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Die Deutsche  
Kreditwirtschaft

# Comments

## **on the discussion paper "Relating to Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR)"**

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## **Comments on the discussion paper "Relating to Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR)"**

### **I. General remarks**

The EBA discussion paper presumably reflects the current status of the EBA working group discussions. It is our impression that the discussions have yet to be completed in many areas. For example, a number of operationalisations seem to be lacking if the purpose of a uniform European application of the "prudent valuation" concept is to be achieved. The objective should be to find a reasonable balance between the degrees of freedom which institutions require for their internal, model-based implementation of the demands and the goal of a uniform European application of the requirements. We nevertheless welcome that the EBA has included the banking industry in its deliberations at an early stage both with respect to the publication of the present discussion paper and also with the hearing in June 2012.

However, we consider it to be undesirable to decouple the supervisory from the accounting valuation further and further. The outcome is that individual financial instruments measured at fair value end up with various values. This immediately raises the question as to the "correctness" of the individual values compared with each other and how this impacts net income. The increasing decoupling of valuations leads to the necessity of parallel data pools and the continual updating of accounting records, which can ultimately have significant consequences. Such a discrepancy generated between these two worlds leads to a large number of mutual adjustment and exceptions. Those in turn call for considerable effort for their reconciliation and internal clarification. In addition, steering the altogether three equity capital variables (consolidated balance sheet equity, regulatory capital and economic risk cover capital) is rendered all the more difficult. The supervisory valuation requirements have to be implemented for Pillar I; for the economic capital calculation of Pillar II it still has to be examined what relevance the adjustments in the individually selected scenario for the risk-bearing capacity calculation may have and how their content would have to be interpreted still. The three capital perspectives of the balance sheet, the regulatory and the economic capital are thus on diverging methodical paths and may sometimes lead to considerably conflicting steering signals. Some of the required costs and risks that should be covered in the AVAs are already covered in the IFRS fair value approach (e.g. bid/ask spreads). We therefore argue that a common standard be defined for determining the fair value, which should then also apply for prudent valuation. In addition, from our understanding, value adjustments that have already been made with an income statement impact need not be applied again for the purpose of "prudent valuation". On the other hand, additional supervisory value adjustments need not be applied in accounting.

There can be no doubt that adjusting the valuation for receivables for the widest possible range of influencing factors, which incidentally are dependent on the market phase, will have an extremely procyclical effect. It also runs counter to the efforts of the recent regulatory changes to reduce the pro-cyclicality of supervisory capital requirements. For example, bid/ask spreads broadened sharply after the Lehman Brothers insolvency, as is usual in situations of a rapidly falling market. High capital-intensive AVAs would have aggravated the crisis at that point in time and presumably dragged the industry into an even stronger downward spiral – exactly the opposite of what is to be achieved, for example, with the introduction of the prudential filter, which neutralises the valuation effects on the capital ratio to a certain degree. This is in part also due to the fact that the valuation adjustments tend sharply in the direction of liquidation accounting. This distortion was intentionally and rightly avoided in the past. We consider the proposed approach highly dangerous and at odds with regulatory objectives – a bank whose accounts are based on breakup values will not be in a position to fulfil its major economic responsibilities. It needs to be made clear that the going concern concept of valuation should apply even when calculating AVAs.

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Uniform European application of the "prudent valuation" concept, albeit without curtailing adequate flexibility for institution-specific decisions, is essential for competitive reasons. Especially so as it has transpired during the course of the discussion with the EBA in June 2012 that some countries are clearly flouting the already valid CRD III requirements for prudent valuation and have not put in place national requirements to implement the CRD III requirements. In view of the fact that it is unlikely that the directly valid RTS will become effective before 2014, we would expect the EBA to take firm steps to make sure that the valid requirements are complied with by all European countries. The appropriate reviews should be undertaken to ensure this.

In general, we fear that there will be a distinct overlap between a number of the "prudent valuation" requirements and already existing or expected capital requirements. Such overlaps should be avoided at all costs so as to avoid "double-counting" of the same risks. We see such overlaps, for example, in the

- market liquidity requirements under Basel 2.5 (CRD III and CRD IV market risk rules),
- requirements concerning the CVA risk charge and stricter capital requirements under Basel III,
- anticipated requirements for endogenous market liquidity risks expected as part of the trading book review,
- capital requirements for operational risks,
- Pillar II capital requirements for model risks,
- Pillar II requirements for "leverage risk".

