Dear Mr. Farkas

DB’s response to the European Banking Authority’s consultation on draft regulatory standards on Prudent Valuation

Deutsche Bank (DB) welcomes the opportunity to respond to the EBA’s consultation on Prudent Valuation.

We appreciate the EBA’s objective to draft regulatory standards (RTS) in furtherance of Articles 31 and 100 detailing how additional valuation adjustments (AVAs) could in practice be applied by institutions in a consistent manner.

While the intention of the forthcoming draft RTS on prudent valuation is to provide a clear and consistent structure, the consultative document raises several issues that we would like to bring to the EBA’s attention.

General Comments

- **Global harmonisation** - We would ask the EBA to work with other global regulators to align the requirements and draft a global regulatory solution. A European standard on prudent valuation that impacts the capital requirements of mainly European institutions would not be a desirable outcome and would undermine the level playing field.

- **Accounting and valuation symmetry** - DB maintains that for the large majority of trading positions, accounting fair value provides a reasonable and prudent estimate of where positions can be exited, particularly for IFRS Level 1 and Level 2 assets, where there is evidence of market pricing and market depth. That said:
  - Care needs to be taken in establishing the prudential valuation standards such that the new framework does not introduce unintended consequences, further complexity or opportunities for greater inconsistency with an additional measurement framework and data collection process.
  - Many of the AVA elements are already factored into observed prices, or incorporated in other regulatory charges as detailed in our Annexes.
  - Capital charges are already assessed for VaR and Stressed VaR, Incremental credit migration risk, CVA risk, and Operational risk. Care must be taken with the implementation of a prudential valuation framework as to not double count between those and the issues Article 100 focuses on. Moreover, many of the...
assets contemplated in the Discussion Paper, especially Level 3 assets, do not lend themselves to the statistical “confidence interval” valuation approach.

- **Operational considerations** - Firms will need adequate lead time to implement any proposals, as doing so would require processes and procedures to be put into place to capture the required information to run a calculation of prudent value. Estimating the lead time is difficult to do at this stage; however, we recommend that the EBA issue a consultation on this issue before moving forward.

Our detailed comments are delineated in Annex I and responses to the EBA’s questions in Annex II. We would be happy to discuss further any of the points in our response.

Yours sincerely,

Andrew Procter  
Global Head of Government and Regulatory Affairs
Annex I

Executive summary

DB recognises the need for greater consistency and transparency in valuation and financial reporting in order to demonstrate compliance with fair value and prudential value requirements. However, we recommend that significant care be taken in establishing the prudential valuation standards such that the new framework does not introduce unintended consequences, further complexity or opportunities for greater inconsistency in future.

In DB’s view a significant risk of introducing further mandatory adjustments is that different frameworks will create different versions of the same economic and market risk truth. This risks the creation of “another set of books” which must be maintained, which could lead to conflicting market and regulatory risk-management priorities, and inconsistent hedging incentives. In the long term, these distortions could create economic risk for institutions, potentially deteriorating firms’ capital and other limited resources further. We do not believe this is the intent of the legislation, nor that of the regulatory bodies.

In addition, as the principles of prudential valuation are rooted in a current view of market conditions, we recommend that these principles smoothly coexist wherever possible with the established and audited fair value doctrines as defined by IFRS and other bodies. More specifically, when making a fair valuation estimate, judgments have been made by the institution relating to the prevailing environment of market risk, with an explicit or implicit level of certainty being assumed. We believe there will be instances where this degree of certainty will be consistent with that intended by the proposed regulations, and hence there will be situations where AVAs will not be required. It is therefore essential that principles of fair value be used in conjunction with the prudential valuation approach, to recognise what has already been taken into account, and to avoid double-counting adjustments which have already been allowed for. In this way, not only will potential contradictions be minimised, but existing practices and processes can be leveraged without material new operational complexity – something which we believe is in the interests of all industry members, and of the industry’s regulators as a whole.

