EBA/RTS/2020/04

22/04/2020

EBA FINAL draft Regulatory Technical Standards

On prudent valuation under Article 105(14) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)

Contents

1. Executive summary

The EBA published on 31 March 2014[1] its final draft regulatory technical standards (RTS) laying out requirements for the prudent valuation of fair-valued financial instruments under Article 105(14). Delegated Regulation (EU) No 101/2016 of 26 October 2015 was published on 28 January 2016 in the *Official Journal of the European Union*. Additional valuation adjustments (AVAs) are designed to ensure that institutions prudently value their fair-valued financial instruments. 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.

The expansion of the COVID-19 pandemic in the EU and across the globe has triggered levels of extreme volatility throughout financial markets affecting multiple asset classes, which has generated exceptional increases in asset price dispersion and bid–offer spreads, affecting exit costs. Prudent valuation being a point-in-time, forward-looking framework, an increase or decrease in market volatility can be expected to directly affect the computed AVAs. Although AVAs should, in general, mechanically adjust to fluctuating market conditions, the recent COVID-19 outbreaks and the subsequent decisions by public authorities, in the EU and across the globe, to halt large parts of economic activity in their efforts to curb the development of the pandemic have triggered an unprecedented systemic shock and extreme levels of volatility, which have had an excessive impact on aggregated AVAs.

Institutions using the core approach compute, for market price uncertainty, close-out costs and model risk category-level AVAs, individual AVAs for separate valuation exposures, which are then aggregated to provide total category-level AVAs using the formulae in the Annex to the Delegated Regulation. A higher value aggregation factor should be made available for the present period of extreme volatility in market prices and unprecedented systemic impact to mitigate the excessive procyclicality in such circumstances. This provision should be of a transitional nature and apply until 31 December 2020.

Based on first estimations and having regard to the expected impact of the increase in volatility and market dislocation, a value of 66% of the aggregation factor is calibrated to mitigate the excessive procyclical effect of the current prudent valuation aggregation part of the framework. While using the 66% aggregation factor, institutions are required to continue computing AVAs in accordance with the requirements included in the Delegated Regulation and with the principles prevailing before the crisis.

Finally, to ensure a more timely response in exceptional circumstances, the EBA also recommends to the European Commission that, similar to the powers granted in exceptional circumstances in Article 325az(5) of the Capital Requirements Regulation (CRR), a mandate for the EBA to specify the provisions to be applicable for prudent valuation purposes under exceptional circumstances should be included in future revisions to Article 105(14) of the CRR, so that a robust approach can be developed more generally to deal with situations involving market disruptions of a similar nature.

---

[1] Updated on 23 January 2015.

2. Background and rationale

Background

The EBA published on 31 March 2014[2] its final draft RTS laying out requirements for the prudent valuation of fair-valued financial instruments under Article 105(14). Delegated Regulation (EU) No 101/2016 of 26 October 2015 was published on 28 January 2016 in the *Official Journal of the European Union*. The framework was complemented with common reporting (COREP) supervisory reporting templates (reporting framework v2.8), which were published in November 2018 in the *Official Journal of the European Union* and first applied by institutions for the reporting of 31 December 2018 data.

AVAs are designed to ensure that institutions prudently value their fair-valued financial instruments, regardless of whether those instruments are included in the trading book or the non-trading book. The prudent value is the value at which institutions are 90% confident (Article 8(2) of the Delegated Regulation) that they will exit a position based on the applicable market conditions at the time of the assessment (recital 5 of the Delegated Regulation).

Delegated Regulation (EU) No 101/2016 of 26 October 2015 specifies how individual and total aggregated AVAs should be computed. Two approaches are available:

- a core approach;
- a simplified approach.

In line with Article 4 of the Delegated Regulation, the simplified approach is available only to institutions for which the sum of the absolute value of fair-valued assets and liabilities is less than EUR 15 billion and which are not part of the consolidation of a group that exceeds that threshold on a consolidated basis. Other institutions are required to calculate AVAs based on the core approach.

Institutions' total AVAs are deducted from Common Equity Tier 1 in accordance with Article 34 of the CRR.

