CONSULTATION ON EBA/CP/2014/38 ON DRAFT REGULATORY TECHNICAL STANDARDS ON VALUATION UNDER DIRECTIVE 2014/59/EU

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

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Foreword


This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG’s Technical Working Group on Recovery, Resolution and Systemic Issues.

The BSG thanks the efforts made by EBA to develop the conditions and requirements of the independent valuations that help the resolution authorities 1) to take the decision of resolution of an entity that presumably is “failing or likely to fail” [Valuation 1]; 2) inform the resolution action to be adopted, the extent of the write-downs or conversion of capital instruments, and other decisions on the implementation of resolution tools [Valuation 2], and 3) after the resolution, determine whether an entity’s shareholders and/or creditors would have received better treatment had the entity entered into normal insolvency procedures [Valuation 3].

General comments

The Banking Stakeholder Group would like to draw attention to some general comments (this section), before addressing the specific questions included in the Consultation Paper. Whilst welcoming the document, the BSG has several comments with respect to parts of the RTS Drafts.

The BSG realizes that the set of two RTS Drafts related to valuation in case of resolution have been elaborated with the purpose of helping the resolution authorities take informed decisions bearing in mind the content of the valuation reports issued in the three different circumstances described above, and to promote the consistent application of methodologies for these valuations in the interests of a level-playing field throughout the European Union.

In general, we concur with the view that no particular methodology should be imposed on the professionals, but this freedom needs to be accompanied with a justification of the approach used as well as the assumptions made and also the economic and financial variables included in the valuation model. The requirement to use “generally accepted valuation methodologies” is a call for consistency that is applicable to valuers and resolution authorities across all valuations carried out.

On the other hand, we point out that the scenarios depicted in both Drafts call for a continuous interaction between the independent valuers and the competent authorities. The fact that in
valuations 1 and 2 it is possible to issue provisional reports implies that any further reconsideration of the provisional values should only be the result of new information from the entity and from the resolution authority. The valuers, in this context, have to keep their independence with respect to the other parties interested in the resolution process. So, they have to critically consider all the action courses that are possible to take. Specifically, we note that Valuation 2 and 3 are closely related. In order to avoid problems in Valuation 3, it is important to point out in the text of the Resolution that the entity in resolution and the valuer must include in Valuation 2 elements of Valuation 3 in a way that the resolution authority could compare all the existing possibilities, including liquidation.

Regarding the options taken and described in the cost-benefit analysis/impact assessments undertaken, we broadly support the decisions taken, with some exceptions detailed below in the replies to the questions.

Replies to Questions

**Question 1:** Would you suggest any changes to the definitions of valuation approaches (letters e-i)? In particular, are there specific valuation methodologies which the definition of equity value should refer to?

The letters e-i in Article 2 contain several essential definitions of measures used in valuation, more than valuation approaches. All those concepts could be needed for valuation purposes. What would be desirable, in addition to the definitions included, is to highlight that some among them are complementary and could be used together (e.g., hold value and franchise value can be used jointly for purposes of valuing the same item) or are the result of different courses of action (e.g., fair value is also an “exit value” with the difference being that it is measured in a scenario of orderly transactions whereas the term “exit value” within the Draft makes reference to more forced transactions: so it is a “forced exit value”). We suggest revising the scope of these definitions to make them clear and avoid any overlapping.

On the other hand, and regarding the definition of equity value, the reference to generally accepted valuation methodologies is in line with the choices made in the rest of the Draft RTS that gives to the valuer the responsibility to use the best approach to valuation according to the circumstances.

**Question 2:** Should specific types of information be required on deviations from management assumptions, for example on differences in expected cash flows and/or the discount rates?
As the valuation report is addressed to the resolution authority, in case of lack of information or insufficiently detailed analysis, the possibility exists to require further explanations to the valuer. Nevertheless, we believe that the last sentence of the Article 7.3 should be modified to include the justification of the deviations: “….financial statements or in the calculation of regulatory capital and capital requirements shall be identified, explained and justified”.

On the other hand, if the valuer uses a different hypothesis than the management of the entity for valuation purposes, such deviation should be justified in a detailed way.

