EBA/CP/2024/01/rev1

16 January 2024

Consultation Paper

Amending Draft Regulatory Technical Standards

on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013

Contents

1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by **16.04.2024**. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Commission Delegated Regulation (EU) 2016/101 sets out requirements for the prudent valuation of fair-valued financial instruments, and was developed in accordance with the mandate set out in Article 105(14) of Regulation (EU) No 575/2013. Under the prudent valuation framework institutions are required to calculate additional valuation adjustments of their fair-valued financial instruments, which are intended to set valuations at a level that achieves an appropriate degree of certainty for prudential purposes. In accordance with Article 34 of Regulation (EU) No 575/2013 (CRR), additional valuation adjustments are deducted from Common Equity Tier 1 capital.

Commission Delegated Regulation (EU) 2016/101 has been in force since February 2016 to determine additional valuation adjustments and ensured a degree of convergence in an area, where a very wide range of practices existed. The regulation set out, for the first time, a common harmonised methodology for the valuation of fair valued assets for prudential purposes. Given that the prudent valuation framework has been in force for some time, EBA recently reviewed its implementation, noting that differences still exist even though a degree of convergence has been achieved. Consequently, this consultation paper proposes amendments to the currently applicable regulation, to address targeted implementation issues that have emerged during its application.

In addition, this document includes a proposal for how to address the mandate that the CRR3 legislative proposal foresees to be included in Article 34 CRR. That mandate requests the EBA to specify the conditions that the EBA shall use to determine the presence of extraordinary circumstances for the purposes of prudent valuation, and the reduction of the total aggregated additional valuation adjustments under those circumstances. These new provisions are proposed to be included in Commission Delegated Regulation (EU) 101/2016, given the interlinkages of the requirements related to additional valuation adjustments.

Feedback from stakeholders is sought on the proposals made in this document. In parallel to this public consultation, a quantitative impact study (QIS) takes place to calibrate certain aspects of the proposed amendments. The feedback received and the QIS results will be taken into account in the finalisation of the draft RTS.

3. Background and rationale

1. Commission Delegated Regulation (EU) No 101/2016 sets out requirements for the prudent valuation of fair-valued financial instruments and commodities. This regulation has been adopted on the basis of draft regulatory technical standards (RTS) developed by the EBA in accordance with the mandate specified in Article 105(14) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR).

2. Under the prudent valuation framework, institutions are required to calculate additional valuation adjustments (AVAs) for their fair-valued financial instruments and commodities, which are intended to bring the value of those instruments to a level that is appropriately certain for prudential purposes. The prudent value is the value at which institutions are 90% confident that they will exit a position based on the applicable market conditions at the time of the assessment at. AVAs are deducted from Common Equity Tier 1 (CET1) capital in accordance with Article 34 CRR.

3. The legislative proposal for the CRR3[1] adds a mandate for the EBA to Article 34 CRR, requesting the EBA to specify the conditions that the EBA shall use to determine the presence of extraordinary circumstances for the purposes of prudent valuation, and the reduction of the total aggregated additional value adjustments under those circumstances. This document sets out EBA's proposal to address that new mandate, too. The new 'extraordinary circumstances'-provisions are proposed to be included in Commission Delegated Regulation (EU) 2016/101, given the interlinkages of the requirements related to additional valuation adjustments. Commission Delegated Regulation (EU) 2016/101 itself has been applied since February 2016 to calculate AVAs.[2] Taking into account the experience of Competent Authorities regarding their supervision of the requirements on prudent valuation, this consultation paper proposes amendments to that Regulation, in addition to adding the 'extraordinary circumstances'-provision, to implement best practices observed and address targeted implementation issues that have emerged during the application of the prudent valuation framework.

4. The following subsections provide background and rationale regarding the main amendments to Commission Delegated Regulation (EU) 2016/101 that are included in the draft RTS set out in the next section. The draft RTS include also additional amendments where this was considered appropriate, and further explanations related to the amendments are also included in explanatory boxes for consultation, which are included in the next section.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0664

[2] The prudent valuation framework was complemented with common reporting (COREP) supervisory reporting templates (reporting framework v2.8) through Commission Implementing Regulation (EU) 2018/1627, which was published in November 2018 in the Official Journal of the European Union and first applied by institutions for the reporting as of 31 December 2018.

Calculation frequency of AVAs

5. In accordance with Commission Delegated Regulation (EU) 2016/101, AVAs have to be calculated on a quarterly basis. The results of that calculation are then reported on a quarterly basis in accordance with Commission Implementing Regulation (EU) 2021/451.

6. The quarterly calculation and reporting do not provide any insight into how volatile AVAs are within the quarters, including whether there are possible window-dressing opportunities. Having more frequent and recent information about the AVAs could be relevant for the supervisors, but may also increase institutions' awareness of valuation risks.

7. The draft RTS included in this Consultation Paper propose that institutions should calculate AVAs with a monthly frequency upon request from their competent authority. While this provides the supervisor in a targeted manner with access to monthly information on AVAs in particular situations where the AVAs require closer monitoring, it does not introduce yet a regular requirement for all institutions to calculate and report the AVAs on a monthly basis. It is expected that this requirement can be met by institutions without significant cost of compliance, in particular in the light of the requirement in Article 105(3) CRR.

Arbitrage between aggregation methods under the core approach

8. In accordance with Commission Delegated Regulation (EU) 2016/101, institutions can use two different methods to aggregate AVAs for market price uncertainty, close-out costs, and model risk. The two methods are specified in the Annex to the Regulation.

9. The second method yields AVAs which are lower than those determined under the first method, since it is employed when the expected value (i.e. the term EV) is considered greater than the fair value. In addition, the second method may lead to zero AVAs in situations where the expected value is far from the fair value. It has also been observed that institutions and supervisors had different interpretations regarding the way that the expected value should be determined. The second method was originally introduced to ensure that institutions that determine a fair value that is more prudent than the expected value would not get less diversification benefit than those that use the expected value as the fair value. However, it is hard for an institution to prove that the fair value is more prudent than the expected value, as that institution usually does not have information on how other institutions would value the same position. This overall leads to an unlevel playing field, which should be avoided.

10. The EBA also analysed the number of institutions that use each of the two methods for aggregating AVA for market price uncertainty, close-out costs and model risk, based on the data submitted by institutions as part of the regular reporting. The data shows that the majority of institutions in the EU that use the core approach use the first method, with a limited number of institutions using the second method. Some institutions have been also found to use both methods at the same time, which, although not explicitly forbidden by the regulation, may be seen as cherry picking.

11. Taking into account the above considerations and issues described, the draft RTS included in this Consultation Paper propose to remove the second method from Commission Delegated Regulation (EU) 2016/101.

Inclusion of back-to-back derivatives and SFTs in the computation of the threshold

12. EBA Q&A 1715 clarifies that 'exactly matching, offsetting assets and liabilities' specified in Article 4 of the Regulation are to be interpreted as 'positions for which all contractual future cash flows are identical and in opposite direction under any circumstances'. This specification implies that derivative transactions having opposite directions are excluded from the threshold computation, and from the determination of AVAs under the simplified approach, as long as they satisfy the above condition.

13. This condition is typically met by back-to-back derivative structures, where an institution enters into an equivalent, but opposite trade with another counterparty, as soon as it enters into a trade with a counterparty. As clarified in Q&A 2756, these derivatives should be subject to AVAs for valuation uncertainty under the core approach, where a change in accounting valuation implies an impact on CET1 capital.

14. Back-to-back derivative transactions should have overall zero valuation exposure to market risks, as changes in market risk valuation inputs should produce an equal and opposite change in the value of the two transactions of the back-to-back structure. However, the same cannot be said for other sources of uncertainty, such as those leading to unearned credit spread AVAs and investing and funding costs AVAs. The same considerations apply back-to-back securities financing transactions (SFTs), where expected losses from the default of the counterparty are reflected in the fair-value pricing.

15. Against this background, the amending RTS included in this Consultation Paper propose that fair-valued back-to-back derivative transactions and SFTs should be included in the threshold computation. This ensures that valuation risks associated with back-to-back derivative transactions and SFTs that are fair-valued are captured also under the simplified approach and it restores the alignment with the treatment for these transactions under the core approach, which currently already captures those valuation risks.

Requirements on data and pricing models under the core approach

16. The draft RTS included in this Consultation Paper amend the hierarchy of data sources for the purposes of determining AVAs, and include additional requirements related to market data and the calibration of pricing models under the core approach.

17. With regard to the hierarchy of data sources, the proposed amendments move certain data sources previously considered to be eligible in the context of range-based approaches under the expert-based approaches, as those data sources were observed to be less accurate and reliable.

18. With regard to the additional requirements related to market data, a new Article 3a frames the use of historical data in the determination of AVAs under range-based approaches[3]. Furthermore, an amendment to the RTS adds requirements regarding the pricing models used to determine AVAs to Article 8, to ensure that those models are properly calibrated.

Dimensionality reduction and variance ratio test

19. In order to determine AVAs for market price uncertainty and close-out costs, Commission Delegated Regulation (EU) 2016/101 provides for the possibility to reduce the dimensionality of the AVA calculations for valuation inputs consisting of a set of parameters (a vector or a matrix), provided that several criteria are met, including the so-called "variance ratio test" (VRT). The VRT is passed, and the parameter reduction is allowed, if the P&L variance eliminated as a result of the parameter reduction does not exceed 10% of the P&L variance of the original unreduced valuation input.

20. In addition to the operational simplification that may result from having to calculate the relevant market price uncertainty and close-out costs AVAs on a reduced set of parameters, the original intention of introducing the possibility of parameter reduction was to capture the effect of hypothetical hedges that institutions may enter into, thus capturing a type of diversification benefit between the parameters of a valuation input. The experience of competent authorities shows that, the choice of parameters made by institutions, while formally complying with the parameter reduction requirements and the VRT, results, in some cases, in an excessive reduction of the AVA to be deducted from CET1 capital compared to the AVA that would result from performing the calculation on the set of unreduced valuation parameters.

21. The reduction of the AVAs is considered excessive, given the hypothetical nature of the hedging strategy underlying the notion of parameter reduction and the conceptual limitations of the VRT, including the use of the historical profit and loss to estimate the correlations between the point-in-time valuation uncertainties of the valuation parameters. The excessive AVA reductions observed indicate that the current design of the parameter reduction and VRT rules is not consistent with the overall objective of ensuring an appropriate level of certainty for prudential purposes.

22. Against this background, the amending RTS included in this Consultation Paper introduce new, more stringent requirements in relation to the dimensionality reduction of valuation inputs. These more stringent requirements include setting the aggregation factor ‘alpha’ at a prudent level of zero for valuation inputs subject to parameter reduction, limiting the scope of application in terms of eligible parameters, requiring institutions to apply a sound qualitative and quantitative rationale when selecting the reduced set of parameters, and ensuring overall that the parameter reduction does not compromise the objective of ensuring an appropriate level of certainty. The amendments are built on good practices observed and intend to retain some of the benefits of dimensionality reduction, while seeking to avoid an excessive reduction in AVAs compared to the calculation using

[3] AVAs for market price uncertainty and close-out costs can be determined in accordance with either range-based approaches, or expert based approaches. Alternatively, in case it is not possible to determine these AVAs, an institution applying the core approach may make use of the fall-back approach to determine the AVAs associated with the relevant instrument.

unreduced valuation inputs. An alternative way of achieving the desired result could be to remove the option to use the dimensionality reduction altogether.

Absence of fair value adjustments for market price uncertainty and close-out costs

23. Competent authorities have observed that some institutions do not record fair value adjustments related to market price uncertainty and close-out costs, whereas other institutions record fair value adjustments related to those risks for equivalent instruments.

24. Due to the formula used for aggregating AVAs set out in the Annex to Commission Delegated Regulation (EU) 2016/101, institutions that do not book fair value adjustments for those valuation risks are subject to a less conservative treatment for regulatory purposes by comparison to institutions that book fair value adjustments for equivalent positions. Figure 1 shows an example of this occurrence.

Figure 1. Impact of the absence of fair value adjustments

Case A: Fair value adjustments for market price uncertainty and close-out costs are recorded

- Front office price (FO) = 110
- Independent price verification difference (IPV) = 10
- Fair value adjustments (FVAs) = 15
- Fair value (FV) = 110 – 10 – 15 = 85
- Prudent value (PV) = 70

→ AVAs = (1 - alpha)*(FV – PV) = 0.5*(85-70) = 7.5

→ Total valuation risk deducted from capital with respect to FO = 10 (IPV) + 15 (FVAs) + 7.5 (AVAs) = 32.5

Case B: fair value adjustments for market price uncertainty and close-out costs are not recorded

- Front office price (FO) = 110
- Independent price verification difference (IPV) = 10
- Fair value adjustments (FVAs) = 0
- Fair value (FV) = 110 – 10 – 0 = 100
- Prudent value (PV) = 70

→ AVAs = (1 - alpha)*(FV – PV) = 0.5*(100-70) = 15

→ Total valuation risk deducted from capital with respect to FO = 10 (IPV) + 15 (AVAs) = 25

Comparison

In case B, the valuation risk not deducted from capital with respect to FO is equal to 7.5 (= 32.5 – 25).