Furthermore, we believe that the differences between institutions, principally regarding business model (client servicing versus hedging activity), market exposure types and size/sophistication, be taken into account when applying new standards. In our view, if these distinctions are not allowed for this will actually lead to greater inconsistency of application of the prudential valuation principles, as institutions will struggle to apply a “one size fits all” approach to their differing circumstances. Likewise for large portfolios that are well risk-managed, it is not reasonable to assume that valuation uncertainty will act in the same direction with the same magnitude. In our view, if diversification benefits are not permitted, we fear this could lead to conflicting risk management incentives; put simply, if diversification benefits are not recognised, the incentive to hedge appropriately could be decreased, and firms will be put at greater potential risk. We therefore strongly recommend that diversification should be recognised in the construction of a prudential framework, and that firms should benefit from appropriate hedging and other risk mitigation activity. Failure to do so threatens undermining the integrity of the valuation and established risk management principles, and could misrepresent the valuation risks of certain business models and

1 An example of this would be the existing inconsistencies between the hedging of fair value CVA and Basel III CVA capital requirements, which result from different underlying dynamics and where the regulations prescribe hedging instruments which are not always effective at mitigating market or valuation risk.

2 Since prudential valuation attempts to mitigate valuation uncertainty arising from current environment of market risk, it should not capture elements associated with market risk changes through time; so doing could potentially cause double-counting with VaR and stressed VaR.
markets. As a result we anticipate that Local Regulators will have a key role in ensuring that the prudential valuation principles are appropriately applied to institutions under their supervision, yet consistent with the overarching legislation and EBA standards.

Finally, to ensure comparability and transparency, as well as a competitive level playing field, it is important that the principles of the legislation are recognised by global regulators, and that they are applied in a consistent manner. Whilst this issue is not new (especially when one considers differences between US and European regulatory standards), we believe that greater harmonisation is a key aim of all regulators and the broader industry community and will help alleviate cross-border issues over the longer term.

To this end, DB strongly recommends that the prudential valuation concept is defined clearly and in a manner which is straight forward, such that a consistent understanding of the principles can be established. DB proposes a workable definition such as:

**Prudential value is the conservative estimate of a realisable value of a given position or portfolio at a given reporting date within the current market conditions, given risk assumptions that are consistent with the fair value price. Additional valuation adjustments should be applied where fair value does not already encompass a sufficiently conservative degree of certainty. Assumptions and use of judgment should be consistent with the accounting and regulatory views of market practice or standards for such assumptions.**

Detailed comments on key topics from the Discussion Paper are delineated below which will further articulate these conclusions.

**Detailed comments on key topics from the Discussion Paper**

**Current valuation framework and governance**

As part of the fair value assessment, corrections to mid valuations and close-out (bid-offer) through valuation uncertainty are factored in. Out of the scope of this are operational risk, future administrative costs and concentration reserves that are not allowable under accounting standards.

Valuation is assessed, monitored, reviewed and escalated in accordance with a formal and documented policy framework and governance procedures; this includes review of entry and exit P&L. Uncertainty in valuation can result in fair value ranges which need specialist and management judgment to determine the most appropriate fair value level. With appropriate documentation, this range information could be used as the basis for assessing whether incremental AVAs are required.

The accounting framework, for example IFRS 7 (para.27a), requires that entities disclose all fair value measurements within a hierarchy of fair value certainty (i.e. Levels 1, 2 and 3). DB uses this analysis in its fair value assessments, governance processes and disclosure material.

**Characteristics of portfolios in and out of scope for AVAs**

DB believes that Trading Book positions should be in scope and non-Trading Book positions should be out of scope for prudential valuation. The former are actively traded and/or risk managed and a prudential valuation framework could coexist with the fair value requirements. Non-Trading Book positions are typically non-fair-value and hence are not suitable for prudential valuation.
Aside from non-fair-value reserves (e.g. concentration), DB believes that there will be many cases where the prudential valuation and fair value will be the same. Where valuation uncertainty is particularly material, additional AVAs may be required to the extent that these are not already covered by the fair value reserves. The below scheme shows a potential basis for an approach to identify the population that should be in scope for potential AVAs – this could be analogised with the existing IFRS 7 fair value hierarchy for instance:

- **Level 1 and Level 2** – for these positions there is reasonable market transparency. As a result, entry and exit prices can be checked and independently verified with little uncertainty in valuation. Many of these positions are mark-to-price (bonds, equities, etc) directly rather than relying on a mark-to-model approach. Except for concentration (see below), we would not expect any other AVA requirements on these instruments. For positions in this classification using a mark-to-model approach, the inputs are observable and there is sufficient trading activity to ensure minimal valuation uncertainty (e.g. vanilla swaps). Other Level 2 positions may already have adjustments to mid for any model deficiencies (e.g. to compensate for an non-modelled product feature) and close-out costs associated with market price uncertainty and model uncertainty (e.g. alternative models with no clear “best”), as part of the fair value. These adjustments are either deemed observable or insignificant to the overall fair value of the position. However, given that the trading activity over a specific time horizon, extrapolation and proxies may need to be used in the assessment; this could possibly lead to AVAs to meet the Prudential Valuations standards for some Level 2 positions.

