ESBG common response to the European Banking Authority discussion paper relating to Draft Regulatory Technical Standards on prudent valuation.

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First of all, the European Savings Banks Group (ESBG) welcomes the opportunity to share its views on this more detailed discussion paper regarding the Draft Regulatory Technical Standards on prudent valuation requirements under Articles 31 and 100.

I. General observations

The valuation implemented by financial instruments has become extremely complex over the past few years, and the number of valuation parameters has increased. Complexity and impenetrability of valuations are broadly considered as the main drivers of the crisis. Having read the proposal included in this discussion paper, the question is raised whether the introduction of two further layers of complexity in the valuation process, namely the determination and testing of AVAs, is the right approach for tackling this problem. We would suggest that an impact study shall be carried out before finally deciding the prudent valuation rules.

Generally speaking, the ESBG is of the opinion that it is important to specify the differences between general accounting principles and the requirements outlined in the discussion paper. The requirements included in the discussion paper must also be considered in the context of other regulatory changes. Additionally, the thresholds should be implemented taking into account the relevance and the level of detail in a balanced way. It is also relevant to take into account that whereas some relevant accounting standards are considered in this proposal, some adjustments are already covered in the fair value requirement in IFRS (e.g. unearned credit spreads, some market price uncertainty, and model risk when relevant). Nevertheless, we agree that there is still considerable room left for interpretation in the definition of Fair Value in IFRS 13. We would also like to point out that these guidelines may result contradictory or confusing with other “parallel” frameworks for valuate positions given that the values in accounting statements included in these frameworks are indirectly questioned.

It is also important to draw attention to a general principle present in these guidelines. From our understanding this discussion paper bases the valuation of assets for regulatory purposes on a liquidation approach. The possibility of introducing exit fees based on an instantaneous fire sale scenario as valuation criteria is also being discussed. The ESBG would like to raise its concerns regarding the component of volatility (in an already volatile valuation model) that these guidelines may introduce. The fair value method, which could be questioned as to whether it is appropriate for regulatory purposes, directly conflicts with the business view, which is a going concern view, not a liquidation view. From a general point of view we deem this paper – and the underlying draft CRR, Art 31 and 100 – as decisive for the following question: On which basis should credit institutions be steered: On a going concern basis or on a liquidation approach basis?
The ESBG is of the opinion that Regulatory Authorities should consider the idea of strengthening the supervision regarding the implementation of the IFRS standards, instead of developing another framework. Clearer guidance and a higher level of conformity across institutions would lower the need for another regulatory framework - which would be difficult to implement homogeneously. The implementation of another framework would also cause challenges in its interpretation, and hence does not resolve the valuation issue.

In general terms, we consider that to decouple the supervisory even further from the accounting valuation is undesirable. The outcome will most likely be that individual financial instruments measured at fair value end up with various values, which immediately raises the question as to the accuracy of the individual values compared with each other and how this impacts net income. The increasing decoupling of valuations inevitably leads to parallel data pools and the updating of accounting records, which can ultimately have significant consequences. Such a discrepancy generated by these two worlds leads to a large number of mutual adjustment and exceptions, which in turn call for considerable effort for their reconciliation and internal clarification.

Moreover, the discussion paper is very much focused on the quantification of the uncertainty valuation. We fear that this may lead to banks ignoring all non-quantifiable contributors to valuation uncertainty, and thereby result in a false security about the actual uncertainty in the Fair Value estimations. We believe that a judgemental approach is actually the basis for assessing the valuation uncertainty. For the majority of the contributors listed in 4.2, a quantitative approach is not possible. We fear that these Prudent Value guidelines will result in a quantification exercise and therefore there is a risk that the non-quantifiable contributors to valuation uncertainty will end up being ignored.

We would also like to raise some comments concerning the practical questions on the feasibility of the framework suggested. All prices, values and the empirical distributions of financial instrument prices and values depend greatly on the individual circumstances and thus in particular on a possible inclusion of the history (duration, weighting of historical data, reference to "normal" or "stressed" market conditions?) and on the exit horizon, which in turn has to reflect market liquidity considerations. It is not clear how a quantile will be determined. There are in particular considerable differences depending on whether the reference is made to a normal market situation or "stressed" markets. In addition, the terms are not adequately differentiated from each other.

On the other hand, we consider that at this stage of the discussion these guidelines leave considerable room for interpretation in certain aspects. Some parts of the forthcoming RTS needs to be carefully specified/clarified (for example, “instantaneously” and “exit cost” in question 2 or “time horizon” as in question 3).