**Question 3: Would you add, amend, or remove any areas which are likely to be subject to significant valuation uncertainty?**

We see two minor problems in the list of areas with valuation uncertainty:

a) In (c) the uncertainty seems to be related to the inputs used to determine the fair value. While it is true in the case of “mark to market”, when the “market to model” approach is used there is a type of uncertainty created by the model itself that must also be considered by the valuer. In other words, the valuer might find the model as the cause of the valuation uncertainty in which case he/she has to specify a different model and carry out the valuation with the new model.

b) In (d) the valuation of goodwill and intangibles is related, in a correct way, to the valuation of the cash generating units (CGU) where they belong. We believe that somewhere in Article 8 a reference to this fact must be made, insofar as the identification of CGUs is essential for the correct valuation of the entity.

We also consider that further clarification should be given for the collateral valuation since significant uncertainty could arise from it. Thereby, the best point estimate and a value range around it should be provided when presenting the collateral valuation. From fixed income assets to a mortgage portfolio, the implicit volatility of their value could cause significant impacts on accounting and prudential requirements (treatment on Credit Risk Mitigating).

**Question 4: Should the buffer instead always be greater than zero? If yes, how should the buffer be determined?**

No, the buffer value depends on the quality of valuations made in a context of time pressure and lack of relevant information. In some circumstances, for instance in the case of non complex credit entities, the valuer could conclude that a buffer is not necessary.
Furthermore, ordinary valuation methods already include conservative estimations. Therefore, using an additional buffer above zero by default could duplicate the conservative feature of the valuation: first in the estimation of the asset and liability values, and second in the introduction of the buffer. This may imply unintended effects on the final valuation and potential NCWO legal challenges (the valuation should never be worse than in liquidation). For instance, valuation of mortgage portfolios might include conservative past-due payments estimations. If an additional prudential buffer were to be included by default in the calculation, the final valuation will be biased (too conservative).

There are two main determinants of the value for a particular buffer in provisional valuations:

a) The accuracy of valuations effectively undertaken. The amount of the buffer could, in this case, be a function of the extent of the estimation range around the point value determined.

b) The set of circumstances that are not considered due to lack of information or time that: 1) limits the validity of assumptions made, or 2) produces the involuntary exclusion of some items (for instance, impairments in some items or litigation provisions).

**Question 5:** Do you agree that a valuation of post-conversion equity is necessary to inform decision on the terms of write-down or conversion?

Absolutely. In order to decide whether or not to write-down or convert, the resolution authority needs to know in advance the probable consequences of this action on the equities value in order to both minimize the resolution cost and avoid the destruction of value.

The conversion rate or rates play an important role in the determination of the new equities value and the holders of instruments written-down or converted can take actions in case of unfair treatment. For this reason, the valuer can propose in the report to the resolution authority a change in the rates in order to achieve better results.

**Question 6:** Do you agree with the definition of equity value for this purpose in Article 2 (i)? If not, what changes should be made to the definition? Should the definition be more closely linked to the net asset value determined on the basis of the remainder of valuation 2 adjusted for goodwill/‘badwill’, and if so how should that adjustment be estimated?

As remarked in the answer to Question 1, the valuer must adopt a generally accepted methodology and
apply it consistently in order to reach a value. This choice needs to be adequately justified in the valuation report.

The treatment of goodwill/badwill has to be done according to the valuation approach followed (there are, in general terms, approaches based on cost, market or income).

**Question 7:** As an alternative, should the use of information that becomes available after the resolution date be more restricted, and in particular permitted only if it refers to facts and circumstances existing at the resolution date which could reasonably have been known at that date?

Yes: we support the alternative of considering the information that could reasonably and without undue effort be known at the resolution date. The resolution authority is responsible for taking into account all the existing information which affects the interests of the owners/creditors of the entity. That means that the resolution authority, and therefore the valuer in his/her mission, could not disregard or ignore facts or circumstances that are accessible without undue effort or cost.

**Question 8:** Should the use of information available after the resolution date be further limited, for example by requiring that such information is only used if it results in a significant change in the values of the entity’s assets or liabilities?

Yes, we agree. The reconsideration of values should be limited to cases of material changes, so as to avoid a vicious valuation circle and to put time limits to the function of the valuer.

