European Banking Authority (EBA) Discussion Paper

On

Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR)

(EBA/DP/2012/03)

Dated 13 November 2012

Response of Bank of America Merrill Lynch (BAML)

11 Jan 2013

EBA Discussion Paper Response

A. Introduction

Bank of America Merrill Lynch ("the bank") welcome the opportunity to comment on the above Discussion Paper ("the Paper") issued by the EBA. The response has a summary followed by answers to specific questions raised by EBA.

Summary

The paper contains many well constructed thoughts that the bank agrees with which are noted below and accepts that it is useful to have guidance around framework of prudential valuation.

Practical concerns arise from the following areas;-

Confidence level

The use of 95% confidence level is inappropriate for use in prudential valuation.
The bank believes that prudential valuation will typically be driven from less liquid/ observable assets requiring judgement. And that, as such, a lower confidence level would be more appropriate. Instead a "target" confidence level of 80-85% is proposed.

It is understood that the intention is to create a reasonable, conservative lower-bound for an asset values. This will necessitate judgement on illiquid positions and interpretation of ambiguous data, which are inconsistent with a 95% confidence level.

Back-testing

The bank does not consider that back-testing should be performed against prudential valuation.
To the extent that trading activity results in material or systemic financial loss, the internal focus should be on misstatement in fair-values as opposed to the prudential valuation lower boundary.

Prudential valuation should be focussed at pricing uncertainty at balance sheet measurement date.

Systems and controls

Whilst not having fundamental disagreement with the broad themes of systems and controls section, the bank does not consider that this is relevant for the prudential valuation discussion paper.

The points pertain to fair value, as opposed to prudential valuation and should not form part of the final paper.

Regulatory Double-count

The bank considers that elements of paper discuss potential additional valuation adjustments that should be considered in other regulatory returns. There should be an overarching principle that seeks to exclude double-count of regulatory deductions.
Where article 100, paragraphs 10 & 11 include already calculated capital charges, we would not expect to submit as part of prudential valuation return.

This includes but is not limited to the operational risk charge and Balance sheet substantiation charge.

Statistics vs. Judgement

Whilst acknowledging that you need some framework to determine a boundary condition that is comparable.
The majority of prudential valuation adjustments will be generated from illiquid positions (either cash or derivative) and that for these positions, it will typically not be possible to directly observe a distribution of external prices.

We would expect that management focus would be directed towards the more subjective positions, which will tend not to be supported with statistical-only calculations.

Examples

Annexes 1 & 2

Annex 1 – Is predicated on back-testing of prudent valuation, which we do not agree with (see above)
Annex 2 – Is further iteration on this, which becomes unnecessary

The bank considers that these fail a cost-benefit test for the purposes of prudential valuation. Implementation would be expensive and likely have sufficient data only to support conclusions on most liquid/ lowest materiality prudent valuations.

Question per document	BAML Response
1. 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?	No We believe that prudential valuation should be based on specific inventory positions.
2. 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. Prudential valuation framework intention is to provide greater comparability about point-in-time fair values (balance sheet date). The purpose of prudential valuation is to estimate a reasonable downside boundary for fair value. Whilst an instantaneous sale suggests the buyer may not have time to properly consider the asset and would so apply a discount which is not appropriate in a going concern scenario. Determination of a proper prudential valuation requires buyer to be a well-informed counterparty at balance sheet date, where buyer has opportunity to get to know the assets.

3. 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?	No. Different time periods should apply to different assets. Different assets would take different lengths of time to sell for variety of reasons (market specific, complexity/individuality of asset, documentation requirements). Prudential valuation framework relates to pricing uncertainty/ boundaries at the balance sheet valuation date, but should not seek to set aside additional capital for market-movements during exit-period, since we have other metrics that consider this (e.g. VAR) The exception to this is application of specific concentration add-on. This is to capture the impact of market movement as a direct result of risk-reduction activity on material open exposures.
4. 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?	Yes. (However, see note) Support confidence level so we have consistency between banks Intention being to create a reasonable conservative boundary for valuation in orderly markets. However, care is required with the use of “confidence levels”, given that for many adjustments, there will be insufficient data to support a statistical measurement. Indeed, where it is possible to create meaningful assessment, the positions will be by definition liquid and will likely have low level of valuation uncertainty/ prudential valuation adjustment. Therefore application of AVAs for subjective assets will be expected to incorporate judgment. And do not support the highly specific way suggested in the paper.

5. If you support a specified level of confidence, do you support the use of a 95% level of confidence? What practical issues might arise or inconsistencies with other parts of the CRR when using this level of confidence?	No. Since will rely on judgment, prefer 80 to 85% judgment (95% will be impractical) This boundary is more consistent with UKFSA framework and is aligned broadly with FAS157 level 3 classification which is already supported with internal process. We would hope that global regulators could adopt something close to global standard.
6. 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 judgmental approach being necessary?	Not prescriptive, not statistically calibrated. The more material RTS figures will be in assets where there is little data, so prescriptive definition not appropriate Prudential valuation adjustments will tend to be driven from instruments with combination of the following characteristics - Least pricing transparency - Least liquidity - Greatest complexity The characteristics of these are unlikely to support running of statistical tests on results and we would prefer that we use a non-statistical/ judgment when setting boundary conditions. As in answers to questions 4 & 5, we believe that there will be judgment required around application.

