<u>Article 1 – Calculation frequency of AVAs</u>

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.

Further clarity around exact expectations is required. Calculations can only be run at monthly frequency with significant further investment which appears unwarranted. While comprehensive valuation exposures for positions are produced monthly for the trading book and quarterly for the banking book, other critical elements, such as the fuller market data set required to derive percentile values, and all subsequent calculations, are not available. Significant efforts and cost would be required to do this. The relative stability of the numbers over time (excluding the COVID period addressed through amended Article 19) means that the marginal impact on CET1 moves seen because of monthly movements in the Prudent Valuation capital deduct is minor relative to typical headroom on capital adequacy thresholds. Consequently, we do not see that this matter should be prioritised relative to other topics raised here.

Furthermore, the arguments of window dressing that was brought up by ECB inspector during the public hearing is not a subject creating an important concern with regards to Prudent Valuation which aims at covering valuation uncertainty risk. Position that can be easily closed are not an area of risk for valuation uncertainty.

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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.

We find the more structured approach to defining a hierarchy of market data sources as generally a positive development. Certain further changes are required how to ensure appropriateness of usage of market data.

Paragraph 2

The introduction of a binary threshold on point (d) of this paragraph can have unintended consequences and increase volatility of reported AVAs, without a corroborated link to valuation uncertainty.

Consensus services are useful tools for independent valuation control functions to gauge market activity and derive valuation ranges, including the 10th and 90th percentile necessary to adhere to the requirements of the CRR and the RTS. The number of contributors to the service does not, necessarily, have a direct link with the activity in the market or the reliability of the market data. A threshold of ten contributors is proposed, which appears arbitrarily selected. This could have several inadvertent and inappropriate side-effects, for example:

- *An incentive could exist for consensus providers to pursue and increase the number of contributors in a service irrespective of the level of underlying market activity and with no resultant improvement in reliability, and such behaviour could potentially undermine overall quality via the introduction of unreliable data into a previously reliable data set.*
- *Consensus services which are reliable, however have less than ten contributors due to the specifics of a particular financial product or related reference markets, would be classified as expert based with a potentially significant increase in AVAs. However this would not be reflective of underlying valuation uncertainty and could result in AVA outcomes beyond the level of confidence targeted by regulation.*

Therefore, we consider that the proposed requirement for a minimum of ten contributors should be removed.

We also note that tradable vs indicative brokers' quotes are not defined systematically in chats. Therefore, we recommend that in Article 3 the word "indicative" is replaced with "non-tradable".

Furthermore, in addition to overall concerns regarding the potential impact of the proposed regulation reducing the competitiveness of European banks, we consider that Article 3 may also have this effect in smaller markets.

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.

The data used to construct the range should be reliable, relevant and sufficient to reflect the market condition as at reporting date. We consider that this is the objective of Article 3, however certain arbitrary but impactful conditions around this have been introduced without specific justification.

In particular, the introduction of a one month cut off irrespective of the relevance to the current market condition, will eliminate relevant data required to achieve sufficiency of data for many calculations with less liquid exposures.

We believe that such a restriction overweighting the timeliness of the data will, in particular, undermine the use of certain techniques involving highest quality traded data and increase the emphasis on usage of non-binding consensus data. In our view, this would not be aligned with the regulatory objectives.

Whereas we do not support any arbitrary cut-off, in the event that one is required, we consider that three months is more appropriate to strike an appropriate balance between sufficiency and relevance. In general, the requirement should be to use as fresh data as possible and reflecting the current state of the market, but without introducing hard limit on the way to obtain them as proposed in the consultation.

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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.

Concur, no comment proposed.

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.

We concur that the current fallback approach is inappropriate and limited in usage, so we welcome the attempt to address this. However, we find any approach which applies an instrument based notional based fallback approach for derivatives inappropriate, regardless of the exact value of the shock.

The proposed approach has fundamental consequences on derivative trading as it does not reflect the risk driving the valuation uncertainty.