Impact of the revised framework

Case B → AVAs = (1 - alpha)*(FV – PV) = **1***(100-70) = 30 → Total valuation risk deducted from capital with respect to FO = 10 (IPV) + 30 (AVAs) = 40 Under the revised approach, the institution In case B is subject to more stringent rules, requiring it to deduct 7.5 more units from own funds than the institution in case A.

25. As the illustrative example shows, there is an unlevel playing field across institutions depending on whether they record fair value adjustments on equivalent instruments. In particular, institutions that book fair value adjustments, and which accordingly apply a more prudent approach for accounting purposes, are subject to a more conservative treatment for prudential purposes vis-à-vis institutions that do not book fair value adjustments, since their valuation risk deducted from capital will be higher.

26. To address this issue, the amending RTS included in this consultation paper propose that the aggregation factor 'alpha' in the Annex of the regulation should be set to zero, where the amount of fair value adjustments applied for accounting purposes, and reflected in the term 'FV', is not commensurate with the risk other market participants would consider when determining the fair value of the valuation exposure. As different institutions may apply different amounts of fair value adjustments to the fair value of their valuation exposures, or may not have entirely comparable valuation exposures, competent authorities will consider any evidence provided by an institution regarding its fair value adjustments practices, and compare them vis-a-vis their expectations based on those applied by other institutions to assess whether it is justified that the institution sets 'alpha' factor to zero.

27. The proposed treatment is consistent with paragraph 88 of IFRS13, which specifies that a measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. That paragraph also clarifies that it might be necessary to include a risk adjustment when there is significant measurement uncertainty. In the light of these accounting requirements, it is expected that institution book fair value adjustments for market price uncertainty and close-out costs for valuation inputs that exhibit valuation uncertainty.

Absence of independent price verification (IPV) adjustments

28. Article 105(8) CRR requires institutions to perform IPV in addition to daily marking to market or marking to model. It prescribes that the verification of market prices and model inputs shall be performed by a person or unit independent from persons or units that benefit from the trading book, at least monthly, or more frequently depending on the nature of the market or trading activity. That article also envisages prudent measures such as valuation adjustments, where independent pricing sources are not available or pricing sources are more subjective.

29. In accordance with this requirement, competent authorities expect institutions to record IPV differences[4] identified as a result of the IPV process in the fair value, to ensure that positions are marked independently and that the pricing is adjusted to avoid errors or bias. However, competent authorities have observed that some institutions perform the IPV process and estimate the IPV differences, but eventually do not record these in fair value, for example where these IPV adjustments are lower than thresholds defined by the institution. Similarly to the absence of fair value adjustments, as described in the previous section, this absence of IPV adjustments (or the incomplete reflection of the IPV adjustment in the fair value) leads to an unlevel playing field across institutions, because institutions that record IPV differences in the fair value are subject to greater deductions from own funds than institutions that do not record IPV differences for equivalent positions.

30. Accordingly, similar to the treatment in case of absence of fair value adjustments, the draft RTS propose to set the aggregation factor 'alpha' related to valuation inputs with unadjusted IPV differences to zero if unadjusted IPV differences remain after the completion of the IPV process. The reduced alpha is only applied to the amount corresponding to the unadjusted IPV difference (under the assumption that the IPV difference, if it was recorded, entailed a more conservative marking for the fair value).

31. Where independent pricing sources are not available or pricing sources are more subjective, and the institution is not even able to estimate an adjustment for independent price verification, or to translate the result of the IPV process into a prudent measure such as a valuation adjustment, the valuation of the position is very uncertain. The draft RTS included in this consultation paper propose that the valuation position should be subject to the fall-back approach in such a case, to ensure that the AVAs are calculated in a more prudent and standardized manner. Where several valuation inputs influence the value of the valuation position, the valuation position is moved under the fall-back approach as soon as the institution is not able to determine the magnitude of a necessary IPV adjustment for one of those valuation inputs.

Figure 2. Example of the impact of absence of IPV adjustments

Case A: The IPV difference is estimated and is recorded in fair value

- Front office price (FO) = 110
- IPV difference (that has been estimated and is recorded in fair value) (IPV) = 10
- Fair value adjustments (FVAs) = 15
- Fair value (FV) = 110 – 10 – 15 = 85
- Prudent value (PV) = 70

→ AVAs = (1 - alpha)*(FV – PV) = 0.5*(85-70) = 7.5

→ Total valuation risk deducted from capital with respect to FO = 10 (IPV) + 15 (FVAs) + 7.5 (AVAs) = 32.5

[4] IPV differences are defined as differences between the values of the valuation inputs used to determine the fair value and the mid-market level of those valuation inputs, as estimated by the independent price verification process.

Case B: The IPV difference is estimated, but is not recorded in fair value

- Front office price (FO) = 110
- IPV difference (that has been estimated, but has not been recorded in fair value) (IPV) = 10
- Fair value adjustments (FVAs) = 15
- Fair value (FV) = 110 –15 = 95
- Prudent value (PV) = 70

→ AVAs = (1 - alpha)*(FV – PV) = 0.5*(95-70) = 12.5

→ Total valuation risk deducted from capital with respect to FO = 15 (FVAs) + 12.5 (AVAs) = 27.5

Comparison under the current framework

Under case B, the valuation risk not deducted from capital with respect to FO is equal to 5 (32.5 – 27.5).

Impact of the revised framework

If the alpha factor is set to zero in case B for the amount corresponding to the unadjusted IPV difference, the amount deducted from own funds would be equivalent to that under case A:

FVD shall refer to FV – IPV and is equal to 95 – 10 = 85 in case B.

→ AVAs = (1 - alpha)*(FV – PV) = (1 - alpha)*(IPV) + (1 - alpha)*(FVD – PV) = (1 - 0)*(10) + (1 – 0.5)*(85 – 70) = 10 + 0.5*15 = 17.5

→ Total valuation risk deducted from capital with respect to FO = 15 (FVAs) + 17.5 (AVAs) = 32.5

Inadequate scope of application of future administrative costs AVAs

32. Competent authorities also observed variability in institutions' practices regarding the identification of valuation exposures which are within the scope the future administrative costs (FAC) AVA.

33. Pursuant to Article 15 of Commission Delegated Regulation (EU) 2016/101, an institution may not deem the AVA for future administrative costs to be zero for a valuation exposure, if it does not apply a direct exit price for that valuation exposures for the close-out costs AVA. In other words, the current Regulation does not require institutions to determine a FAC AVA amount for valuation exposures for which the market price uncertainty (MPU) and close-out costs (CoC) AVA imply fully exiting the exposure, i.e. the prudent exit price is estimated based on tradeable prices leading to extinguish all rights and obligations arising from the corresponding instrument/portfolio. Conversely, institutions have to calculate a FAC AVA amount, when the market price uncertainty and close-out costs AVA calculated for a valuation exposure do not imply fully exiting the exposure, for instance:

- where is not possible to reliably estimate concentration position AVAs, hence the institution may need to hold and manage the position for a longer exit period than that implied by the concentration positions AVAs;

- where the valuation exposures cannot be mapped directly to tradeable instruments for the MPU AVA and CoC AVA calculation, hence arguably the prices used for AVA purposes reflect only a theoretical exit price;

- where the MPU and CoC AVAs are assessed on a 'cost to hedge basis', for example for non-linear financial products that cannot be statically replicated (i.e. instruments with model risks and unhedgeable risks for which the prudent price is estimated on a cost to hedge basis), or when the MPU and/or CoC AVA calculations are based on a range of 'replicating instruments' for which no tradeable price can be directly observed in the market, or

- for positions that are hard to liquidate because of the existence of legal or regulatory hurdles that prevent the institution from exiting the positions.

34. Competent authorities have noted several cases where institutions' practices do not meet the regulatory requirement presented above. For some institutions, the MPU/CoC AVAs and the FAC AVA are mutually exclusive, while others consider the FAC AVA as an incremental AVA above the MPU and CoC AVAs. Some institutions deem the application of the FAC AVA to be limited to positions in level 3 of the fair value hierarchy – i.e. positions whose value is affected by non-observable inputs – while others apply it to run-off portfolios or sticky positions left in the balance-sheet after a solvent wind-down exercise conducted as part of recovery and resolution planning.

35. In order to ensure a convergence in practices and clarify the scope of positions that should be subject to FAC AVAs, the draft RTS included in this consultation paper specify that the FAC AVA category is an incremental AVA to the MPU and CoC AVAs where

- the MPU, CoC and concentration position AVAs together do not reliably ensure that the institutions fully exits the valuation exposures,

- the valuation exposures cannot be mapped to tradable instruments,

- the valuation exposures require dynamic re-hedging activities and/or

- there are obstacles to exiting the valuation exposure (e.g. valuation exposures that are hard to liquidate because of their bespoke nature, complexity or illiquidity of the underlying market; valuation exposures requiring client consent; valuation exposures with a tailored legal set-up; valuation exposures subject to regulatory holding hurdles).

36. The FAC AVA is particularly relevant for the most illiquid, less marketable assets that carry higher valuation uncertainties, as mentioned in the last bullet point.

Amendments on unearned credit spread (UCS) AVAs

37. In the light of diverging interpretations and practices observed, the provisions on the calculation of the UCS AVAs have been refined.

38. The scope of the UCS AVAs was expanded to fair-valued SFTs which are subject to CVA risk. The revised article also specifies that the UCS AVA shall take all sources of uncertainty into account, whether they arise with regard to the estimate of the probability of default, the loss given default, or the expected exposure profiles. A floor has been included for the margin period of risk employed in the calculation for margined transactions, to be consistent with that employed for calculating capital requirements for CVA risk and to provide for a level playing field across institutions, taking into account the diverging practices in this area.

39. Furthermore, the amendment to the RTS included in this proposal introduce a measure to address the concentration of UCS AVAs. Where the UCS AVAs are concentrated towards particular counterparties[5], their amount materially depends on the credit quality of those counterparties, and may fluctuate strongly even in case of minor changes to the valuation inputs used to determine the respective AVA. The concentration of the UCS AVAs on certain counterparties questions the idea of diversification embedded in the use of the alpha factor, which is why it is proposed to set that value to zero for concentrated portfolios or major counterparties. This consultation paper proposes two ways of identifying concentrations of the UCS AVA, and seeks industry's feedback on the preferred one.

Removal of the Advanced Measurement Approach (AMA) for operational risk AVAs

40. When CRR is revised to implement the Basel III post-crisis reforms, the Advanced Measurement Approach (AMA) will no longer be available to determine own funds requirements for operational risk, and, therefore, neither to determine the operational risk AVAs. Accordingly, the draft RTS included in this Consultation Paper propose to update the requirements for operational risk AVAs to align them with the upcoming revisions to the CRR.

Calibration of the fall-back approach

41. The fall-back approach under the core approach was introduced with the intention to provide a treatment for those positions for which it is not possible to determine the 'category level AVAs'. In this regard, this approach was calibrated in a way that entails a conservative treatment of valuation risks arising from positions where the institution has no or very limited data available to substantiate the valuation.

[5] As this concentration corresponds to a concentration in the institution's portfolio, rather than to a concentration of a market, this consultation paper does not suggest tackling it throught the concentrated positions AVA; the technique to determine the latter is based on assuming longer liquidity horizons, which would not be suitable for capturing a concentration on counterparties

42. Many institutions that apply the core approach have only a very limited number of positions under the fallback-approach. Supervisors faced challenges when requesting institutions to move positions under the fall-back approach in response to observed shortcomings of the treatment of those positions under the range-based or expert-based approaches, due to the sizeable impact of that approach on the institution's capitalisation.

43. Against this background, the draft RTS included in this Consultation Paper propose to revise the calibration of the fall-back approach, which would reduce the capital deductions deriving from this approach. This should allow institutions to make a broader use of this approach, where limited data is available to determine AVAs, and ensure that supervisors can more easily request the use of this approach by institutions, where justified.

Unlisted equities under the core approach

44. Contrary to the valuation of listed equities where quoted prices are available to stakeholders, the valuation of unlisted equities held at fair value cannot be corroborated with any observable market data[6] in many instances. In addition, accounting standards leave room for institutions on how to value those positions[7]. Against this background, it is difficult to ensure that the prudent values calculated for positions for which no quotes are available are appropriate, and that there is a level playing field and institutions apply the RTS in a harmonised manner.

45. For this reasons, the draft RTS included in this Consultation Paper propose that AVAs of unlisted equities should be determined in accordance with the fall-back approach.

RTS on extraordinary circumstances

46. The amendments to Article 34 CRR envisaged by the CRR3 legislative proposal introduce a framework for dealing with extraordinary circumstances on Prudent Valuation. In accordance with this framework, under the presence of extraordinary circumstances the existence of which is determined by an opinion provided by EBA, institutions may reduce the total AVAs to be deducted from Common Equity Tier 1 capital. Article 34 mandates the EBA to develop draft RTS to specify the indicators and conditions that the EBA will use to determine the presence of extraordinary circumstances for the purposes of Prudent Valuation, and to specify the reduction of the total aggregated AVAs under those circumstances.

