Banking supervision
And Accounting issues Unit

The Director

Paris, January 11st 2013

FBF Response - EBA Discussion Paper relating to Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft CRR. (DP/2012/03)

Dear Sir,

The French Banking Federation (FBF) is the professional body representing over 450 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The FBF welcomes the opportunity to comment on the Discussion Paper relating to Draft Regulatory Technical Standards on prudent valuation.

GENERAL COMMENTS

- The FBF understands that with this discussion paper, EBA intends to provide technical details to supplement the level 1 requirement of the articles 31 and 100 of the CRR. Prudent valuation is already required under CRD III and is therefore already implemented though sometimes in an inconsistent way. While we do not challenge the concept that valuation must be prudent in essence, we would like however to underscore that the introduction of a prudent valuation clearly dissociated from the accounting approach of fair value is not grounded on sound principles as the differences between the two concepts are actually very limited. In that respect, **the extremely prescriptive nature of this Discussion Paper may have perverse effects as it could lead to undesirable divergences while the regulators and accounting standard setters should on the contrary aim at a unity between the economic value that is at the heart of business decision making, the fair value and the prudent value**.

Mr Adam FARKAS
Executive Director
EUROPEAN BANKING AUTHORITY
Tower 42 (level18)
25 Old Broad Street
London EC2N 1HQ

It is therefore a pity that the BCBS and IABS have not managed to agree upon a single standard which is prudent enough from both prudential and accounting points of view while anywhere else they encourage the prudential and accounting convergence as a best practice.

- On top of generating significant and costly administrative burden for banks and their supervisors, **this divergence may also create a perverse effect in terms of market transparency**. It virtually creates two sets of profit and loss account that will clearly not promote transparency. Most of the elements required to be taken into account in determining the prudential additional value adjustment (AVA) can/should also be taken into account in the fair value, apart from operational risk and administrative costs. This implies that **the more a prudent fair value approach is applied by institutions, the less valuation adjustments will be externalised which might confuse market analysts**. In contradiction with the EBA's intention, it leads to unduly penalizing institutions with a prudent fair value practice in place. In addition, by departing from the principle-based approach of the CRR, the Discussion Paper introduces too many prescriptive rules with complexities and possible arbitrages that are likely to jeopardize the expected benefits of transparency and management's interest.

- While the concerns underlying the Discussion Paper make sense overall, we believe some of the tools proposed by EBA may not be the most appropriate answers. In particular, we are concerned about the following proposals which go far beyond the level 1 requirement.

  - First of all, **a predefined confidence level of 95%, on top of not being clearly justified, is excessively prudent compared to what is believed to be the standard market practice, and to the current UK requirements which are themselves highly disputable**[1]..We understand that EBA aims at a harmonised and comparable measure. To serve this purpose, a predefined confidence level can be acceptable only if it is, first, calibrated to a reasonable level to ensure it is achievable and statistically meaningful, second, exclusively used as a benchmark as opposed to a compulsory measure. Hence, while a determined confidence level can serve as guidance, flexibility should be left to handle cases where there is simply not enough data to achieve any statistical measure or alternatively, cases where a simple count of available quotes or indications provides enough confidence on the realizable value. .Anyway, should the concept of a confidence level be maintained, we encourage EBA to conduct a QIS for its final calibration.

  - Second, **the back testing requirement associated with this confidence level involves a very heavy and complex implementation** (data, methodology, allocation of portfolio effect to deals…). **The effort required to implement and assess the relevance and the adequate use of the results is likely to be disproportionate to the actual benefits and will instead divert resources**

[1] FSA's Policy Statement PS12/7 Regulatory Prudent Valuation Return: "*The 'Upside Valuation Uncertainty' similarly represents the amount by which the correct fair value might be higher than the 'Net B/S' figure supplied (that is, there is* ***90% confidence*** *(or alternative confidence interval defined by the firm) that the actual value is lower than the 'Net B/S' plus the 'Upside Valuation Uncertainty')*"

from the core objective of setting a prudent valuation to the most complex transactions. The paradox of this requirement is that any back-testing would really matter in terms of valuation uncertainty only for positions where observable data is not or less available. Moreover, for certain transactions, in particular client driven ones, the exit price simply does not exist against which a back-test can be performed. Finally, another hurdle to such back-testing consists in the fact that some of the adjustments are computed on a net portfolio basis, while the exit price is deal-based. We therefore consider that this requirement should be simply removed from the EBA RTS.