Also, and of critical importance, under FRTB SA, the SbM risk of these derivatives subject to RRAO is not stripped out and segregated from the portfolio as the hedging practices are appropriately recognised. In contrast, the fallback proposal stipulates an instrument-based charge. This effectively means that the underlying risks of these positions ought to be segregated from the rest of the portfolio, leading to additional MPU/CoC charges on the remaining portfolio based on a hypothetical unhedged risk approach, which is not commensurate with economic reality or the underlying valuation risk.

The fundamental challenges with the calculation are compounded by the proposed significant increase in scope of application. The proposed text scopes into fallback all positions with any uncertain parameter, irrespective of the significance of that parameter. Additionally, the interpretation of "more subjective" pricing sources could be interpretated and used differently, not creating the fair level playing field among EU banks wished by the CP.

The resulting capital charges for derivative positions would, as a result, be inexplicably conservative and penalising, transforming the competitive landscape between the European institutions and their US & UK competitors.

We believe that explicit consideration for unlisted equities is inappropriate and unjustified and insufficiently defined. The RTS should not be instrument specific nor prescriptive, but more principle based. Notably, market transparency and information in relation to specific instruments may evolve over time and may depend on firms' access to information.

Overall, this is a significant detriment to European institutions offering clients hedging products or participating in the real economy via unlisted shareholdings. Naturally, US competitors will keep increasing their market share. Furthermore IPV processes and valuation controls have been developed in the recent years by the industry leveraging on guidelines issued by the IPEV. Existence of such control framework should justify avoiding arbitrary forfeits, that have no link with the real uncertainty of the exposure.

We consider that banks should be incentivised to use risk metrics to quantify the valuation uncertainty, and to establish robust frameworks to demonstrate the appropriateness and conservativeness of approaches applied in the assessment valuation risk for positions with limited and subjective market data sources for a subset of valuation risk drivers. Relying on a fallback approach would decrease the quality of the output and would only achieve a penalising, albeit meaningless, approach for all institutions.

<u>**Article 8 – General requirements for the calculation of AVAs under the core approach**</u>

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.

The requirements have become more complex and at times unclear. The following proposals aim to address these concerns and meet the intended policy objectives.

Article 8 (3): Capping of adjustment offset

The language utilised in the 3rd subparagraph, including points (a) and (b) is confusing and would require some simplification. We propose the following wording instead:

"The sum of all the "eligible adjustments" that the institutions applied in accordance with the first subparagraph for the purposes of determining the AVAs shall be less or equal to the institutions' total fair value and Day-1 Profit deferral accounting adjustments".

Article 8 (6): Model calibration

We do not consider that an explicit requirement is necessary, however, should one be required, we propose the following wording, which removes the language around the joint calibration of AVAs and EOD 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. The calibration shall ensure that the models reflect current market conditions."

Article 8 (7): Sensitivities for the VRT

We consider the addition of this paragraph is unnecessary and the additional requirements increase complexity for institutions. Convexity and cross-order effects are by definition captured via full revaluation calculations and are more prevalent when large market moves are observed, in particular during stress market conditions.

Full revaluation techniques that provide offsets across valuation risk drivers and the term structure of individual drivers are, generally, not encouraged in the determination of the AVAs. In fact, they are

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being prohibited by the introduction of the variance ratio test, as a reduction in risk buckets, similar to what would be implied by a full revaluation calculation of the portfolio would not meet the requirements of the test.

As such, we see this as an inconsistent requirement, which should be removed.

In conjunction with the reading of Articles 9 and 10, we infer that the competent authorities aim to limit the usage of aggressive practices when the bucket reduction is achieved via the variance ratio test. We consider that a more appropriate way to achieve this goal would be via technical restrictions in the variance ratio test application, such as:

- *Requiring liquidity of selected buckets and replicating instruments to be supported by market data;*
- *Introducing prudency when buckets with sufficient traded activity/observability and buckets without sufficient trading activity/observability are netted together, by assigning the maximum shift between the two buckets.*

<u>Articles 9, 10, 11 – MPU, CoC and model risk AVAs</u>

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.

<u>Articles 9 and 10</u>

We find the new articles significantly more complex to follow, which will inevitably lead to differences in interpretation between institutions. From a presentational point of view, we consider that adding additional requirements with regards to the alpha factor applicability as part of the Annex is not appropriate and any such significant requirements should be part of the articles themselves.

