European Banking Authority

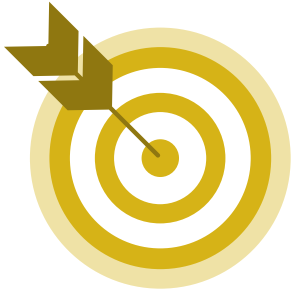
Public hearing on amendments to the RTS on Prudent Valuation

Virtual meeting, 4 March 2024, 14:00-16:00

EBA Roadmap on market risk mandates under CRR3/CRD6 (link)

Priorities	EBA regulatory products	Reference	Deadline	Status
Phase 1: Mandates with a deadline of up to one year after the entry into force of the banking package.	RTS on conditions to determine that an instrument is a hedging position	Art. 325u(6) CRR3	0 months a.e.i.f.	Under consultation
	RTS on extraordinary circumstances for FRTB-IMA	Art. 325az(9) CRR3	0 months a.e.i.f.	Finalisation
	RTS on the specification of long and short positions	Art. 94(10) CRR3	12 months a.e.i.f.	
	RTS on supervisory delta for commodity prices	Art. 279a(3)(a) CRR3	12 months a.e.i.f.	Under consultation
	RTS on FX and commodity risk in the banking book	Art. 325(9) CRR3	12 months a.e.i.f.	Under consultation
	RTS on risk factor modellability	Art. 325be(3) CRR3	12 months a.e.i.f.	Under consultation
	RTS on profit and loss attribution	Art. 325bg(4) CRR3	12 months a.e.i.f.	Under consultation
	RTS on crypto	Art. 501d(5)(sub1) CRR3	12 months a.e.i.f.	
Phase 2: Mandates with a deadline up to two years after entry into force of the banking package.	RTS on data inputs	Art. 325bc(6) CRR3	18 months a.e.i.f.	
	RTS on structural FX	Art. 104c(4) CRR3	24 months a.e.i.f.	
	RTS on conditions for not counting overshootings	Art. 325bf(10) CRR3	24 months a.e.i.f.	
	RTS on extraordinary circumstances for prudent valuation	**Art. 34(4) CRR3**	**24 months a.e.i.f.**	**Under consultation**
	RTS on CVA risk of SFTs	Art. 382(6) CRR3	24 months a.e.i.f.	
Phase 3: Mandates with a deadline up to three years after the entry into force of the banking package.	RTS on the hypothetical portfolios of CIUs in the trading book	Art. 325j(7) CRR3	30 months a.e.i.f.	
	Report on haircut floors for SFTs	Art. 519d CRR3	30 months a.e.i.f.	
	RTS on net short credit and equity positions	Art. 104(8) CRR3	36 months a.e.i.f.	
	Guidelines on exceptional circumstances for the reclassification of a position	Art. 104a(1) CRR3	36 months a.e.i.f.	
	RTS on proxy spread	Art. 383a(3)(a) CRR3	36 months a.e.i.f.	
	RTS on further technical elements for regulatory CVA	Art. 383a(3)(b) CRR3	36 months a.e.i.f.	
	RTS on instruments appropriate to estimating PDs	Art. 383a(3)(c) CRR3	36 months a.e.i.f.	
Phase 4: Mandates with a deadline of more than three years after the entry into force of the banking package.	RTS on assessment methodology for the FRTB-SA	Art. 325c(5b) CRR3	48 months a.e.i.f.	
	RTS on the materiality of extensions and changes for the SA-CVA	Art. 383a(5)(a) CRR3	48 months a.e.i.f.	
	RTS on assessment methodology for the SA-CVA	Art. 383a(5)(b) CRR3	48 months a.e.i.f.	
	Report on the exemption from residual risks for hedging positions	Art. 325u(7) CRR3	66 months a.e.i.f.	
	Guidelines on excessive CVA risk	Art. 104(3) CRD6	No deadline	
	RTS on the definition of material exposures to default risk and thresholds for material counterparties and positions in traded debt or equity instruments	Art. 77(4) CRD6	No deadline	

Objectives



‘Extraordinary circumstances’

Article 34 CRR3
Framework for the identification of extraordinary cirumstances and the application of the PruVal rules in those circumstances

Promote best practices

Revise the rules to harmonise application of the RTS, promote best practices and level the playing field

Consultation accompanied by a

Quantitative Impact Study (QIS)

to **assess the impact** of some of the policy proposals included in the consultation paper

and

to **calibrate certain elements** of the proposal

Overview: Amendments by type of entity affected

Institutions applying the simplified approach	Institutions applying the core approach
	'Extraordinary circumstances' framework
Revised threshold/measurement basis	*Revised threshold/measurement basis*
Calculation frequency	Calculation frequency
	Changes to the core approach
(Reflecting ESG in PruVal)	(Reflecting ESG in PruVal)