- **Level 3** – mark-to-model positions with unobservable parameters can have a large degree of valuation uncertainty. As part of the fair value assessment this valuation uncertainty is assessed and largely encapsulated in the reserves through mid corrections and close-out reserves, which include market and/or model uncertainty. A range of fair value outcomes may be obtained by considering a number of plausible scenarios (e.g. views on inputs or models) with management judgment used to decide on the representative valuation. There will be a prudent-end of this fair value range and being closer to this should mitigate the need for AVAs to a significant extent. Enhanced documentation of these ranges may be of benefit to show the extent to which valuations are already prudent.

- **Concentration** – all of the above classifications could require an AVA if the concentration of the position were significant and not covered by additional reserving approaches as part of the fair value.

- **Future administrative costs and operational risks** – to the extent that these are not covered by fair value, other AVAs and market risk changes, these could be considered for AVAs.

**Netting / diversification**

DB’s view is that diversification should be included within the prudent valuation framework in order to arrive at an overall AVA amount. Diversification for Prudent Valuation should be aligned with an institution’s fair value and risk management frameworks otherwise there would be no regulatory incentive to perform accounting and risk management hedges which
should provide a prudent valuation offset but instead, could then lead to an increase in AVAs for a reduction in net risk.

In large and diversified portfolios, it is not reasonable to assume that all valuations will suffer the same valuation uncertainty with the same magnitude and direction at the same time. If diversification is not allowed, you could for example calculate the same AVAs for a portfolio with 10 bonds of €100m each as another portfolio of 100 bonds of €10m each. This would not reflect the institutional risk and diversification benefits of a bond portfolio that would have much more risk diversification by country, company, sector, maturity and credit exposure.

The DB view would be that diversification should be accounted for in a non-prescriptive way. The example in Annex 4 of the EBA's Discussion Paper seems too prescriptive, and would not necessarily be appropriate for all institutions. An in-house approach that accounts for the differing natures of an institution's portfolios should be allowed, as long as it has been subject to supervisory approval. The EBA could provide an approval framework for their member Regulators to benchmark and assess the reasonableness and appropriateness of an institution's in-house diversification approach.

The concept of portfolio-level valuation adjustments on a net open risk position is part of the fair value accounting framework. DB believes that any prudential valuation assessment should also make use of these concepts, as appropriate to the risk profile, when determining portfolio level AVAs.

**Confidence interval**

An overall level of calibration for the prudent valuation regime is sensible, as this should help to ensure a minimum level of consistency between firms. However, we feel that rather than set an arbitrary statistical measure, this would be better achieved through the regulators and the EBA benchmarking the banks approaches and assessing the controls around the application of the prudent valuation framework.

Moreover, the confidence level of 95% suggested in the paper can only be applied with any degree of accuracy to liquid instruments, where there is an abundance of observable data. However, these instruments are subject to very limited or nonexistent valuation uncertainty risk, and the mechanically strict application of a confidence interval to this population of instruments will involve significant costs but little benefit. More complex portfolios would require the use of management judgment to assess prudent valuation and any such confidence level often cannot be applied mathematically for such positions due to a lack of data.

For the reasons above, whilst we do not agree with the confidence level approach, if one were to be adopted we think that an appropriate confidence level approach for the less liquid instruments would be a 1 standard deviation level of 80-85%.

**Back-testing**

DB, as with many Firms, operates comprehensive independent price verification (IPV) and reserving processes in accordance with the formal and documented valuation control policies and procedures.

The fair value reserves and IPV spans the full spectrum of fair-valued Trading Book positions; the challenges for this can be from portfolios with low complexity but potentially high volumes/concentrations, to portfolios of greater complexity. Results are presented through a monthly valuation governance forum splitting the population into independent direct price, (i.e. non-modelled), modelled products and their observable inputs, modelled products with
uncertainty in the modelling or inputs and untested; a mapping to the fair value hierarchy (i.e. Level 1, Level 2, Level 3) population can be made from these.

It is our view that this control is a robust test of valuations and the associated uncertainty. This process considers a wide variety of data sources including entry/exit prices, broker quotes, consensus services, collateral management and client valuation. Introducing the proposed back-testing scheme is not, in our view, going to increase control as it will not have any further data to input into a back-testing process therefore adding no significant value to the control. Furthermore, it will add operational complexity and may have an unintended consequence of effectively creating another set of accounts which we believe is undesirable.

