

BSG Comments on EBA Discussion Paper on Prudent Valuation

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GENERAL COMMENTS

With this Discussion Paper, EBA intends to provide technical details in view of the RTS for the implementation of the articles 31 and 100 of the CRR. The prudent value is based on an exit price which does not need to be instantaneous. The Additional Valuation Adjustment (AVA), set as the difference between the fair value, reported in the balance sheet, and the prudent value, should be calculated with an explicit level of confidence that would be set at 95%. A statistical approach should be used when extensive and reliable data are available.

We fully support the idea that prudence should be embodied in the valuation of financial instruments for supervisory reporting. The use of a RTS is appropriate to establish the basis of a level playing field across the EU and could result in improvements to valuation procedures across the banking industry. However, the BSG has identified major concerns and issues in the technical standards included in this Discussion Paper. These concerns are summarized hereafter:

- The framework underlying the AVA calculation needs to be clarified

A main concern relates to the framework or the conception underlying the calculation of the prudent valuation. We think it is also necessary to well define why differences may arise from a fair value measurement as defined under IFRS 13 in the light that AVAs were introduced in the text of the CRD much earlier than the recently adopted IFRS 13 requirements.

For example, operational risks, future administrative costs, and possibly some/all of the close-out costs are parameters that are not part of the fair value definition under IFRS 13. However, operational risks are covered by a separate capital charge and therefore the valuation risks stemming from operational risk factors, which are hard to estimate, should not be a part of the prudent value. It may also happen that in the national accounting framework of a Member State the fair valuation rules are not in complete harmony with the IFRS 13, since the accounting directives at present do not include such an obligation. Therefore, they require a clear understanding of what aim is pursued by the regulator that should be different from the accounting perspective (for which the underlying principles, as for all the financial statements, is a business-as usual scenario).

As for concentration, the IFRS 13 text may already authorize concentration effects to be included, notably when the unit of measurement retained is the net portfolio position, and the position is not a level 1 holding. While this may reduce divergences between Fair and Prudent measure, the risk of conflict with other requirements (i.e. the Pillar 2 capital need for concentration risk, the outcome of the Fundamental Review of the Trading Book) has to be considered.

Beyond clarification of the objective of the measure, regulators should also demonstrate the benefit of calculating such a liquidation value to be deducted from common equity tier one instead of keeping the exit price fair value that is already accounted for. In this regard, it is our view that the Prudent Valuation measure should retain the fundamental principle that measurement relates to a potential transaction taking place at the measurement date.

Additionally, if we consider that most of the risks listed should be taken into account for determining the fair values according to IFRS 13 and that the others should be dealt with outside of the valuation of the individual assets and liabilities, the concept of AVAs becomes even questionable. We would rather favour considering the requirements of the Discussion Paper as application guidance for the determination of fair values according to IFRS 13 and restrict AVAs to only those areas where prudence and fairness of valuation are irreconcilable (which should be rare). Such an approach would avoid creating a costly double set of accounts.

In this regard, we must indicate that setting Banking prudential valuation standards that differ from the accounting ones might discredit the accounting framework. In the method proposed in the Discussion Paper prudence is defined as a set of banking prudential valuation standards separate from the accounting ones. In fact, it would virtually amount to creating two sets of profit and loss account that will clearly not promote the interests of transparency. This can be extremely confusing for the market and the investors which eventually will generally consider the “right” value as being on the safe side and therefore the prudential one. While understanding the criticisms around some of the concepts of the IFRSs, we strongly think that sanctioning material inconsistencies between the prudential valuation and the fair value would not only be detrimental to the IFRSs but also to the banking sector as a whole.

We also note that whatever the degree of prescription of the RTS and IFRS, both Fair and Prudent value will still require a significant level of judgment. It follows that the more institutions adopt a prudent fair value approach, the less additional valuation adjustments they will disclose. This is likely to be misinterpreted by market analysts. In fact, in contradiction with the EBA’s intention, this could have the effect of penalising institutions with a prudent accounting practice in force. Some banks might subsequently become less conservative in their fair value estimate for the sake of obtaining a significant AVA for which the disclosure is explicit.

In this regard, it is remarkable that the de Larosière Group^a recommended that regulators and accounting standard setters should coordinate their responses to address valuation issues. Specifically, recommendation no. 4 of the de Larosière Report states (among others) that “the IASB and other accounting standard setters should clarify and agree on a common, transparent methodology for the valuation of assets

^a De Larosière, J. (dir.) (2009). Report of the High Level Group on Financial Supervision in the EU. Available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

in illiquid markets where mark-to market cannot be applied” and that “the IASB further opens its standard-setting process to the regulatory, supervisory and business communities”. We thus support the idea of a clear cooperation between banking regulators and the IASB rather than an open conflict on valuation rules.

The de Larosière Report also states that “over-regulation should be avoided [...] Furthermore, the enforcement of existing regulation, when adequate (or improving it where necessary), and better supervision, can be as important as creating new regulation” (de Larosière Report, P 13).

Finally, there are several points which deserve further explanation. First, it is important that AVA determination reflects the Going Concern status of institutions, and that defined AVA determination approaches do not require the use of an inappropriately low instantaneous exit / forced sale valuation. In this regard, it is important to clarify the scope of “exit price” and “instantaneous” and the intention of the wording. Under the going concern perspective it is presumed that an entity will be able to realize its assets and discharge its liabilities in the normal course of business. The concept of “cost” value should also be further explained. Furthermore, risks which are not reflected in fair values, should, as much as possible, be treated in the framework of the relevant risk type.