<u>VRT (Annex)</u>

On substance, the proposal for the removal of the diversification benefit when applying the parameter reduction as part of the VRT is not aligned with the purpose of the alpha factor, which is meant to represent diversification across risk drivers of the portfolio and is not meant to be a compensating control for methodological weaknesses. More specifically, we note that the EBA had previously defined the diversification benefit as:

- *"the principle of allowing for a diversification benefit is based on the theory that an institution with many small valuation uncertainties may face a very different total valuation uncertainty when compared to an institution with one large valuation uncertainty"*
- *"any diversification benefit should in any case only apply to certain AVAs as some relate to uncertainty around the fair value of individual positions which could be positive or negative (and which would not all be expected to be at the bottom of the range of plausible values at the same time) while others relate to reserves that are required for particular reasons that are only negative."*

Furthermore, the proposal dis-incentivises hedging, in particular it penalises hedging strategies not matching exactly End Of Day risk buckets. It could lead to the AVA of a not perfectly hedged portfolio increasing with the addition of the hedges as compared to an unhedged portfolio, which should not be aimed by the regulation.

In addition, the proposals could increase dispersion of capital across banks, subject to each bank's risk bucket definition and choice of hedges.

Finally, we consider that the proposal is inconsistent with other capital requirement measures (e.g. FRTB NMRF and SBA), where prescribed bucket reduction does not penalise aggregation across factors.

We understand that the introduction of this new requirement was aimed to discourage a set of aggressive practices relying on liberal interpretations of the existing RTS. A more appropriate way to address such practices would be the use of technical restrictions within the application of the VRT instead. We consider the proposal should be amended in line with the following:

- *Remove proposed alpha factor requirement for the VRT*
- *Introduce restriction in VRT application in the form of:*
    - *Requiring liquidity of selected buckets and replicating instruments to be supported by market data – we note that such requirements are introduced in paragraph 4 (c) (iv)*
    - *Introducing prudency when buckets with sufficient traded activity/observability and buckets without sufficient trading activity/observability are netted together, by assigning the maximum shift between the two buckets.*

Article 11

To date no comments proposed.

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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.

Article 12 (1): SFTs

The introduction of SFTs in scope for UCS AVA is not appropriate and paragraph 1 does not require a change as compared to the original RTS.

SFTs that are Fair-Valued typically do not attract CVA fair-value adjustments as part of the accounting process due to various reasons, including:

- *SFTs are usually very short-dated (between 1 day and 3 months).*
- *SFTs are self-collateralised and self-funded with daily margining being the standard, as stipulated in the governing master agreement.*
- *By volume, collateral is very liquid (government debt). Moreover, contractual haircuts, informed by the liquidity and volatility of the underlying collateral are standard market practice.*
- *The repo spread agreed to enter SFT transactions is an all-in spread that encompasses all relevant information and further fair-value adjustments are not required.*

Market data supports the view that contractual haircuts are considered a sufficient credit risk mitigant by market participants and re-negotiation of these levels is not seen when market conditions change.

We note CRR III stipulates that accrual accounted SFTs are not in scope of the CVA risk charge. Fair-Valued SFTs are only in scope if material. The EBA is tasked with providing regulatory guidance on the assessment of materiality. Similar materiality tests are not included in the UCS AVA calculation creating inconsistencies within European regulatory measures and unnecessary operational burden for the quantification of an immaterial risk.

For the reasons outlined above we consider the introduction of SFTs in scope for UCS AVA as not appropriate. We propose that paragraph remains unchanged as compared to the original RTS.

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<u>Article 12 (3): Correlation</u>

We consider the explicit inclusion of considerations for the dependency between the exposure and the probability of default of the counterparty in point (a) as appropriate when there are clear indications of Wrong-Way Risk dynamics, which would be reasonably expected to influence the determination of the CVA charge requested in an arms-length transaction as there is likely causality. This is predominantly relevant for Emerging Market exposures, where the credit quality of the counterparty might be linked to the currency and potential monetary or fiscal policy decisions. In other cases, the correlation is spurious as no causality can be demonstrated.