No specific/dedicated rules introduced

The ‘extraordinary circumstances’-framework

Identification of extraordinary circumstances

Align to the extent possible/meaningful with principles laid out in RTS on ‘extraordinary circumstances for continuing the use of an internal model’

- **Cross-border financial market stress** or **major regime shift**
- Factors to be assessed:
  - Relative/absolute shifts in levels of volatility indicators,
  - market liquidity,
  - other indicators reflective of the nature of the stress

AVA calculation in extraordinary circumstances

Simplified approach

No change. Same calculation as in ordinary circumstances

Core approach

Increased ‘diversification’ alpha for aggregation of MPU/CoC/model risk AVAs

- 0.33 instead of 0
- 0.66 instead of 0.5

Calculation frequency

Issue identified

- **Intra-quarter volatility** of AVAs and possible window-dressing
- Insufficient awareness of valuation risks between AVA calculation/reporting

Measures to address the issue

- No general increase in calculation frequency, but…
- … Competent authority (CA) **may impose monthly frequency for the calculation** of the AVAs

‘calculate’ ≠ ‘report’, but CA may also request monthly reporting (based on CRD)

Revised threshold for choice between approaches and measurement basis for simplified approach

Issue identified

- (Exactly matching) **back-to-back derivatives and securities financing transactions** are free from valuation uncertainty arising from market risks…
- … but **not from valuation uncertainties arising from counterparty credit / CVA risk**
- Misalignment between simplified approach and core approach

Measures to address the issue

Inclusion of both parts of the back-to-back transaction into the threshold calculation and therefore also into the **AVA under the simplified** approach.

Accompanying QIS aims to understand

- If/how many institutions migrate from simplified to core approach
- how AVAs under the simplified approach change

Core approach:
Data sources and data recency requirements, model calibration

Issue identified		Measures to address the issue
Certain data sources were **observed to be less accurate and reliable**	➡	**Revised hierarchy of data sources**
AVAs cannot reflect point-in-time, forward-looking valuation, if calculated based on **historical data**	➡	Range-based approach: AVA calculated based on **data reflecting market conditions at reference date** (or <1m before ref. date with adjustm./corrections)
Excessive use of the expert-based approach, where range-based approach could be used	➡	Need to prove that accurate, sufficient and reliable data **could not be obtained with reasonable effort**
Aim to ensure consistency between valuation for financial statements and for prudential purposes	➡	More **qualitative requirements for calibration** of valuation models

QIS aims to understand drivers behind ‘migration’ of valuation exposures from range-based to expert-based approaches and possibly change in AVAs because of the new requirements

Core approach (MPU and CoC AVAs): Dimensionality reduction and variance ratio test

Issue identified

- **Aggressive assumptions for reducing the number of parameters** in a valuation input consisting of a matrix of parameters lead to **underestimation of AVAs**
- Aggressive assumptions e.g. for mapping of valuation exposures associated with dropped parameters to remaining parameters

QIS aims to understand if the scope of valuation inputs where the institution makes use of the dimensionality reduction changes, and how that affects the AVAs overall.

Measures to address the issue

- More **stringent qualitative conditions** for application of dimensionality reduction
- **'diversification alpha' of zero**, if institution applies dimensionality reduction
  ('hedging' / 'diversification' benefit already recognised in dimensionality reduction)
- Dimensionality reduction **not available for parameters** the value of which is derived from **less reliable data sources or extrapolated**

Core approach (MPU and CoC AVAs): Methods for aggregating individual AVAs

Issue identified

- Unclear/non-harmonised understanding of ‘expected value’ (Method 2)
- Inability to prove that fair value is more prudent than prudent value (Method 2)
- Parallel use of both methods by one and the same entity implies ‘cherry picking’
- Overall very little use of method 2 in the EU

Measures to address the issue

- **Drop aggregation method 2**

Core approach (UCS component of MPU, CoC, model risk AVAs): UCS AVA and concentrated portfolios

Issue identified

- Diverging practices and interpretations regarding the **scope and purpose/calculation of the UCS AVA**
- **Concentration of portfolio on certain counter-parties** implies material dependence of the AVA on credit quality of those counterparties

QIS aims to understand how the change and clarification of the scope, purpose and calculation of the UCS AVA changes the AVAs, and to decide between options 1 and 2

Measures to address the issue

- **Expansion of the scope** to fair-valued securities financing transactions and introduction of **floor for margin period of risk** (alignment with CVA)
- **Disallowing the use of the 'diversification' alpha for aggregating AVAs in case of concentrated portfolios** (Option 1) or for the five biggest counterparties (Option 2)

Spotlight: Identification of concentrated portfolios in the context of the UCS AVA

Option 1

Portfolio is deemed to be concentrated (on non-EU counterp.) if

$$\frac{\text{UCS AVA}_i}{\sum_{i=1}^{N} \text{UCS AVA}_i} \geq 10\%$$

for at least one counterparty i.