Another aspect whose rationale should be further explained is the waiver for institutions using an accounting framework where positions should be shown at the lower of cost and market value, specifically in a case when market value is the lowest of the two. Such explanations would help to make the conceptual background clearer.

- Double-counting with capital requirements and balance sheet substantiation

The Discussion Paper should be analysed in parallel with other requirements that are expected (i.e. Fundamental Review of the Trading Book, the Supervisory Guidance for Assessing Banks’ Financial Instrument Fair Value Practices^b), as it also gives rise to several potential double-counting issues.

Firstly, it is noticeable that it is suggested to consider the concentration and liquidity horizons in measuring the prudent value on top of all the elements specified in the CRR. Such orientation is either unclear or already taken care of by the Fundamental Review of the Trading Book framework.

Secondly, measuring the operational risk might not be appropriate in this framework. Incorporating the operational risk in the exit price seems unnecessarily complicated and may overlap with the operational risk capital charge.

Finally, checking that the balance sheet accounts are tested and agreed with individual assets and liabilities and their valuations and defining an AVA when the tests fails or is not completed should not be part of such a paper on prudent valuation. This is because it relates to accounting and auditing issues that should remain out of the scope of this paper. The compliance of the accounts to normal internal control rules and the

^b Basel Committee on Banking Supervision (2009). Supervisory guidance for assessing banks’ financial instrument fair value practices, Bank for International Settlements, Basel, Switzerland. Available at <http://www.bis.org/publ/bcbs153.pdf>

completeness of accounts cannot be circumvented or compensated through prudential valuation adjustments.

- There is an excess of prescriptive and complex rules that depart from the principles-based approach of the CRR

We must also take into account the complexity of the current regulation. The details surrounding the application of either set of accounting standards are already frustratingly complex for even the most sophisticated observers and practitioners; in this context, the implementation of a second regulatory set of rules for valuation purposes contains the danger that the understanding of the banks solvability would become more and more difficult.

Indeed, one of the main features of the methods outlined in the Discussion Paper is their complexity and the excess of quantitative rules. Although management should be fully aware of valuation risk, departing from the principles-based approach of the CRR implies many possible regulatory and disclosure arbitrages, which will ultimately affect the level playing field of EU banks. In this context, we are afraid that the expected benefit of transparency could be lost.

So, we advise against introducing additional complex and very detailed regulations for prudent valuation. The future RTS on prudent valuation should, instead, mirror the Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices. It is also noticeable that the procedures outlined in the Discussion Paper mean that, in practice, the assessment of many AVAs is likely to follow judgemental processes, particularly for more illiquid structural / complex positions and exposures where AVAs are more significant in size. This should be reflected in the RTS to come, through a much greater focus on articulation of the aims of prudent valuation in order to better guide judgemental AVA assessment.

We think that, to be adaptive to varying conditions and avoid regulatory arbitrages, a regulation should be principle-based with its application being controlled by the regulators. In this regard, it would be useful to benchmark best practices in the industry with respect to prudent valuation, among others:

- Internal processes and regulation that assure a prudent valuation end-to-end, from the capture and validation of market data to the calculation of valuation adjustments.
- The level of interdependency within the areas that perform the prudent valuation and the business area.
- Formal and periodic processes in order to identify the necessary adjustments and valuation.
- Internal reporting framework.

Finally, the complexity raises the question of a cost-benefit assessment. This Discussion Paper is highly demanding in terms of documentation, systems, control and reporting requirements to a point where it appears unrealistically heavy to implement in an operational context. That is, the required set up implies significant investment for collecting additional data and developing additional statistical tools, while the benefits of such requirements are not clearly demonstrated.

- Setting a 95% confidence level is overly prudent and not really feasible

The benefits of the predefined confidence level of 95% are not clearly justified. In addition, we think it is excessively conservative compared to what is believed to be the standard market practice.

Some positions may in fact show losses at their inception where the predefined level is not compatible with the actual pricing of the risk in the market. Moreover, an estimation based on a fixed high confidence level without an associated guidance on what are the relevant sources, can bias the value measure. In the case of consensus for example, the participation of non-active players may lead to wider price distributions, and therefore, a predefined confidence level might result in an unrealistic valuation adjustment, a non-tradable price and, as such, to unnecessary capital requirements.

As statistics can be used only if the number of observations is sufficient, a simpler and more appropriate method could consist in choosing the minimum price after selecting a reasonable number of quotes amongst the most reliable data. As an example, we consider that for the purpose of determining the AVA for the illiquid positions, the information available is limited. Thus, the sample does not have the quality needed for an adequate statistical analysis. In consequence, neither a confidence interval nor statistical tests are appropriate.

- Many other features proposed in the Discussion Paper are too complex and may have unintended effects

- The diversification benefit

With a view to mitigate the aforementioned high confidence level, the Discussion Paper recognizes the existence of diversification benefits. However, this benefit is very difficult to measure and to allocate to business lines especially where diversification amongst different asset classes are considered. We would rather prefer the diversification effect to be measured from time to time and used as a scaling factor for adjustments that are additive and can therefore be allocated to individual business lines. A more pragmatic approach could be to consider the diversification benefit for the determination of the confidence level.

- Pro-cyclical effects

Although prudent valuation is a requirement of Arts. 31 and 100 of the CRR, we must stress that if technical implementation or its conceptual background go far beyond fair value requirements, its enforcement might have unintended pro-cyclical effects, especially in the less liquid markets, creating a vicious circle (prudence influences Front Office pricing, which in turn leads to a lower fair value, which requires more prudence in the supervisory reporting in order to give an adequate “prudent image” of the company, etc...).