- o With a view to mitigate the high confidence level, this Discussion Paper allows factoring in the diversification benefit. However practically speaking, this benefit is very difficult to measure and to allocate to business lines. **We would rather measure the diversification effect occasionally and use it as a scaling factor for adjustments that can be added up and allocated to individual business lines**. Even more pragmatically, we would strongly recommend to adopt a much lower confidence level guidance (around 70%) which would integrate on a fixed by simple to implement basis the diversification.

- o Finally, some of the AVAs contemplated in this Discussion Paper are either irrelevant or already taken care of in the denominator. An example of the former is the balance sheet substantiation which goes beyond the CRR requirements. Indeed, we believe that the completeness of accounts and audit failures should not be dealt with prudential valuation adjustments and are out of the scope of the EBA RTS. Similarly, measuring the operational risk might not be appropriate in this framework as incorporating the operational risk in the exit price seems complicated and may overlap with the operational risk capital charge. Last but not least, concentration and liquidity horizons are already taken care of by the fundamental review of the trading book framework. **Overall, we are concerned that it would result in double counting the AVAs in the numerator and the denominator of the solvency ratio.**

You will find in the appendix attached our responses to specific questions of the Discussion Paper.

We thank you for your consideration of our remarks and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

Jean-Paul Caudal

APPENDIX - RESPONSES TO SPECIFIC QUESTIONS

A. Introduction

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?

While we don't fully understand what the term "proportionality" means in this particular context, we do believe that prudent valuation setup should incorporate materiality consideration.
For sake of simplicity, materiality threshold should not be based on the contemplated measures but rather primarily driven by expert judgment based on internal policy and thorough documentation regarding the materiality of fair-valued positions in the balance sheet.

As far as the question was to determine whether all the financial institutions are concerned or just a portion, we believe that aligning this concept with the one used in the accounting standards seems reasonable.

B. Process to calculate AVA

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 fair value measurement needs to incorporate conditions that prevail at the measurement date. Departing from this concept would make accounting fair value and prudent value irreconcilable.

We refer EBA to IFRS13 which states that the exit price refers to a <u>hypothetical</u> transaction that is <u>not necessarily actual sale</u> or forced transaction or distressed sale (BC30).
In other areas of the same standard, the entity does not even need to be able to sell the asset at the measurement date, and only need to be able to access the market.
Finally, the fair value assessment generally takes into account the worst situations of inactive market.

Ultimately, fair value measurement is an elaborated approach that factors conditions that prevail at the measurement date, and aim at determining what the transaction price at that date could be (even if there isn't actually a market).

Therefore, , the fair value measurement assumes implicitly that there is always a possibility to determine the price at which a transaction could take place with a hypothetical knowledgeable, willing, risk-averse market participant who is acting in its best interest.

Had that transaction taken place at the measurement date, it would be consistent with the fair value measurement; if it takes place at a later time T, then it is comparable with the fair value measure at this time T.

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 believe that a specific time horizon for exit should not be set when assessing prudent valuation. Marketability horizon is at best an intrinsic feature of a product in a given market context. It cannot be set exogenously by regulation.
This feature may have some influence on the value, for example through some positive or negative premium that may be explained by the ability or inability to easily sell/liquidate the products. Also, size of bid/offer may also depend on the marketability horizon and is not necessarily linked to capital considerations or capital horizon.

This is typically the area where the double counting mentioned in the general comments would occur. Time horizon is an element to be taken into account in the RWA calculation and not in the valuation. The liquidity horizon issue is by the way one of the main concepts put forward in the fundamental review of trading book.

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 do support the idea of providing a generic guidance when assessing uncertainty and determining valuation adjustments; however, judgement is necessary to these purposes.
As a matter of illustration, there are circumstances where the market available information is biased by the participation of market players that are neither active, nor really willing to deal nor knowledgeable. This could be the case in certain consensus where the increased number of participants do not add to clarity, and instead increase the variance of prices. Predefined confidence level in such situations will lead to requiring additional capital that is not economically substantiated.

In some cases, alternatives to the confidence level exist such as the simple number of binding or indicative quotes provided by active and willing market players.

We also draw the attention of the EBA on the fact that a predefined level of confidence, together with a high degree of prescription in the required AVAs, will affect prices. That is because valuation adjustments are usually allocated to the desks and contribute to setting the return hurdle for Front Officers. Hence, an extreme degree of prudence may prove very procyclical as it will result in bringing prices lower and lead to downward spiral or even worse, market extinction. Conversely, not allocating AVAs to the desks would raise the question of ownership and governance around the potential capital charge.

We understand that EBA aims at a harmonised and comparable measure. To serve this purpose, a predefined confidence level can be acceptable only if it is calibrated to a reasonable level and exclusively used as a benchmark and not a compulsory measure. Also, we think that in many instances, other alternatives could be proposed such as the simple count of quotes.

