Response to consultation on EBA regulatory technical standard EBA/CP/2014/38

Dear Sirs,

Consultation on the draft regulatory technical standards on valuation under Directive 2014/59/EU (the "CP")

We are responding to your invitation to comment on the above CP on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of those firms who commented on the CP.

We recognise that valuation forms an integral part of the resolution infrastructure required to support the Bank Recovery and Resolution Directive ("BRRD"). We agree that establishing a clear set of principles for the valuations with the aim of achieving consistency in methodology across Europe is an important step forward in these situations especially given the current lack of guidance. We welcome the CP as an important part of that process.

We support the EBA's overall approach but believe there are areas in the draft standards where more clarity would be helpful e.g. around timing of the valuations (what is pre versus post resolution), how they tie in with each other and what role each plays in the resolution process.

We have attached our responses to your questions in the attached appendix. We would be happy to discuss our response with you in further detail if that is helpful to you.

Yours faithfully

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Question 1: Would you suggest any changes to the definitions of valuation approaches (letters e-i)? In particular, are there specific valuation methodologies which the definition of equity value should refer to?

We note a reference to 'Exit value'; however, this might confuse the reader given that IFRS fair value is also an exit value concept. Perhaps an alternative term such as disposal value or realisable value would be more readily understood.

The diagram provided in the background states that the valuations to inform the resolution decision should be based on a prudent 'economic value' approach, but economic value is not explicitly defined. Section 4 Part III of the RTS states that for these valuations should be based on hold value. It might be helpful to clarify if these terms are being used interchangeably. We note that economic value could be taken to mean the European Commission's Real Economic Value but it is not clear that this is the intention of the RTS.

We have commented on the definition of equity value in our response to question 6 below.

With regard to Valuation 1, we note that this valuation may be quite focused and intended to deal with specific issues or questions the resolution authority needs answered. It may for example take the form of a focused skilled persons review of provision adequacy or expected future loan loss development. The basis of value may need to be more widely defined. Valuation 1 is defined as the current accounting basis i.e. amortised cost or such other basis as appropriate under accounting and prudential standards applicable to the firm. However, this valuation may also be required to take account of forward projection of incurred losses (i.e. expected losses) as the authorities may need to consider the firm's prospects in accordance with Prudential standards, over a defined projection period.

Question 2: Should specific types of information be required on deviations from management assumptions, for example on differences in expected cash flows and/or the discount rates?

There should be sufficient information to support the conclusions derived. Where assumptions have deviated significantly from those applied by management it would be desirable to explain the nature of the difference and the rationale. It may also be desirable to show sensitivity analysis highlighting the impact of the deviation.

Question 3: Would you add, amend, or remove any areas which are likely to be subject to significant valuation uncertainty?

We note that the list cannot be exhaustive. However, some significant areas of uncertainty that could be added are with respect to instruments measured at fair value and the actions of counterparts under any agreements that include redemption, conversion or any other termination or variation options.

We further note that when considering the NCWO, there are many others areas e.g. instruments where default triggers change the waterfall profile of trade, actions by office holders in other jurisdictions, security holders, depositories and financial contract counterparties etc. This is important in a NCWO comparison.

Question 4: Should the buffer instead always be greater than zero? If yes, how should the buffer be determined?

If the calculation of recapitalisation is expected to be conservative, there is an argument for the buffer always to be greater than zero. We would not recommend specifying exactly how to determine a buffer as the approach ought to be flexible and allow judgment, however, some general principles may be useful in order to arrive at a consistent outcome.

Question 5: Do you agree that a valuation of post-conversion equity is necessary to inform decision on the terms of write-down or conversion?

We agree that it is necessary to have a post-conversion equity value, firstly because it informs the conversion rate (in these situations, the book value of equity is often not equal to its economic value) but also because it informs part of the authorities' assessment of potential compensation costs and risks if creditors are not treated equitably in exchanges. The ex-ante valuation gives an indication of potential compensation costs while the ex-post valuation sets it.