Lastly, we would like to note that in several places in the document there are references to different "sections" without any corresponding headlines. To facilitate the understanding of the references made to different sections it would be easier to have the section number used in headlines.
II. Answers to the questionnaire

**Q1. Do you believe that a proportionality threshold should be considered before requiring an institution to assess the prudent value of all fair value positions? If yes, how would you define the threshold?**

The ESBG is of the opinion that it is appropriate to set up a threshold given that the efforts – in the first instance the implementation effort – related to this exercise are deemed to be very high. The approach to set up this threshold should be to assess whether a legal entity/portfolio is of systemic relevance or not. In our view this exercise should only apply to systemic relevant legal entities/portfolios.

The ESBG supports the introduction of a proportional _de minimis_ threshold. It is important to note that the threshold should not be complex, and therefore easy for the institution to calculate. It should not lead to any additional complexity. We suggest introducing a threshold based on the ratio of fair valued assets over total assets or total capital. The approach should be to assess whether the FV-portfolio is of systemic relevance or not. Furthermore, it would be logical to exclude level 1 holdings from the scope (presuming use of relevant accounting requirements).

Below is an example of how limits could be set up:

- Listed shares: Fair value IFRS > 20% of own funds. If the value has been overestimated with 10% of the amount approved for the exception, then the worst case is that own funds is overestimated by 2%.
- Unlisted shares: Fair value IFRS > 10% of own funds. If the value has been overestimated with 20% of the amount approved for the exception, then the worst case is that own funds is overestimated by 2%.

Furthermore, concerning the threshold certain aspects remain unclear in the discussion paper:

- are liabilities also addressed by this paper
- are trading and banking book addressed by this paper.

In our opinion this should be set out clearly. From our point of view it is questionable to include under AVA the following positions:

- **AfS portfolio**: Besides the fact that it is used mainly for liquidity purposes and usually held to maturity, it still continues the discussions about the treatment of AfS unrealised gains and losses in own funds. If AfS revaluation will be filtered from own funds it would – in our view – make no sense to apply AVA to AfS.
• Hedging derivatives and hedged items in case if fair valued (fair value hedging or cash flow hedging of ‘fair valued’ A/L): It is unclear in relation to Article 30 – treatment of cash flow hedges (the fair value reserves related to gains and losses on cash flow hedges of financial instruments that are not valued at fair value shall not be included in any element of own fund).

• A/L under ‘fair value option’. FVO is usually used instead of hedge-accounting; these are mostly held to maturity items.

Therefore, we are of the opinion that these items should be excluded from the AVA application.

Should the EBA expect that the institutions have to meet the requirements, even though they are below the threshold, then the application of the ITS should reflect the concept of proportionality, as set out in the Pillar II provisions.

Q2: Do you agree that the exit price used as the basis of prudent value does not necessarily need to be based on an instantaneous sale? If yes, provide argument to support your view.

The ESBG clearly rejects the view that an instantaneous sale should be taken as the basis for calculating the exit price. This seems to be fairly unrealistic – even in a liquidation view. The shorter the time horizon the more volatility is being added to an already volatile fair valuation model. This could end in a kind of “vicious circle”-scenario.

Furthermore, there is a need for clarifying the meaning of “instantaneous” and the cases in which it would be applicable. The meaning of “exit price” is also not clear in this context. If the exit price is not to be based on an instantaneous sale then we believe that it can be represented by the fair value. Since the Prudent Value is defined as the uncertainty in the Fair Value estimation, the outset for the Prudent Value should be the same as the basis for Fair Value. It may not be relevant to calculate an exit price on some positions, for example under Fair Value Option.

We would like to add that the IFRS 13 ‘Fair value measurement’ includes the term ‘exit price’. Fair value is defined in this standard as the exit price: ‘The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date’. Without any time horizon, it will be confusing to find the difference. Therefore, we think that it would make sense to align with IFRS 13.
**Q3. Should a specific time horizon for exit be set when assessing the prudent valuation? If so, how the time horizon should be set (e.g. the same time horizon for calculating Value-at-Risk (VaR), Credit Risk Capital Requirements, etc.), what should it be and how would it feed into the calculating of AVAs?**

In general, the ESBG supports the idea of a consistent approach with respect to the corresponding capital requirements. A clearer statement as to how market liquidity risks could be included would be helpful because the determination of the "time horizon" has a very considerable influence on the size of the AVAs.