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?

As previously specified, we do not only believe a predefined level should be compelling but we also consider that 95% is too excessive. It is stricter than the new FSA requirement which is already much higher than the standard practices..

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 the RTS should not be prescriptive neither with regard to the level of confidence nor around the number of data points required for such level. A judgmental approach is preferable, combined with requirements to build robust IPV, and model risk assessment processes, where the ex-post analysis of profits (notably unwinds) is one of the possibilities.

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 "hard" specified level of confidence but we believe that an explicit guidance would be useful and would make the industry practices more homogeneous.

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

No. The RTS is sufficiently precise at this stage.

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

No. We believe that the waterfall of sources has to be defined in accordance with IFRS13, which contains a fairly good guidance on fair value hierarchy, and has been the result of extensive effort of clarification from the IASB, FASB to which add a fairly comprehensive interpretative documentation from audit industry.
Waterfall of sources has to be documented and should be associated with appropriate governance structure to cope with complex situations and to maintain methodologies. Supervisors have access to the documentation and could review its relevance.

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?

No. The EBA's Discussion Paper contains what we believe is a summary of best practices and is fairly comprehensive. We think that there is no need to be more prescriptive.

C. Description of how to calculate AVA

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

Most of the large uncertainty lies in products which embed risks that are traded one way only and not replicable (at best these are diversifiable). This is because the only protection for such risk is a self-constituted cushion of prudence or equivalently a risk premium.
Losses arise in situations where cushion of prudence constituted (Valuation adjustment) is less than the risk premium requested by market participant, to bear the risk.
This form of risk premium is the most difficult to predict and the premium gets precisely bigger when risk increases i.e. when one could get rid of the risk.

A useful indicator of such risks is the degree of active turn over observed for a given risk exposure (a volatility, a correlation…).

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?

- Unearned credit spreads and market price uncertainty are relevant and the approach described in the Discussion Paper is clear enough.

- The close out cost seems to make sense however calls for further clarification: The paragraph 23, dealing with Close out cost specifies that "the methodology should be consistent with or demonstrably more prudent than the most accurate hedging of the risk available using tradable instruments taking into account liquidity". This requirement if interpreted as requiring a very granular input could be over-punitive. In some cases, this may mean that almost no netting is possible while market would certainly consider substantial one. The prescriptive nature of this requirement may also create a divergence between the way entities look at aggregated risks in a day to day management and prudent valuation. In line with the IFRS, we suggest that this be replaced by a principle based approach where "the methodology should be consistent with the level of netting acceptable by risk management" and that the netted risks should be "substantially the same". In order to fulfil the prudence objective, EBA might consider a different requirement that entities capture the residual model risk associated with the internal risk aggregation approach, leaving to the entity the flexibility to document what it believes the optimal hedging cost/residual model risk ratio would be from a market participant stand point. A side advantage of this is that the residual model risk could be factored in an eventual diversification exercise. In assessing the cost and residual model risk, entities might be asked to use (to the extent this is possible and taking liquidity and size into account) some market-based information.

- Balance sheet substantiation: First of all, it should be highlighted that this new adjustment was not required by the level 1 text and rightly so. The Balance Sheet substantiation requirement is indeed about audit failure and therefore, we do not understand its inclusion in prudent valuation.

- Concentration and liquidity horizons: Those adjustments appear to be in overlap with the market risk RWA approach, in particular with regards to the current Fundamental Review of the Trading Book. The RTS should at best clarify that capital requirements (RWAs) should cover those requirements and avoid double counting.

- Operational risk: We believe part of the operational risk adjustments is also in overlap with other capital requirements while the other part is not an operational risk per se. As an example, we note that the deliberate choice of a model that turned out to be incorrect is not an operational risk but is a model risk, while the unintentional use of wrong model or bugs in code are operational risks. The latter should be clearly segregated from the prudent valuation, while the former should be captured through model risk. Reserving for marking risk of books not actually covered comprehensively through IPV might be a form of reserving some operational risk that is not captured through capital charge. Concentrating the requirement on those precise cases could provide incentive to entities to aim at a more complete IPV coverage, while not being in overlap with other requirements.

- Early termination: The Early Termination AVAs are primarily driven by client relationship and should not be material to the Valuation in normal course of business. Under stress situations, the decision to preserve client relationship conflicts with the necessity to survive. Therefore, a measure that is grounded on past experience is not necessarily relevant. We therefore believe that flexibility should be given to entities to evaluate whether this AVA is material or not and the charge, if any, reserved to strategic clients possibly with a documented process that incorporates some stress assumptions.