We therefore ask for an explicit statement in the future technical standard that all and any double counting can be offset against each other.

The uncertainties on how to approach the discussion paper start already with the fundamental terms "prudent value", "exit price" and "true realisable value". Whether the goal "to set valuations at a level that achieves an appropriate degree of certainty that the valuation used for regulatory purposes is not higher than the true realisable value" can even be achieved is more than doubtful. We therefore ask for standardisation of the terms.

We assume that the starting point for the AVA calculation, the fair value, will differ from jurisdiction to jurisdiction. It is unclear how the EBA intends to deal with this issue.

All prices and values respectively and the empirical distributions of financial instrument prices and values respectively depend strongly on the circumstances and thus in particular on a possible inclusion of the history (duration, weighting of historical data, reference to "normal" or "stressed" market conditions?) and on the exit horizon, which in turn has to reflect market liquidity considerations. It is not clear how a quantile shall be determined. There are in particular considerable differences whether reference is made to a normal market situation or "stressed" markets. It is also of considerable relevance whether "fire sales" are assumed or not. In addition, the terms are not adequately differentiated from each other. On the other hand, if valuation is carried out on the assumption of a "one-sided" distribution that is based on a single point in time, it should likewise be clarified how precisely the quantile is to be determined. For a point in time-based perspective, the market depth is a key aspect, which generally provides insufficient data in practice.

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Terminological confusion, differentiation difficulties and overlap problems also derive from the analysis of the example on page 5: a general market price uncertainty - as depicted in the example - is already incorporated in the market risk VaR, so that the described case is, in our opinion, not suitable as justification of prudent valuation. The example concerns the case of greater uncertainty due to risk aversion. The degree of risk aversion is, however, completely irrelevant for fair valuation (here: fair value positions), because risk-neutral (fair) valuation is applied. Hence the conceptual approach to the topic of "prudent valuation" is muddled by the example and needs to be revised.

Fundamental for all estimates and calculations stated in this draft is the transparency of the respective market, in particular transaction volumes and prices, but also the number of participants. Without this information, the required calculations are not meaningfully possible or can actually lead to false conclusions.

In addition, the valuation of many financial instruments has become extremely complex over the past few years, and the number of valuation parameters has (quite rightly) increased. Generally, one cause of the crisis is attributed to the complexity and impenetrability of valuations. The question arises whether the introduction of two further layers of complexity in the valuation process, namely the determination and testing of AVAs, is the right approach for tackling this problem. We would suggest that an impact study be carried out before finally deciding the prudent valuation rules. Even if various member states already have regulations for implementing CRD III, the proposals go far beyond what is currently valid in certain countries. One possibility would be to introduce a notification obligation, analogue to the LCR transition arrangement, whose results could then be used to determine the definitive rules.

### **II. EBA questions**

1. 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?

We support the introduction of a (de minimis) threshold. We support the inclination of the EBA already apparent in the question of introducing an *a priori* rule that spares the affected institutions the effort of calculating valuation adjustments right from the start. Otherwise, there would be no appreciable alleviation. For the structure of the de minimis threshold we suggest the orientation on the ratio of fair value positions to the institution's total assets or capital. Important is that the threshold be easily determined by the institution and that it can be quickly calculated. It should not lead to any additional complexity.

A threshold based on already calculated AVAs has been in place in Germany since implementation of the corresponding CRD III rules. From the methodology perspective, we would prefer the threshold to be determined as follows: the grand total of the AVA is at least x% of the total value of the considered transactions and the grand total is not less than EUR y million. Here, x should be at least 10 and y at least EUR 50 million. Such a threshold should be defined in addition to the aforementioned *a priori* rule.

Depending on the definition, the AVA will be volatile to a certain extent. We assume that a decline of the grand total of AVAs allows a reduction of the CET1 deductions and would invite a corresponding statement on this.

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The material scope is to be limited such that only those cases not already governed by a national or international safeguard mechanism are covered. For Germany, one example would be Section 340e Subs. 4 of the Commercial Code, which provides for the formation of a fund for general banking risks as a surrogate for limitation on distribution for unrealised gains.