Recent COVID-19 outbreak

The expansion of the COVID-19 pandemic in the EU and across the globe has triggered levels of extreme volatility throughout financial markets affecting multiple asset classes, which has generated exceptional increases in asset price dispersion and bid–offer spreads, affecting exit costs.

Prudent valuation being a point-in-time, forward-looking framework, whereby the capacity to exit a position is assessed with a 90% target level of certainty based on the applicable market conditions at

[2] Updated on 23 January 2015.

the time of the assessment, an increase or decrease in market volatility can be expected to directly affect the computed AVAs.

The cyclicality of the framework results from the natural adjustment – upwards or downwards – to the new applicable market conditions in line with the valuation uncertainty observed at that time. Although AVAs should, in general, mechanically adjust to the fluctuating market conditions, the recent COVID-19 outbreaks and the subsequent decisions by public authorities, in the EU and across the globe, to halt large parts of economic activity in their efforts to curb the development of the pandemic have triggered an unprecedented systemic shock and extreme levels of volatility, which have had an excessive impact on aggregated AVAs.

It should be noted that the two approaches are not equally affected by changes in market conditions. Under the simplified approach, total AVAs being equal to 0.1% of the sum of the absolute value of fair-valued assets and liabilities, the ratio of total AVAs to fair value will remain constant, whereas, because of the particular features of the core approach, that ratio is expected to exhibit different behaviour under that approach, considering, in particular, the fact that for AVAs for market price uncertainty, close-out costs and model risk individual AVAs are computed for separate valuation exposures and then aggregated using the formulae in the Annex to the Delegated Regulation.

Proposed amendment

The aggregation formulae included in the Annex to the Delegated Regulation rely on a simple summation of individual AVAs after the application of an aggregation factor set at 50%. This factor was introduced in recognition of expected overlaps in the measurement of individual valuation uncertainties that AVAs aim to make when aggregating individual AVAs at overall institution level.

While the value of 50% should carry on being used in most periods – whether quiet or volatile – a higher value aggregation factor should be made available for the present period of extreme volatility in market prices combined with a systemic shock, considering its excessive procyclical impact, to mitigate the increase in aggregated AVAs at institution level. As the extreme volatility due to the COVID-19 pandemic is expected to subside as the pandemic subsides, this provision should be of a transitional nature and apply until 31 December 2020 inclusive.

As the aggregation factor (alpha) applies to the three main category AVAs only, i.e. AVAs for market price uncertainty, close-out costs and model risk, it will not affect other AVAs (e.g. concentrated position AVAs), which are also expected to increase.

Based on initial estimations of the expected impact due to the increase in volatility and market dislocation, the value of 66% of the aggregation factor is calibrated to partially mitigate by 20–30% the excessive procyclical effect of the current prudent valuation framework.

While using the 66% aggregation factor, institutions are required to continue computing AVAs in accordance with the requirements included in Delegated Regulation (EU) 101/2016 and with the principles prevailing before the crisis:

- exit valuation exposures with a target level of certainty of 90%;

- use the market conditions applicable at the relevant reporting dates (31 March 2020, 30 June 2020, 30 September 2020), as prudent valuation is a point-in-time, forward-looking framework;

- expert-based approaches should use the qualitative and quantitative information available to achieve the same level of certainty in the prudent value as in cases in which sufficient data exist to construct a range of plausible values, as referred to in Articles 9(5)(b), 10(6)(b) and 11(4), and competent authorities should be notified of the valuation exposures to which those approaches are applied and the methodology used to determine AVAs.

In particular, competent authorities are invited to set backstops and closely monitor the development of category-level AVAs before and after diversification (i.e. before and after the application of the aggregation factor), as provided for under COREP, and also to assess the effect of the increase in the aggregation factor to 66% on the computation of all category AVAs over the whole period for which the increased aggregation factor is applied to avoid any regulatory arbitrage.

Exceptional circumstances

To ensure a more timely response in exceptional circumstances, the EBA also recommends to the European Commission that, similar to the powers granted in exceptional circumstances in Article 325az(5) of the CRR, a mandate for the EBA to specify the provisions to be applicable for prudent valuation purposes under exceptional circumstances should be included in future revisions to Article 105(14) of the CRR, so that a robust approach can be developed more generally to deal with situations involving market disruptions.