The article does not distinguish for this effect and makes a generic requirement. We believe it is more appropriate to amend the language as follows:

> *"(a) the dependency between the exposure and the probability of default of the counterparty, where a Wrong Way Risk relationship can be established."*

We consider the requirement set out in point (b) of paragraph 3 a more academic / theoretical requirement that does not warrant an explicit requirement in the article. A distribution of CVA prices necessarily incorporates the uncertainty of all parameters that form part of the CVA adjustment and parametrising a component of the total uncertainty to be allocated to the correlation parameter introduces further operational burden without necessarily improving the quantification of the valuation uncertainty associated with CVA. Thus, we believe that paragraph 3(b) should be removed.

<u>Article 12 (4): MPOR</u>

We consider the introduction of a requirement to compute UCS AVAs on collateralised exposures not appropriate, fundamentally. We propose the removal of the requirement set out in paragraph 4.

Furthermore, introducing a requirement that sets the margin period of risk window to a level equal or greater than that employed for the purposes of determining the own funds requirements for CVA risk an indication of double-counting and a further deviation from the market practice for Fair Value purposes, the uncertainty of which is meant to be addressed via AVAs.

The conceptual deviation from market practice becomes evident when considering the interbank market. Portfolios against other dealers are typically larger, which according to the rules for the CVA risk charge, may introduce requirements for an increase in the margin period of risk window, due to

the size of the portfolio. This is expected to lead to larger AVAs for the interbank trades. However, derivative transactions in the interbank market are typically executed via screens (electronically) or via broker runs where dealers stream prices to be hit by other dealers, agnostic of the counterparty. There is no exchange of additional fees over the quoted (counterparty agnostic) bid-offer to reflect CVA adjustments. Therefore, CVA does not form part of the determination of the price (and fair value) of these transactions and, by extension, their valuation uncertainty. The introduced requirements in this paragraph, however, require penalising calculations for valuation uncertainty, not commensurate to the economic risk nor the market practice between knowledgeable participants in arms-length transactions.

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.

In article 14, the use of the liquidity horizon set by article 325 bd of CRR below which no concentrated position AVA is required is a welcome amendment that compensate for increased market risk charge when liquidity horizon is longer for less liquid risk factors and avoid double counts.

In article 15, the precisions added in paragraph 1 are useful but sub-paragraph 1(c) can be misleading as all option positions require some form of dynamic re-hedging even when these options are actively traded and all risks could be exited with a measurable CoC, MPU and CP. There should be a precision that dynamic re-hedging to maturity of the position is the only possibility as there is no competitive market price for exit of the risk.

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<u>**Articles 19a and 19b – Framework for extraordinary circumstances**</u>

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.

Introducing provisions for extraordinary circumstances in line with the mandate stipulated in Article 34 CRR is a welcome addition to the Prudent Valuation RTS. The choice of providing larger diversification benefit when extraordinary circumstances arise is a straightforward tool, consistent with the treatment during the Covid-19 stress period. It can also be easily implemented. Hence, we consider this addition useful.

We also find the choice of factors and indicators set out in Article 19a as appropriate, given past realisations. However, we would propose that narrowly focusing on the levels seen during the 2008-2009 financial crisis and 2020 Covid pandemic might prove to be too restrictive as, for example, the significant stress market conditions observed during the 2012 EU Sovereign Debt crisis may not qualify as a period of significant stress based on volatility index indicators. We would, thus, propose that the requirements set out in Article 19a allow for flexibility to incorporate such stress periods in the assessment.

To that effect we consider it appropriate that the proposed regulation be extended to include an additional intermediary solution allowing for the application of an alpha factor between 0.5 and 0.66 in instances of market volatility that represent stress conditions, where market volatility is heightened from normal levels as evidenced by elevated volatility indices, and with an impact on market price dispersion, however the stress level is below the severity seen in the global financial crisis / 2020 COVID.

In addition, we consider that the timing and process for triggering this article of the RTS is vague. It would be useful for the article to be more specific with regards to the process, i.e. what conditions trigger the EBA review, what the timeline for EBA to conclude the review is, which governing body has the authority to bring the article into effect following the EBA recommendation (we assume it's the European Commission) and what conditions need to be met for the extraordinary measures to be reversed.

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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.

