable internal debate between first and second lines, one of the most valuable aspects of IPV, which might be lost if automatic remarking were applied.

Moreover, only considering the negative unadjusted IPV differences as is suggested in the consultation paper will result in excessively large capital impacts simply due to valuation noise across a well hedged trading book. Applying the proposal to only negative IPV differences will not achieve the intention of creating a level playing field across institutions.

Some members of the BSG are of the view that the application of risk factor reduction should not affect the diversification factor. In this context they note that the diversification factor aims to capture the lack of correlation in valuation uncertainty across different risk factors, whereas risk factor reduction aims to capture the frequently high correlation of different inputs within a specific risk factor. According to those members, the application of the diversification factor should therefore not be made dependent on the non-application of risk factor reduction.

Some members of the BSG recommend not to amend the Annex.