

Prudent Valuation Crédit Agricole SA comments on EBA Discussion Paper

General remarks:

1) Fair Value v/s Prudent Value:

As a very first remark, we would like to highlight that the introduction of a prudent valuation opens the door **to potential dissociations between this new valuation and the accounting concept of fair value**, which we do not support:

- We fully understand that the valuation must be prudent by essence and that prudential requirements do not pursue the same goals as accounting norms.

But the concept of “fair value” is - and must remain - unique.

The concept of prudent valuation is defined in this Discussion Paper as a “true realisable value”: the difference with the concept of “faire value” according to Accounting Norms is unclear. It seems misleading or even confusing compared to the “exit price” defined in accounting norms.

Under IFRS, and US gaap as well, “fair value” has been subject to several experts debates for years and now leads to a consensus between FASB and IASB: “Fair value” is defined as an “exit price” (i.e. a price that would be received to sell an asset or paid to transfer a liability in an orderly transaction under current market conditions). The “fair value” already promotes the use of quoted price in liquid markets, and maximises the use of observable and relevant data.

Thus, the concept of “prudent valuation “grounded on a “true realisable value” is confusing and will in most cases be exactly similar to the “fair value” accounted for (apart from specific AVA such as DVA).

It could be understood that this Discussion Paper tries to challenge conclusion of expert groups (following the recommendations of the G20/FSB/FSF) which finally converged to a unique definition of fair value in accounting norms, and defined a complete guideline framework to compute fair value under all circumstances even for illiquid markets (IFRS 13 under IFRS and TOPIC 820 under US gaap). On the contrary, we think that the objective should be to ensure full convergence between the accounting fair value and the prudential one.

Of course , we are fully aware that prudential requirements do not pursue the same goals as accounting norms, and once accounting fair value determined, specific prudential adjustments may be required in that respect. But our understanding is that such adjustments are mainly out of the scope of “fair value”.

Since prudent valuation does already exist under CRD III framework, and will be required under the upcoming Basel III regulatory framework – article 31 and 100 of CRR – a critical issue will be to clearly differentiate, quantify and explain the reason why and to what extent the prudent value requires adjustments to the accounting fair value.

Besides, we understand that the Fundamental Review of the trading book already addresses several of the issues raised in that Discussion Paper (such as concentration and liquidity cf Q12). We think that these topics can't be reviewed without international regulators input in order to ensure a global levelled playing field.

- The accounting fair value **cannot be contestable regarding level 1 instruments**: liquid positions, where fair value is not materially different from prudential value, should be **excluded from the scope of AVA**. It can be acceptable that some slight difference may appear between the account fair value and the so-called prudent value, but only on level 3 or at least level 2 instruments, where less observable market data exist.

To this extent, we would like to point out the fact that the current Discussion Paper is too much prescriptive for liquid position, whereas it gives very slight guidance regarding the illiquid and complex positions, which required a higher level of subjective judgments.

2) Additional reporting and administrative costs:

The AVAs and in particular the testing for prudence of valuation, **will be extremely operationally complex to implement, and will lead to strongly increase the administrative costs.**

If a large part of the adjustment newly required by the AVA are already made in practice, the data collection (which is very dependant on the availability of good quality data, which is scarce for products likely to attract higher AVAs) and the back-testing will be strongly demanding and require heavy IT developments in order to collect data, to prove the 95% confidence level is respected. It will also unreasonably increase the reporting burden.

3) Overlapping and redundancy of AVA and other prudential requirements:

Moreover, we would like to point out that the capital requirements linked the AVA **might overlap requirements already taken into account through the accounting fair value** (model risk for example) or **already covered by other Pillar 1 prudential requirements**, such as operational risk or future administrative costs (deducted from Core Tier 1).

Some of the AVA seems to be clearly **redundant within each others**, and also with the work currently done at BIS level with the Fundamental Review of the Trading Book.

4) Confidence level and aggregation of the AVA:

The aggregation of AVAs and the definition of a level of confidence might be **considered as a whole**. We do not support a 95% level of confidence, which already appears **too prescriptive** regarding market practices.

We believe that it could be **dangerous to apply a common fixed threshold**, which does not necessary fit with all market instruments. We would prefer a **global and judgmental approach** taking into account the specificities of each type of instruments, the possibility to aggregate the AVA and the level of confidence instead of too prescriptive data points. Having a common methodology, instead of a quantified level, could be a good way to ensure harmonisation.

Last but not least, we would recommend taking into consideration **global level playing filed issues** in order to ensure harmonisation with the practice and accounting standards used by non-UE jurisdiction.

Answer to specific questions:

A. Introduction

Q1. Do you believe that a proportionality threshold should be considered before requiring an institution to assess the prudent value of all fair value positions? If yes, how would you define the threshold?

- Answer to Q1: Yes, we support the idea to introduce a materiality threshold.