Our view is that that prudent valuation should not result in a material aggravation of the pro-cyclical nature of the fair value itself.

This point is also mentioned in the de Larosière Report, which states that regulation "should concentrate on the major sources of weaknesses of the present set-up (e.g. dealing with financial bubbles, strengthening regulatory oversight on institutions that have proven to be poorly regulated, adapting regulatory and accounting practices that have aggravated pro-cyclicality,.....)". The de Larosière Report also recommends that “the accounting system should be neutral and not be allowed to change business models – which it has

been doing in the past by "incentivising" banks to act short term. The public good of financial stability must be embedded in accounting standard setting" (for further details see recital 2 of the CRR draft).

- Back-testing

The Discussion Paper establishes that in case of Marked to Market positions, institutions should use a sample of reliable data, without giving precision about what reliable data is.

The reliability of the proposed approach depends on the availability of price data of sufficient quantity and quality— this will not be the case for all but the most liquid markets. This is not the least because most of the business in structured transactions (in particular those that are client driven ones) is about dynamic risk management of such transactions using the most liquid instruments rather than exiting client trades in the dealer market. In this context, there will be few data to make exit price back-testing possible or reliable.

In fact, the lack of reliable data is precisely the cause of valuation uncertainty. Thus, by definition, it is difficult to quantify the uncertainty.

Another hurdle to such back-testing comes from the fact that some of the valuation adjustments are computed on a net portfolio basis, while the exit price, if any exists, is deal-based. Thus, the back-testing exercise inevitably requires proprietary conventions.

Globally, we consider this requirement has to be removed or alleviated to a minimum considering its operational impediments as it involves a very heavy and complicated implementation with unclear benefits.

RESPONSES TO SPECIFIC QUESTIONS

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?

A threshold does seem to be appropriate. A measure that could be used to define the threshold could be the ratio of Fair Valued Assets over Total Assets, with institutions under a specified level excluded (subject to Competent Authority permission). Other possibilities are the use of a) the balance sheet amount and b) the total amount of instruments valued at Level II and Level III for IFRS purposes, irrespective of national GAAP.

For institutions that have to assess prudent value, the materiality of individual positions / exposures should also be considered when determining the need to establish AVAs. For insignificant products / exposures (relative to the total) AVA assessments should not be required. In this regard, it could be useful to establish materiality thresholds which are not based on the contemplated measures but rather be primarily driven by expert judgment based on internal policy and documentation.

If an institution has to assess prudent value, thresholds should also be separately applied to assets and liabilities, as well as to individual subsidiaries, prior to considering consolidated balance sheets. Individual subsidiaries that fall below thresholds should be excluded from computation at the consolidated level.

Another possibility is the introduction of a proportionality threshold after institutions assess prudent value. A proportionality threshold after the assessment of prudent value is less subjective than a proportionality threshold before the assessment of prudent value, as the size of the AVAs would not be known otherwise. An institution with insignificant AVAs relative to its capital base might not be required to deduct AVAs from CET1 capital.

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.

Yes, we think that the exit price used as the basis for prudent valuation should not be based on an instantaneous sale. The prudent value measurement should reflect the Going Concern status of an institution, which is very different from the pricing that would be appropriate for under a forced sale / ~break-up situation. Instantaneous sale-based pricing would reflect this latter situation and hence would be inappropriate, particularly for markets / risk exposures that are not highly liquid. Particularly for complex products, the concept of instantaneous sale will be extremely hard to assess. These are transactions that normally take time to be executed.

However, we believe the same analysis as for IFRS 13 should be made: IFRS 13 states that the exit price refers to a hypothetical transaction that is not necessarily actual sale or forced transaction or distressed sale (BC30). In other areas of the same standard, the entity does not even need to be able to sell the asset at the measurement date, as it only needs to be able to access the market. Being defined as a “thought experiment”, the fair value can be generally obtained even in the worst situations of inactive markets, and is compatible with the on-going concern principle.

The Discussion Paper does, however, require further explanations. Among these, we highlight the need for clarifying the meaning of “instantaneous” in line with the definition of fair value and where it would be applicable. Furthermore, the meaning of “exit price” is not perfectly clear.

The exit price should take into account the normal marketing period taken by an institution to exit the position before the reporting date. This normal marketing period, which would vary between products and instruments, is necessary for any market player to obtain sufficient number of bids from potential counterparties before a trading decision is made. For example, a market player would expect a shorter marketing period in disposing of its listed equity share holdings (not concentrated) as compared to its unlisted equity share holdings. If prudent value were based on an instantaneous sale, stress conditions would be implied. Prudent value should be based on valuation uncertainty at the reporting date and not distressed valuations under stress conditions, so as to avoid double counting with Stress Value-at-Risk.

In the financial statements, the purpose is to give a possible executable price at a given point in time and not under a time horizon to exit a position. The fair value measurement needs to incorporate conditions that prevail at the measurement date. Departing from this concept would make accounting fair value and prudent value irreconcilable.

Ultimately, fair value measurement is an elaborated approach that factors conditions that prevail at the measurement date, and aims at determining what the transaction price at that date could be (even if there isn't actually a market). Implicitly, the fair value measurement assumes that there is always a possibility to determine the price at which a transaction could take place with a hypothetical knowledgeable, willing, risk adverse market participant who is acting in its best interest.

However, it is clear that the transaction is hypothetical. Had that transaction taken place at the measurement date, it would be consistent with the fair value measurement; if it takes place at a later time T, then it is comparable with the fair value measure at this time T.

