Set up in 1990, the Czech Banking Association (CBA) is the voice of the Czech banking sector. The CBA represents the interests of 37 banks operating in the Czech Republic: large and small, wholesale and retail institutions. The CBA is committed to supporting quality regulation and supervision and consequently the stability of the banking sector. It advocates free and fair competition and supports the banks’ efforts to increase their efficiency and competitiveness.

We appreciate the opportunity to comment on EBA Discussion Paper relating to DRAFT REGULATORY TECHNICAL STANDARDS ON PRUDENT VALUATION UNDER ARTICLE 100 OF THE DRAFT CAPITAL REQUIREMENTS REGULATION (EBA/DP/2012/03). Our response is divided into two parts – general comments and responses to EBA questions.

**General comments**

RTS should be carefully considered and tested before its application. RTS application should be restricted by the threshold which could have also qualitative nature, not only proportional. E.g. institutions under IFRS should be exempted from AVA RTS application.

Draft of the Capital Requirement Regulation (CRR) requires regulated institution to make prudent valuation on all its assets measured at fair value (CRR article 100 – additional valuation adjustment, AVA) and to deduct from CET1 any AVAs (CRR article 31). The RTS draft proposes the methodology for AVA calculation. We consider application of RTS for institutions using fair value measurement according to the IFRS 13 (effective since 1 January 2013) as redundant, extremely extensive and deeply beyond the IFRS framework and its concept of an exit price.

Under IFRS 13, fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date ("exit price"). When an institution applies the fair value approach, all the relevant factors affecting the exit price must be comprised in that value (bid/ask, assumptions about risk, credit valuation adjustment etc.) so that the fair value is sufficiently prudent valuation. In our understanding only operational risk of valuation is not included, but it should be covered by own funds requirements for operational risk within CRR framework.

In our opinion, if there is a range of bid quotations (i.e. market participants declare to buy the asset at the stated price) at the closing of the reporting date, the average of bid prices should be used as fair value (or an average of mid quotations adjusted by relevant bid/ask spread). The institution will be able to sell the asset for that average price and possible variances in the real sale price will compensate each other.

There is no real loss and thus no additional valuation adjustment at a specified level of confidence (95%) is necessary.
Moreover, it is not very clear what the 95% percentile is referring to. It is probably referring to the percentile derived out of number of quotations available on the market at given time (“old” quotations are not relevant to the derivation of current price of an asset). It is not very unusual that only few quotations are relevant on the market at given time. To derive 95% percentile out of few quotation would require taking strong assumption on the distribution of this random variable. Any of such strong assumption might be disqualified by the market quickly. Additionally the 95% percentile would be very sensitive to outliers which normally are considered to be off-market quotations and it is the market practice not to take them into account.

There is no alignment with IFRS 13, mainly with the 3 levels categories of fair valued assets and liabilities.

RTS defines AVA as a difference between booked fair value and prudent value which is based on the realizable exit price. Referring to IFRS 13 at least the Level 1 and Level 2 in the fair value hierarchy shall be excluded from AVA.

(“Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. [IFRS 13:76] A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available, with limited exceptions. [IFRS 13:77] If an entity holds a position in a single asset or liability and the asset or liability is traded in an active market, the fair value of the asset or liability is measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity, even if the market’s normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price. [IFRS 13:80]”)

Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. [IFRS 13:81] Level 2 inputs include:

- quoted prices for similar assets or liabilities in active markets
- quoted prices for identical or similar assets or liabilities in markets that are not active
- inputs other than quoted prices that are observable for the asset or liability, for example interest rates and yield curves observable at commonly quoted intervals or implied volatilities or credit spreads • inputs that are derived principally from or corroborated by observable market data by correlation or other means (‘market-corroborated inputs’)

Level 3 inputs are unobservable inputs for the asset or liability. [IFRS 13:86].”)

The uncertainty in valuation of derivatives tends to zero with time near to maturity. From this reason also derivatives positions with fair value in the Level 2 of IFRS hierarchy shall be excluded from AVA.
Summarizing the IFRS fair value hierarchy approach AVA shall be introduced only for Level 3 instruments. Standardized approach shall be permitted as well.

In fact, the RTS requires the institution to make another parallel fair valuation system which is supposed to produce prudent prices, i.e. in general lower fair value prices than IFRS. From accounting point of view it is seen as counter-productive and reputation problem as accounting should be first of all trustworthy and reliable which is questioned by this RTS concept. Moreover RTS requires institutions to establish new processes which will be highly demanding from capacity and system point of view. Also from capital management point of view RTS creates another source of uncertainty for the capital level which even has not been quantified as RTS is just a methodology proposal.

RTS is extremely demanding as regards AVA calculation and testing for all asset positions and all elements defined in Article 100. Especially evidence of a sufficient prudency in valuation of these elements and judgmental approach might be unachievable. It is extremely complicated or even impossible at the Czech market to calculate AVA of all elements (unearned credit spreads, operational risk, model risk, etc) stated in the discussion paper due to the lack of market data.