We disagree with both of the proposed approaches, and in particular the consequence of Option 1 which we understand to be the disallowance of diversification benefit for all UCS AVA calculations if a single position is determined to be concentrated (>10%).

Neither of the two criteria can adequately identify concentrated counterparties as this might require quantitative and qualitative criteria, specific to the nature of the transaction, the nature and credit quality of the counterparty and the overall status of the client relationship. Furthermore, counterparty-specific, idiosyncratic conditions might lead to concentration risk, regardless of the size of CVA.

We do acknowledge that the size of the counterparty credit risk could be an indicator of a harder to exit position due to the relevant size, but that the capital requirement for that exposure only should be increased accordingly.

Therefore, we propose an alternative as the only viable approach in the form of:

- *A requirement for institutions to perform systematic portfolio level analysis to identify concentrated positions (which may give consideration to the identification of individual exposures which exceed a threshold of 10% applied to Fair Value CVA).*
- *Only consider the removal of the aggregation factor provided the institution has not taken alternative, bespoke measures to address the specific risk in the UCS AVA, to the satisfaction of the competent authority.*
- *Apply the removal of the aggregation factor only to the counterparty being seen as concentrated and not to the whole UCS AVA.*

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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.

The Annex contains fundamental additions to the RTS, which can materially change the AVA calculation. Such fundamental points should have been clear and part of the articles themselves.

Paragraph 2 introduces restrictions that are not commensurate with the valuation risk and incentivises institutions to reclassify Fair Value adjustments used to achieve fair value. We see this as an expansion of prudential supervisory discretion to accounting Fair Value. We note that proper accounting practice is a responsibility of the bank and its auditors and enforced by ESMA.

Comments with regards to the VRT and alpha factor have been provided as part of question 8, which refers to Articles 9 and 10.

Comments with regards to the UCS and alpha factor have been provided as part of question 12.

<u>FV adjustment requirement</u>

Paragraph 2 (a) (i) (1) introduces a requirement for an inclusion of an eligible accounting fair value adjustment in accordance with Article 8 (3), which is commensurate with the adjustment other market participants would consider, for the institution to be allowed to use the 0.5 alpha (diversification) factor.

We consider this requirement vague, penalising and unnecessary. Institutions are penalised if they do not attribute their Fair Value based on the competent authority's view, which is forcing significant operational burden, without altering the bank's Fair Value. Furthermore, the framework/principles required to ensure no adjustment to the alpha factor are unclear and, thus, banks will assume worst case in pricing, increasing competitiveness gap. This is due to the fact that institutions could not have a clear view of other institutions' practices a priori and they would, thus, have to wait for feedback from the horizontal review of the ECB. This introduces a dependency to the ECB for institutions BAU activity, which should not be the aim of the regulation.

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Institutions already substantiate their Fair Value as part of reporting their audited accounts and, as such, the overall Fair Value is supported and substantiated, whether an explicit fair value adjustment has been specifically and separately reported or not.

The outcome of this regulatory requirement would be for a significant increase in operational burden for the institutions to parametrise but, importantly, not alter their Fair Value in a way that is compliant with the instructions of the RTS, to achieve inclusion to the diversification benefit and achieve the same outcome as currently achieved.

This is an inappropriate and unworkable proposal and should be eliminated.

IPV Differences

The language in paragraph 2 (a) (ii) (2) is complex and could lead to misinterpretation.

The requirement of capitalising IPV differences that have not been reflected in an institution's Fair Value in an asymmetrical and very granular manner introduces significant ramifications in the way institutions operate and can have unwanted consequences that reduce the quality of the reported profits and losses for an institution, while weakening the significant control a valuation function may have with regards to challenging, as a 2nd line of defence.