The conceptual framework of fair value is clear. Conversely, the conceptual framework that underpins the AVAs (Additional Valuation Adjustments) still needs to be clearly stated. It is of utmost importance to well define the rationale of the methodology to be able to assess why and when differences may arise from a fair value measurement as defined under IFRS 13. If such principles are not explained, the set of rules proposed in the Discussion Paper could create confusion in terms of market transparency as well as running the risk of discrediting financial statements and undermining transparency.

For example, a regulator may elect to measure “what would be the price for an orderly sale of full or part of fair valued business, at the measurement date, assuming that the buyer is knowledgeable, willing, risk adverse and that this buyer would continue that business”. Depending on the regulator's view, differences with the Fair Value as computed for the financial statements under IFRS 13 (for which the underlying principles, as for all the financial statements is a business-as usual scenario) should be clearly explained.

It is important that the prudent value measurement reflects the Going Concern status of an institution, which is very different from the pricing that would be appropriate under a forced sale / 'break-up' situation. Instantaneous sale-based pricing would reflect this latter situation and hence would be inappropriate, particularly for markets / risk exposures that are not highly liquid.

Finally, it is important that in order to maintain consistency with the exit price concept, AVAs should include the potential tax liability deductions that would occur on the balance sheet if valuations were more prudent. Tax is a major consideration by institutions when determining the exit price of a position.

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?

No. we believe that there is some confusion here between marketability horizon and liquidation horizon. For any product, even a simple product, there is a marketability horizon, which is the time needed for a buyer to become knowledgeable and willing to transact. A value measurement for financial statement assumes that this marketability period has taken place prior to the measurement date, so that the parties are already knowledgeable and ready to transact at the measurement date. Marketability horizon is an intrinsic feature of a product in a given market context. This feature may have some influence on the value, for example through some positive or negative premia that may be partly explained by the ability or inability to easily sell/liquidate the products (from the buyer perspective). Bid/offer ranges may also depend on the marketability horizon and this is not easily linkable to capital considerations or capital horizon. In any case, accounting for a marketability horizon may double count with the other close out costs; moreover, as it is instrument-dependent, it cannot be unique or, as with VAR, exogenously set by regulation.

Conversely, the liquidation horizon is a different concept. It is the time needed by a given entity with a given portfolio to liquidate the deal in a future date assuming it has taken the decision to do so and then the marketability period starts at the measurement date. This is entirely driven by the entity and book specificities. Indeed, time horizon for each instrument depends on (i) the exogenous observable market liquidity and (ii) the endogenous liquidity relative to the bank's specific position size relative to the market deepness. But more importantly, the "realizable value" is based on an hypothetical transaction that takes place at a future date and thus the end result can depart significantly from the market conditions prevailing at the measurement date. Thus this makes "liquidation" value more of a risk measure than a value measure.

This is typically the area where the double counting mentioned in the general comments would occur. Liquidation time horizon is an element to be taken into account in the RWA calculation and not in the valuation. The liquidity horizon issue is one of the main concepts driving the Fundamental Review of the Trading Book.

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?

We question the purpose of defining some additional adjustments already required by the accounting standards without clearly understanding the benefit of setting a 95% level of confidence.

The calculation of a confidence level is relevant only when using a sufficient number of observations that are directly comparable to the purpose of the value being measured, and that is available at the measurement date. In practice, the number of available quotes/executable/consensus prices to compute AVA for each position may not be high enough. Quotations provided by brokers depend on specific factors such as:

- Volume of transactions.
- Risk appetite of the institution.
- Type of counterpart.
- Commercial strategy.
- etc.

These factors may generate discrepancies between the sample used to calculate AVAs and actual exit prices on a specific entity portfolio. We think that the priority should be set on the quality of the observable data, that is, on the reliability of the dataset rather than on a confidence level.

Nevertheless, we support the idea of providing a generic guidance for applying judgement when assessing uncertainty and determining valuation adjustments with a view to determining the fair value of financial instruments. This allows reaching some kind of confidence. Two examples where predefined level of confidence may not be the most appropriate choice illustrate our concern with such a concept:

- In some cases, alternatives to the level of confidence exist such as the simple number of binding or indicative quotes provided by active and willing market players.
- Conversely, there are circumstances where the market available information is biased by the participation of market players who are neither active, nor really willing to deal nor knowledgeable. This could be the case where the increased number of participants contributing to a certain consensus does not add to clarity, and instead increases the variance of prices. Predefined confidence levels in such situations will lead to a requirement for additional capital that is not economically substantiated.

We also draw the attention of the EBA to the fact that a predefined level of confidence, together with high degree of prescription in the required AVAs, will affect prices. That is because valuation adjustments are usually allocated to the desks and contribute to the setting of rate of return hurdles for Front Officers. Hence, an extreme degree of prudence may result in bringing prices lower and lead to market extinction or downward spiral. Conversely, not allocating AVAs to the desks would raise the question of ownership and governance around the potential capital charge.

We understand that EBA aims at a harmonised and comparable measure. To serve this purpose, a predefined confidence level can be acceptable only if it is calibrated to a reasonable level and exclusively used as a benchmark and not a compulsory measure. Also, we think other alternatives could be proposed, such as the simple count of quotes.

Finally, we must indicate that in small markets and for small institutions which would be constrained to use more judgemental approaches because of insufficient data, the confidence level would be difficult to interpret and validate. This reinforces the need for guidance on the application of judgemental approaches to determine AVAs.

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?