- Investing and funding costs: The funding valuation adjustment (FVA) raises tricky questions from both quantitative and practical perspective and there is no consensus in the market on this topic. While, from a liquidation perspective, the incorporation of such effect might be relevant, the FVA has far reaching consequences in terms of liquidity management and interaction between value and funding policy. In particular, the EBA's requirement is to use own cost of funds, while at the same time excluding the own credit effect through excluding DVA. Overall, EBA's Discussion Paper does not give many details in a context where own cost of funds may have several meanings: internally defined transfer price, all-in cost of the funds, secured funds/unsecured etc… There are also other forms of market benchmarks for fund price. In absence of market established practice, it seems premature to introduce RTS with regard to that issue.

- Future administration cost: It seems to us that the requirement for this AVA is over-punitive. This provision makes the prudent value depart from the announced objective of realization of value in an on-going concern basis, by assuming full exit of the entire activity. We believe more clarity is needed in this respect. It also seems to us that from a market participant perspective, the future administrative costs that might be charged are mainly incremental charges because it is very likely that such market participant has already an active running book.

- Therefore, we recommend a less strict requirement in this area which could be the highest between i) the incremental administrative costs from market participant stand point and a dismantlement cost and ii) a full allocation of the on-going costs over the lifetime of the portfolios (with an underlying assumption that the book is run back to back and size reducing progressively).

- Model risk: This adjustment corresponds to the current practice. However, it might be appropriate to review it once the new capital framework for trading book kicks-off as Regulators are contemplating to introduce capital add-ons for model risk.

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?

We believe the RTS cover all the material causes of valuation uncertainty.

The materiality assessment for the adjustments that are not usually part of the fair value (such as operational risks or future administrative costs) is difficult to determine as we do not have any process or data enabling such exercise. We can only outline their conceptual flaws and propose them to be reconsidered.

D. Testing for prudence of valuation

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?

Overall, we do not fully understand Annex 2 and its purpose. <u>We can however point out to the following limitations in EBA's proposal:</u>

- First and as explained above, a consistent framework needs that valuation back-testing is separated from price variation effect which is a market risk already attracting risk weight.
  EBA's Discussion Paper contains some examples of back-testing at close of business with the transactions taking place the day after. We believe that such a test is acceptable only if the time window is narrow enough. But when this is the case, this limits the interest of the non-judgmental test to only those instruments that actively trade within a narrow time window (in practice, this will be limited to level 1 or most observable level 2).

- Second, the guidance does not prescribe precisely the test and whether it applies for a given instrument or a group/class of similar instruments. We observe that if the transactions that compose the data samples are related to fungible instruments, then this restricts the interest of the exercise basically to actively traded securities and actively traded listed derivatives, which are most likely level 1.

  This would exclude almost all OTCs. Other approaches to the testing require a more precise definition of asset classes of homogeneous instruments, and more complete segmentation across product features and modelling features. Such approach hardly accommodates prescriptive requirements, and would be more meaningful with an internal model.

- Finally, another point to which we draw EBA's attention is that the interest of the test might be limited, because it embeds a clear bias towards those deals that are profitable. Indeed, as explained in the general developments, the valuation and valuation adjustment framework act as a return hurdle to the trading desks, hence there is a clear incentive to enter or exit deals where hurdle is passed; otherwise the deal may either remain in the book or not be entered at the first place. Accordingly, we can reasonably expect that the test will generally be passed in normal conditions, and therefore it has little predictive power.

Alternatives

A consistent approach to back-testing a point-in-time measurement, using real transactional data, necessarily needs to be grounded on an analysis/explanation of the instantaneous P&L of each transaction.

This approach is the one used to derive the Day One Profit for level 3 instruments from the End of Day process, which is aimed at providing the best proxy to instantaneous P&L. However it has many limitations notably because (amongst other issues) i) there isn't such an instantaneous official revaluation process hence there is no negligible noise embedded in the initial P&L ii) there isn't a simple, non-conventional way to allocate Valuation Adjustments to individual deals and not the least iii) the initial P&L may embeds commercial margins.

Overall, we believe a robust documentation/justification of the valuation adjustments under the supervision of Auditors and Regulators remain the most appropriate 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?

A few principle based requirements should be enough to ensure comparability.
Such principles should provide basis to accept or reject the Valuation Adjustment framework under 'current' market conditions. There are many features that need to be considered in practice: the frequency at which the validation is done, the minimum / maximum period of time it covers, the number, size and direction of trades, the degree of similarity of the instruments within the sample.
More importantly, it is very important to define precisely the objective of the validation process, in particular whether the entire AVA framework is being tested or an individual AVA or a combination of some AVAs or a adequacy of AVAs for a given product etc…

Instead of being too prescriptive, and in order to ensure comparability of the levels of prudence, we also recommend that EBA circulates "test portfolios" to be valued among credit institutions.