47. With regard to the first objective of the mandate – i.e. draft RTS that specify the indicators and conditions that the EBA should take into account to determine the presence of extraordinary circumstances through the issuance of an Opinion – this consultation paper includes the proposal to conceptually align the provisions for the Prudent Valuation framework to those specified to the draft RTS on extraordinary circumstances for the purposes of the alternative internal model models

[6] Under the CRR3 legislative proposal, unlisted equities are assigned to the banking book in accordance with Article 104(3) of the CRR.

[7] IFRS13 mentions the usage of the income approach or the market approach as valuation techniques when observable prices are not available for these positions.

approach for market risk referred to in Article 325az(9) CRR, given the interlinkages across the frameworks.

48. In line with the provisions presented also in that latter RTS, deviations from the prudential framework – here the prudent valuation framework – should only occur in most extraordinary, systemic circumstances, that affect several institutions. In particular, the extraordinary circumstances could be recognised only where there is a situation of significant cross-border financial market stress, or a major regime shift that is likely to result in an excessive increase of AVA amounts. For this purpose, the assessment should consider if volatility levels are comparable or exceed those observed during the global financial crisis or the COVID-19 pandemic.

49. The analysis of the volatility levels can be complemented by other analyses, such as analyses of the liquidity affecting exit costs in financial markets, and other indicators may be employed to assess the nature and impact of the financial market stress or the regime shift. Nevertheless, as the type and extent of stress and crises are commonly not predictable, this consultation paper does not specify in further detail what kind of indicators and factors could be considered, similar to the draft RTS referred to in Article 325az(9) CRR.

50. With regard to the second objective of the mandate – i.e. the specification of the magnitude of the reduction of the total AVAs in the period of extraordinary circumstances – the draft RTS included in this consultation paper propose an approach similar to that used in Commission Delegated Regulation (EU) 2020/866. This Regulation was adopted on the basis of amending draft RTS developed by the EBA[8], and introduced a higher aggregation factor 'alpha' of 66% (instead of 50%) for the purposes of determining AVAs for market price uncertainty, close-out costs, and model risk of institutions that apply the core approach, in order to reduce the total aggregate AVAs in the extraordinary circumstances experienced under the COVID-19 pandemic.

51. Accordingly, the draft RTS included in this consultation paper propose to set the value of the aggregation factor 'alpha' to 66% - instead of 50% - in a period of extraordinary circumstances. Where the value of the aggregation factor for valuation exposures is set to zero under normal circumstances, it shall be increased to 33% under extraordinary circumstances. These revised levels for the aggregation factor in a period of extraordinary circumstances allow to offset (compensate) an increase of up to 50% of the AVAs for market price uncertainty, close-out costs, and model risk, due to extraordinary circumstances[9].

52. The modification of the value of the alpha-factor retains the risk sensitivity of the core approach while providing for some capital relief in the light of a possible excessive procyclicality of the AVA

8 https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2020/RTS/882753/EBA-RTS-2020-04%20Amending%20RTS%20on%20Prudent%20Valuation.pdf

9 The revised alpha values ('alpha target') satisfy the following system of equations when setting x equal to 0.5:

$$(1 - \text{alpha}) \cdot \text{APVA}_{\text{normal}} = (1 - \text{alpha target}) \cdot \text{APVA}_{\text{stressed}}$$

$$\text{APVA}_{\text{stressed}} = \text{APVA}_{\text{normal}} \cdot (1 + \text{x})$$

amounts in a period of extraordinary circumstances. In addition, this approach is simple to implement, and allows for a level playing field across institutions.

53. In contrast to those under the core approach, AVAs under the simplified approach should not be subject to adjustments in such period. AVAs under the simplified approach are calculated as a fixed percentage of the fair value of the instruments they refer to, hence these AVA change proportionally with the changes in fair value of instruments. In addition, portfolios under simplified approach are usually composed of vanilla and liquid instruments that should not be subject to a surge of valuation uncertainty, even if the volatility in financial markets increases substantially. On the contrary, for AVAs under the core approach an increase of volatility is expected to result in an increase of AVAs to be deducted from capital.

ESG in Prudent Valuation

54. As explained in the recently published EBA report on the role of environmental and social risks in the prudential framework[10], the EBA expects that the assessment of the prudent value of instruments performed under Commission Delegated Regulation (EU) 2016/101 mechanically reflect the valuation uncertainty stemming from environmental risks that affect the pricing of fair-valued financial instruments. More specifically, it is expected that environmental risk would emerge as a driver of valuation uncertainty for existing valuation inputs, rather than being considered as a new valuation input or even a new type of valuation uncertainty. Sustainability-linked products may be an exception to this expectation, as they could lead to the emergence of new valuation inputs, which in turn would need to be considered as part of the current prudent valuation framework, e.g. as a valuation input for the market price uncertainty AVA or the close-out cost AVA, or as a new type of instrument in the consideration of the model risk AVA. In order for the valuation uncertainty arising from environmental risks to be appropriately reflected as a risk driver of traditional valuation inputs, institutions would need to ensure that the granularity of the calibration of the uncertainty permits capturing a distinction in the level of uncertainty that may be present for valuation inputs differently exposed to environmental risks or ensure the immateriality of this aspect through appropriate validation analysis. This distinction may be most important for valuation inputs that have a name-specific dimension (e.g. equity prices, credit spreads and related volatilities). However, since the prudent valuation framework will mechanically capture this once there is concrete evidence that environmental risk influences the valuation uncertainty addressed by the prudent valuation framework, no specific action appears necessary at this stage, and the amending RTS presented in this consultation paper do not include specific provisions on the treatment of environmental and social risks. As stated in Annex 3 of the Discussion paper published on 2 May 202211, the EBA intends to monitor future developments in this respect and reassess whether a change in prudential valuation rules could be warranted in the future to better reflect the valuation uncertainty stemming from environmental risks.

10 https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2023/1062711/Report%20on%20the%20role%20of%20environmental%20and%20social%20risks%20in%20the%20prudential%20framework.pdf

11 See Annex 3 on Environmental risks in accounting and valuation in the EBA Discussion Paper on *The role of environmental risks in the prudential framework*, 2022, (link)

4. Draft regulatory technical standards

In between the text of the draft RTS/ITS/Guidelines/advice that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

EUROPEAN COMMISSION

Brussels, XXX
[…](2022) XXX draft

COMMISSION DELEGATED REGULATION (EU) …/...

of XXX

amending Delegated Regulation (EU) No 101/2016 of 26 October 2015 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for prudent valuation under Article 105(14) of Regulation (EU) No 575/2013

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012, and in particular of Article 105(14), third subparagraph, and Article 34, sixth subparagraph, thereof,

Whereas:

(1) Delegated Regulation (EU) 2016/101 requires to calculate additional valuation adjustments ('AVAs) quarterly. Information regarding the development of the AVA amounts during a quarter could be relevant for supervisory purposes in certain situations, and should also increase awareness of valuation risk for institutions. Accordingly, the AVAs amounts should be calculated on a monthly basis, where this is considered relevant by the competent authority.

(2) Delegated Regulation (EU) 2016/101 sets a hierarchy of data sources that can be used to determine AVAs for the range-based and expert-based approaches, respectively. Some data sources currently used to determine AVAs under range-based approaches have been observed to provide less reliable information for the determination of the AVAs, and therefore they should only be considered eligible data sources for the calculation under expert-based approaches from now on. In addition, the determination of AVAs using historical data may not ensure that the valuation is a point-in-time and forward looking valuation at the reference date for which AVAs are calculated. As a result, the use of historical data should be framed to clarify when the resulting AVAs are considered falling under expert-based approaches. In addition, the calibration and accuracy of the pricing models are key to ensure the appropriateness of the AVAs and prudent values. As a result, requirements on the calibration of pricing models should be introduced to meet this objective.

(3) In accordance with Delegated Regulation (EU) 2016/101, exactly matching, offsetting fair-valued assets and liabilities are excluded from the calculation of the treshold to determine whether institutions are eligible to use the simplified approach and what the AVAs under that approach are. However, fair-valued derivatives and securities financing transactions falling under that exclusion give rise to valuation risks that are currently not reflected in Common Equity Tier 1 capital. To ensure that those risks are accounted for in institutions' capital, those transactions should be included in the calculation of the threshold.

(4) The fall-back approach available to institutions that apply the core approach under Delegated Regulation (EU) 2016/101 provides a methodology to determine AVAs in those cases where it was not possible to determine the total category level AVAs, and should represent a conservative treatment to deal with valuation risks arising with regard to positions where institutions do not have sufficient and reliable data available to substantiate the valuation of those positions, including when such a position is a position in an unlisted equity. Nevertheless, the calibration of the fall-back approach should not result in AVAs that significantly overestimate the valuation risk associated with those positions, and should therefore be revised.

(5) In order to determine AVAs for market price uncertainty and close-out costs, Delegated Regulation (EU) 2016/101 provides for the possibility to reduce the dimensionality of the AVA calculations for valuation inputs consisting of a set of parameters, provided that several criteria are met, including the so-called 'variance ratio test' (VRT). Competent authorities' assessment of institutions' practices shows that, in some cases, the choice of parameters made by institutions, while formally complying with the parameter reduction requirements and the VRT, results in an excessive reduction of the AVA compared to the AVA that would result from performing the calculation on the set of unreduced valuation parameters. Given the hypothetical

nature of the hedging strategy underlying the notion of parameter reduction and the conceptual limitations of the VRT, the excessive AVA reductions observed indicate that the current design of the parameter reduction and VRT rules is not consistent with the overall objective of ensuring an appropriate level of certainty of the valuation for prudential purposes. As a result, the requirements allowing a dimensionality reduction for the calculation of AVAs associated to valuation inputs consisting of a set of parameters should be revised.

(6) Delegated Regulation (EU) 2016/101 envisages two methods for the purposes of aggregating AVAs for market price uncertainty, close-out costs, and model risk, which are specified in the Annex of the Regulation. The use of the second method may lead to zero AVAs for situations where the expected value is far from the fair value, and practices for determining the expected value vary greatly. Furthermore, while the introduction of the second method originally aimed to ensure that institutions that use a fair value that is more prudent than expected value would not benefit less from diversification than those that use the expected value as the fair value, institutions may not be able to prove that the fair value is more prudent then the expected value, as they do not known how other institutions would value the same position. Overall, this leads to an unlevel playing field, which should be avoided. To this end, the second method to aggregate AVAs for market price uncertainty, close-out costs, and model risk should be removed from Delegated Regulation (EU) 2016/101.

(7) Institutions proved to have different understanding of the positions that should be in the scope of unearned credit spreads (UCS) AVAs and future administrative costs (FAC) AVAs. They applied also very different practices regarding the determination of UCS AVAs. These aspects should accordingly be clarified and harmonised to ensure a level plalying field across institutions. In addition, the UCS AVAs were observed to be very dependent on the value of the valuation inputs, and to change significantly even in case of a small change to that value, where the institutions' portfolios are concentrated towards particular counterparties. Institution should not benefit from the diversification through the 'alpha' aggregation factor set out in the Annex to determine the elements of UCS AVAs, where in fact there is no diversification.

(8) The starting point for the calculation of the AVAs in accordance with this Regulation is the mid-market fair value of the valuation positions, and the AVAs bridge the gap between the mid-market fair value and the prudent value of the valuation positions determined with 90% confidence. Institutions are expected to compensate for any difference between the value of the position as determined on the basis of the exit price and the mid-market price of such a position by making fair value adjustments in accordance with their applicable accounting standards ('accounting fair value adjustments') or adjustments in response to the independent price verification process in accordance with Article 105(8) of Regulation (EU) No 575/2013 ('IPV adjustments'). Contrary to that objective, institutions that make less or no accounting fair value or IPV adjustments are currently subject to lower deductions from their CET1, than institutions that make proper efforts to account for uncertainties in their valuation already prior to the application fo the AVA framework. Against this background, institutions should determine the AVA for a position on the basis of the fall-back approach, where they do not have enough reliable data to ensure that the fair value they would compare to the prudent value for the purposes of calculating the AVA is the mid-market fair value. Where institutions have enough reliable data, but either do not make accounting fair value adjustments or IPV adjustments, or make accounting fair value adjustments that are not commensurate with the level of adjustments that market practice suggests, the calculation of the AVAs should be modified to remove the unjustified advantage regarding the deduction from CET1. In addition, considering that accounting fair value adjustments are often determined at portfolio level, while AVAs are determined at the level of a valuation position, it should be ensured that institutions do not use one and the same accounting fair value adjustment to reduce more than one individual AVA. Therefore, this Regulation should specify a cap for the amount of accounting fair value adjustments that institutions can actually use to reduce AVAs.

(9) Other minor amendments to Delegated Regulation (EU) 2016/101 are necessary to align it with changes in the regulatory framework. Most notably, the calculation of concentrated positions AVAs needs to take into account liquidity horizons other than the 10 day liquidity horizon, and the operational risk AVA needs to reflect the revised approach for calculating own funds requirements for operational risk.