Institutions shall be forced to book all IPV variances (whether aggressive or conservative) to avoid the punitive AVA outcome, resulting in:

- *Removing the 1st Line / 2nd Line segregation of duties for Fair Value, as the 2nd Line of Defence outcome will automatically be reflected in the financials, in all cases.*
- *Equation of expertise and market knowledge between trading desks with direct knowledge of the market, informed daily, and an independent function that is required to perform monthly processes with more limited information.*

To avoid these unintended consequences, while still adding a conservative layer for overall aggressive 1st Line of Defence marking, we would propose to:

- *Maintain the 0.5 aggregation factor for all unadjusted IPV variances with a differentiated treatment between reliable and subjective independent pricing sources:*

- *For reliable independent pricing sources adjust the overall Group level MPU by the net aggressive unadjusted IPV variance.*
- *For subjective independent pricing sources adjust the individual risk factor MPU AVA by the net aggressive unadjusted IPV variance; Institutions should develop a framework to identify via systematic assessment the unreliable subset where asymmetric approach is to be followed.*

For the purpose of classification of independent pricing sources as either reliable or subjective we recommend that the regulatory text reflects usage by institutions of established internal market data hierarchies which also give consideration to the classifications of market data as set out in the requirements of Articles 3(2) and 3(3).

Removal of Method 2

Method 2 was developed in the delegated regulation 2016/101 to ensure that more prudence in the fair value definition would not lead to incoherent deduction. The point developed by the EBA was the following: "For the purpose of aggregating AVAs it should also be made possible to receive diversification benefits on the difference between the expected value and the prudent value so that banks with a fair value which is already more prudent than expected value do not get less diversification benefit than those that use the expected value as the fair value."

We believe that bank using Method 2 are with significant trading activities and that the arguments developed in the RTS to align the treatment on the majority of banks who include also the less sophisticated one will only decrease the competitivity of European banking industry compared to US peers.

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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.

Operational Risk double count

We consider that there is a double counting of the operational risk RWA on valuation. This introduces a large increase in AVA for institutions that were previously exempt, without these institutions being more operationally risky. Institutions that were utilising the AMA for Op Risk RWA were exempt under the current RTS. With the AMA being replaced by the SA for Op Risk RWA this exemption lapses in particular in a context where the Op Risk RWA is significatively larger under SA than AMA for all banks. Adding another dedicated Operational risk charge in valuation RTS will introduce duplication. In particular, one can read in the CRR3 final documents (§35) that: "Therefore, and in order to simplify the operational risk framework, all existing approaches for estimating the operational risk capital requirements were replaced by a single non-model-based method." The proposal made by the EBA does not take into account such requirement. Furthermore, operational risk event *as described in §311 includes valuation operational incident, which will be counted in the computation of annual operational risk losses. This suggest that operational risk losses linked to valuation framework are effectively part of the own fund requirement for operational risk under title III. We would therefore kindly request Operational Risk AVA to disappear from the new RTS.*

From a conceptual point of view, AVA size is not a good indicator of Op Risk and disincentives institutions from implementing conservative practices due to the subsequent increases in Op Risk AVA, given it is a function of the overall MPU & CoC. Furthermore, the scope for Op Risk is very broad as it is applicable to all products regardless of complexity, penalising market making.

It should be noted that there is also a regulatory timing misalignment with CRR3 projected to go live on the 1st of January 2025 for Europe, however, this draft RTS is forecasted to be effective in 2026. Hence, there is a gap of up to 2 years whereby the advanced method Op Risk RWA will not be applicable anymore, but the new PruVal RTS will not be live. This would mean that due to this misalignment, institutions that are currently under the AMA approach are going to be penalised overnight on the 1st

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of January by a 10% increase in AVA based on the current RTS, which is not reasonable, especially given the specific article is up for review.

We would, thus, request a letter of no action for the period between the CRR3 go-live date and the date the new PruVal RTS draft becomes final and effective to avoid this unwarranted increase in AVA charges.

Lack of Day One PL offset

Article 8 (3): Day-1 Profit Deferral accounting adjustment double-counting

The proposed amendments to Article 8 (3) do not address a fundamental double-counting in CET1 deductions between the deferred Day-1 Profit accounting adjustments and the AVAs.

The original Article 8 (3) clarifies that the AVA from PruVal is the excess of valuation adjustments required to achieve the prudent value over any adjustments applied in the fair value addressing same source of valuation uncertainty. Both the AVA and the Day One Profit deferral adjustment impact CET1 capital in excess of the fair value and they both manifest due to valuation uncertainty.