We also refer to previous answers on the limitation of the proposed testing approach.

E. Aggregation of valuation adjustments

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?

A tricky case is related to Day One profit adjustment and it depends whether it is considered to be part of fair value or not. Under IAS 39, Day One profit is included in fair value as the fair value is an entry cost for non-observable transactions. Under IFRS 13, Day One Profit could be considered as an adjustment outside fair value, with the assumption that there are two markets and that entry price differs from exit price. This interpretation achieved the convergence with US practice which does not generally defer Day One Profits.
We observe that the Prudent Value is defined as an exit price which is possibly more prudent than the IFRS13/USGAAP. It also possibly incorporate early termination effect could include portion of initial margins/profits. This might overlap with the day one profit under EU rules, while it does not under US rules.
We therefore consider that an appropriate way of deriving prudent valuation is to consider that Day One Profit is not part of the valuation. However, we also observe that deferral of initial profits overlaps with some of Prudent Valuation concept, particularly when introducing future administrative costs; hence its capital treatment requires further clarification.

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

The diversification benefit makes sense especially in case such a high confidence level is to be applied as this Discussion Paper suggests. We propose that the scaling factor be calibrated from a companywide diversification factor allowing a reallocation of prudent value to different business lines. This approach will be as such beneficial from the use-test perspective.

An important point with regard to diversification (mentioned in annex 4) is that it is likely that Fair Value already incorporate a substantial part of the prudence required by CRR. Regarding the level playing field, it is important that the diversification “benefit” does not benefit only to those entities that are the most aggressive in fair value. Therefore, we believe that more clarity is introduced in the EBA guidance to ensure that diversification applies across all the valuation adjustments and not just the AVAs that are introduced under the Prudent Value concept.

Finally, in case diversification effects are disregarded for the purpose of calculating the valuation adjustments, then a much lower confidence level guidance (around 70%) should be introduced to avoid reaching unrealistic and uneconomic amounts of adjustments.

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?

Overall, we believe that standardisation will be detrimental to the use-test.
In addition, in the simplified aggregation approach proposed in Annex 4, we do not understand why the long and short positions need to be aggregated separately. When two positions offset well (same risk factor), only the residual net position should be considered. If the netting is imperfect (different tenors or strikes) then some correlation must be considered. This said, we understand the need for a simplified standard approach in particular for banks with limited fair-valued portfolios and are willing to contribute to developing such approach.

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?

Yes, the aggregation method must be developed in-house and validated by regulators. However, it needs to be simple. We should compare the correlated uncertainties with the sum the absolute uncertainties. The ratio is the diversification benefits. We may impose a floor for this ratio. The use of a simple auditable covariance matrix calculation should be preferred. The ratio will not only depend on the choice of correlations but also the level of granularity of uncertainty factors.

F. Offset to AVAs when calculating the adjustment to common equity tier 1

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 estimation of AVAs should avoid overlapping requirements. We consider that adjustments to Common Equity tier 1 should not be double counted. We therefore believe that the concepts of time horizon and operational risks should be dropped from the requirements. Finally, we re-emphasize the need to clarify the interlink between AVAs and Day One Profit deferred stocks.

G. Documentation, systems and controls requirements

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?

This Discussion Paper is highly demanding in terms of documentation, systems, control and reporting requirements which in principle appears to be reasonable but unrealistically heavy to implement.

These requirements will create difficulties for justifying and explaining the gap between the fair value (accounting framework) and the prudent value (prudential framework) to accounting supervisors, statutory auditors, the internal audit committee, the executive committee or the board of Directors.

H. Reporting requirements

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 a certain degree of cushion 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 only AVAs are eligible to diversification.
However, the AVA framework is somehow auto-realizing and will 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.
Potential effect is therefore that the cost for clients will increase for the products that embed large model risk or measurement uncertainty or that have high operational cost.
Another potential effect could be to give clear incentives for firms that do not have solid franchises, optimisation capabilities, good knowledge of the products and cost optimisation capabilities to exit the business. EBA should realize that the highly prescriptive nature of the methodologies is such that the operational cost associated with the implementation is very high even for banks that already have solid valuation frameworks and a long tradition of prudent valuation.

As far as a 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 a clear disclosure of all valuation adjustment (and not only AVAs), and 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?

At this stage, we believe that setting up a reporting template is premature.