(10) The AVA framework set out in Delegated Regulation (EU) 2016/101 is inherently procyclical. In extraordinary circumstances, more specifically in case of significant cross-border financial market stress or a major regime shift, the AVAs may increase significantly, and no longer reflect the actual valuation risk associated with the valuation positions. In order to mitigate the procyclical impact of the framework, this Regulation should set out a framework for identifying extraordinary circumstances, and should specify how AVAs should be calculated under those extraordinary circumstances.

(11) Delegated Regulation (EU) No 101/2016 should therefore be amended accordingly.

(12) This Regulation is based on the draft regulatory technical standards submitted by the European Supervisory Authority (European Banking Authority) (EBA) to the Commission.

(13) EBA has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010,

HAS ADOPTED THIS REGULATION:

Article 1

Amendments to Delegated Regulation (EU) 2016/101

Delegated Regulation (EU) No 101/2016 is amended as follows:

(1) in Article 1 the following paragraph is added:

'By derogation from the first subparagraph, institutions shall calculate AVAs with a monthly frequency, where requested by their competent authority.';

Explanatory text for consultation purposes

Article 105(3) CRR requires institutions to revalue trading book positions at fair value at least on a daily basis, and report changes in the value of those positions in the profit and loss account of the institution. For that reason, institutions should, at least for trading book positions, be able to calculate AVAs with a monthly frequency. While it may pose more challenges for non-trading book (banking book) positions than for trading book positions, it is also expected that there should be, in principle, no significant impediments to calculating AVAs on a monthly basis for fair-valued positions in the non-trading book, although. The EBA seeks feedback on the institutions' capabilities to meet the proposed requirement, and potential simplifications that they may would have to employ in the calculation.

Question 1.

Are you able to calculate and report fair values and AVAs with a monthly frequency?

If not, please describe the challenges you face with regard to a monthly calculation, and the monthly reporting of fair values and AVAs (e.g. with the COREP templates). Please make clear if those challenges arise in general or with regard to specific positions (e.g. type of instruments), whether they arise for positions assigned to the trading or non-trading book, and whether they arise for positions treated under the simplified or core approach. Please describe any simplifications and/or assumptions you would have to apply to determine fair values and AVAs on a monthly basis.

(2) Article 3 is replaced by the following:

'Article 3

Sources of market data

1. Institutions shall use at least the same range of market data as a basis for calculating the AVAs, as they use in the independent price verification ('IPV') process referred to in Article 105(8) of Regulation (EU) No 575/2013, provided that the market data meet the requirements set out in this Article.

2. Institutions shall consider a full range of available and reliable market data to determine a prudent value using one or more of the following market data sources:

(a) exchange prices in a liquid market;

(b) trades between parties at arm's length in the exact same or very similar instrument, either from the institution's own records or, where available, trades from across the market;

(c) tradable quotes from brokers and other market participants;

(d) consensus service data where the number of contributors is greater than or equal to 10 and the institution has performed a valuation backtesting.

For the purpose of the first subparagraph, point (d), valuation backtesting refers to the testing of the data source to confirm that the data from this source is consistent with actual market transactions.

3. Where institutions apply an expert-based approach in accordance with Articles 9(5), point (a)(ii), 10(6), point (a)(ii) and 11(4), they shall consider additional methods and sources of information, including, where relevant, the following:

(a) consensus service data not meeting the conditions in paragraph 2, point (d);

(b) indicative broker quotes;

(c) counterparty collateral valuations;

(d) the use of proxy data based on similar instruments for which sufficient data is available;

(e) the application of prudent shifts to valuation inputs;

(f) the identification of natural bounds to the value of an instrument.';

Explanatory text for consultation purposes

As explained in the Background and rationale, the amendments to Article 3 intend to amend the hierarchy of data sources for the purposes of determining AVAs to reflect observations regarding the accuracy and reliability of data from the different sources. Certain data sources originally included in paragraph 2, and therefore eligible for use in the context of the range-based approaches, are moved to paragraph 3 and will only be eligible under expert-based approaches.

As regards the consensus service data referred to paragraph 2, point (d), the limit of 10 contributors is derived from observed market practice, and considers that a lower number of contributors may make the AVA estimation less reliable. Consequently, data from consensus data services with less than 10 participants would only be eligible in the context of the expert based approaches.

Question 2. Do you have any comments on the amendments to Article 3 in general, and specifically with regard to the threshold of ten contributors set out in paragraph 2, point (d)? If you consider a different threshold should be applied, please describe how to set it, and provide a rationale and evidence supporting your proposal.

(3) the following Article 3a is inserted:

'Article 3a

Requirements on the use of market data

1. Prudent values and AVAs shall be calculated using the most recent market data reflecting the market conditions at the reference date for which AVAs are reported.

2. For the purposes of the range-based approach referred to in Article 9(5), point (a)(i), and 10(6), point (a)(i), where there is no market data reflecting the market conditions at the reference date for which the AVAs are reported, institutions shall use market data that meets all the following conditions:

(a) the data represent the most recent market data, and are regularly updated;

(b) the data do not refer to a date earlier than one month before the reference date for which the AVAs are reported;

(c) where appropriate, the data include a correction to reflect the market evolutions between the reference date for which the AVAs are reported and the reference date of the market data.

Where the conditions set out in the first subparagraph are not met, institutions shall calculate the respective AVAs using either the expert-based approach in accordance with Article 9(5), point (a)(ii) and Article 10(6), point (a)(ii), or the fall-back approach set out in Article 7(2), second subparagraph.

Institutions shall define and document the criteria for applying corrections to the market data in accordance with the first subparagraph, point (c), and the unit or personnel responsible for the approval and validation of those corrections.

3. Where institutions apply an expert-based approach in accordance with Articles 9(5), point (a)(ii), 10(6), point (a)(ii) and 11(4), they shall be able to demonstrate to their competent authority that:

(a) there are no sufficient and reliable market data sources, as referred to in Article 3(2), to calculate AVAs under range-based approaches, and institutions made reasonable efforts to obtain data from such sources;

(b) the alternative methods and sources of information referred to in Article 3(3) are accurate, sufficient, and reliable.';

Explanatory text for consultation purposes

Article 3a frames the usage of market data. Prudent values and AVAs should represent a point-in-time, forward looking valuation at the time of the assessment. Therefore, the new article requires that the AVAs are calculated be based on market data reflecting the market conditions at the reference date for which AVAs are reported.

To allow for some flexibility in the absence of market data referring to the date for which the AVAs are reported, the market data used could refer to an earlier date, but no date earlier than one month before the reference date for which the AVAs are reported. Where such less recent data is used, it should be adjusted to reflect possible market evolutions (such as seasonality effects, material market movements experienced following the reference date of the market data, etc.), where appropriate, to ensure that the resulting AVAs are not underestimated because of the fact that they are calculated on less recent data.

If the institution wishes to use market data referring to dates earlier than one month before the reference date, the calculations are considered to make use of historical data, which may no longer be reflective of the market conditions at the date for which AVAs are reported and may have to be considered with more significant modifications. Therefore, the AVA calculated on those data is deemed to be one determined based on an expert-based approach.

The proposed amendments also intend to ensure that the expert-based approach is used only in those cases where sufficient reliable market data sources for using range-based approaches are truly not available, i.e. the institution needs to demonstrate that it made reasonable efforts to obtain the necessary data for using the range-based approaches. This should avoid an excessive use of the expert-based approaches, and will limits its use in cases where reliable data sources would be available, but institutions do not wish to make efforts to access them, for example because it could be expensive or burdensome. The requirements are also intended to avoid opportunistic postponements of the update of data sources. Such behaviours result in a detriment to the accuracy and reliability of the AVAs, and in turn their soundness for prudential purposes.

Question 3. Do you have any comments with regard to the requirements proposed in Article 3a? If you consider that some of those requirements should be adjusted, please describe how you would revise them in order to meet the policy objectives that the proposed amendments try to achieve, and provide the rationale supporting your proposal.

(4) in Article 4, paragraph 2 is replaced by the following:

‘2. Exactly matching, offsetting fair-valued assets and liabilities, with the exception of assets and liabilities arising from derivatives transactions and securities financing transactions, shall be excluded from the calculation set out in paragraph 1.

Where a change in accounting valuation of fair-valued assets and liabilities has a partial or zero impact on the Common Equity Tier 1 (‘CET1’) capital, the value of those assets and liabilities shall only be included in the calculation set out in paragraph 1 in proportion to the impact of the relevant valuation change on the CET1 capital. This subparagraph shall not apply to exactly matching, offsetting fair-valued assets and liabilities arising from derivative transactions and securities financing transactions.’;

Explanatory text for consultation purposes

The amendment to Article 4 is intended to include in scope of the threshold fair-valued back-to-back derivatives and SFTs, as described in the background and rationale. This will imply that those positions should be subject to AVAs also under the simplified approach.

In accordance with the second subparagraph of Article 4(2), no reduction of the amounts of fair-valued back-to-back derivatives and SFTs is permitted for the purposes of the determination of the threshold and the AVAs under the simplified approach, on the basis that changes in their values could have partial impact on CET1 capital. For example, where the fair values of two back-to-back derivatives are respectively +90 and -100, the amount included in the threshold and calculation of AVAs under the simplified approach should be |90|+|100|=190.

The business nature of back-to-back derivatives and SFTs is intrinsically different from other hedged positions for which the second subparagraph of Article 4(2) could apply. Back-to-back trades of this kind are typically concentrated towards particular counterparties, exposing the institution to significant counterparty risk. At the same time, while the net fair value of such back-to-back trades could be very low, the volume and gross fair values could be very material, especially in cases where an institution is consistently transferring a particular business to another entity via back-to-back trades. Accordingly, it is appropriate that an institution uses the core approach for the determination of AVAs, if it is engaged in back-to-back trades to a material extent, to ensure that relevant concentration risk is properly captured by the prudent valuation framework.

Question 4. Do you agree with the proposed amendment to capture valuation risks stemming from fair-valued back-to-back derivative transactions and SFTs? Do you agree that this would restore alignment with the treatment under the core approach? If not, please describe how you would suggest to revise the amendment providing any rationale and supporting evidence.

(5) Article 7 is amended as follows:

(a) paragraph 2 is replaced by the following:

2. For the purposes of paragraph 1, point (a), institutions shall calculate the total category level AVAs in accordance with Articles 9 to 17.

Where the application of Articles 9 to 17 is not possible for certain valuation positions, and in the cases set out in paragraph 3, institutions shall calculate an AVA in accordance with the 'fall-back approach' set out in paragraph 4.

(b) the following paragraphs are added:

3. Institutions shall use the fall-back approach in accordance with paragraph 2, second subparagraph, to calculate the AVAs for the following valuation positions:

(a) valuation positions consisting of unlisted equities;

(b) where independent pricing sources are not available or pricing sources are more subjective, valuation positions for which institutions are not able to estimate and record an adjustment for independent price verification in their accounting, or are only able to estimate and record such an adjustment for some of the valuation inputs.

4. Under the fall-back approach, institutions shall determine the individual AVA for a valuation position as the following amount:

(i) [1% - 10%] of the notional value of the related financial instruments and commodities included in the valuation position in case of derivatives;

(ii) [1% - 15%] of the absolute value of the fair value of the valuation position in case of non-derivatives.

Institutions shall determine the total AVA in accordance with the fall-back approach as the sum of the individual AVAs calculated in accordance with the first subparagraph for all valuation positions included in the fall-back approach.';

Explanatory text for consultation purposes

With regard to the calibration, the reference to the concept of 'unrealised profit' in the current version of Article 7(2), point (b)(i), of the Regulation (EU) 2016/101 is removed, which should avoid interpretative and operational issues associated with its use, and should also simplify the calculation under the fall-back approach. The QIS performed alongside the public consultation will provide the data to determine the appropriate percentages to be multiplied by the notional, within the range of 1% to 10% shown points (i) and (ii) above.

Question 5. Do you agree with the proposed amendments to the calibration of the fall-back approach? If you consider that a different range of percentages should be considered, or that the AVAs under the fall-back approach should be calculated in a different manner, please suggest a range or a methodology, as applicable, and provide a rationale and evidence supporting your proposal.

Question 6. Do you have any comments in relation to the positions proposed to be subject to the fall-back approach? If you consider a different treatment should be applied to these

positions, please describe how you would treat them in order to meet the intended policy objectives, and provide the rationale and any evidence supporting your proposal.

(6) Article 8 is amended as follows:

(a) paragraph 3 is replaced by the following:

'3. AVAs shall be considered to be the excess of valuation adjustments required to achieve the identified prudent value, over any adjustment to the fair value already applied by institutions in accordance with the applicable accounting standard that can be identified as addressing the same source of valuation uncertainty as the AVA ('eligible accounting fair value adjustment').

Where an accounting fair value adjustment cannot be identified as addressing a specific AVA category at the level at which the relevant AVAs are calculated, that adjustment shall not be considered an eligible accounting fair value adjustment.

For each level at which the requirements of this Regulation are applied in accordance with Part One, Title II of Regulation (EU) No 575/2013, the amount referred to in the following point (a) shall always be lower than or equal to the amount referred to in the following point (b):

(a) the sum of all the eligible accounting fair value adjustments that the institutions applied in accordance with the first subparagraph for the purposes of determining the AVAs;

(b) the total amount of adjustments to the fair value that the institutions applied in accordance with the applicable accounting standard and that can be identified as addressing the same source of valuation uncertainty as the AVAs determined in accordance with this Regulation.'