B. Process to calculate AVA

Q2. Do you agree that the exit price used as the basis of prudent value does not necessarily need to be based on an instantaneous sale? If yes, provide argument to support your view.

- Answer to Q2: Yes. The exit price shall not necessarily be based on an instantaneous sale. As a matter of fact, an instantaneous sale will lead in practice to a liquidation value, which will be by essence very different from fair value, nor prudent value. The accounting value is based on the principal of going concern, which is incompatible with an instantaneous or forced sale under distressed market conditions.

Q3. Should a specific time horizon for exit be set when assessing the prudent valuation? If so, how the time horizon should be set (e.g. the same time horizon for calculating Value-at-Risk (VaR), Credit Risk Capital Requirements, etc.), what should it be and how would it feed into the calculating of AVAs?

- Answer to Q3: The time horizon used when assessing the prudent valuation strongly differs from an asset to another. It shall be left at the discretion of credit institutions, and at least take into account the specificities of each asset classes.

Moreover, the Value-at-Risk measure under the market risk prudential framework already takes into consideration the maximal potential losses which could occur under a 10 days time horizon. For certain types of market instruments, there might be an overlapping between the AVA (deducted from Common Equity Tier 1), and the capital requirements already covered by the VaR, which already includes a prudent “worst case scenario” thought the shocks applied.

Q4. Do you support the concept of a specified level of confidence to determine AVAs? If not, why? Are there any AVAs where the use of a specified level of confidence is not appropriate?

Q5. If you support a specified level of confidence, do you support the use of a 95% level of confidence? What practical issues or inconsistencies with other parts of the CRR might arise when using this level of confidence?

- Answer to Q4 & Q5: The aggregation of AVAs and the definition of a level of confidence might be considered as a whole.

We understand that the aim of setting up a level of confidence is to ensure homogeneity and level playing field between credit institutions. A 95% level seems to be more prescriptive, and is not consistent, for example, with the 90% confidence level which is currently used under UK prudential framework. Having a common methodology, instead of a quantified level, could be a good way to ensure harmonisation.

Furthermore, it is essential to differentiate market making activities (realised on behalf of customers), from proprietary trading activities. Indeed, in case of market making activities, if a credit institution has to exit quickly from a position, it will be on the precise demand of a customer, whereas for proprietary activities, the bank will try to exit from its position on the best possible market condition

(and will decide consequently on the best horizon of time to do so). The level of confidence for the AVA will be very different in practice.

Moreover, if a credit institution has to exit from a transaction on the demand of a customer, the impact on P&L will be transferred to the concerned customer. For proprietary trading activities, if the market conditions are not economically relevant, Front Office will keep the position in its book. This previous example also demonstrates that using the instantaneous sale is not relevant in both cases.

Q6. How prescriptive do you believe the RTS should be around the number of data points that are required to calculate a 95% level of confidence without any more judgemental approach being necessary?

Q7. If you support a specified level of confidence, do you support the explicit allowance of using the level chosen as guidance for a more judgemental approach where data is lacking?

- Answer to Q6 & Q7: As previously described, we believe that it could be dangerous to apply a common fixed threshold which does not necessary fit with all market instruments. We would prefer a global and judgmental approach taking into account the specificities of each type of instruments, the possibility to aggregate the AVA and the level of confidence instead of too prescriptive data points.

Q8. Should any additional possible sources of market prices be listed in the RTS?

Q9. Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?

Q10. Should the RTS be more prescriptive on how to use the various alternative methods or sources of data to obtain a range of plausible prices where there is insufficient observable data to determine the range by direct statistical methods? If so how?

- Answer to Q8, Q9 & Q10: No, the RTS is sufficiently precise at this stage.

C. Description of how to calculate AVA

Q11. Are there any other indicators of large market price uncertainty which should be included?

- Answer to Q11: No.

Q12. Do you believe the approaches set out above are appropriate for each of the adjustments listed in Article 100? If not, what approaches do you believe would be more relevant?

- Answer to Q12: In our opinion, some of the AVAs listed on the Discussion Paper do not make sense, regarding that the adjustments are clearly taken into account through accounting fair value, or others are clearly redundant with each others. On the contrary, some adjustments to the accounting fair value could make sense on very specific cases (unearned credit spread, close-out costs, early termination, concentration and liquidity), as specified thereafter.

Unearned credit spread: we would like to point out that there are too many uncertainties at this stage on the final CRR requirements on CVA to clearly identify area for prudential adjustments in the valuation.

Close-out costs: The close out cost seems to make sense however calls for further clarification: the paragraph 23, dealing with Close out cost specifies that “the methodology should be consistent with or demonstrably more prudent than the most accurate hedging of the risk available using tradable instruments taking into account liquidity”. This proposal needs clarification.

Early termination: we consider that the impact of early termination costs should remain immaterial within the normal course of business. Related AVA, if any, should therefore take this consideration into account.