Question 6: Do you agree with the definition of equity value for this purpose in Article 2 (i)? If not, what changes should be made to the definition? Should the definition be more closely linked to the net asset value determined on the basis of the remainder of valuation 2 adjusted for goodwill/'badwill', and if so how should that adjustment be estimated?

The definition of equity value in terms of "estimate of the assessed market price" may not be appropriate. We expect that in the event of resolution, there will be considerable uncertainty and the "assessed market price" could vary wildly. For instance, it could be influenced heavily by illiquidity in the market. As a result of this we believe that market value would be very challenging to estimate and the reliability of valuations could be called into question.

Furthermore we note that the market price could be susceptible to manipulation by creditors who sell a small portion of shares at a low value in order to set a low observable market price for the purposes of subsequently making an NCWO claim.

To avoid the risk of manipulation, an alternative valuation basis might be 'fair and equitable' value, which has traditionally been used in articles of association of companies. This would estimate a value that is 'deemed to be equitable to both parties, and recognise that the transaction is not in the open market. The buyer has not been able to seek the lowest price and nor has the seller been able to hold out for the highest price.'

We note that net asset value approaches adjusted for good or bad will are in effect only estimation methods and in general we believe it is preferable to leave the methodology to the independent valuer as that allows them to select an appropriate basis for the circumstances.

Question 7: As an alternative, should the use of information that becomes available after the resolution date be more restricted, and in particular permitted only if it refers to facts and circumstances existing at the resolution date which could reasonably have been known at that date?

To minimise the risk of claims, only information that was known or knowable as of the date of resolution should be taken into account.

With regard to comparing the outcome at two different dates (actual treatment date versus resolution date), we note that opening up a gap between the dates for the compensation calculation does inherently expose the resolution authority to a greater risk of owing compensation. In most cases the resolution itself should occur quickly, with the terms of conversion decided at a later date but with the promise of them at the resolution date, effectively resulting in the quasi compensation in shares etc being held in trust at the resolution date. The basis of valuation of those shares at the resolution date may consider the illiquidity of the shares. That does raise a general question as to subsequent

assumption about control and liquidity adjustments (liquid minority vs illiquid minority vs illiquid or liquid controlling values). It would be helpful if the RTS provided explicit guidance on application of discounts and premia.

Question 8: Should the use of information available after the resolution date be further limited, for example by requiring that such information is only used if it results in a significant change in the values of the entity's assets or liabilities?

In general if it was a material fact that was or should have been known at the resolution date, then yes it should be taken into account. Otherwise it may be ignored, unless on aggregate with other similar facts it is material. The resolution date is the valuation date so this is the most consistent approach.

Question 9: Should these technical standards provide further detail on the characteristics of appropriate discount rates?

Yes, further detail on discount rates would be helpful. We note that there is limited guidance in this area and no provision in UK insolvency law for this. It is a significant assumption and it would therefore make sense to provide further guidance. For instance, is the RTS referring to risk-free rates or some other rate (e.g. in the UK there is a statutory rate of interest that applies in insolvency being 8% plus the Bank of England base rate),

Question 10: Are there any changes you would suggest to the methodology for determining actual treatment of shareholders and creditors in resolution? In particular, should the methodology for valuing equity be further specified and, if so, what should be included in that specification (whether additional detail on the current approach, or a different approach, linked for example to net asset values adjusted for goodwill/badwill)?

We believe that valuation approaches are best left to the discretion of the valuer as the appropriate basis will depend on the circumstances. The paper could perhaps note that the valuer should apply such methods as they deem appropriate including discounted cash flow approaches, market multiples and where appropriate adjusted net asset values.

As mentioned in our response to question 6, net asset value approaches adjusted for good or bad will are unlikely to be sufficiently robust.

Question 11: Should the valuer be required to accompany the comparison envisaged in Article 7 of this Regulation with additional relevant disclosures? If yes, what should those be (for example, documentation of any differences between the valuation of actual treatment and the market price that would be observed for those same claims were they traded in an active market)?

There should be sufficient information to support the conclusions derived but we would not recommend that the actual treatment is 'bridged' to the market price of claims.