'Reference fair value' shall mean the fair value after taking into account only the eligible accounting fair value adjustments in accordance with the first and second subparagraph.;

(b) the following paragraphs are added:

'5. For the determination of the AVAs, with the exception of the determination of the model risk AVAs in accordance with Article 11(4) and Article 11(6), point (a), institutions shall use the same pricing models that they use to determine the changes in the value of positions reported in their financial statements. If sensitivities are used in the determination of AVAs, they shall be based on those models.

6. The calibration of the models used to determine the AVAs shall reflect the most recent observable prices, and shall be performed at least quarterly jointly with the calculation of the AVAs. The calibration shall ensure that the models reflect current market conditions.

7. Where institutions apply a sensitivity-based approach to determine the AVAs or the profit and loss employed for the purposes of variance ratio test set out in Article 9(6) and 10(6), institutions shall be able to demonstrate to the competent authority that the sensitivities used in the computation provide an accurate representation of the actual profit and loss, including convexity and cross-order effects.';

Question 7. Are the requirements included in Article 8 clear? If you consider them to be not clear or to be particularly challenging to meet in specific circumstances, please describe the issue you

encounter and how you would address it in order to meet the intended policy objectives, and provide the rationale and any evidence supporting your proposal.

(7) Article 9 is replaced by the following:

‘Article 9

Calculation of market price uncertainty AVA

1. Market price uncertainty AVAs shall be calculated at valuation exposure level (‘individual market price uncertainty AVAs’).

Where institutions use a valuation model to determine the exit price of the valuation position, they shall calculate individual market price uncertainty AVAs on valuation exposures related to each valuation input that the institutions used in the relevant valuation model to determine that exit price. Each of the valuation inputs shall be treated separately. Where a valuation input consists of a matrix of parameters, every parameter in the matrix shall be considered as a separate valuation input, subject to the specifications in paragraph 4.

Where institutions do not use a valuation model to determine the exit price of a valuation position, they shall calculate the individual market price uncertainty AVAs at the level of the price of each financial instrument or commodity included in the valuation position. The institution shall treat its position in each such financial instrument or commodity as a separate valuation exposure.

2. Institutions shall determine the total category level AVA for market price uncertainty as follows:

(a) they shall assess whether the individual market price uncertainty AVAs for a valuation exposure can be considered to be zero in accordance with paragraph 3;

(b) where the individual market price uncertainty AVA for a valuation exposure cannot be deemed to be zero in accordance with paragraph 3, institutions shall determine its individual market price uncertainty AVA in accordance with paragraphs 4 to 5;

(c) institutions shall determine the total category level AVA for market price uncertainty by aggregating the individual market price uncertainty AVAs referred to in point (b) in accordance with the formula in the Annex.

3. The individual market price uncertainty AVA shall only be equal to zero where both of the following conditions are met:

(a) the institution has firm evidence of a tradable price for a valuation exposure or a price can be determined from reliable data based on a liquid two-way market as referred to in Article 338(1), second subparagraph, of Regulation (EU) No 575/2013;

(b) the sources of market data set out in Article 3(2) do not indicate any material valuation uncertainty.

4. Where a valuation input consists of a matrix of parameters, the following additional specifications shall apply for the purposes of calculating the individual market price uncertainty AVAs in accordance with paragraph 5:

(a) where the value of the parameter cannot be directly derived from tradable instruments, institutions shall map the parameter and the related valuation exposure to a set of market tradable instruments;

(b) where the value of a parameter is not derived from available and reliable data sources listed in Article 3(2), or where the value of a parameter is extrapolated from parameters of the same valuation input, the individual market price uncertainty AVAs referring to those parameters shall be determined in accordance with the expert-based approach referred to in paragraph 5, point (a)(ii);

(c) institutions may calculate the individual market price uncertainty AVAs for the parameters of the valuation input the value of which is derived from available and reliable data sources listed in Article 3(2) based on a reduced set of parameters, where all of the following conditions are met:

(i) the sum of the valuation exposures associated with the reduced set of parameters is equal to the sum of the valuation exposures associated with the full set of parameters;

(ii) the valuation exposures associated to parameters that are not in the reduced set of parameters are mapped to the nearest parameters of the reduced set of parameters;

(iii) the reduced set of parameters is mapped to a set of market tradable instruments the value of which is based on the data sources referred to in Article 3(2);

(iv) the institution is able to demonstrate that there is sufficient liquidity to exit the valuation exposure associated to the reduced set of parameters, and that the selection of the reduced set of parameters is based on an exit strategy commonly used by the institution or observed in the market;

(v) the variance ratio test, performed for the valuation input consisting of the matrix of parameters in accordance with paragraph 6 is met.

5. The individual market price uncertainty AVAs for a valuation exposure shall be determined as follows:

(a) Institutions shall determine the prudent value of the valuation input as referred to in paragraph 1, second subparagraph, or the prudent price of the financial instrument or commodity as referred to in paragraph 1, third subparagraph, as follows:

(i) where sufficient data exists to construct a range of plausible values for the valuation input or price institutions shall apply the range-based approach as follows:

(1) for a valuation input or price, as applicable, where the range of plausible values is based on exit prices, institutions shall estimate a point within the range where they are 90% confident they could exit the valuation exposure at that price or better;

(2) for a valuation input or price, as applicable, where the range of plausible values is created from mid prices, institutions shall estimate a point within the range, where they are 90 % confident that the mid-value they could achieve in exiting the valuation exposure would be at that price or better;

(ii) where insufficient data exists to construct a plausible range of values for the valuation input, or price, institutions shall determine the prudent value

of the valuation input or price, as applicable, on an expert-based approach subject to the specifications in paragraph 10.

(b) Institutions shall calculate the individual market price uncertainty AVA for the valuation exposure based on one of the following approaches:

(i) where institutions use a valuation model to determine the exit price of the valuation position, as referred to in paragraph 1, second subparagraph, they shall multiply the difference between the value of the valuation input as used to determine the reference fair value of the valuation position and the prudent value of that valuation input estimated in accordance with point (a), by the sensitivity of the valuation position to that valuation input;

(ii) Where institutions use a valuation model to determine the exit price of the valuation position, as referred to in paragraph 1, second subparagraph, they shall revalue the valuation position to determine the prudent value PV of the valuation position that the valuation exposure belongs to, by combining the prudent value of the valuation input estimated in accordance with point (a) with the value of all other valuation inputs, as they were used to determine the reference fair value of the valuation position. Institutions shall then determine the individual market price uncertainty AVA corresponding to that valuation input as the difference between the reference fair value of the valuation position and the prudent value PV of the valuation position;

(iii) Where institutions do not use a valuation model to determine the exit price of a valuation position, as referred to in paragraph 1, third subparagraph, they shall determine the individual market price uncertainty AVA corresponding to the price of the financial instrument or commodity as the difference between the reference fair value of the financial instrument or commodity and the prudent value of the financial instrument or commodity determined on the basis of the prudent price estimated in accordance with point (a).

6. Institutions shall perform the variance ratio test separately for each valuation input that consists of a matrix of parameters. They shall perform the test at least on a quarterly basis, at the time of the calculation of the AVAs.

The variance ratio test shall be deemed to be met, where

$$\frac{Var(\widehat{PL} - PL)}{Var(PL)} < 0.1$$

where:

$Var(\dots)$ means the variance;

PL are the profits and losses over the last 100 business days associated with the valuation exposures associated with the parameters of the valuation input considering the full set of parameters of the valuation input;

$\widehat{PL}$ are the profits and losses over the last 100 business days associated with the valuation exposures associated with the parameters of the valuation input, considering the reduced set of parameters of the valuation input.

Explanatory text for consultation purposes

The profits and losses are understood to be changes in the value of the portfolio determined based on a comparison between the end-of-day value of the portfolio and its actual value at the end of the previous day, excluding fees and commissions, and taking into account only the valuation exposures associated with the parameters of the valuation input.

7. Where institutions use the option to calculate the AVA based on a reduced number of parameters in accordance with paragraph 4, point (c), a unit that is independent from business trading units, and composed of personnel that is not and was not responsible for the development of the methodology and algorithm for the variance ratio test, shall verify the institution's compliance with the conditions and requirements set out in that point. The independent unit and personnel shall asses whether the reduction of the number of parameters as well as the methodology and the algorithm applied for the variance ratio test are clearly documented and supported by a robust and appropriate qualitative and quantitative rationale.

The independent verification referred to in the first subparagraph shall take place at least on an annual basis.

8. Where institutions use the option to calculate the AVA based on a reduced number of parameters in accordance with paragraph 4, point (c), they shall submit the report on the independent assessment referred to in paragraph 7, and an estimate of the magnitude of the change in the individual market price uncertainty AVAs resulting from the use of a reduced set of parameters, to their competent authority. Institutions shall be able to explain the main drivers of the reduction.

Institutions shall send the report and information referred to in the first subparagraph at least annually, and within one month of the completion of the assessment referred to in paragraph 7.

9. Institutions shall apply a sound methodology to determine the prudent value of the valuation input on the basis of the expert-based approach referred to in paragraph 5, point (a)(ii), and shall take available qualitative and quantitative information into consideration, so that the level of certainty of the prudent value estimated under that approach is equivalent to that targeted under the range-based approach referred to in paragraph 5, point (a)(i). Any weakness in the methodology applied shall be addressed by including a margin of conservatism in the determination of the estimate.

10. Where institutions apply the expert-based approach referred to in paragraph 5, point (a)(ii), a unit that is independent from business trading units, and composed of personnel that is not and was not responsible in the development of the methodology for the expert-based approach, shall verify the adequacy of the assessments made and the methodology applied

The independent verification referred to in the first subparagraph shall take place at least on an annual basis.

11. Where institutions apply the expert-based approach referred to in paragraph 5, point (a)(ii), they shall submit the report on the independent assessment referred to in paragraph 10 to their competent authority. They shall notify the competent authority of the methodology used to determine the largest individual market price uncertainty AVAs under that approach, representing at least 20% of the total individual AVAs determined on the basis of that approach. The notification shall also include evidence that the requirements set out in paragraph 9 are met.

Institutions shall send the report and notification referred to in the first subparagraph at least annually, and within one month of the completion of the assessment referred to in paragraph 10.'

(8) Article 10 is replaced by the following:

'Article 10

Calculation of close-out costs AVA

1. Close-out costs AVAs shall be calculated at the level of a valuation exposure ('individual close-out costs AVAs').

Where institutions use a valuation model to determine the exit price of a valuation position, they shall calculate individual close-out costs AVAs on valuation exposures related to each valuation input that the institution used in the relevant valuation model to determine that exit price. Each of the valuation inputs shall be treated separately. Where a valuation input consist of a matrix of parameters, every parameter in the matrix shall be considered as a separate valuation input, subject to the specifications in paragraph 5.

Where institutions do not use a valuation model to determine the exit price of a valuation position, they shall calculate the individual close-out costs AVAs at the level of the price of each instrument included in the valuation position. The institution shall treat its position in each such financial instrument or commodity as a separate valuation exposure.

2. Institutions shall determine the total category level AVA for close-out costs as follows:

(a) they shall assess whether the individual close-out costs AVAs for a valuation exposure can be considered to be zero in accordance with paragraphs 3 or 4;

(b) where the individual market price uncertainty AVA for a valuation exposure cannot be deemed to be zero in accordance with paragraph 3, institutions shall determine its individual market price uncertainty AVA in accordance with paragraphs 4 to 5;

(c) institutions shall determine the total category level AVA for close-out costs by aggregating the individual close-out costs AVAs referred to in point (b) in accordance with the formula in the Annex.

3. Where institutions have calculated a market price uncertainty AVA for a valuation exposure based on an exit price, they may consider the individual close-out costs AVA to be zero.

Where institutions apply the derogation referred to in Article 105(5) of Regulation (EU) No 575/2013, they may consider the individual close-out costs AVA to be zero, provided that they are able to demonstrate to their competent authority that they are 90% confident that sufficient liquidity exists to support the exit of the related valuation exposures at mid-price.

4. Where a valuation input consists of a matrix of parameters, the following additional specification shall apply for the purposes of calculating the individual close-out costs AVAs in accordance with paragraph 5:

(a) where the value of the parameter cannot be directly derived from tradable instruments, institutions shall map the parameter and the related valuation exposure to a set of market tradable instruments;

(b) where the value of a parameter is not derived from available and reliable data sources listed in Article 3(2), or where the value of a parameter is extrapolated from parameters of the same valuation input, the individual close-out costs AVAs referring to those parameters shall be determined in accordance with the expert-based approach referred to in paragraph 5, point (a)(ii);

(c) institutions may calculate the individual close out costs AVAs for the parameters of the valuation input the value of which is derived from available and reliable data sources listed in Article 3(2) based on a reduced set of parameters, where all of the following conditions are met:

(i) the sum of the valuation exposures associated with the reduced set of parameters is equal to the sum of the valuation exposures associated with the full set of parameters.