Portfolio **concentrated**
→ MPU, CoC, model risk components of UCS AVAs
for **every counterparty** to be **aggregated using α = 0**

Portfolio **not concentrated**
→ MPU, CoC, model risk components of UCS AVAs
for **every counterparty** to be **aggregated using α = 0.5**

Option 2

- MPU, CoC, model risk component of UCS AVAs for valuation exposures to the **five biggest counter-parties** are **to be aggregated using α = 0**
- MPU, CoC, model risk component of UCS AVAs for valuation exposures to **any other counterparty** are **to be aggregated using α = 0.5** (unless ‘diversi-fication alpha’ disallowed for other reasons)
- Five biggest counterparties identified based on the overall UCS AVA (UCS AVA_i = sum of MPU, CoC, model risk component)

Option 1 addresses the identified policy issue more accurately than option 2, but it also entails a **potentially significant cliff effect,** in case a portfolio becomes/stops to be concentrated.

Core approach: Fair value adjustments and adjustments for independent price verification (IPV)

Issue identified

- Unlevel playing field
  - Some entities do not adjust the fair value of their positions in response to the results of the **IPV process**
  - Entities that make **more (eligible) fair value adjust-ments** (FV adj.) for accounting purposes are **currently subject to a more conservative treatment** than entities that do not (or make less eligible FV adj.)

→ AVA not sufficient to bridge the gap between the fair value and the (prudent) value determined at 90% level of confidence

Measures to address the issue

- Valuation exposure moved under **fall-back appr., if IPV adj. cannot be determined**
- If IPV adj. can be determined, but no adj. is made: Part corresponding to **IPV difference aggregated using 'diversification' alpha = 0**
- AVAs for valuation exposures with **no / too low eligible FV adj.** compared to market standard (to be determined by supervisor) **aggregated using 'diversification' alpha = 0**

QIS aims to understand the impact of the two new provisions on the treatment of valuation exposures with(out) IPV adjustments

Core approach:
Future administrative cost AVA (FAC AVA)

Issue identified

- Variability of institutions' practices regarding the **trigger for (not) calculating a FAC AVA**

QIS aims to understand the impact of the revised provisions on scope/purpose of the AVA, including the (stricter) requirements for deeming the FAC AVA to be zero.

Measures to address the issue

Clarification that FAC AVA needs to be calculated (in addition to MPU / CoC AVAs), if

- MPU, CoC and concentration position AVAs together **do not reliably ensure that the institution fully exits the valuation exposures**,
- the valuation exposures **cannot be mapped to tradable instr.**,
- the valuation exposures require **dynamic re-hedging activities**

and/or

- there are **obstacles to exiting the valuation exposure**

Core approach: Concentrated positions AVA, operational risk AVA

Issue identified	Measures to address the issue
Concentrated positions AVA	*Concentrated positions AVA*
▪ CRR3 change: Liquidity horizon dependent on asset class instead of current assumption of 10 days	▪ Assessment **whether prudent exit period exceeds liquidity horizon specified in the CRR3** required
Operational risk AVA	*Operational risk AVA*
▪ CRR3 change: Removal of advanced measurement approach	▪ Simple calculation of the **opRisk AVA as 5% of the sum of the total MPU and CoC AVAs**

The QIS captures the impact of the new provisions for the concentrated positions and opRisk AVAs as part of the ‘overall impact’ panel.

Core approach:
Scope and calibration of the fall-back approach

Issue identified

- **conservative calibration**
  → significant **cliff-effects** when valuation exposure previously treated under range-/expert-based approaches (has to) move under fall-back approach
- **Valuation** of unlisted equities and valuation exposures where IPV adjustments cannot be determined **cannot be corroborated with any observable market data**

Measures to address the issue

- **Unlisted equities and valuation exposures where IPV adjustments cannot be determined** by default in scope of fall-back approach
- Revised **(simpler) measurement basis** for calculating the AVA and **revised calibration**

QIS aims to understand the impact of the changed scope and assesses different scenarios for the percentage to be applied to calculate the AVA under the fall-back approach.

Thank you!

Please remember to provide

your written response

to the public consultation by submitting it via the

EBA consultation paper page.

Deadline: **16 April 2024**

The final proposal for the amending RTS
will also take the results of the quantitative impact study into account and will be published at the earliest in Q4 2024.

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