**Question 9:** Should these technical standards provide further detail on the characteristics of appropriate discount rates?

The structure and calculation of discount rates to be applied are settled by the valuation approach adopted. What is important for valuers is to explicitly define that approach and follow it consistently. That means that the valuer could adhere to any of the generally accepted valuation standards (for instance, International Valuation Standards) as a means of justifying his/her choices of discount rates. Otherwise, the valuer needs to describe, explain and justify the approach followed in each particular case.

Nevertheless, in order to help in the choice of discount rates, the RTS Draft on valuation 1 and 2 for resolution purposes contains a short description of the process of formation of those rates in Article 2(g), which could be applied in valuation 3 to determine differences in treatment. That description is meaningful because it acknowledges that the discount rate is a sum of factors (free interest rate plus...
risk premia corresponding to similar instruments issued by similar entities). This choice excludes others such as, for instance, approaches using only risk-free interest rates applicable to cash flows in the entity’s economic context.

Moreover, we consider it worth mentioning that different discount rates could be used depending on whether it is the whole institution being valued or a specific part of it. When valuing the whole entity, the discount rate used must be based on the entity’s weighted cost of capital. However, the BRRD on its article 37 sets different resolution tools (sale of business, bridge institution and asset separation) for which the valuation of a concrete assets pool or business line would be necessary. For these cases, the idiosyncratic characteristics of the assets being valued should be recognized by using a discount rate based on comparable instruments instead of the whole entity’s cost of capital.

Furthermore, some BSG members think that the concept of discount rate should be used in a homogeneous way within each Member State and across EU countries. In the case that EBA judges that there is a possibility for this homogeneity to be impaired or used to manipulate valuations, it would be useful to elaborate some specific guidance on the formation and use of discount rates.

**Question 10:** Are there any changes you would suggest to the methodology for determining actual treatment of shareholders and creditors in resolution? In particular, should the methodology for valuing equity be further specified and, if so, what should be included in that specification (whether additional detail on the current approach, or a different approach, linked for example to net asset values adjusted for goodwill/badwill)?

Our view in this regard is in line with the answer given to Question 6, related to the RTS Draft on valuation for resolution purposes. So, it is the valuer who establishes the approach to be followed in the report, considering the generally accepted valuation standards and methodologies. Such methodology must be identified, described, justified ... and consequently followed. The details thereof have to be provided in the report itself.

The choice of a particular methodology will give more comparable measures, but could impede taking into account the specific circumstances of each particular valuation, which could help to make appropriate decisions. Nevertheless, the same text of the Draft (6.1 & 6.2, Baseline) recognizes that there is no common EU framework to be followed for resolution purposes. BSG does not support to limit the valuation approaches, in the same line as the RST Drafts.

**Question 11:** Should the valuer be required to accompany the comparison envisaged in Article 7 of this Regulation with additional relevant disclosures? If yes, what should those be (for example, documentation of any differences between the valuation of actual treatment
and the market price that would be observed for those same claims were they traded in an active market)?

The comparison is, as the Question says, required by Article 7. For a valuation report it is usual to disclose the results reached under both scenarios (insolvency and resolution) in order to justify the differences of treatment estimated (if any). The measurements and figures to be disclosed are just those that evidence a similar or different treatment. Following the spirit of the Drafts, the Article 7 should require not only the comparison to be made but an analysis and justification of the conclusions reached regarding the treatment of owners and creditors in the resolution and the normal insolvency scenario.

Other relevant points (date of valuations and concerns about independence)

**Date of the valuations 2 (for decisions of write-off and convert) and 3 (for differences in treatment):** We concur with the choice of the resolution date as the date of reference for valuation, even when that date lies in the future, because this moment is the one that is relevant for the resolution authority to justify any decision.

**Independence of the valuer:** Given the close relationship between the valuer, on the one hand, and the management of the institution / resolution authority on the other, there is a risk that the independence of the former is undermined, with the implication that the valuation report is only a justification of decisions taken in advance by the resolution authority. Hence it is important to ensure and reinforce the independence of valuers. Within the text of the report, an explicit statement of independence with respect to the entity and the resolution authority would be welcome.

Submitted on behalf of the EBA Banking Stakeholder Group

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