If the EBA expected that the institutions have to meet the requirements, even though they are below the threshold, then the application of the ITS should reflect the concept of proportionality, as set out in the Pillar II provisions.

2. 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.

The consideration of regulatory costs in the determination of the "exit price" leads to significant distortions compared with an economic risk view. This applies in particular for positions which have to be deducted from capital, for example, due to undifferentiated regulatory treatment (such as high quality ABS position without external rating). In addition, it cannot be expected that the regulatory costs for potentially all the capital market participants be predicted for every individual position (regulated/unregulated; national/ international). An asymmetric applicability of regulatory requirements in pricing, e.g. between regulated financial institutions and unregulated or differently regulated financial institutions (e.g. insurance companies), leads to lower trading volume and thus lower market liquidity, which in turn can trigger other value adjustments in regulated financial institutions etc. ("self-fulfilling").

Not every position should be viewed solely under the possibility of an instantaneous exit point (for example hedge positions); the basis for the assessment should in particular not be "fire sales". Secondly, arbitrage transactions, for example, might not be held with the intention of exit at any time, but held specifically for the short or medium term.

In so far as the calculation of AVAs requires applying the value of a position that can be realised from an instantaneous sale, there is a risk that this would encourage short-termism. A lower valuation could mean that a limit is crossed below which a sale has to be effected. This could even accelerate a further fall in value. If there is an expectation that the value of the position may recover in the near term, this could be taken into consideration in the assessment. This could avoid the actual realization of losses.

3. 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?

In general, we support the idea of a consistent approach with respect to the corresponding capital requirements. A clearer statement as to how market liquidity risks could be included would be helpful because the determination of the "time horizon" has a very considerable influence on the amount of the AVAs. The aim should also be that the AVA requirements do not lead to "double-counting" with respect to the future requirements arising, for example, from the Basel Trading Book Review.

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In addition, flexibility concerning the exit horizon would give the institutions further latitude. At the same time, such a process requires additional proof to be kept at the level of individual positions and would have to be underpinned with corresponding quantitative studies. This would entail not inconsiderable use of resources. Defining a general horizon is, in our opinion, meaningful; however, it must be ensured that deviations from the horizon are permitted in both directions in justified cases (e.g. market maker portfolios, hedging transactions, structured products).

4. 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?

In our opinion, restraint should be applied in the determination of a confidence level and only where there are corresponding data as a basis should thought be given to opting for such a statistical approach. However, EBA must provide sound conceptual reasons as to why the lowest quotes should be used for the quantile estimate of the market price uncertainty on a confidence level basis. The selling institution will usually select the highest offered price from the various prices quoted by possible counterparties (with allowance for their liquidity) and conclude the transaction at that price. Therefore, the application of the same probabilities for all the available quotes is not plausible. In addition, with respect to model quality it is to be assumed that the values at the lower end are of a poorer quality than those in the centre of the distribution. Hence we reject the quantile concept for determining AVAs even if there are sufficient market data.

As a rule, it is also to be expected that the confidence level cannot be calculated for want of data, since a statistical process only supplies robust results if there is a sufficient data basis for the calculation. Where there is an inadequate data basis we see the problem of a large estimation error in the determination of AVAs, which would lead to an unjustified fluctuation in measuring the risk. It would hence generate spurious accuracy for the affected institution, the supervisory agency and third parties which could not be corroborated due to the lack of data (for example, we fail to grasp how a statistical procedure can be expected to deliver a reliable 95% interval with only 15 data points). In this context, it should also be borne in mind that the industry also lacks sufficient experience for determining valuation adjustments.

Especially with a quantile estimate based on expert opinions for market-to-model positions we fear unreasonable and too high safety loadings. There is also a risk that various banks – also with the consent of their supervisors – will come to very different estimates. That would thwart consistent European regulation. In our opinion, AVAs which reflect uncertainties in valuation should be largest in illiquid markets. But precisely in those cases, a reliable estimate of a large quantile will not be possible due to a lack of data. In addition, expert-based distribution functions cannot be drawn up for certain AVAs. This includes, for example, model uncertainties.