(ii) the valuation exposures associated to parameters that are not in the reduced set of parameters are mapped to the nearest parameters of the reduced set of parameters;

(iii) the reduced set of parameters is mapped to a set of market tradable instruments the value of which is based on the data sources referred to in Article 3(2);

(iv) the institution is able to demonstrate that there is sufficient liquidity to exit the valuation exposure associated to the reduced set of parameters, and that the selection of the reduced set of parameters is based on an exit strategy commonly used by the institution or observed in the market;

(v) the variance ratio test, performed for the valuation input consisting of the matrix of parameters in accordance with paragraph 6, is met.

5. The individual close-out costs AVAs shall be determined as follows:

(a) Institutions shall determine the estimated bid-offer spread as follows:

(i) where sufficient data exists to construct a range of plausible bid-offer spreads for a valuation input as referred to in paragraph 1, second subparagraph, or a price, as referred to in paragraph 1, third subparagraph institutions shall estimate a point within the range where they are 90 % confident that the spread they could achieve in exiting the valuation exposure would be at that price or better;

(ii) where insufficient data exists to construct a range of plausible bid-offer spreads for a valuation input as referred to in paragraph 1, second subparagraph, or price, , as referred to in paragraph 1, third subparagraph, institutions shall determine the estimated bid-offer spread based on an expert-based approach subject to the specifications specified in paragraph 10.

(b) Institutions shall calculate the individual close-out costs AVA for the valuation exposure based on one of the following approaches:

(i) Where institutions use a valuation model to determine the exit price of a valuation position, as referred to in paragraph 1, second subparagraph, they shall multiply 50% of the estimated bid-offer spread determined in accordance with point (a) by the sensitivity of the valuation position to the valuation input.

(ii) Where institutions use a valuation model to determine the exit price of a valuation position, as referred to in paragraph 1, second subparagraph, they shall revalue the valuation position to determine the prudent value PV of the valuation position that the valuation exposure belongs to by combining the valuation input adjusted by 50% of the estimated bid-offer spread determined in accordance with point (a), with the value of all other valuation inputs as they were used to determine the reference fair value of the valuation position. Institutions shall then determine the individual close-out costs AVA as the difference between the reference fair value of the valuation position and the prudent value PV of the valuation position;

(iii) Where institutions do not use a valuation model to determine the exit price of a valuation position, as referred to in paragraph 1, third subparagraph, they shall determine the individual close out cost AVA corresponding to the price of the financial instrument or commodity as the difference between the reference fair value of the financial instrument or commodity and the prudent value of the financial instrument or commodity, obtained by adjusting the price by 50% of the bid-offer spread determined in accordance with point (a).

6. Institutions shall perform the variance ratio test separately for each valuation input that consists of a matrix of parameters. They shall perform the test at least on a quarterly basis, at the time of the calculation of the AVAs.

The variance ratio test shall be deemed to be met, where

$$\frac{Var(\widehat{PL} - PL)}{Var(PL)} < 0.1$$

where:

$Var(\dots)$ means the variance.

PL are the profits and losses over the last 100 trading days associated with the valuation exposures associated with the parameters of the valuation input, considering the full set of parameters of the valuation input;

$\widehat{PL}$ are the profits and losses over the last 100 trading days associated with the valuation exposures associated with the parameters of the valuation input, considering the reduced set of parameters of the valuation input.

7. Where an institution use the option to calculate the AVA based on a reduced number of parameters in accordance with paragraph 5, point (c), a unit that is independent from business trading units, and composed of personnel that is not and was not responsible for the development of the methodology and algorithm for the variance ratio test, shall verify the institution's compliance with the conditions and requirements set out in that point. The independent unit and personnel shall assess whether the reduction of the number of parameters, as well as the methodology and the algorithm applied for the variance ratio test are clearly documented and supported by a robust and appropriate qualitative and quantitative rationale.

The independent verification referred to in the first subparagraph shall take place at least on an annual basis.

8. Where an institution use the option to calculate the AVA based on a reduced number of parameters in accordance with paragraph 4, point (c), they shall submit the report on the independent assessment referred to in paragraph 7 and an estimate of the magnitude of the change in the individual close out costs AVAs resulting from the use of reduced set of parameters to their competent authority. Institutions shall be able to explain the main drivers of the reduction.

Institutions shall send the report and information referred to in the first subparagraph at least annually, and within one month of the completion of he assessment referred to in paragraph 7.

9. Institutions shall apply a sound methodology to determine the estimated bid-offer spread on the basis of the expert-based approach referred to in paragraph 5, point (a)(ii), and shall take available qualitative and quantitative information into consideration, so that the level of certainty of the bid-offer spread estimated under that approach is equivalent to that targeted under the range-based approach referred to in paragraph 5, point (a)(i). Any weakness in the methodology applied shall be addressed by including a margin of conservatism in the determination of the AVA.

10. Where institutions apply the expert-based approach as referred to in paragraph 5, point (a)(ii), a unit that is independent from business trading units, and composed of personnel that is not and was not responsible in the development of the methodology for the expert-based approach, shall verify the adequacy of the assessments made and the methodology applied.

The independent verification referred to in the first subparagraph shall take place at least on an annual basis.

11. Where institutions apply the expert-based approach referred to in paragraph 5, point (a)(ii), they shall submit the report on the independent assessment referred to in paragraph 10 to their competent authority. They shall notify the competent authority of the methodology they use to determine the largest individual close-out cost AVAs under that approach, representing at least 20% of the total individual AVAs determined on the basis of that approach. The notification shall also include evidence that the requirements set out in paragraph 9 are met.

Institutions shall send the report and notification referred to in the first subparagraph at least annually, and within one month of the completion of the assessment referred to in paragraph 10.'

(9) Article 11 is amended as follows

(a) paragraph 1 is replaced by the following:

'1. Institutions shall estimate a model risk AVA for each valuation model ('individual model risk AVA') by considering valuation model risk which arises due to the potential existence of a range of different models or model calibrations, which are used by market participants, and the lack of a firm exit price for the specific valuation position, financial instrument or commodity being valued. Institutions shall not consider valuation model risk which arises due to calibrations from market-derived valuation inputs or parameters used in the valuation model, where that risk is already captured by the market price uncertatinty AVAs calculated in accordance with Article 9.'

(b) paragraph 5 is replaced by the following:

'5. The expert-based approach shall consider all of the following:

(a) the complexity of products relevant to the model;

(b) the diversity of possible mathematical approaches and model parameters, where those model parameters are not related to market variables;

(c) the degree to which the market for relevant products is 'one way';

(d) the existence of unhedgeable risks in relevant products;

(e) the adequacy of the model in capturing the behaviour of the pay-off of the products in the portfolio.

The level of certainty of the prudent value determined in accordance with the first subparagraph shall be equivalent to that targeted by the method referred to in paragraph 3.Any weakness in the expert-based methodology shall be taken into account by including a margin of conservatism in the determination of the AVA.

Institutions shall notify their competent authority of the methodology used to determine the largest individual model risk AVAs in accordance with paragraph 4, representing at least 20% of the total individual AVAs determined in accordance with that paragraph. The notification shall also include evidence that the requirements specified in the first and second subparagraph are met.

Institutions shall send the notification referred to in the third subparagraph at least annually.'

(b) paragraph 7 is replaced by the following:

'7. Institutions shall calculate the total category level AVA for model risk by applying the formulae laid down in the Annex to individual model risk AVAs.';

Explanatory text for consultation purposes

In Article 9, 10 and 11, new requirements are introduced with regard to the dimensionality reduction and variance ratio test of valuation inputs consisting of a set of parameters, as well as new requirements regarding the calculation of AVAs under expert-based approaches.

The amendments to Articles 9 and 10 in particular are complemented by a new provision in the Annex, that sets the alpha factor to zero for aggregating AVAs stemming from a valuation input consisting of several parameters, if the institution has made use of the dimensionality reduction. As the dimensionality reduction already introduces a certain degree of netting between exposures associated with different parameters of the valuation input, it would not be appropriate to allow for additional diversification benefits through the alpha factor.

With regard to model risk AVAs, the amendments clarify that institutions should not consider valuation model risk which arises due to calibrations from market derived parameters, when that calibration is already captured in accordance with Article 9, to allow some flexibility in the allocation and avoid double counting of AVAs.

Question 8. Do you have any comments with regard to the amendments to Article 9, 10 and 11? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

(10) Article 12 is amended as follows:

(a) paragraph 1 is replaced by the following:

'1. Institutions shall calculate the unearned credit spreads AVA to reflect the valuation uncertainty in the adjustment applied in accordance with the applicable accounting standard to incorporate the current value of expected losses due to counterparty default on derivatives and securities financing transactions.';

(b) the following paragraphs are added:

3. For the purposes of paragraph 1, institutions shall consider all sources of uncertainty to estimate the probability of default, the loss given default, and the expected exposure profiles. The sources of uncertainty shall include:

(a) the dependency between the exposure and the probability of default of the counterparty;

(b) the correlations between risk factors taken into consideration to generate the exposure profiles.

4. For the purposes of paragraph 1, where the transactions in a netting set are subject to a margin agreement, the margin period of risk shall be equal to or greater than that employed for the purposes of determining the own funds requirements for CVA risk of those positions in accordance with Regulation (EU) No 575/2013.';

Explanatory text for consultation purposes

Unearned credit spreads AVAs should capture the valuation uncertainty with regard to credit valuation adjustments (CVA), which is the adjustment to the valuation that reflects the current value of expected losses due to counterparty default. In this regard, paragraph 1 of Article 12 is amended to specify that unearned credit spreads (UCS) AVAs are expected to be calculated also for fair-valued SFTs where CVA is recorded for those instruments, and not solely for derivatives.

As regards instruments which are not derivatives or SFTs, but whose value is affected by changes in the credit spread of an issuer, such as bonds, the uncertainty in the valuation due to changes in the credit spread is considered to fall under market price uncertainty (MPU) and close-out costs (CoC) AVAs, and not UCS AVAs. For example, the valuation uncertainty associated to the credit spreads of the issuers of a bond would be explicitly assessed, if the institution decides to calculate the MPU and CoC AVAs of the bonds at the granular level of each valuation input of the bond. In this case, the valuation uncertainty regarding the credit spread would be accounted for in the MPU and CoC AVAs of the bonds referring to the credit spreads. Alternatively, this valuation uncertainty would be captured implicitly in the overall MPU and CoC AVAs associated to the bond price, if the institution does not decompose the AVA for the various valuation inputs of the bond's price.

Article 12 has also been amended, to clarify that institutions are expected to consider all sources of uncertainty that affect the CVA when they determine UCS AVA. In addition, a floor for the margin period of risk considered in the calculation of UCS AVA of margined counterparties is introduced, to ensure a treatment consistent with that used for determining capital requirements for CVA risk, and to provide for a level playing field across institutions.

The amendments to Article 12 are complemented by an amendment to the annex, which sets the alpha factor to zero for the aggregation of the MPU, CoC and model risk components of the UCS AVA. Please refer to the explanations in the annex.

Question 9. Do you have any comments with regard to the amendments to Article 12? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

(11) in Article 14(1), point (c) is replaced by the following:

‘(c) where the prudent exit period exceeds the liquidity horizons that are assigned to the valuation inputs of the position in accordance with Article 325bd of Regulation (EU) No 575/2013, they shall estimate an AVA taking into account the volatility of the valuation input, the volatility of the bid-offer spread and the impact of the hypothetical exit strategy on market prices.’;

(12) in Article 15, paragraphs 1 and 2 are replaced by the following:

‘1. Institutions may consider the AVA for future administrative costs for a valuation exposure (‘individual future administrative costs AVA’) to be zero, where all of the following conditions are met:

(a) the individual market price uncertainty, close-out costs, and concentrated positions AVAs imply fully exiting the exposure;

(b) the valuation exposure is mapped to tradable instruments;

(c) the valuation exposure does not require dynamic re-hedging activities;

(d) there are no impediments or dependencies preventing the institution from disposing of the valuation exposure.

2. Where institutions cannot consider the individual future administrative costs AVA to be zero for a valuation exposure in accordance with paragraph 1, they shall calculate the amount of the individual future administrative costs AVA by considering the administrative costs and future hedging costs over the expected life of the valuation exposure, and discounting those using a rate which approximates the risk free rate.’;

Explanatory text for consultation purposes

Article 14, point (c), is amended as shown to align the RTS requirements with those of Article 105(11), point (a), CRR, as amended by Regulation (EU) 2019/876. In accordance with that article, the additional amount of time to exit the position is determined as the time beyond the liquidity horizons assigned to the risk factors in accordance with Article 325bd CRR. Hence, the ten days horizon specified in point (c) has to be replaced by the liquidity horizons set out in Article 325bd CRR.

Article 15 is amended to clarify the scope of future administrative costs AVAs and the conditions under which those AVAs can deemed to be zero. Background associated to these amendments is provided in the background and rationale section of this document.