We plead for time horizons which are compatible with the average holding periods in the regulatory framework for market risk. A position that is relevant for the overall liquidity situation should have a shorter time horizon for exit. Positions that are deemed as not relevant for the overall liquidity situation and that has a short time to maturity may be excluded from the AVA since the Exit price calculation becomes less relevant. Therefore, assets which are eligible as collateral for the ECB repo-trades – especially government bonds – should be excluded as there seems to be no necessity for applying a fire-sale scenario as these assets can be taken as collateral for liquidity at any time.

**Q4. Do you support the concept of a specified level of confidence to determine AVAs? If not, why? Are there any AVAs where the use of a specified level of confidence is not appropriate?**

Generally speaking, we do not support this highly quantitative approach. The existence of a confidence level could lead to wrong interpretations and provide false security. From our point of view the specified level of confidence seems very high and would add more volatility to the system. Instead it would be preferable to have the EBA expressing in words the level of conservatism that they are asking for.

In our opinion, caution should be applied in the determination of a confidence level, and only where there is corresponding data as a basis should thought be given to opting for such a statistical approach. We reject the quantile concept for determining AVAs even if there are sufficient market data. Since a statistical process only supplies robust results if there is a sufficient data basis for the calculation, we see the problem of a large estimation error in the determination of AVAs when there is an inadequate data basis, which would lead to an unjustified fluctuation in measuring the risk and hence spurious accuracy for the affected institution. Especially, we fear that a quantile estimate based on expert opinions for market-to-model positions will be unreasonable and will probably count with an excessive safety loading. Banks should at most have the possibility of adopting this approach voluntarily.
Q5. If you support a specified level of confidence, do you support the use of a 95% level of confidence? What practical issues might arise or inconsistencies with other parts of the CRR when using this level of confidence?

Q6. How prescriptive do you believe the RTS should be around the number of data points that are required to calculate a 95% level of confidence without any more judgemental approach being necessary?

Q7. If you support a specified level of confidence, do you support the explicit allowance of using the level chosen as guidance for a more judgemental approach where data is lacking?

The ESBG is of the opinion that the suggested 95% level of confidence does not seem to fit to every situation; e.g. for situations of illiquid markets, where no market price is available, this system does not work out. Should the EBA not provide a definition of confidence level, we are expressly in favour of the application of a lower level, not greater that 75 – 80%. In addition this threshold would also alleviate the problem discussed under question 4 and would require less data from institutions. An alternative could be the implementation of a simple aggregation approach that allows for diversification. Nevertheless, we would like to stress that we have strong concerns with regards to the introduction of a model based on confidence levels since this will most likely result in a complex valuation uncertainty model.

Furthermore, the ESBG is of the opinion that some leeway to decide the positions for which they can and want to carry out a statistical calculation of the valuation adjustments should be left to the institution. The necessary number of data points can vary from instrument to instrument, and hence the institution would have to justify the decision it has taken. Given this latitude, other factors could then be included in a case-by-case decision basis.

Lastly, the ESBG would like to raise its concerns regarding the potential conflicts of overlapping/frictions with the calculation of the model reserve, specifically in view of structured derivatives in IFRS.

Q8. Should any additional possible sources of market prices be listed in the RTS?

We consider that there should be more focus on the guideline, given the preconditions for using different sources for collecting market prices. The RTS should not define the actual sources. Since the market data quality of individual market data sources will vary over time, it is probably better to give examples rather than publish a definitive list.

If, at last, the sources were to be defined in the RTS we are of the opinion that they should be in line with the Fair Value hierarchy present in IFRS. Furthermore, additional possible sources of market prices (see paragraph 4 on page 11) should be supplemented with a new number "IV); Indicative
quotes from financial data vendors. Remaining numerations are moved a step forward. Additionally, clarification is needed on the meaning of the current 4 iv) Consensus service concerns.

Q9. Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?

Q10 Should the RTS be more prescriptive on how to use the various alternative methods or sources of data to obtain a range of plausible prices where there is insufficient observable data to determine the range by direct statistical methods? If so how?

From our point of view the greater the flexibility the better the system would work. Definitely, we think that it will be not be possible to describe each and every scenario appropriately. Every description of how to use certain data sources entails a risk of distortion. For this reason we plead for not being too restrictive/prescriptive in the descriptions.

Rather than extending the list, we would favour transferring responsibility to the individual institution. This can then apply sources suitable for the specific product.

Q11. Are there any other indicators of large market price uncertainty which should be included?

The "bid-offer-width" indicator could be included in the analysis.

