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European Banking Authority
Tower 42 (level 18)
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By email

7 October 2013

Dear Sirs,

Draft Regulatory Technical Standards on prudent valuation under Article 105(14) of Capital Requirements Regulation (EU) 575/2013

About the IVSC

1. The IVSC is an independent, not-for-profit, private sector organisation formed with the objective of strengthening worldwide valuation practice in the public interest. It achieves this objective by:

   - Developing high quality international standards and supporting their adoption and use;
   - Facilitating collaboration and cooperation among its member organisations;
   - Collaborating and cooperating with other international organisations; and
   - Serving as the international voice for the valuation profession.

2. The membership of the IVSC comprises nearly sixty professional valuation bodies from fifty countries. The IVSC also receives financial and logistical support from a number of the global valuation firms and banks. Members of our member bodies and supporting firms undertake valuations of all types of assets and liabilities, including derivatives and other types of financial instrument for a wide range of purposes.

3. As the global valuation standard setter the IVSC's comments on the EBA's proposals are limited to those concerning valuation procedures and definitions. We have no remit or capacity to comment on how valuations may need to be adjusted once they have been prepared in order to meet regulatory objectives for ensuring an institutions' capital adequacy.

4. The IVSC considers that it is in the public interest that references to valuation in EU Regulations and any Regulatory Technical Standards (RTS) produced in support of them are consistent with established valuation practice and terminology in the International Valuation Standards and other literature such as the International Financial Reporting Standards. This will avoid confusion and enable entities and others applying the regulations to relate them to generally accepted valuation principles.

General Comments

5. Our first comment does not relate to the proposed RTS CP but to the draft CRR, which contains a potential contradiction. Article 34 of the CRR requires the provisions of Article 105 to be applied to **all assets** measured at fair value. Article 105 states that all "trading book" positions shall be subject to the specified standards for prudent valuation. In the CRR a "trading book" is defined as all positions

in financial instruments and commodities held by an institution. However, since an institution can have assets other than financial instruments that are measured at fair value, Article 34 seems to suggest that Article 105 and the RTS can be or are intended to be applied to these assets as well. We assume that the intention is for the RTS to only apply to financial instruments held in an institution's trading book but this should be made clear.

6. Articles 8-16 of the RTS CP introduce and discuss various different categories of Additional Valuation Adjustments (AVAs). However, since earlier reference is made in the paper to some of these categories it would help understanding if cross references to the relevant explanatory information were included, or if it were mentioned in the preamble or Article 1 that there are multiple types of AVA that are discussed in in the RTSs.

Specific Comments

7. We note that the initials "FVA" are used in the "Executive Summary" on p4 as an abbreviation for "Fair Value Adjustment". This may cause confusion as the term "FVA" is regularly used to in the banking industry to represent "Funding Valuation Adjustment". This term is not used in the proposed RTS proper and should not be introduced in any summary. Moreover, the term is used only once so does not require abbreviating. However, more fundamentally the whole of the first bullet summarising the core approach is poorly phrased. There are better ways of describing the requirement to consider each of the possible sources of uncertainty identified and then making an AVA where this uncertainty is not already reflected in the reported fair value.

8. We believe that the preamble on p11-12 is very poorly written and should be improved. The language used is not sufficiently clear or consistent with industry and recognised accounting terminology. For example point (1) states that AVAs should be calculated as the difference between the prudent and fair value. This is illogical, as the prudent value is the result of the AVA not an input into its calculation. A better wording would be: *"The prudent value of a valuation position is equal to its fair value, less any additional valuation adjustments (AVAs). As such, the prudent value can be equal to or lower than its fair value, but never greater. The aggregate amount of those AVAs should be deducted from Common Equity Tier 1 capital".*

9. Point (6) states that *"Since institutions with small fair value portfolios will typically be subject to limited valuation uncertainty, they should be permitted to apply a simpler approach to estimate AVAs than those ins(t)itutions with larger fair value portfolios."* We take no issue with having a core and simplified approach, as this is the EBA's prerogative; however we would argue that the first half of the sentence is incorrect. Valuation uncertainty is not a factor of the size of a portfolio. For example a large portfolio of blue-chip exchange traded shares will have a small degree of valuation uncertainty, whereas a smaller portfolio of privately held shares may have both a larger absolute and relative degree of valuation uncertainty.