As specified in the previous answer, not only we do not believe a predefined level should be compelling but we also consider that 95% is excessive. It must be taken into account that several industry groups suggest that the confidence level should be between 75% and 85%. In smaller markets the 95% confidence level may be influenced by specific deals and therefore it could produce an extreme value. The determination of the optimum level of confidence should require the system to be implemented and running for some time covering different scenarios (also covering stressed conditions).

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?

First, we must indicate that a sound answer to this question should also require the system to be implemented and running for some time.

Furthermore, the determination of a prescriptive methodology in this regard should be abandoned due to several limitations.

First, a consistent framework needs valuation back-testing to be insulated from any price variation effect which is a market risk already attracting risk weight. EBA's Discussion Paper contains some examples of back-testing a price at close of business with the transactions taking place the day after. We believe that such tests are acceptable only if the time window is narrow enough. But when this is the case, this limits the relevance of the non-judgmental test to only those instruments that actively trade within a narrow time window (in practice, this will be limited to level 1 or most observable level 2).

Secondly, another limitation in EBA's Discussion Paper is that the guidance does not prescribe precisely the test and whether it applies for a given instrument, or a group/class of similar instruments. We observe that if the transactions that compose the data samples are related to fungible instruments, then this restricts the relevance of the exercise basically to actively traded securities and actively traded listed derivatives, which are most likely level 1. This would exclude almost all OTCs. Other approaches of the testing require a more precise definition of asset classes of homogeneous instruments, and more complete segmentation across product features and modelling features. Such approach hardly accommodates prescriptive requirements, and would be more meaningful with an internal model.

As an alternative, a consistent approach to back-testing a point-in-time measurement, using real transactional data, need necessarily to be grounded in an analysis/explanation of the instantaneous profit and loss of each transaction.

This approach is the one used to derive the Day One Profit for level 3 instruments from the End of Day process, which is aimed at providing the best proxy for instantaneous profit and loss. However it has many limitations notably because (amongst other issues) i) there is not such an instantaneous official revaluation process and hence there is non-negligible noise embedded in the initial profit and loss, ii) there is no simple, non-conventional way to allocate Valuation Adjustments to individual deals and not the least iii) the initial profit and loss may embed commercial margins.

Another point to which we draw EBA's attention is that the validity of the test might be limited, because it embeds a clear bias towards those deals that are profitable. Indeed, as explained in the general developments, the valuation and valuation adjustment framework act as a return hurdle to the trading desks, which means there is a clear incentive to enter or exit deals where the hurdle is passed; otherwise the deal may either remain in the book or not be entered in the first place. Accordingly, we can reasonably expect that the test will generally be passed in normal conditions, and therefore it has little predictive power. Furthermore, AVAs determined for positions / exposures in highly liquid markets are likely in reality to be small given the greater transparency of actual market levels, and hence the AVA focus for the EBA and Competent Authorities will likely be on the more illiquid structural / complex positions and exposures, precisely the positions and exposures where data for AVA assessment is limited.

In any case, we believe that a judgmental approach is preferable, combined with requirements to build robust IPV, and model risk assessment processes, where the ex-post analysis of profits (notably unwinds) is one of the possibilities.

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?

We do not support the use of a specified level of confidence as we think that a judgmental approach is better than prescriptive quantitative parameters and methodologies. For the specific case of small markets, only judgmental approaches could work in determining the AVAs.

With regard to the use of the confidence level as guidance for judgments, it is not clear how this could be implemented. In this regard, we believe that an explicit guidance for judgmental assessments would be useful and make the industry practices more homogeneous. In this respect, illustrative examples may help industry convergence, while idealized test portfolios could be used by regulators as a supervisory tool. Stress should be put on the use of observable data in consistency with the IFRS 13 accounting guidance.

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

The Discussion Paper is sufficiently precise at this stage. However, the subsequent RTS may focus on adding more clarity on the preconditions for using different sources for collecting market prices and the ways to determine a hierarchy between sources, while remaining consistent with IFRS. In any case, the RTS should not define the actual sources, but list possible ones based on industry best practices.

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

No. We believe that the waterfall of sources has to be defined in accordance with IFRS 13, which contains a fairly good guidance on fair value hierarchy. With regard to this point we must underline the extensive effort of clarification by the IASB, FASB and a fairly comprehensive interpretative documentation from the audit industry. Furthermore, EBA should note that not all of the externally available market prices represent tradable prices at the reporting date. The institution should also consider entity specific factors in determining prudent value for its positions. For example, an institution may have different AVAs as

compared to other institutions for its concentrated positions or when it has limited access in certain markets.

Waterfall of sources has to be documented and should be associated with appropriate governance structure to cope with complex situations and to maintain methodologies. Supervisors have access to the documentation and could review its relevance.

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?

We think the EBA's Discussion Paper is fairly comprehensive and does not require more prescription.

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

It would be helpful if the EBA could provide clarification about whether the prudent value is a point estimate. In Article 100 of CRR it seems like possible future changes to e.g. markets (going from normal to stress situations) should be taken into consideration when estimating the AVA's. This somewhat contradicts the definition of fair value and prudent value. In our view changes in the value due to possible future market stress should be reflected in the market risk capital requirement and not in the prudent value.

Most of the large uncertainty lies in products which embed risks that are traded one way only and not replicable (at best these are diversifiable). This is because the only protection for such risks is a self-constituted cushion of prudence or equivalently a risk premium. Losses arise in situations where the constituted cushion of prudence (valuation adjustment) is less than the risk premium required by market participants, to bear the risks. This form of risk premium is the most difficult to predict and the premium gets precisely bigger when risk increases. A useful indicator of such risks is the degree of active volume observed for a given risk exposure (i.e. a volatility or a correlation).

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?