The AVA concept as proposed represents inappropriate demands and costs for banks and brings further uncertainty since especially AVA for assets with unobservable inputs will be hardly justified. To meet all requirements in the RTS for all positions (including zero AVA positions) the valuation process will become very complex and complicated and bring high operational risk. Additionally, verification of these processes will not be practically realizable neither from audit nor supervisor perspective. Costs for AVA processes and their verification probably reduce the sense of the business in fair valued instruments. This could lead to the preference of the HTM portfolio and limitation of the liquidity on the market.

Therefore we recommend EBA to introduce also some standardized approach for AVA as additional capital charge for valuation uncertainty, for example a percentage of fair value volume of the relevant positions.

The RTS works with liquidation situation (gone-concern) although the business is steered under going-concern view. The conflict between these views (gone-concern vs. going-concern) can have a negative impact on steering day-to-day business (e.g. on pricing).

We are concerned about overlaps with credit, market and operational risks capital charges and deepening of additional capital requirements. AVA capital charge concept will multiply capital demands together with (conservative, countercyclical, SIFI etc.) capital buffers, which shall cover also some uncertainties.

The relevance of positions for AVA should be reconsidered. For example instruments under Fair value option should be excluded since they practically replace hedge accounting which is not ordinarily fair valued. Further collateralized assets - especially government bonds –
should be excluded since these assets will not be liquidated and can be used as collateral for liquidity purposes any time.

We see also some confusion in the text.

It is not clear if the RTS addresses only assets (Article 31) or all fair value positions (Article 100). Especially treatment of derivatives and hedged assets or liabilities in hedge accounting is not evident. Most of the banks operating in CEE and owned by foreign parent company have the trading book for the purpose to provide the service to local corporate clients and practically all positions are closed backed to back with a parent company. For such back-to-back positions AVA would bring distortion in the business model and risk adjusted performance measurement considering additional capital charge only for one part of these double transaction.

Response to questions

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?

Definitely yes, RTS should set a proportionality threshold which would exclude from the scope of application such institutions having fair valued positions as insignificant part of the balance sheet and thus the potential AVA is immaterial. We suggest setting the threshold for ratio of fair valued assets and total assets equal to 20%. It is overtaken from the estimation/expert judgment of KPMG that considers mentioned ratio equal to 15-25% as a break even point distinguishing the investment-banking focused bank from customer-business focused bank (we suppose the customer-business focused bank does not have the AVA material).

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.

Yes, the prudent value should not be based only on instantaneous sale. See also comment concerning IFRS 13 definition of fair value.

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?

The prudent valuation should be related to the reporting date as unexpected exit price at this day. No time horizon should be set because an unexpected fair value change is covered by the market risk capital charge (VaR and stressed VaR).
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?

We support specified level of confidence level only for observable inputs, it means only for instruments with Level 2 fair value. For AVA in Level 3 instruments a specified confidence level is not appropriate.

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?

We do not support the approach based on any level of confidence. We prefer prudent valuation based on average of bid prices reflecting all the relevant factors affecting the exit price. The level of confidence for uncertainty in fair value at the reported day is not necessarily linked to the confidence level for unexpected losses which are covered by market, credit and operational risks capital charges.

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?

We are against more prescriptive RTS. The complexity of products, markets, valuation methods can not be covered by a prescriptive approach.

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?

We do not support a confidence level for judgmental approach.

Q8-9. Should any additional possible sources of market prices be listed in the RTS? Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?

No, the IFRS fair value hierarchy is sufficient.

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?

RTS could offer more alternative approaches only for unobservable data, i. e. for Level 3 fair value.
Q11-13. Are there any other indicators of large market price uncertainty which should be included? 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? 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?

No.

Q14-15. 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? 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?

The testing approach in Annex 2 is too theoretical, very far pragmatic and realizable approach and unrealistic for huge amount of transactions. It does not reflect practical issues (volatility, intraday market). More flexibility in validation can create more reasonable and implementable system.

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?

N/A.

Q17-19. 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. 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? 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?

We would support availability of both simple aggregation and diversification benefit including simplified standard and in-house approaches. Different approaches fit to different institutions.
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)?

Theoretically in RTS there should not be significant overlap with other Pillar 1 capital requirements and thus no need for offsets against AVAs. In case of existence of overlaps, offsets of AVA with other Pillar 1 capital should be permitted. We would prefer specification of some allowed offsets in RTS along with allowing also other offsets individually assessed by the institutions and agreed with the regulator.

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?

The system should be as simple as possible.

Q22-23. 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? If you agree with a reporting form being introduced, could you please provide a suggested template?

No, we do not believe in benefits of implementation of AVA at all. We are sure of unreasonable costs associated with that and see a threat of level playing field distortion.

We hope that our response to EBA Discussion Paper is sufficiently clear and our views are helpful for preparing regulatory technical standards.