10. Whilst we have provided two examples above of imprecise wording, we recommend that the structure and language of the entire preamble be revisited.

11. We also believe that the proposed RTS could be improved by either including or cross referencing the IFRS definition of Fair Value. Whilst we appreciate that not all of the EBA's constituents will report under IFRS, it will be the most commonly used accounting standard. IFRS 13 *Fair Value Measurements* was introduced after many years deliberation. It is also consistent with its equivalent

under US GAAP. We believe that it would help consistent application of the RTSs if there was also consistency in the calculation of fair value and that firms should be encouraged to use IFRS 13 as a benchmark unless they are reporting under alternative accounting standards that have alternative requirements for measuring fair value.

12. The CP uses the terms “exit price” and “tradable price” in various places. We note that the EBA’s FAQs on its website indicates that these terms are assumed to be the same. However these terms are not interchangeable. In IFRS 13 “exit price” is used to emphasise that the entity preparing the accounts is assumed to be selling (exiting) a position. However, the phrase has no bearing on the price that would be agreed in the assumed transaction, which can equally be termed an “entry price” if viewed from the buyer’s perspective. Exit price simply confirms that there is deemed a sale of a position, as opposed to “tradable price” which relates to the price itself. We therefore recommend that the EBA only use “tradable price”, as this is the most appropriate term to describe the value required and will reduce potential misinterpretation of the RTS.

13. We were pleased to see recognition of the difference between valuation parameters and inputs on p14, we believe it is important that the distinction between the two is made and understood.

14. We have also provided answers to the following questions:

Q1. Do you agree with the minimum list of alternative methods and sources of information defined above for expert based approaches? If not, what others could be included, or which points from the current list should be removed? State your reasons.

Response: We do not have any objections with the list itself; however Article 3, paragraph 2 currently states “The market data used to determine a prudent value shall include a full range of available and reliable data sources including **all** of the following.” We do not believe that it is necessary to utilise the full range of data sources in all cases. For example, when valuing an asset with exchange prices in a liquid market, the inclusion of a less liquid measure such as indicative broker quotes will not necessarily improve the accuracy of said valuation, in fact it could be argued this may lower the usefulness of the result. We would suggest that the word “all” be removed and that the list be presented as an example of sources that can be used. It will then be up to the entity to choose the most appropriate sources in a “waterfall” process from most reliable and liquid to the least.

Q4. Do you agree with the proposed simplified approach? Do you think the risk sensitiveness of the approach is appropriate? Are there alternative approaches that you believe would be more appropriate? State your reasons.

Response: Article 5, part (a) proposes that under the simplified approach you must sum all unrealised gains and losses and net them against one another. If the bank has a net unrealised profit then an AVA of 25% is charged on this amount and if the bank has a net unrealised loss then an AVA of 0% is charged. Although it is for the EBA to determine how banks should calculate required levels of capital, we would like to point out that unrealised gains and losses are not signs of valuation uncertainty in themselves. Such a method does not appear to us to be based on sound valuation principles, but rather on a need for simplicity and expediency. If an alternative approach is considered we would suggest that the EBA base this upon a more robust valuation method.

Q12. Do you agree with the requirement for institutions using the core approach to implement the above ongoing monitoring tool as an indicator of the adequacy of data sources of valuation inputs used to calculate the AVAs described in Articles 8 to 10? If not, what other approach could be prescribed? State your reasons.

Response: We do not agree with this in principle. It is not necessary for entities to track the "performance" of valuation inputs over time because a valuation is a point estimate that should have no bearing on valuations undertaken at different times. The suitability of a valuation input is not determined by its reliability in predicting future values, but rather by its appropriateness relative to other inputs at the relevant valuation date.

Yours faithfully,

C G Thorne
Technical Director
International Valuation Standards Council