We think that the Discussion Paper does not clearly identify the adjustments that are already part of the fair value measurements according to the IFRS accounting standards. For example, unearned credit spreads, market price uncertainty are already part of IFRS 13, whereas operational costs, early termination penalties, concentration and liquidation costs are clearly not.

More precisely, we have the following comments on the proposed approaches.

Unearned credit spreads

Unearned credit spreads and market price uncertainty are relevant and the approach described in the Discussion Paper is clear enough. But we wish to emphasize the fact that such adjustments should be part of the fair value under accounting rules rather than constitute the basis for AVAs.

Close out costs

The close-out costs seem to make sense. However this point calls for further clarification: paragraph 23, dealing with close-out costs, 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 requirement, if interpreted as requiring a very granular input, could be over-punitive. In some cases, this may mean that almost no netting is possible while markets would certainly consider it substantial. The prescriptive nature of this requirement may also create a divergence between the way entities look at aggregated risks in a day to day management and prudent valuation. In line with IFRS 13, we suggest that this be replaced by a principles-based approach where “the methodology should be consistent with the level of netting acceptable by risk management” and that the netted risks should be “substantially the same”.

In order to fulfil the prudence objective, EBA might consider a different requirement that entities should capture the residual model risk associated with the internal risk aggregation approach, leaving to the entity the flexibility to document what it believes the optimal hedging cost/residual model risk ratio would be from a market participant stand point. A side advantage of this is that the residual model risk could be factored into an eventual diversification exercise. In assessing the cost and residual model risk, entities might be asked to use (to the extent this is possible and taking liquidity and size into account) some market-based information. Finally, supervisors may use a combination of illustrative examples to guide industry judgment, and idealized test portfolios as a supervisory tool enabling comparison.

Model risk

The description in paragraph 45 seems to make sense. However this is also an overlap with the on-going Fundamental Review of the Trading Book which will require a capital add-on. Moreover, under Pillar 2 supervisors already have the possibility to require additional capital for model risk and this will remain under the CRD IV, too. Additionally, there is also potentially an overlap with fair value determined according to IFRS 13 general principles.

Future administration costs

For future administration costs, the proposed cost elements are appropriate for a full exit of a business line, which makes us believe that the intention of the regulator is an orderly sale of the business assuming continuity of it by the buyer. Clarity on this fundamental piece of the background is crucial. We stress that for the exposures which are a result of “normal course of business” with no intention of business exit, any administration costs should be offset by corresponding future earnings expectations when AVAs are assessed.

We would favour more clarity in this respect. It also seems to us that from a market participant perspective, the future administrative costs that might be charged are mainly incremental charges because it is very likely that such a market participant already has an active running book. Therefore, we would favour a less strict requirement in this area.

It should also be tested whether future administrative costs based on a sound conceptual background are sufficiently relevant to differentiate the prudent value from the fair value as in IFRS 13.

Funding and investing

Furthermore, paragraph 40 on funding valuation adjustments (FVA) should be disclosed more closely to paragraph 21 regarding the credit valuation adjustments (CVA). Several market makers assert that current market prices of OTC products incorporate CVA, FVA and the gain or loss on liabilities reported by the

institution due to its own credit quality (debit valuation adjustments - DVA). Moreover, FVA may combine liquidity and DVA effects. EBA should therefore provide further guidance on how each effect should be calculated.

The FVA has far reaching consequences in terms of liquidity management and interaction between value and funding policy. In the absence of a full fair value balance sheet model, the allocation to trading desks of funding cost as a normal risk factor might give wrong risk and hedge incentives since liquidity is managed differently from the other market risks.

Finally, while the EBA's requirement is to use own cost of funds, the Discussion Paper does not give much clarity in a context where own cost of funds may have several meanings: internally defined transfer price, all-in cost of funds, secured funds/unsecured etc... In the absence of market established practice EBA should either be prescriptive or refer to market practice in a broad manner.

Overall, we consider that incorporating FVA into AVAs might be premature as there is no current market consensus over the calculation of this adjustment. In line with our response to Question 13, we recommend that the EBA do not necessarily rule what markets should do, because prescriptive rules are auto-realizing. Instead, a reference to what market participants actually would do ensures that if an FVA adjustment is required, then it should be taken in line with market practice.

Balance Sheet substantiation

Checking that the Balance Sheet accounts are tested and agreed with individual assets and liabilities and their valuations and defining an AVA when the tests fail or are not completed should not be part of such a paper on prudent valuation, since it relates to accounting and auditing issues that should remain out of the scope of this paper. The compliance of the accounts with normal internal control rules and their completeness cannot be circumvented or compensated through prudential valuation adjustments. In addition, balance sheet substantiation is not mentioned in Article 100 of the CRR and is hence out of scope.

Operational risk

The operational risk either overlaps with other requirements, or is not per se an operational risk. We note that the deliberate choice of a model that turned out to be incorrect is not an operational risk but is a model risk, while the unintentional use of a wrong model or bugs in code are operational risks. The latter should be clearly segregated from the prudent valuation, while the former should be captured through model risk. Reserving for marking risk of books not actually comprehensively covered through IPV might be a form of reserving some operational risk that is not captured through capital charge. Concentrating the requirement for such types would provide incentive to entities to aim at a more complete coverage, while not overlapping with other requirements.

Early termination

The Early Termination AVAs are primarily driven by client relationship and should not be material to the valuation in the normal course of business. Therefore, a measure that is grounded in past experience is not necessarily relevant. We therefore believe that flexibility should be given to entities to consider that this compulsory AVA might be considered as non-material and the charge if any reserved for strategic clients possibly with a documented process that incorporates some stress assumptions.