A better approach may be to consider implementing a benchmarking test that could be standardised across regulators. To accomplish this, similar institutions would need to be benchmarked against one-another at the global level irrespective of their location and home regulator. The FSA currently conducts such a poll for its institutions; this approach could be expanded to cover more regulators with an agreed set of data provided and metrics produced.

*Time horizon / liquidity*

The time horizon used to assess prudential valuation should be commensurate with that used for the fair value assessment. It is important that the assessment is made in terms of normal trading activity in the current market (i.e. not reflecting a fire-sale which may also trigger or be triggered by distressed market conditions).

For example, the time horizon for the orderly disposal of a listed cash bond in an active market will be different to that of a bespoke real estate-linked product in an illiquid market. The current 10-day proposal would be too long for the former and too short for the latter.

*Deduction of capital*

The proposal to deduct prudential value from capital needs to be applied with care. It is key that this deduction would not double count with current regulatory charges and does not distort the market by application to inappropriate products/portfolios. So doing would increase transaction costs and could result in, for example, Corporates running open risk positions as they can no longer afford to purchase hedging instruments.

*Prudential valuation: standardised and advanced approaches*

We recognise the desire of regulators to harmonise the approach banks take. For institutions with more complex portfolios requiring more judgment in their valuation, a “one size fits all approach” is not appropriate: institutions will need to tailor their approach to their particular portfolio, but following the Prudential Valuation guidelines.

We believe that it makes sense therefore to split into a “standardised” and “advanced” approach to Prudential Valuation. To follow the advanced approach, institutions would need to consult with their regulator in order to show that they meet the relevant criteria. These criteria could include tests of materiality for products in certain categories which correspond to those that potentially require significant AVAs on top of the fair value assessment.

*Global harmonisation and application consistency*

We would ask the EBA to work with other global regulators to align the requirements and draft a global regulatory solution. A European standard on prudent valuation that impacts the capital requirements of mainly European institutions would not be a desirable outcome and would undermine the “level playing field”.
Given the wide reaching scope of the proposals and the importance of defining a workable prudent valuation framework, we would propose that a consultation group, comprising industry, regulators and auditors be set up to collectively agree how such a prudent valuation framework should be defined.
Annex II

Answers to questioned posed by EBA:

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?

DB does believe there should be a proportionality threshold. We would urge the EBA to consider the application of a materiality threshold similar to that outlined in current national regulatory circulars on prudential valuation that note if the application of prudent valuations lead to a lower value for the position than the value reported in the financial accounts, the difference would have to be deducted from regulatory capital, but only if this difference would exceed 3% of the value of all trading book assets.

This could also be achieved by excluding certain types of financial instruments where accounting valuations are already certain (for example, listed equities, liquid securities, and vanilla swaps).

Additionally, prescriptive, one-size-fits-all rules are not ideal and will cause challenges from smaller banks and banks with different business models. In Annex I we discuss the idea of a standardised and advanced approach which could be used.

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, we believe the definition of exit price within the accounting guidance achieves the same goals as prudent valuations as described in the Discussion Paper for the vast majority of instruments. Therefore, as discussed in the Fundamental Review of the Trading Book, we do not believe a prudent valuation should be based on an instantaneous sale, or "fire sale", of an entire position, but in an orderly transaction(s) between a willing buyer, and importantly, a willing seller. This is also applicable to large positions that would move the market if sold instantaneously (e.g. concentrations).

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?

We do not regard specifying "a one-size fits all" time horizon as appropriate. The time horizon used to assess prudential valuation should be commensurate with that used for the fair value assessment. It is important that the assessment is made in terms of normal trading activity in the current market, i.e. not reflecting a fire-sale which may also trigger or be triggered by distressed market conditions.

For example, the time horizon for the orderly disposal of a listed cash bond in an active market will be different to that of a bespoke real estate-linked product in an illiquid market. The current 10-day proposal would be too long for the former and too short for the latter.

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?
An overall level of calibration for the prudent valuation regime is sensible, as this should help to ensure a minimum level of consistency between firms. However, we feel that rather than set an arbitrary statistical measure, this would be better achieved through the regulators and the EBA benchmarking the banks approaches and assessing the controls around the application of the prudent valuation framework.

Moreover, the confidence level of 95% suggested in the paper can only be applied with any degree of accuracy to liquid instruments, where there is an abundance of observable data. However, these instruments are subject to very limited or nonexistent valuation uncertainty risk, and the mechanically strict application of a confidence interval to this population of instruments will involve significant costs but little benefit. More complex portfolios would require the use of management judgment to assess prudent valuation and any such confidence level often cannot be applied mathematically for such positions due to a lack of data.