Accordingly, we recommend that quantile rules be dispensed with for expert estimates, too, and that a "best available estimate" approach be applied instead. Banks should at most have the possibility of adopting the quantile approach voluntarily.

In general, there should be stronger incentives for process improvements instead of opting for an across-the-board statistical metric. Incentivisation could be improved, for example, in the IPV (independent price verification) and NPI (new product introduction) process, and also in monitoring the management of stale positions. Such qualitative improvements can contribute to the definition of "prudent values".

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In addition, we would in general argue that the confidence level - in so far as it is to apply for every individual position - should only have to be applied for the aggregate of the valuation adjustments from the various grounds. This would enable institutions to offset potential AVAs that cannot appear at the same time as each other and prevent quantiles for individual risk factors adding up to a disproportionately high value adjustment.

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

If the EBA does not wish to fully dispense with the definition of a confidence level, we expressly favour that a lower level of not more than 75 – 80% be applied. This would also alleviate the problem discussed under question 4. In return, an aggregation approach that allows for diversification could possibly be dispensed with, provided that potential overlaps between individual criteria could be ruled out (see also our remarks on aggregation).

In addition, in our opinion, it should be borne in mind that specific AVA requirements generate de facto additional capital requirements for "fair value positions". Here, the EBA should take into consideration the additive impact of AVAs in addition to the capital requirements when calibrating or defining the quantile.

6. 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?

In our opinion, it should be left to the institution themselves to decide for which positions they can and want to carry out a statistical calculation of the valuation adjustments. The necessary number of data points can vary from instrument to instrument, and hence the institution would justify the decision it has taken. Given this latitude, other factors could then be included in the case-by-case decisions.

By the same standard, the institution should also be permitted to demonstrate that no valuation adjustments at all are needed. For example, certain OTC derivatives tend to have narrower bid/ask spreads than certain exchange-traded products. Here it should be possible to forego a mark-down for closing costs.

Even for statistical calculations with a sufficient number of data points, bid/ask spreads are not necessarily a good indicator of the actually achievable exit price once the market has become illiquid.

Besides the forecast horizon, the EBA has to declare if a historical observation period is to be considered for the quantile estimation. The specifications determined so far are surely insufficient for an internationally consistent application. For example, the duration of the history, the weighting of historical data and whether a specific period of the history is to be selected should also be discussed with the industry. Alternatively, we would consider it better to apply a concept of "best available estimates" in order to obtain consistent estimates.

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7. 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?

As already discussed, quantile rules should be avoided in general.

We do not share the opinion that OTC products should generally not be included in "mark-to-market positions" (see page 11, No. 3). For example, "forward rate agreements" (FRAs), futures or "interest rate swaps" (IRS) may well be standardised, highly liquid products, for which AVAs may not even be required at all in certain circumstances. This is, for example, also the position expressed by the European Central Bank in its opinion on the EU Commission consultation "on the regulation of indices" (see page 4 of the opinion of November 2012).

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

We do not consider this to be necessary. Since the market data quality of individual market data sources will vary over time, it is probably better to give examples rather than publish a binding list.

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

We do not consider this to be a good idea. Every description of how to use certain data sources entails a risk of distortion. Such distortions can be a danger in practice.

10. 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?

The data basis in the discussion paper is already sufficiently prescriptive. Rather than extending the list, we would favour transferring responsibility to the individual institution. This can then apply sources suitable for the specific product.

At best, thought could be given to whether examples of "best practice approaches" rather than binding references to such approaches might be helpful.

Otherwise, we refer to our response to question 6.

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

Thought could be given to including the "bid-offer-width" in the analysis.

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12. 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?

The differentiation of market price uncertainty from the other categories is, in our opinion, unclear. Concerning the uncertainty in the input parameters of valuation models, seeking to achieve prudent valuation via an adjustment is understandable. However, this adjustment should not be to individual model parameters but address all the necessary model parameters in their totality. In general, risk-based determination of AVAs (instead of complete re-evaluation) should be permitted because the determination is in any case based on expert opinions and thus quantification possible only with a fuzziness.

In addition, we assume that the requirements for "counterparty credit risk" (especially CVA charge, and the cover for default risks) are sufficiently conservative. Therefore, the assessment of "unearned credit spreads" should be dropped (para. 21).