Q12. Do you believe the approaches set out above are appropriate for each of the adjustments listed in Article 100? If not, what approaches do you believe would be more relevant?

The decision tree seems most appropriate for market parameter uncertainty and less appropriate for the other contributors to valuation uncertainty mentioned in the Discussion paper (unearned credit spreads, close-out costs, early termination, future administrative costs etc.). Administrative costs, including close-out costs, should also be taken into account. Also, concentration risk seems to be missing in the left part of the tree, as this will also be present for marked-to-market positions with a sufficient range of bid-ask quotes. Additionally, the differentiation of market price uncertainty from the other categories is, in our opinion, unclear.

Concerning the uncertainty in the input parameters of valuation models, the idea of seeking to achieve prudent valuation via an adjustment seems understandable. However, this adjustment should not to be applied by individual model parameters but address all the necessary model parameters in its entirety.
Q13. Are there any other material causes of valuation uncertainty that the RTS should describe an approach for? Or are any of the adjustments listed above not material and should not be included?

There are many non-quantifiable contributors to valuation uncertainty, which are not addressed in the RTS, such as the choice of revaluation curves. Choosing the wrong curve will have significant impact on the valuation. However, it is difficult to quantify the impact. We believe it is important that banks assess all types of factors that generate uncertainty.

Balance sheet substantiation should not be included since it is not a part of the scope of prudent valuation according to article 100.10 of the draft CRR. (It's not reasonable that the completeness of accounts should be dealt with prudential valuation adjustments.)

Furthermore, we assume that the reference to operational risk seems to be overlapping with the already existing requirements concerning the calculation of the capital requirement for operational risks. In the operational risk regime the mentioned instances are already to be covered, at least via the use of external data bases. Also a possible overlapping with the provisioning regime could take place. In any case, we consider that double counting should be avoided.

Q14. Do you believe that the testing approach in Annex 2 represents a useful tool to test for prudence of valuation? If not, what weaknesses make it unsuitable?

Generally speaking, the approach selected is likely to produce volatility due to the aforementioned reasons. Furthermore, as expressed above, the introduction of statistical tests might lead to banks focusing too much on the products where there is plenty of data and very little uncertainty, and ignore the illiquid products where the uncertainty is much bigger. Hence, we do not see any value in setting up tests as described in Annex 2.

Q15. Do you believe that the RTS should be prescriptive with respect to validation techniques? If not, how do you believe that comparable levels of prudence should be ensured for the valuations across institutions? Are there other validation techniques that you believe should be detailed in the RTS?

From our point of view the greater the flexibility the better the system would work. It will be not be possible to describe each and every scenario appropriately. For this reason we plead for not being too restrictive/prescriptive in the descriptions. Nevertheless, achieving comparability across institution boundaries requires the definition of a minimum level of clear requirements and procedures by the supervisory bodies. On the other hand, the particular characteristics of the institutions and their scale of trading activities have to be heeded in order to bring about individually reasonable solutions.
The EBA could further clarify their expectations on the outcome of the Prudent Value assessment in banks. Instructive examples would also make it more clear what is expected. Both initiatives would increase the alignment across institutions.

Q16. Do you support the concept that prudent value can never be greater than fair value including fair value adjustments at both the individual position and the legal entity level? If not, what would be the reason to justify your view?

Generally speaking, we agree that the Prudent Valuation should be equal to the sum of the Fair Value and the reservations made for valuation uncertainty (the AVA’s). Nevertheless, in specific cases, such as in the case of Germany, financial statements drawn up in compliance with the German Commercial Code have to have VaR-based adjustments for valuation uncertainties (see Section 340e Subs. 3, Commercial Code). Since this is a blanket mark-down, it can lead to the market value carried in the balance sheet being lower than the "prudent value", which allows for the individual valuation adjustments.

Q17. Would you support the availability of a diversification benefit within the aggregation of position-level AVAs? Please explain the reasons and justification why, providing any evidence available to support your arguments

Q18. If simple aggregation better reflect your assumptions and practices or would you support the availability of diversification benefit, do you support creating a simplified standard approach, an example of which is shown in Annex 4? If you do, do you have alternative suggestions on how this standard approach should be specified? Are the suggested correlations in the example appropriate, if not what other values could be used?