Question 10. Do you have any comments with regard to the amendments to Article 14 and 15? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

(13) Article 17 is replaced by the following:

‘Article 17

Calculation of operational risk AVA

Institutions shall calculate an operational risk AVA to account for potential losses that may be incurred as a result of operational risk related to valuation processes. The operational risk AVA shall be determined as 5% of the sum of the total category level AVAs for market price uncertainty and the total category-level close-out costs AVA.';

Explanatory text for consultation purposes

In line with the BCBS framework, the CRR3 will introduce a new standardised approach for operational risk in the prudential framework, which replaces the existing approaches for operational risk. The current Advanced Measurement Approach (AMA) will no longer be available to determine capital requirements for operational risk, as soon as CRR3 will apply. Article 17 is amended to remove any provisions regarding the AMA, which would have no effect as soon as the CRR3 applies.

The new standardised approach for operational risk as it will be implemented in the EU does not appear to specifically account for operational risks relating to valuation processes. A derogation similar to the one included currently for the AMA in Article 17(2) should not be kept for the new standardised approach.

However, it is proposed to reduce the percentage for the determination of operational risk AVA from 10% to 5%, in order to mitigate the impact of the removal of AMA models.

(14) Article 18(1) is amended as follows:

(a) the following point (da) is inserted after point (d):

'(da) the criteria for applying corrections to the market data in accordance with Article 3a(2), first subparagraph, point (c), and the unit or personnel responsible for the approval and validation of those corrections;'

(b) point (h) is replaced by the following:

'(h) the fair-valued assets and liabilities for which a change in accounting valuation has a partial or zero impact on CET1 capital in accordance with Article 4(2) and Article 8(1);

(i) where institutions use the option to calculate the AVA based on a reduced number of parameters, the methodology applied to reduce the number of parameters of valuation inputs that consist of a matrix of parameters, and the methodology applied to perform the variance ratio test, , including the description of how valuation exposures are allocated to the reduced set of parameters,;

(j) the methodology for allocating eligible accounting fair value adjustments to valuation exposure-level reference fair values for the purposes of determining the individual AVAs.';

(15) after Chapter IV, the following Chapter IVa is inserted:

'Chapter IVa

Extraordinary circumstances

Article 19a

Presence of extraordinary circumstances for the purposes of Prudent Valuation

1. For the purposes of determining the existence of extraordinary circumstances at a given date in accordance with Article 34, second subparagraph, of Regulation (EU) No 575/2013, the EBA shall assess, whether the following conditions are met:

(a) significant cross-border financial market stress has been observed or a major regime shift has taken place;

(b) the financial market stress or major regime shift referred to in point (a) is likely to result in amounts of AVAs that are not reflective of the valuation risk associated with the valuation positions.

2. In order to assess whether the conditions specified in paragraph 1 are met, factors and indicators that are representative of or reflect the nature of the stress or regime shift shall be taken into account, including the following:

(a) the analysis of relevant volatility indices, and indicators of realised volatilities, deemed to be suitable to capture the nature of the financial market stress or regime shift.

(b) the assessment of whether the financial market stress or major regime shift led to volatility levels that are comparable to, or exceed, those observed during the global financial crisis or the COVID-19 pandemic;

(c) the assessment of how quickly the financial stress manifested or the regime shift happened, and how quickly the financial stress or regime shift may be expected to cease.

Where appropriate in the light of the nature of the financial market stress or regime shift, the analysis referred to in the first subparagraph, point (a), may be complemented by an analysis of the reduction of liquidity in financial markets.

Article 19b

Reduction of AVAs under extraordinary circumstances

Where extraordinary circumstances are deemed to be in place in accordance with Article 34 of Regulation (EU) No 575/2013, the following shall apply:

(a) AVAs calculated in accordance with the simplified approach set out in Chapter II shall not be subject to any reduction;.

(b) for the purposes of determining the AVAs under the core approach, the value of the aggregation factor alpha as referred to in the Annex, paragraph 2, shall be the following:

(i) 0.66, where it is set equal to 0.5 in ordinary circumstances;

(ii) 0.33, where it is set equal to zero in ordinary circumstances.';

Question 11. Do you agree with the requirements set out in Article 19a and Article 19b? If you do not agree, please describe how you would suggest to revise those Articles and address the mandate on extraordinary circumstances outlined in Article 34 CRR. When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.

(16) the Annex to Delegated Regulation (EU) No 101/2016 is replaced by the Annex to this Regulation.

Article 2

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 1, points (11) and (13) referring to the provisions for the determination of concentration position AVAs and operational risk AVA shall apply from … [OP please insert the date of appplication of [the CRR3]].

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the President

Annex

'ANNEX

Formulae to be used for the purpose of aggregating AVAs under Article 9(2), point (c), Article 10(2), point (c), and Article 11(7)

1. Institutions shall use the following formulae in order to determine the total category-level AVA in accordance with Articles 9(2), point (c), Article 10(2), point (c) and Article 11(7), as applicable:

APVA	=	$(FV - PV) - \alpha \cdot (FV - PV)$ $= (1 - \alpha) \cdot (FV - PV)$
AVA	=	Σ APVA

where:

FV =the valuation-exposure reference fair value after the application of any eligible accounting fair value adjustment in accordance with Article 8(3),

PV =the valuation exposure-level prudent value determined in accordance with this Regulation,

FV - PV =the individual AVA, as calculated in accordance with Articles 9(6), point (b), 10(6), point (b), and 11(3) or (4), as applicable,

α =the aggregation factor, the value of which is determined in accordance with paragraph 2,

APVA =the valuation exposure-level AVA after adjusting for aggregation,

AVA =the total category-level AVA after adjusting for aggregation.

2. The value of the aggregation factor shall be determined as follows:

(a) where institutions calculate APVA for an individual market price uncertainty AVA as referred to in Article 9(6) or for an individual close-out costs AVA as referred to in Article 10(6), the following shall apply:

(i) The value of the aggregation factor 'α' shall be 0.5, if all of the following conditions are met:

(1) the term FV includes an eligible accounting fair value adjustmentin accordance with Article 8(3), and that eligible accounting fair value adjustment is commensurate with the adjustment other market participants would consider when determining the reference fair value of the position;

(2) where the valuation input consists of a matrix of parameters, the institution did not reduce the number of parameters of the valuation input for the purposes of calculating AVAs in accordance with Article 9(4) and 10(4).

OPTION 1,

(3) where the individual AVA represents the market price uncertainty AVA component or the close-out cost component of an unearned credit spread AVA in accordance with Article 12(2), the institutions' valuation positions subject to unearned credit spread AVAs in accordance with Article 12 are not concentrated on certain counterparties.

OPTION 2

(3) where the individual AVA represents the market price uncertainty AVA component or the close-out cost component of an unearned credit spread AVA in accordance with Article 12(2), the valuation exposure is not an exposure to one the five most significant counterparties.

(ii) The value of the aggregation factor 'α' shall be 0, in the following cases:

(1) where the conditions in point (i) are not met;

(2) where the APVA calculated is a market price uncertainty AVA and the conditions in point (i) are met, but an unadjusted IPV difference remains after the completion of the independent price verification ('IPV') process in accordance with Article 105(8) of Regulation (EU) No 575/2013.

(b) where institutions calculate APVA for an individual model risk AVA as referred to in Article 11(1), the following shall apply:

(i) the value of the aggregation factor 'α' shall be 0.5, where one of the following conditions is met:

(1) the individual model risk AVA does not represent the model risk component of an unearned credit spread AVA in accordance with Article 12(2);

OPTION 1

(2) the individual model risk AVA represents the model risk component of an unearned credit spread AVA in accordance with Article 12(2), and the institutions' valuation positions subject to unearned credit spread AVAs in accordance with Article 12 are not concentrated on certain counterparties;

OPTION 2

(2) the individual model risk AVA represents the model risk component of a UCS AVA in accordance with Article 12(2), and the valuation exposure is not an exposure to one the five most significant counterparties;

(ii) the value of the aggregation factor 'α' shall be 0, where neither of the conditions in point (i) is met.

OPTION 1

For the purposes of the first subparagraph, point (a)(i)(3) and (b)(i)(2), the institutions' valuation positions are deemed to be concentrated on certain counterparties, if the following ratio is equal to or higher than 10% for at least one counterparty i:

$$\frac{\text{UCS AVA}_i}{\sum_{i=1}^{N} \text{UCS AVA}_i}$$

Where:

UCS AVA_i is the individual unearned credit spread AVA associated with the valuation positions consisting of transactions with counterparty i,

N is the total number of counterparties for which the institutions calculates individual unearned credit spread AVAs.

Counterparties that are fully consolidated in accordance with Article 18 of Regulation (EU) No 575/2013 for the purposes of the application of the requirements of this Regulation on a consolidated basis, shall not be considered in the computation of the ratio referred to in the second subparagraph;

OPTION 2

For the purposes of the first subparagraph, points (a)(i)(3) and (b)(i)(2), the five most significant counterparties shall be those attracting the five highest amounts of individual unearned credit spread AVAs in accordance with Article 12.

Counterparties that are fully consolidated in accordance with Article 18 of Regulation (EU) No 575/2013 for the purposes of the application of the requirements of this Regulation on a consolidated basis, shall not be considered when determining the five most significant counterparties in accordance with the second subparagraph;

For the purposes of the first subparagraph, point (a)(ii)(2), 'IPV differences' shall mean the differences between the valuation exposure-level reference fair value and the value of the valuation exposure determined based on the mid-market value of the relevant valuation input or valuation inputs, as estimated by the IPV process, provided that using the mid-market value of that valuation input or those valuation inputs would result in a more conservative valuation. An IPV difference is considered to be an unadjusted IPV difference, where it was neither already reflected in the institution's profit and loss account nor has reduced the institutions common equity tier 1 capital.

For the purposes of the first subparagraph, point (a)(ii)(2), the aggregation factor 'α' shall only be set to 0 for the amount corresponding to the unadjusted IPV difference.

Please refer to the background and rationale and the explanation on the individual articles for information on the intentions of setting the alpha factor to zero in case of missing or insufficient fair value adjustments, in case the institution makes use of the dimensionality reduction, or in case unadjusted IPV differences remain.

As explained in the background and rationale, the fourth case where the alpha factor is set to zero is related to a concentration of UCS AVAs. This consultation paper proposes two mechanisms for deciding on the value of the alpha factor:

- Under option 1, the aggregation factor alpha used to adjust the MPU, CoC or model risk component of the UCS AVAs for aggregation should be set to zero, as soon as the UCS AVAs for a single counterparty account for 10 or more percent of the total UCS AVAs;

- Under option 2, the aggregation factor alpha would be set to zero only for adjusting the MPU, CoC and model risk components of the UCS AVAs associated to the five counterparties of the institution that attract the highest amounts of UCS AVAs.

Under Option 1, the MPU, CoC and model risk components of the UCS AVAs would not be affected by the requirement, until the 10% threshold is exceeded for at least one counterparty, i.e. the alpha factor would either be zero or 0.5 for every MPU, CoC and model risk component of the UCS AVA. Thus, there could be a cliff effect as regards the total category-level UCS AVAs depending on whether the threshold is exceeded (or no longer exceeded) over time. Option 2

avoids such a cliff effect, but would subject the UCS AVAs of the counterparties attracting the highest UCS AVAs to a zero aggregation factor even if the UCS AVAs may are not truly concentrated towards those counterparties. Views from stakeholders are welcome on the two options for addressing concentrations of UCS AVAs.

Question 12. Which of the two options presented do you consider more appropriate for the purposes of addressing concentration of UCS AVAs? When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.

Question 13. Do you have any comments with regard to the amendments introduced in the Annex? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

Question 14. Do you have any other comments on this consultation paper? If you do not agree with any of the proposed requirements, please describe how you would adjust or design them in order to meet the policy objectives that the proposals try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

55. Commission Delegated Regulation (EU) No 101/2016 lays out requirements for the prudent valuation of fair-valued financial instruments. This regulation has been adopted on the basis of draft regulatory technical standards (RTS) developed by the EBA in accordance with the mandate specified in Article 105(14) of the CRR.

56. The draft RTS included in this consultation paper are intended to amend Commission Delegated Regulation (EU) 2016/101, to address targeted implementation issues that have emerged on the application of this regulation, and to address the mandate proposed to be included in Article 34 CRR by the CRR3 legislative proposal.

57. Article 10(1) of Regulation (EU) No 1093/2010 (EBA Regulation) provides that any RTS developed by the EBA should be accompanied by an analysis of 'the potential related costs and benefits'. This analysis should provide an overview of the findings regarding the problem to be dealt with, the options proposed and the potential impact of these options.

58. This section presents the cost-benefit analysis of the main policy options included in this CP. The analysis is high-level and qualitative nature.

59. In parallel with the consultation, the EBA is launching a data collection to assess the impact of the provisions proposed in these draft RTS. The data may also be used to adjust and/or extend these provisions in the final draft RTS.

A. Problem identification

60. Commission Delegated Regulation (EU) 2016/101 sets out requirements for prudent valuation of fair-valued positions of institutions. Under the prudent valuation framework institutions are required to calculate AVAs of their fair-valued financial instruments, which are intended to set valuations at a level that achieves an appropriate degree of certainty, so that the valuation used for regulatory purposes is not higher than the true realisable value. In accordance with Article 34 CRR, AVAs are deducted from Common Equity Tier 1 capital.