Valuation uncertainty is addressed by both:

1. *Banks are required to take Day One Profit deferral because of valuation uncertainty inherent in unobservable market parameters.*
2. *PruVal addresses a wider range of valuation uncertainties, including unobservable parameters.*

It should be noted that unobservable parameters typically attract larger PruVal charges as the valuation uncertainty is higher.

We believe that, provided the overlap between the two can be appropriately quantified and mapped, an offset is justified, and Article 8 (3) ought to be updated to explicitly allow for this, provided there is sufficient justification and controls / safeguards when applying such offset.

The offset between the Day-1 Profit accounting adjustment and the AVA is currently prohibited based on the EBA Q&A 2019_4458, which stipulates that Day One Profit deferral cannot offset against AVA, because:

- *Day One Profit deferral is not a fair value adjustment.*

- *Day One Profit deferral addresses unobservable parameters whereas AVA addresses confidence from observed parameters.*
- *Subsequent amortisation of Day One Profit deferral balance over time can give rise to uncertain revenues.*

We believe that the Q&A fails to acknowledge that:

- *Day One Profit deferral and PruVal both address valuation uncertainty for unobservable parameters.*
- *The disallowance of Day One Profit reserve offset against AVA does not mitigate uncertainty which may exist in subsequent revenue recognition in line with IFRS.*

The lack of offset between Day One Profit deferral and AVA means EU banks have to double-count valuation uncertainties in capital. This leads to a valuation level considered in capital in excess of the 90% confidence level required by the 2016 RTS and the level implied by the EU legislator in CRR Art.105

Besides exceeding the intentions of the legislator, the higher deductions in capital also undermine EU banks' competitiveness for EU clients (and globally). U.S. banks have a double advantage, because they have neither the same prudential requirements for PruVal, nor the same accounting requirements for Day One Profit Deferral.

The review of the current RTS provides an opportunity to address this issue and eliminate this double-counting. A methodology with safeguards can ensure the offsetting is done transparently, verifiably, and consistently across banks.

To that effect, we propose the below wording for Article 8 (3), which we believe would materially and justifiably address the double counting:

> *"3. AVAs shall be considered to be the excess of valuation adjustments required to achieve the identified prudent value, over any adjustment applied in the institution's fair value and Day-1 Profit deferral accounting adjustments and can be identified as addressing the same source of valuation uncertainty as the AVA ("eligible adjustment").*
>
> *Where an adjustment applied in the institution's fair value and Day-1 Profit deferral accounting adjustments 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 "eligible" and will not be included in the calculation of AVAs.*

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> *With regards to the Day-1 Profit deferral accounting adjustments, the institution should be able to demonstrate to the satisfaction of the competent authority that they are appropriately mapped against the corresponding valuation uncertainty risk drivers to make them "eligible". The institution should only offset this "eligible adjustment" against the corresponding AVA, with the offset capped by the AVA level, at a portfolio level.*
>
> *The deferred Day-1 Profit accounting adjustment is required to be allocated to the unobservable valuation uncertainty risk drivers to become an "eligible adjustment". The appropriate way of allocating the deferred Day-1 Profit accounting adjustment would be proportional, based on the calculated Fair Value impact of stressing the unobservable parameters to their prudent range at inception, on a transaction level.*
>
> *The sum of all the "eligible adjustments" that the institutions applied in accordance with the first subparagraph for the purposes of determining the AVAs shall be less or equal to the institutions' total fair value and Day-1 Profit deferral accounting adjustments."*

It should be noted that certain approximations may be required to map historically deferred Day-1 profit adjustments upon adoption of the language, to account for historical prudent range information that may no longer be retained.

<u>Overall complexity, cost</u>

The RTS under consultation introduces several changes with a negative impact, with increased conservatism and supervisory discretion not commensurate to the economic risk assessed. It also introduces significant complexity and operational burden, increasing costs. It also introduces inconsistencies with other capital requirement metrics (e.g. FRTB) and can increase dispersion in implementation among peers and capital volatility. The RTS seems to be responding to liberal interpretations by some banks by penalising all EU banks, rather than introducing appropriate constraints to limit these practices only, e.g. via the Pillar 2 framework. Without change, the RTS will worsen the competitive gap with U.S. banks and will introduce a new competitiveness gap with UK peers, as the PRA is not impacted by the revised RTS.

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