Diversification effects of AVAs relating to the position should definitely be allowable. Instinctively, the approach of considering that a well-diversified portfolio has less valuation uncertainty than a portfolio consisting of a few very large positions seems right. Simple aggregation of individual AVAs to a 95% confidence level without consideration of diversification would, as a rule, lead to an unreasonably high AVA for the overall position. On the other hand it is difficult – or almost impossible – to estimate correlations between uncertainties, and it adds complexity to the model and could lead to the impression of an exact model for estimation of valuation uncertainty. Perhaps it would be better if it would be allowed to use netting. We also would like to refer to our aforementioned suggestion of introducing a confidence level of 75 to 80% and then simple aggregation on the basis thereof.
Q19. If you support the availability of diversification benefit, do you support allowing an in-house approach which should be subject to approval by the regulator, an example of which is shown in Annex 4?

The overall intention of this RTS is to reduce the leeway for subjectivity of institutions in the valuation process. As it is not possible to set up an RTS covering all aspects of diversification following the aggregation and since this might be approached differently by different institution, we would like to see an opening for an internal model approach. However, allowing an in-house approach leaves room for interpretation and could lead to big differences between banks. On the other hand it makes sense to allow for using an in-house model if such a model already exists and is regarded as being more correct than the standard approach. It is difficult to see how the regulators should be able to verify the accuracy in different approaches for calculating diversification effects. We would suggest that some experience with the concepts is needed before allowing for internal models.

The diversification effect raises the justification of the correlation between uncertainties which is not an observable data and the approval process of the regulator would still be based on a judgmental in-house process. There is a difficulty in calculating correlations between different valuation uncertainties, and therefore one should be cautious about applying diversification rules. Since it is, by nature, very difficult to quantify valuation uncertainty, the model for doing it should preferably be very simple. A complex model will only increase the uncertainty in the estimation of the valuation uncertainty.

Q20. Would you agree that offsets against AVAs for overlaps with other Pillar 1 capital requirements should not be permitted? If not, what offsets might be appropriate and under what conditions might they be allowed (e.g. individually assessed by the institution and agreed with the regulator rather than specified in the RTS)?

We are of the opinion that double counting should be in any case avoided. Therefore at least an offsetting possibility should be included to avoid this problem. We believe that overlaps with other Pillar 1 capital requirements should be permitted for off-setting, but we also believe, besides the operational risks, that overlapping requirements should not occur if the prudent valuation is correctly applied. We also consider that further clarification is needed concerning paragraph 63 and several examples should be provided. For example, where offsets against AVA ought to be applicable is when CVA-adjustments have to be made on derivatives.

Q21. Do you believe the above requirements are appropriate? If not, what other requirements could be necessary and what requirements stated above are considered not to be relevant?
Generally speaking, the requirements included in this discussion paper here are all appropriate as an overall ambition. The EBA has focused on ensuring an adequate prudent framework for valuation, e.g. sound valuation governance structure, high control standards, exhaustive documentation etc. We are of the opinion that all these principles should conceptually be already in place. Nevertheless, we would like to draw the attention to the burden that these requirements will entail for financial institutions if they are considered as strict requirements instead of just general principles. Therefore, we would like to plead for the inclusion of the principle of avoidance of unnecessary administrative and bureaucratic burdens and costs. The system should be as simple as possible; unnecessary complexity should be avoided. Additionally, we consider that overlapping and double counting should be avoided.

Q22. What would be the sources of costs and benefits of requiring (a) the implementation of a unique AVA methodology and (b) a consistent format for reporting AVA? Do you agree that the benefits of such requirements outweigh the costs associated with them?

It is our belief that it is important for banks to assess their valuation uncertainty, and we also support external reporting of Prudent Value. However, we support that the methodology for the reporting should be kept simple; the regulator should concentrate on a simple, standardised, consistent and comparable approach. The objective for the RTS should be to ensure a level playing field.

As many internal systems would be affected by this new regulation the implementation would be a huge cost driver. Definitely, the instructions on how to calculate the Prudent Value would require extra IT developments and reporting. On the other hand a fair level playing field has to be established.

Concerning the second question we doubt that the benefits of the requirements will exceed the costs.

Q23. If you agree with a reporting form being introduced, could you please provide a suggested template?

From our understanding, an AVA report is not suitable for achieving a level playing field because AVAs, as a difference between fair values after adjustments and prudent values, are not a suitable metric. A direct comparison of prudent valuation only makes sense if applied to identical or sufficiently identical portfolios. We therefore reject the idea of a general report template.
About WSBI-ESBG (European Savings Banks Group)

WSBI-ESBG – The European Voice of Savings and Retail Banking

WSBI-ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,631 billion, non-bank deposits of €3,500 billion and non-bank loans of €4,200 billion (31 December 2011). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI-ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI-ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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