61. Taking into account the experience from Competent Authorities in their supervision of the requirements on prudent valuation, this consultation paper proposes amendments to that Regulation, to address targeted implementation issues that have emerged during its application. In addition, this document includes for consultation draft RTS to address the mandate that is proposed to be included in Article 34 by the CRR3 legislative proposal[12], to specify the conditions that the EBA shall use to determine the presence of extraordinary circumstances for the

[12] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0664

purposes of prudent valuation, and the reduction of the total aggregated additional value adjustments under those circumstances.

B. Policy objectives

62. The objective of the draft RTS included in this consultation paper is to address policy and implementation issues that have emerged in the application of Commission Delegated Regulation (EU) 2016/101 since its application. In this way, the draft RTS contribute to ensure a consistent implementation of the prudent valuation framework in the EU.

63. Generally, these draft RTS aim to create a level playing field, promote convergence of institutions practises and enhance comparability of own funds requirements across the EU. Overall, these draft RTS are expected to promote the effective and efficient functioning of the EU banking sector.

C. Baseline scenario

64. In the absence of the introduction of the amendments proposed in the draft RTS included in this consultation paper, the implementation issues considered in this document that have emerged in the application of Commission Delegated Regulation (EU) 2016/101 would remain unaddressed, which would be detrimental for the effective and consistent application of the prudent valuation framework and capitalisation of institutions in the EU. In addition, in the absence of the draft RTS to address the mandate in Article 34 CRR, there would be no framework to deal in place to effectively deal with a situation of extraordinary circumstances for prudent valuation.

D. Options considered, cost-benefit analysis and preferred options

1. Arbitrage between aggregation methods under the core approach

65. The EBA has considered two options to address this policy issue:

Option 1a: provide guidance or specifications related to the concept of 'expected value' that is used for the purposes of second method included in the Annex of Commission Delegated Regulation (EU) 2016/101 to aggregate AVAs for market price uncertainty, close-out costs, and model risk.

Option 1b: remove the second method from the regulation.

66. Option 1a requires to develop and agree on specifications on the concept of 'expected value' used in the second method. Even if that concept was further specified, it would not be guaranteed that stakeholders would interpret it consistently and in the same manner, though. Thus, even if the meaning of 'expected value' was clarified, it might not address the issues associated with the use of the second method, and might lead to an unlevel playing field between institutions, which should be avoided.

67. The EBA also analysed the number of institutions that use either of the two methods for aggregating AVAs for market price uncertainty, close-out costs and model risk. Figure 1 shows that the vast majority of EU institutions apply Method 1 of the core approach, while only a minority uses the second method. In particular, some institutions apply both methods at the same time, which, although it is not explicitly forbidden by the Regulation, may be seen as cherry picking between the methods.

Figure 1. Number of institutions at highest level of EEA consolidation using Method 1 and Method 2 of the core approach, EU/EEA.

	Number of institutions
Method 1 only	52
Method 2 only	2
Both Method 1 and 2	6
No diversification benefits reported	9
Total	69

Source: EUCLID data, as of 30 June 2023.

68. Taking into account the above issues associated with Option 1a, and the evidence regarding the number of institutions that use either of the methods, Option 1b was preferred. This should in particular also ensure a level playing field across institutions for the purposes of aggregating AVAs for market price uncertainty, close-out costs, and model risk under the core approach, while at the same time leading to a simplification in the usage of the regulation.

2. Calculation frequency of AVAs

69. The following options were considered to address this policy issue:

Option 2a: Include a mandatory requirement in the RTS for the calculation of monthly AVAs.

Option 2b: Require that institutions shall calculate AVAs with a monthly frequency upon request by the competent authority.

70. Option 2a involves a regular increase in the calculation frequency of AVAs with respect to current practices, whereas under Option 2b the frequency is expected to increases only in particular periods, where this is considered appropriate by the competent authority. This could

for example be relevant to review the potential increase of AVAs under extraordinary circumstances, but also to perform any supervisory scrutiny regarding possible window dressing behaviours.

71. The increase in the calculation and reporting frequency may pose challenges to institutions. In addition, Option 2a should also involve a parallel change of the ITS on reporting to introduce a monthly reporting frequency, which may increase the reporting burden. Taking into account these considerations, at this stage it has been considered appropriate to keep Option 2b. This however should not prevent going forward to introduce a regular requirement for the calculation of monthly AVAs, if this was considered suitable.

3. Absence of fair value adjustments of MPU, CoC and model risk

72. The following options were considered to address this policy issue:

Option 3a: Provide specifications regarding the determination of those adjustments, to ensure convergence in practices.

Option 3b: Provide competent authorities with the power to set the aggregation factor to 1 in case the absence (or insufficiency) of fair value adjustments is not warranted.

73. Option 3a would envisage providing guidance on accounting standards to ensure convergence of practices, which is typically a role more suited for other institutions. In addition, it is challenging to provide guidance in this area, given the variety and specificities of positions and practices, and may not avoid that ultimately institutions apply different approaches in their accounting practices. Taking into account these considerations, the approach taken in the RTS is to rely on institutions' fair value adjustment practices, and use the aggregation factor as a tool to address deficiencies in their determination in case they are identified by the supervisors. This approach should enable institutions to explain their practices and motivate why recorded amounts of fair value adjustments are in line with relevant requirements, while at the same time ensure that non-warranted aggressive approaches relating to fair value adjustments result in an unlevel playing field across institutions, or in undue reductions of AVAs. Accordingly, Option 3b is preferred.

4. Procyclicality of the Prudent Valuation framework and derogation under exceptional circumstances

74. The amendments to Article 34 CRR envisaged by the CRR3 legislative proposal introduce a framework for dealing with extraordinary circumstances on Prudent Valuation. In accordance with the revised Article 34 CRR, institutions may reduce the total AVAs to be deducted from Common Equity Tier 1 capital in the presence of extraordinary circumstances, the existence of which is determined by an opinion provided by EBA. In line with the mandate of Article 34 CRR, the amending RTS specify in general terms which situations may qualify as extraordinary and list exemplary indicators and conditions that the EBA will use to determine the presence of

extraordinary circumstances, sets out how the total aggregated AVAs shall be calculated under those circumstances.

75. With a view to achieving consistency across the different provisions of the regulatory framework, the amendments set out in this consultation paper follow the principles established for the continuation of the use of an internal model in extraordinary circumstances (see EBA/CP/2023/19), but take duly account of the differences between the FRTB-Internal models and Prudent Valuation framework. As such, the EBA states in the draft RTS that extraordinary circumstances shall be deemed to be in place, where significant cross-border financial market stress or a major regime shift can be observed that is likely to result in excessive AVA amounts, i.e. amounts of AVAs that are not reflective of the valuation risk associated with the valuation positions. In order to facilitate the identification of significant cross-border financial market stress and major regime shifts, the EBA considered two options:

Option 4a: Setting granular and quantitative criteria in the RTS that would automatically trigger the recognition of the significant cross-border financial market stress or major regime shift.

Option 4b: Setting more general criteria in the RTS that should be taken into account to recognize the significant cross-border financial market stress or major regime shift.

76. As in the case of the RTS on extraordinary circumstances for continuing the use of an internal model, granular and quantitative criteria that automatically trigger the recognition of the significant cross-border financial market stress or major regime shift would have the benefit of simplicity; the EBA, tasked with issuing an opinion, as well as any other interested party would only have to analyse the development of specified indicators, and without having to pay attention to the nature of the stress or regime shift, and without the need to identify and assess indicators and factors suitably reflecting the nature of the extraordinary circumstances. Such an 'automated' or 'quasi-automated approach' based on pre-identified indicators, such as volatility indicators, and pre-set thresholds would reduce the response time, once extraordinary circumstances manifest.

77. On the other hand, elements of a crisis leading to financial market stress, or of a regime shift, are unique to every such crisis or regime shift. As such, it is not possible to judge, ex ante, whether the circumstances will lead to excessive AVAs, and to specify a reliable and exhaustive list of suitable indicators or factors in the RTS, that adequately capture the nature and intensity of potential future financial market stress or regime shift. Establishing a meant-to-be exhaustive, but, considering real developments, possibly too narrow list of indicators and factors feeding into an automated mechanism may result in the extraordinary circumstances framework being triggered too frequently or prematurely, and may effectively undermine the existing prudential framework.

78. For these two reasons, it is not advisable to prescribe, which indicators or factors – and their levels – should serve as the basis for identifying a significant cross-border financial market stress

or major regime shift. More general, and therefore more flexible, criteria are deemed to be more fit for purpose.

79. As regards the cost of compliance with the provisions of the RTS, it is not expected that institutions would incur significant costs with regard to either option. Institutions do not need to monitor the developments themselves, as the application of the 'extraordinary circumstances'-derogations is dependent on an opinion by the EBA; and the implementation of the simple 'downscaling' of the aggregation factor is necessary in either case. The EBA has to invest a bigger effort to make a tailored analysis in order to recognise – or not – a significant cross-border financial market stress or major regime shift, when the RTS only stipulate more general criteria, compared to applying concrete, predefined granular and quantitative criteria. However, the costs are not deemed to be material in either case and are exceeded by the above-mentioned benefits.

80. On the basis of the above, Option 4b has been chosen as the preferred option and the Draft RTS will set more general criteria that should be taken into account to recognize the significant cross-border financial market stress or major regime shift.

5. Assessment of the impact of other policy proposals included in this consultation paper

81. The impact of all other proposals included in this consultation paper will be assessed as part of a quantitative impact study that is performed alongside the public consultation, including the following issues:

- Inclusion of back-to-back derivatives and SFTs in the calculation of the threshold,
- The revised scope, design, and calibration of the fall-back approach under the core approach,
- Impact of the new provisions for the treatment of valuation inputs consisting of a matrix of parameters (dimensionality reduction and variance ratio test)
- The impact of the clarification of the scope and of the specifications of the future administrative cost AVA,
- The impact of the clarification of the scope and of the specifications of the UCS AVA, including the two options for addressing a concentration of the portfolio on a low number of counterparties,
- The revised specification of the concentrated positions and operational risk AVAs,
- Impact of the reduced aggregation factor in case of missing IPV adjustments.

5.2 Overview of questions for consultation

Articles 1 – Calculation frequency of AVAs

Question 1. Are you able to calculate and report fair values and AVAs with a monthly frequency?

If not, please describe the challenges you face with regard to a monthly calculation, and the monthly reporting of fair values and AVAs (e.g. with the COREP templates). Please make clear if those challenges arise in general or with regard to specific positions (e.g. type of instruments), whether they arise for positions assigned to the trading or non-trading book, and whether they arise for positions treated under the simplified or core approach. Please describe any simplifications and/or assumptions you would have to apply to determine fair values and AVAs on a monthly basis.

Article 3– Data sources

Question 2. Do you have any comments on the amendments to Article 3 in general, and specifically with regard to the threshold of ten contributors set out in paragraph 2, point (d)? If you consider a different threshold should be applied, please describe how to set it, and provide a rationale and evidence supporting your proposal.

Article 3a – Data requirements

Question 3. Do you have any comments with regard to the requirements proposed in Article 3a? If you consider that some of those requirements should be adjusted, please describe how you would revise them in order to meet the policy objectives that the proposed amendments try to achieve, and provide the rationale supporting your proposal.

Article 4 – Threshold calculation

Question 4. Do you agree with the proposed amendment to capture valuation risks stemming from fair-valued back-to-back derivative transactions and SFTs? Do you agree that this would restore alignment with the treatment under the core approach? If not, please describe how you would suggest to revise the amendment providing any rationale and supporting evidence.

Article 7 – Fall-back approach

Question 5. Do you agree with the proposed amendments to the calibration of the fall-back approach? If you consider that a different range of percentages should be considered, or that the AVAs under the fall-back approach should be calculated in a different manner, please suggest a range or a methodology, as applicable, and provide a rationale and evidence supporting your proposal.

Question 6. Do you have any comments in relation to the positions proposed to be subject to the fall-back approach? If you consider a different treatment should be applied to these positions, please describe how you would treat them in order to meet the intended policy objectives, and provide the rationale and any evidence supporting your proposal.

Article 8 – General requirements for the calculation of AVAs under the core approach

Question 7. Are the requirements included in Article 8 clear? If you consider them to be not clear or to be particularly challenging to meet in specific circumstances, please describe the issue you encounter and how you would address it in order to meet the intended policy objectives, and provide the rationale and any evidence supporting your proposal.

Articles 9, 10, 11 – MPU, CoC and model risk AVAs

Question 8. Do you have any comments with regard to the amendments to Article 9, 10 and 11? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

Article 12 – UCS AVAs

Question 9. Do you have any comments with regard to the amendments to Article 12? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

Articles 14 and 15 – Concentrated positions AVAs and FAC AVAs

Question 10. Do you have any comments with regard to the amendments to Article 14 and 15? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.

Articles 19a and 19b – Framework for extraordinary circumstances

Question 11. Do you agree with the requirements set out in Article 19a and Article 19b? If you do not agree, please describe how you would suggest to revise those Articles and address the mandate on extraordinary circumstances outlined in Article 34 CRR. When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.

Annex – Aggregation factor for UCS AVAs

Question 12. Which of the two options presented do you consider more appropriate for the purposes of addressing concentration of UCS AVAs? When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.