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?

No. The valuation adjustments are the result of market developments and the materialization of risks.

Typically, a valuation adjustment for uncertainty in the discounting curve to be used would not have been required a few years ago, and some counterparty risks would have been considered as remote.

Hence, it is preferable that the RTS refers explicitly to what market participants would do in the circumstances, rather than attempting to be prescriptive on the list of potential AVAs.

The materiality assessment is difficult to determine as we do not have any process or data enabling such an exercise. Thus we can only outline their conceptual flaws (cf. Q 12) and propose that they be reconsidered.

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?

The test in itself is a standard statistical test and is useful as it has an explanatory dimension. However, many specifications are lacking in the definition of the sample that should be considered (period of time tested...). This approach requires frequent observable close out values for equivalent positions / exposures held by an institution - these may not be available for many markets / products / exposures.

Also, intraday market level changes may account for differences to ex-ante model values and close out values – these changes are not reflected within the ex-ante model values for AVA, and may inappropriately result in poor model predictability. We believe that reference should be made to instantaneous profit and loss made on the deal.

So, Annex 2 should be further clarified, in the event that it is included in the subsequent RTS.

In any case, should the back-testing requirement be maintained, we call on EBA to leave flexibility to entities to define an internal testing model, subject to supervisor authorisation and review and not to attempt to be too prescriptive.

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?

We do not believe that the RTS should be prescriptive with respect to validation techniques. A prescriptive approach is too restrictive as institutions have different control infrastructure setups and testing of prudence of valuation can be proven via various methods.

A few principles-based requirements should be enough to ensure comparability. Such principles should provide the basis to accept or reject the Valuation Adjustment framework under “current” market conditions. There are many features that need to be considered in practice: the types of validation tests, the frequency at which the test is done, the minimum / maximum period of time it covers, the number, size and direction of trades, the degree of similarity of the instruments within the sample, the thresholds of

validation tests to facilitate reporting of breaches. In this regard, as discussed above, a limitation stems from the fact that where pricing data is lacking the use of quantitative / statistical techniques is inappropriate.

It is also very important to define precisely the objective of the test, in particular whether the entire AVA framework is being tested or an individual AVA or a combination of some AVAs or the adequacy of AVAs for a given product etc...

As a starting point, the following validation tests could be considered for testing of prudence of valuation. These validation tests are well developed in the market and could be implemented by any institution:

Validation Test	Frequency	Thresholds
Compare close-out values and prudent values of transactions with significant exit PnLs* (PnL exceeding a certain value on an absolute basis) for the last one year.	Quarterly	Percentage, dollar amount or number of transactions where prudent values are less prudent than close-out values. The threshold should vary according to the size and number of transactions with significant exit PnLs.
Compare day one transacted values and prudent values of transactions with significant day one PnLs* (PnL exceeding a certain value on an absolute basis) for the last one year.	Quarterly	Percentage, dollar amount or number of transactions where prudent values are less prudent than day one transacted values. The threshold should vary according to the size and number of transactions with significant day one PnLs.
Analysis of profit and loss versus risk factors	Daily	The number of days where unexplained PnL exceeds a certain percentage or dollar threshold when compared to total PnL. The threshold should vary according to the size of the position or portfolio.
Price testing of output prices for existing positions, wherever possible.	Monthly	Threshold for price testing variance to vary according to size of the position or portfolio.

Price testing of input prices for existing positions, if price testing of output prices are not possible.	Monthly	Threshold for price testing variance to vary according to size of the position or portfolio.
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*Testing for transactions with insignificant exit or day one PnLs is challenging to implement and would have limited benefits.

Finally, a possible supervisory tool is to propose idealized test portfolios against which banks' valuation adjustment frameworks might be compared.

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?

As a general principle, while considering that, in most cases, prudent value should not differ from fair value, we believe that prudent value can never be above the fair value (as based on relevant accounting standards). However, the fair value should not be stated as a cap to the valuation outcome in the capital adequacy. The rationale of the approach is in considering prudent values at the level of an individual position rather than at the entity level is also arguable.

In addition, it must be taken into account that there could be instances where provision allocation approaches contained in regulation result in unrepresentative allocations of provisions to certain exposures. Where excess provision is allocated, this could result in fair value being artificially low, and less than the corresponding prudent valuation measure.

A specific case is that of Day One profit adjustment. We observe that deferral of initial profits overlaps with some of the prudent valuation concepts. Hence, its capital treatment requires further clarification in the RTS. A possibility would be to calculate own fund deductions only if the AVAs exceed the unamortized Day One Profit stock.

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

The diversification benefit is a must if a high confidence level is to be applied as this Discussion Paper proposes. This is because the simple sum of many individual AVA elements each determined at a high level of confidence (such as 95%) is unlikely to be an appropriate total AVA measure where there is no common factor(s) forcing each AVA to be simultaneously at such an adverse level.

We suggest that the scaling factor should be calibrated from a companywide diversification factor allowing a reallocation of prudent value to different business lines. This approach will be also beneficial from the use-test perspective.

An important point with regard to diversification (mentioned in annex 4) is that it is likely that, as indicated above, fair values already incorporate a substantial part of the prudence required by CRR. In order to level the playing field, it is important that the diversification effect does not benefit those entities that are the most aggressive in fair value. Therefore, more clarity could be introduced in the EBA guidance on the elimination of prudent biases and in determining what is eligible for diversification and what is not.

There is another way of looking at the trade-off between diversification/confidence level which would consist in setting a lower confidence interval guidance. This would be a pragmatic and efficient way of tackling the issue.