3. FINAL regulatory technical standards on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013 (Capital Requirements Regulation)

EUROPEAN
COMMISSION

Brussels, XXX
[…](2020) 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 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012,[3] and in particular the third subparagraph of Article 105(14) thereof,

Whereas:

(1) The expansion of the COVID-19 pandemic in the Union and across the globe has triggered levels of extreme volatility throughout financial markets affecting multiple asset classes, which has generated exceptional increases in asset price dispersion and bid–offer spreads. Delegated Regulation (EU) No 101/2016 which specifies how institutions should calculate additional valuation adjustments (‘AVAs’), provides in its Article 8(2) that valuation uncertainties are to be determined with reference to a 90% level of certainty based on the applicable market conditions at the time of the calculation. As a result of this and in light of the systemic shock caused by the COVID-19 pandemic and the decisions by public authorities, in the Union and across the globe, to halt large parts of economic activity in their efforts to curb the evolution of the pandemic, individual AVAs computed at the level of valuation exposures are expected to significantly increase in comparison with their levels in normal times. Further, Delegated Regulation (EU) No 101/2016, with regard to institutions that calculate AVAs under the core approach set out in that Regulation, specifies an aggregation approach for the calculation of the total category level AVAs for market price uncertainty, close-out costs and model risk, which takes account of overlaps among individual AVAs that occur in the aggregation of those categories of AVAs. Although the adjustment of individual AVAs to new market conditions is a normal process, the aggregation of significantly increased individual AVAs is expected, in the present circumstances, to have an excessive impact on aggregated AVA amounts. As a result of the COVID-19 pandemic, it has become clear that rules for prudent valuation should be revised so that, besides providing for an aggregation factor to be used under normal market conditions, set at 50% (which was already provided for in the formulae contained in the Annex to Delegated Regulation (EU) No 101/2016), they also provide that institutions should apply a higher aggregation factor for this specific period of extreme volatility in market prices and systemic shock due to the COVID-19 pandemic.

(2) Further, as it is expected that such extreme market volatility due to the COVID-19 pandemic will subside with the subsiding of the pandemic within the next months, such provision should be of a transitional nature and apply for the currently expected duration of that extreme market volatility combined with systemic shock.

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

[3] OJ L 176, 27.6.2013, p. 1.

(4) Due to the urgency in the treatment of AVAs during this period of extreme volatility caused by the unprecedented difficulties of the COVID-19 pandemic, which requires the speedy update of the rules to provide comfort to the institutions potentially affected by the crisis in their calculation of AVAs, the EBA decided not to carry out public consultations or cost–benefit analysis. Further, since action must be taken urgently in accordance with the above and consultation was impossible, the EBA informed the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010.[4]

(5) Due to the urgency in the matter as explained in the preceding recitals and given the lengthier procedures involved in the adoption of delegated regulations, especially where they are based on draft technical standards submitted by European Supervisory Authorities, this Regulation should enter into force on the day following that of its publication.

(6) Delegated Regulation (EU) No 101/2016 should therefore be amended accordingly,

HAS ADOPTED THIS REGULATION:

Article 1

Amendments to Delegated Regulation (EU) No 101/2016

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

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

Article 2

From the date of entry into force of this Regulation until 31 December 2020, the aggregation factor α referred to in the Annex to this Regulation shall be set to 66%.

Article 3

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

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

[4] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2020, p. 12).

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 Articles 9(6), 10(7) and 11(7)

Method 1

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

Method 2

$$APVA = \max\{0, (FV - PV) - \alpha \cdot (EV - PV)\}$$
$$= \max\{0, FV - \alpha \cdot EV - (1 - \alpha) \cdot PV\}$$
$$AVA = \Sigma\, APVA$$

Where:

FV = The valuation exposure-level fair value after any accounting adjustment applied in the institution’s fair value that can be identified as addressing the same source of valuation uncertainty as the relevant AVA,

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

EV = The expected value at a valuation exposure level taken from a range of possible values,

α = The aggregation factor, which shall be set to 50%,

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

AVA = The total category-level AVA after adjusting for aggregation.’