Likewise, we assume that the capital requirements for operational risks already provide for such risks. This is the case in particular with application of the AMA. In order to avoid double counting, the passage "Operational Risks" should be deleted (para. 26).

It is correct that trades "away from fair value" are possible upon "early termination" (para. 37). However, "early termination" tends to be combined with a restructuring which can generate additional revenue. Here, "offsetting" should be possible. The same goes for future administrative costs which may lead to corresponding revenue (para. 41 – 44).

We consider the additional consideration of "investing and funding costs" to be unnecessary (para. 38-40), because these are already reflected in fair value. Recent years have seen the development of new market standards in this area which ensure that these factors are taken into account (e.g. consideration of maturity-specific interest rate curves, distinction between forward prediction and discounting and OIS discounting). Supervisors should have confidence in these market standards – especially when it comes to calculating funding valuation adjustments.

We consider quantification of the model risk not even possible in some cases and would suggest that the requirement be deleted (para. 47). It may often be impossible in actual fact to obtain an overview of all the instrument models used in the market (especially for complex products that require simulation approaches for their valuation, for example). Here, the institution just has to live with the situation that there is no such thing as "the" model price. Therefore, there is probably little point in using valuation adjustments to create de facto pillar I capital requirements for model risk; a better approach is probably to leave consideration entirely under pillar II.

The requirement in para. 53 should be deleted. In our view, a portfolio approach is frequently a more effective way of identifying potential concentration and potential illiquidity than is analysis at position level.

The requirements in para. 54 are not clear, in our view, and need further explanation. We see no necessity to introduce additional procedures over and above the existing checks on balance sheet items (such as FO/BO reconciliation, reconciliation of totals), particularly since these checks are also regularly reviewed by auditors.

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13. 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?

We do not see any points missing.

14. 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?

No, we do not share that belief. A test based solely on the number of "prudent valuations" compared with "imprudent valuations" ignores the magnitude of the "imprudent valuations".

Since the discussion paper already admits that AVAs cannot be statistically calculated for many instruments, we see no additional value in a statistical review of those expert-based estimates. At the same time, it makes little sense in demanding a test solely for the statistically calculated values. We assume that even without explicit back-testing a qualitatively good best practice will emerge from the oversight by the supervisory agency and auditors. Since, as argued above, neither the benefit nor the practicability of this additional complexity layer is apparent, we assume that the test approach is superfluous.

In practical cases, AVAs are frequently meaningfully determinable at the portfolio level but not at the level of individual transactions, however. In our opinion, the determination of AVAs at the portfolio level is acceptable in principle, but does lead to problems in the testing approach. If no AVA is assigned to an individual transaction a priori, it will in practice be hardly possible to determine the "ex-ante change in value" for a transaction. Under the proposed system this would require the portfolio's AVAs to be determined with and without the actual transaction. The effort this requires is scarcely imaginable.

In the proposed test approach, the prior day price is to be compared with the actually traded price and then compared with the valuation adjustment. We do not believe that this approach should be used as the standard procedure because the comparison is not particularly informative. Due to the time lags, market changes cause "market contamination". In addition, the situation in which the institution sells a position is different for each transaction. A blanket test approach will not be conducive to achieving the goal.

The effort entailed by the proposed test approach is exorbitant. Since all marked-to-model positions ought to be included, it would also have to be applied, for example, for swaps with non-standardised maturities. Re-evaluating all those positions, in part a hundred times over, would be beyond the capacity of many institutions.

15. 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?

In our view, the discussion paper fails to address an important point – namely that validation, while always serving a useful purpose, does nothing in itself to significantly improve risk management. The starting point, as we see it, should be to develop policies capable of preventing concentrated, complex or stale

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positions. Instead of prescribing individual validation techniques, the focus should primarily be on these policies and on compliance with them in practice. The analysis of buying and selling prices doubtless makes good sense for certain portfolios and is already standard practice.

As in other areas, the RTS should be sufficiently prescriptive so as to avoid misunderstandings and impractical requirements. Problematical is the trade-off between the necessary requirements and consideration of the institutions' individuality. This calls for a practicable solution. Achieving comparability across institution boundaries requires the definition of a minimum level of clear requirements and procedures by the supervisory bodies. On the other hand, the particular characteristics of the institutions and their scale of trading activities have to be heeded in order to bring about individually reasonable solutions.