Concentration and liquidity: Liquidity horizon is somewhat already covered by both market risk and counterparty credit risk weighted assets (VaR time horizon and margin period of risk) and is also addressed through the Fundamental Review of the Trading Book

Operational risks: this item is already covered by Pillar 1 prudential requirements and presents a clear risk of double counting in terms of capital requirements.

Market price uncertainty: the AVA seems clearly redundant and already covered by all the other AVAs.

Future administrative costs: already deducted from capital for regulatory purposes.

Model risk, when relevant: model risk is already covered by provisions, so this item seems clearly redundant with accounting rules.

Balance sheet substantiation: this AVA seems redundant with operational risk

Investing and funding costs: There is currently significant uncertainty within the industry as to whether individual contracts or securities should be priced by including entity-specific funding costs, and we note that well-renowned academics have argued strongly and publically that funding costs should not be included. We are unaware of any consensus that exists between broker/dealers of how funding costs should be incorporated into derivative pricing and even in which circumstances this is done.

Q13. Are there any other material causes of valuation uncertainty that the RTS should describe an approach for? Or are any of the adjustments listed above not material and should not be included?

- Answer to Q13: See comments below (answers to question 12).

D. Testing for prudence of valuation

Q14. Do you believe that the testing approach in Annex 2 represents a useful tool to test for prudence of valuation? If not, what weaknesses make it unsuitable?

- Answer to Q14: We do not understand the purpose of the example set out in Annex 2. As a general remark, if the back-testing requirement is maintained in the final RTS, we support the idea that EBA should be less prescriptive and leave some flexibility to entities to define an internal testing model.

Q15. Do you believe that the RTS should be prescriptive with respect to validation techniques? If not, how do you believe that comparable levels of prudence should be ensured for the valuations across institutions? Are there other validation techniques that you believe should be detailed in the RTS?

- Answer to Q15: Instead of being too prescriptive, and in order to ensure comparability of the levels of prudence, we recommend that EBA circulates “test portfolios” to be valued among credit institutions.

E. Aggregation of valuation adjustments

Q16. Do you support the concept that prudent value can never be greater than fair value including fair value adjustments at both the individual position and the legal entity level? If not, what would be the reason to justify your view?

Q17. Would simple aggregation better reflect your assumptions and practices or would you support the availability of a diversification benefit within the aggregation of position-level AVAs? Please explain the reasons and justification why, providing any evidence available to support your arguments

- Answer to Q16 & Q17: We strongly support the aggregation of all AVAs, and the benefit of diversification. We think that the arithmetic sum of high level of confidence is too conservative and unrealistic in practice. As previously explained, we consider that a major part of the proposed adjustments are redundant each others and diversification is necessary in the appreciation of AVA, taking into the high level of confidence required by the Discussion Paper.

Q18. If you support the availability of diversification benefit, do you support creating a simplified standard approach, an example of which is shown in Annex 4? If you do, do you have alternative suggestions on how this standard approach should be specified? Are the suggested correlations in the example appropriate, if not what other values could be used?

- Answer to Q18: We think that aggregation and diversification methodology might be left to the appreciation of institutions, leaving some flexibility regarding the portfolio and the types of instruments carried by institutions, with a validation by the regulators.

Q19. If you support the availability of diversification benefit, do you support allowing an in-house approach which should be subject to approval by the regulator, an example of which is shown in Annex 4?

- Answer to Q19: Yes, we support the idea of having an in-house approach, validated by the regulator.

F. Offset to AVAs when calculating the adjustment to common equity tier 1

Q20. Would you agree that offsets against AVAs for overlaps with other Pillar 1 capital requirements should not be permitted? If not, what offsets might be appropriate and under what conditions might they be allowed (e.g. individually assessed by the institution and agreed with the regulator rather than specified in the RTS)?

- Answer to Q20: Yes, we agree that offsets against AVAs for overlaps with other Pillar 1 capital requirements should not occurred.

G. Documentation, systems and controls requirements

Q21. Do you believe the above requirements are appropriate? If not, what other requirements could be necessary and what requirements stated above are considered not to be relevant?

- Answer to Q21: The Discussion Paper is highly demanding in terms of documentation, systems, controls and reporting requirements, which appears unrealistically heavy to implement.

H. Reporting requirements

Q22. What would be the sources of costs and benefits of requiring (a) the implementation of a unique AVA methodology and (b) a consistent format for reporting AVA? Do you agree that the benefits of such requirements outweigh the costs associated with them?

Q23. If you agree with a reporting form being introduced, could you please provide a suggested template?

- Answer to Q22 and Q23: at this stage, we think that setting up a reporting template is premature. Moreover and as previously explained, we think that AVA will strongly increase the administrative costs in terms reporting and back-testing, and we are not in favour of an additional reporting template.