Q5. If you support a specified level of confidence, do you support the use of a 95% level of confidence? What practical issues or inconsistencies with other parts of the CRR might arise when using this level of confidence?

Whilst we do not agree with the confidence level approach, if one were to be adopted we think that an appropriate confidence level approach for the less liquid instruments would be a 1 standard deviation level of 80-85%.

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 believe that for the portfolios where there is sufficient data points to calculate AVAs, typically AVAs would not be required. For those portfolios where AVAs may be required, there would not normally be sufficient data points and a more judgmental approach should be used.

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 would refer you to our answers to Q4, Q5 and Q6 above. DB believes that, where data is lacking, management judgment consistent with the accounting and regulatory views of market practice and standards should be used. Given the relative materiality of AVAs for complex and/or illiquid instruments and positions, which will tend to be relatively lacking in available data, such a judgmental approach is preferred for calibration of the framework more generally.

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

The RTS already provides scope (“including but not limited to”) to add other data sources, so it is not necessary to attempt to list these prescriptively. Also, as such data sources develop over time, trying to capture a complete list is not appropriate.

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

No, more description should not be included. Institutions should use appropriate methodologies, to be challenged, if and where appropriate, by regulators. Indicative description may be useful for some participants but should not be binding for all banks.
DB believes that the sources of market prices should be defined in accordance with accounting standards such as IFRS13, which contains guidance on fair value hierarchy, and has been the result of extensive effort of clarification from the IASB and FASB alongside a fairly comprehensive interpretative documentation from the audit industry. Any alternative approach risks the creation of “another set of books” which must be maintained, which could lead to conflicting market and regulatory risk-management priorities, and inconsistent hedging incentivisation.

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?

Where possible the guidance should be principles based and provide guidelines, not prescriptive rules and regulations. Given the complex and dynamic market for financial instruments, it will be impossible to capture all the relevant sources of market prices, or descriptions of how to use those various sources of market prices. Any guidance on valuations needs to provide a framework for the analysis and broad based principles to within that framework. Detailed rules and prescriptive requirements will never capture all relevant possibilities and will often result in inappropriate conclusions.

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

No, DB does not believe additional items should be included.

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?

We would refer to our detailed description in Annex I.

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?

Valuation is assessed, monitored, reviewed and escalated in accordance with a formal and documented policy framework and governance procedures; this includes review of entry and exit P&L. Uncertainty in valuation can result in fair value ranges which need specialist and management judgment to determine the most appropriate fair value level. With appropriate documentation, this range information could be used as the basis for assessing whether incremental AVAs are required.

As part of the fair value assessment, corrections to mid valuations and close-out (bid-offer) through valuation uncertainty are factored in. Out of the scope of this are operational risk, future administrative costs and concentration reserves that are not allowable under accounting standards. Consequently, including these items in prudential valuation will cause divergence from fair value where these are not allowed.

DB believes that there will be many cases where the prudential valuation and fair value will be the same. Where valuation uncertainty is particularly material, additional AVAs may be required to the extent that these are not already covered by the fair value reserves.
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?

DB believes that the approach proposed is not useful. This approach could only be properly implemented for the more liquid, low uncertainty instruments, where the AVAs will be relatively low.

In addition, when unwinding less liquid exposures, institutions already perform comparative analysis against FVA’s on a one off basis. Institutions should have their own methods for assessing the adequacy of their valuation approaches, including prudent valuation, which regulators should assess using a benchmarking approach.

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?

Where possible the guidance should be principles based and provide guidelines, not prescriptive rules, regulations, or tests. Any guidance on valuations needs to provide a framework for the analysis and broad based principles to within that framework. Detailed rules and prescriptive tests will: 1) often be very difficult to perform given the limited data available on uncertain valuations; and 2) may result in inappropriate conclusions.

DB, as with many Firms, operates comprehensive independent price verification (IPV) and reserving processes in accordance with the formal and documented valuation control policies and procedures. The fair value reserves and IPV spans the full spectrum of fair-valued Trading Book positions; the challenges for this can be from portfolios with low complexity but potentially high volumes/concentrations, to portfolios of greater complexity. Results are presented through a monthly valuation governance forum splitting the population into independent direct price, (i.e. non-modelled), modelled products and their observable inputs, modelled products with uncertainty in the modelling or inputs and untested; a mapping to the fair value hierarchy (i.e. Level 1, Level 2, Level 3) population can be made from these.