16. 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?

We do not support this view. For example, financial statements drawn up in compliance with the German Commercial Code have to have VaR-based adjustments for valuation uncertainties (see Section 340e Subs. 3, Commercial Code). Since this is a blanket mark-down, it can lead to the market value carried in the balance sheet being lower than the "prudent value", which allows for the individual valuation adjustments. Offsets should be permitted in such cases.

17. 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

Diversification effects of AVAs relating to the position should definitely be allowed (see also last paragraph to question 4). Many of the individual causes stated contain substantial overlaps (e.g. market price uncertainty and model risk) or are uncorrelated (e.g. model risk and concentration risk). We assume that the discussion paper already implies that institutions can take such overlaps into consideration during their calculations.

The definition of a supervisory standard procedure for aggregating AVAs seems most compatible with the EBA's goal of achieving a "level playing field". This would spare institutions the effort for deriving, demonstrating and documenting the applied methodology. Institutions should nevertheless be permitted to apply an internal method if they can demonstrate that the standard approach would result in significantly distorted values. It would doubtless make good sense to use existing internal market risk models that have already been approved by supervisors.

The definition of a confidence level that should apply at both the level of the individual AVA components and also the overall AVA of a position does raise certain questions, however. Simple aggregation of individual AVAs to a 95% confidence level without the consideration of diversification would as a rule lead to an unreasonably high AVA for the overall position. An aggregation approach allowing for diversification could, in an ideal situation, avoid this issue, but in practice it may well be impossible to deliver proof of the appropriateness of such an approach. Here we fear considerable additional effort that brings little added value. Therefore, we refer to our suggestion above that a confidence level of 75 to 80% be applied

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and advise simple summation on that basis thereof. We believe that this is a meaningful trade-off, in particular against the background that aggregation with diversification would prove to be scarcely robust and thus presumably bring a hefty portion of "arbitrariness" with it.

In conclusion, we see no need to exclude the AVAs for operational risk, early termination, concentration and illiquidity when calculating the diversification benefit. Since these are not deterministic amounts, a diversification effect arises even if the correlation is below 100%.

18. If simple aggregation better reflect your assumptions and practices or would 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?

Please see our reply to question 17.

19. 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?

Please see our reply to question 17.

20. 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)?

In principle, the aim should be to define regulatory requirements in such a way that there are no overlaps. Where there are clear overlaps, offsetting should be possible. Even better would be to drop AVA requirements e.g. for "unearned credit spreads" and "operational risk". If the institution can demonstrate other overlaps, the AVAs should be reduced accordingly.

In addition, we would like to point out that AVAs can also have an impact on Pillar II. We ask that the interactions with ICAAP be given more attention.

21. 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?

The standards for "systems and controls" are part of an appropriate governance for fair value. We consider a specific right to demand higher capital requirements in the event of deficits in this area to be unnecessary because this right exists in any case and would again lead to substantial overlaps with AVAs. For banks using internal models, valuation controls already play a major role in determining multipliers for calculating capital requirements.

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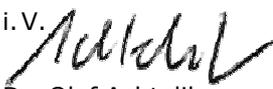
22. What would be the sources of costs and benefits of requiring (a) the implementation of a unique AVA methodology and (b) a consistent format for reporting AVA? Do you agree that the benefits of such requirements outweigh the costs associated with them?

The main benefit of a uniform AVA system is the consistency of values within the institution. A uniform format would lead to better comparability. However, a certain degree of flexibility should also be possible so as to accommodate the different circumstances faced by institutions. The costs are, however, considerable and involve in particular HR and IT costs. In essence, "entry to the AVA world" requires a second "fair value process", one which many institutions frequently do not have.

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

From our understanding, an AVA report is not suitable for achieving a level playing field because AVAs, as a difference between fair values after adjustments and prudent values, are not a suitable metric. A direct comparison of prudent valuation only makes sense if applied to identical or sufficiently identical portfolios. We therefore reject the idea of a general report template.

  
Dr. Andreas Martin

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Dr. Olaf Achteлик