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?

We welcome a simplified standardised approach, because even if the proportionality principle is applied, there will be some small or mid-sized institutions which will be unable to provide reliable measures for the quantification of the diversification benefit. In a standard approach a possible treatment of the diversification benefits could be a rescaling factor imposed by regulators.

However, it must be taken into account that standardisation will be detrimental to the use-test. In the simplified aggregation approach proposed in Annex 4, it should be explained why the long and short positions need to be aggregated separately. When two positions offset well (same risk factor), only the residual net position should be considered. If the netting is imperfect (different tenors or strikes) then the possibility of some correlation must be considered.

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?

It seems that the aim of the future regulation on prudent valuation is to reduce the role of judgements in the valuation process. Since it is not possible to establish an RTS covering all aspects of diversification following the aggregation, and since this might be differently approached by different institutions, we welcome the possibility of an internal model approach. The diversification effect raises the justification of the correlation between uncertainties which are not observable data and the approval process of the regulator would still be based on a judgmental in-house process. In this regard, it must be taken into account that where there is only limited price data available it will be very difficult to statistically support a particular correlation assumption.

Furthermore, we also call for the simplicity of the approach. There is a difficulty in calculating correlations between different valuation uncertainties, and therefore caution is needed when applying diversification rules. Since it is, by nature, very difficult to quantify valuation uncertainty, the model should preferably be very simple. A complex model would only increase the uncertainty in the estimation of the valuation uncertainty.

A feasible method could be to compare the correlated uncertainties with the sum of the absolute uncertainties. The ratio is the diversification benefit. A floor could be imposed to this ratio. The use of a

simple auditable covariance matrix calculation should be preferred. The ratio will not only depend on the choice of correlations but also on the level of granularity of uncertainty factors.

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)?

AVAs will overlap with Market Risk capital (both Market Risk Pillar 1 and IRRBB Pillar 2). Observed market prices and quotes will reflect both market uncertainty, but also intraday or intraperiod (for non-liquid markets / exposures) movements in the actual market level. Such movements in market levels are captured within Market Risk (and IRRBB) capital requirements, and so double counting of such elements in AVAs is likely.

In addition, some Regulators are currently supplementing Pillar 1 Market risk VaR-based capital requirements with extra capital requirements for illiquid / structural-type risks, and the Basel Committee has proposed additional capital for illiquid risk exposures within the Fundamental Review of the Trading Book proposals issued in May 2012. These developments have extended, and will further extend, the potential overlap with AVAs and Market Risk capital requirements.

It is important that AVA measurement does not result in significant overcapitalisation (through double counting of both CET1 reduction and capital requirements) of risk exposures. So, it is necessary to specify mechanisms to identify and reduce such overcapitalisation.

In sum, we should not double count adjustments to CET1. We therefore believe that the concepts of time horizon and operational risks should be dropped from the requirements. A proper application of the prudent valuation rationale should not lead to overlaps. Finally, we re-emphasize the need to clarify the interlink between AVAs and Day One Profit.

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?

First of all, we must comment that paragraphs on documentation, systems and control and reporting requirements might be premature, regarding the early stage of the process.

We regard the requirements as being broadly appropriate. Institutions with significant control weaknesses should be subject to additional AVAs. Likewise, institutions with strong control systems which reduce concerns around valuation should be subject to less AVAs. However, the requirement in paragraph 73 that “institution valuation and risk measurement systems should systematically recognise and account for valuation uncertainty” should more appropriately refer to “institution valuation and risk measurement processes” rather than “systems” to reflect the wider range of activities undertaken in this regard.

The EBA may consider including a scoring system for regulators to assess adequacy of prudent valuation controls in each institution. For example, if institutions adjust all price testing variances found from good quality pricing sources, especially for derivatives, concerns around reliable and prudent valuations will be addressed to a great extent.

In addition, we think that even though many procedures should already be covered in existing processes this Discussion Paper is highly demanding in terms of documentation, systems, control and reporting requirements which in principle appears to be reasonable but unrealistically burdensome and costly to implement.

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?

It is doubtful that the benefits to be derived from implementing this approach outweigh the involved costs, although it is true that a unique AVA methodology ensures comparability between entities and a cushion in the system for risks that can only be ensured by setting reserves. Instead of adopting this approach, it could be more useful for the whole system to advance in working towards applying consistently and disclosing appropriately the IFRS accounting standards and disclosure requirements.

Initial capital cost might be high even for the most prudent banks if some punitive elements are maintained or if only AVAs are eligible to diversification. The AVA framework is somehow auto-realizing and will be incorporated to a large extent into fair value (to the extent this is admissible in such measurement) and into pricing guidelines. Also, additional non-fair value capital charges are likely to be allocated to trading desks. This may substantially increase the entry hurdle cost and conversely lower the exit hurdle cost.

Potential effect is therefore that the cost for clients will increase for the products that embed large model risk or measurement uncertainty or that have high operational costs. Another possible effect would be to give clear incentive for firms that do not have solid franchises, optimisation capabilities, good knowledge of the products and cost optimisation capabilities to exit the business. EBA should realize that the highly prescriptive nature of the methodologies is such that it causes the operational costs associated with the implantation to be very high even for banks that already have a solid valuation framework and a long tradition of prudent valuation.

Additionally, as indicated previously, the required set up implies significant investment in IT systems and other administration resources needed for collecting additional data and developing additional statistical tools. The benefits of such requirements are not clearly demonstrated.

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

At this stage, we believe that setting up a reporting template is premature. However, it must be noted that the AVAs are already considered in the Pillar 1 reporting templates.