It is our view that this control is a robust test of valuations and the associated uncertainty. This process considers a wide variety of data sources including entry/exit prices, broker quotes, consensus services, collateral management and client valuation. Introducing the proposed back-testing scheme is not, in our view, going to increase control as it will not have any further data to input into a back-testing process therefore adding no significant value to the control. Furthermore, it add operational complexity and may have an unintended consequence of effectively creating another set of accounts which we believe is undesirable.

A better approach may be to consider implementing a benchmarking test that could be standardised across regulators. To accomplish this, similar institutions would need to be benchmarked against one-another at the global level irrespective of their location and home regulator. The FSA currently conducts such a poll for its institutions; this approach could be expanded to cover more regulators with an agreed set of data provided and metrics produced.

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?

No, as noted above, we believe that prudent value would often be equal to fair value including fair value adjustments at both the individual position and the portfolio level. One area where prudent value could be bigger than fair value is those positions where a bank has held back upfront profit and one exception where prudent value would be lower than fair value is block
discounts. Where the prudential value is outside of the fair value range, or additional non fair value requirements are needed, then prudential value will be greater.

Q17  Would simple aggregation better reflect your assumptions and practices or 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

DB’s view is that diversification should be included within the prudent valuation framework in order to arrive at an overall AVA amount. Diversification for prudent valuation should be aligned with an institution’s fair value and risk management frameworks otherwise there would be no regulatory incentive to perform accounting and risk management hedges which should provide a prudent valuation offset but instead, could then lead to an increase in AVAs for a reduction in net risk.

In large and diversified portfolios, it is not reasonable to assume that all valuations will suffer the same valuation uncertainty with the same magnitude and direction at the same time. If diversification is not allowed, you could for example calculate the same AVAs for a portfolio with 10 bonds of €100m each as another portfolio of 100 bonds of €10m each. This would not reflect the institutional risk and diversification benefits of a bond portfolio that would have much more risk diversification by country, company, sector, maturity and credit exposure.

Q18. If 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?

The DB view would be that diversification should be accounted for in a non-prescriptive way. The example in Annex 4 of the EBA’s Discussion Paper seems too prescriptive, and would not necessarily be appropriate for all institutions. An in-house approach that accounts for the differing natures of different institution’s portfolios should be allowed, as long as it has been subject to supervisory approval. The EBA could provide an approval framework for their member Regulators to benchmark and assess the reasonableness and appropriateness of an institution’s in-house diversification approach.

The concept of portfolio-level valuation adjustments on a net open risk position is part of the fair value accounting framework. DB believes that any prudential valuation assessment should also make use of these concepts, as appropriate to the risk profile, when determining portfolio level AVAs.

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?

As per our response to Q18 and Q19, we would support allowing an in-house approach. The EBA could provide an approval framework for their member Regulators to benchmark and assess the reasonableness and appropriateness of an institution’s in-house diversification approach.

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)?
The principles of fair value must be understood when applying the principles of prudential valuation, to recognise what has already been taken into account in fair value, and to avoid double-counting adjustments which may already form part of that. Moreover, since prudential valuation attempts to mitigate valuation uncertainty arising from current environment of market risk, it should not capture elements associated with market risk change; so doing could potentially cause double-counting with VaR and stressed VaR.

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 the standards set out for systems and controls are too prescriptive. Please refer to the Annex 1 and previous responses for our detailed views.

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?

A unique AVA methodology ensures comparability between entities and certain degree of buffers in the system for risks that can only be ensured by setting reserves. Initial capital cost might be high, even for most prudent banks, if some punitive elements are maintained or if diversification is not allowed. However, the AVA framework should be incorporated to a large extent into Fair Value (to the extent this is admissible in such measurement) and into pricing guidelines. Also, additional non-Fair Value capital charges are likely to be allocated to trading desks. This may substantially increase the entry hurdle cost and conversely lower the exit hurdle cost. The benefits in the approach as currently documented certainly do not outweigh the associated costs.

As far as consistent format is concerned, we believe that as long as the information is intended for the sole purpose of supervisors, and as long as there is clear disclosure of the diversification effect, there is some benefit in defining a consistent reporting format. If there should be any harmonisation of reporting, that will need to be decided at the international level.

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

We feel that a standardised template would aid the benchmarking process. The purpose and format should be agreed by the suggested consultation group, comprising industry, regulators and auditors.