7. If you support a specified level of confidence, do you support the explicit allowance of using the level chosen as guidance for a more judgmental approach where data is lacking	Yes. Indeed, we typically envisage the use of judgment in the assessment of prudential valuation and see no practical alternative to this. The more material RTS figures will be in assets where there is little data, so prescriptive definition not appropriate Prudential valuation adjustments will tend to be driven from instruments with combination of the following characteristics - Least pricing transparency - Least liquidity - Greatest complexity The characteristics of these are unlikely to support running of statistical tests on results and we would prefer that we use a non-statistical/ judgment when setting boundary conditions.
8. Should any additional possible sources of market prices be listed in the RTS?	No. Since RTS already includes catch-all "including but not limited to" language. We see little value in attempting to further extend to a more exhaustive list.

9. Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?	No. Focus should be instead on the intention of result, as opposed to prescriptive practice to interpret potentially scarce/ ambiguous data. It is expected that more material prudential valuation will be generated from FAS157 level 3-type assets based on scarcity of data and judgment. Attempting to describe upfront how to interpret this information is impractical.
10. 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. See previous points. We anticipate that judgment and business/ market acumen will be required to create frameworks for specific products/markets.
11. Are there any other indicators of large market price uncertainty which should be included?	No.

12. 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 consider each of the potential AVA drivers in turn. We do not agree with all approaches. Unearned Credit spreads – agreed - There exists uncertainty in the fair value of CVA adjustment Close-out costs – agreed - Note that there is potential conflict/ duplication between close-out costs and future administrative costs Operational risks – not agreed - There is a capital buffer held for operational risks under the operational capital charge - It is inappropriate to provide buffer twice Market price uncertainty – agreed - Market level uncertainty against mid-market levels agreed Early termination – agreed, see note - To the extent that client prices differ from book value agree that there should be an adjustment - We note that this is potentially a non material adjustment Investing and funding costs – agreed, see note - Will consider investment/ funding costs but need to take care with determination and application of the appropriate funding curve Future administrative costs – agreed, however - Note that there is some overlap that should not be double counted. - Bid-offer costs will overlap to some degree Model risk – agreed Concentration and liquidity – agreed

<table>
<tr><td></td><td>- Concentration adjustments are specifically not allowed under fair value accounting
- There is evidence that hedging of significant concentration can have an effect on mid-market levels

Balance sheet substantiation – not agreed
- Balance sheet substantiation specific to fair valued assets should be captured with market price uncertainty
- Broader balance sheet substantiation should be incorporated in operational risk charges</td></tr>
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<tr><td>13. 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?</td><td>No.

We note that Balance sheet is covered by accounting
We note that Operational risk is covered by Operational risk capital

We would expect not to provide incremental capital buffer against these measures.</td></tr>
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<tr><td>14. 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?</td><td>No.

This describes a potential approach for assessing realized P&L on more-liquid part of asset spectrum where there is significant trading activity.
We already existing procedures in place to substantiate marks on the books from a business as usual perspective and would not seek to extend a separate process to evidence the “mid” level.

We believe that prudential valuation should be more focused on the hard-to-price portfolios with a more subjective input.
For which this approach would not be implementable due to lack of data.</td></tr>
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15. 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?	No. Prescriptive guidance on techniques is impractical given the nature of assets which is expected to drive the majority of prudential valuation. (See point 14 above.) Market trades are an input to price verification and measurement of fair value. Valuation techniques are commonly used in the market and accepted as basis for valuation by independent audit providing a degree of comparability, but will differ in application/ inputs and results between institutions. The breadth of assets/markets potentially in scope for prudential valuation makes prescriptive guidance impractical. (indeed in Annex I identifies different "sets" of assets to consider independently)
16. 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?	Yes. We expect that prudent valuation should be a lower-uncertainty bound adjustment to our fair valued positions. We believe that reporting of prudential valuation should focus only on this downside measurement.

17. 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	Yes. As articulated in the background and rationale part of discussion paper, diversification benefit should be recognized. It is intuitive given Prudent valuation calculation that hits our capital buffer, that a diverse institution should benefit vs. a concentrated one We would expect to calculate prudential valuation adjustments based on open positions at a business level We believe there should be some cross business diversification as well as asset-asset benefit.
18. If simple aggregation better reflect your assumptions and practices or would you support the availability of diversification benefit, do you support creating a simplified standard approach, an example of which is shown in Annex 4? If you do, do you have alternative suggestions on how this standard approach should be specified? Are the suggested correlations in the example appropriate, if not what other values could be used?	No. As referred to in point #17 we see diversification applying at a number of levels and would expect to maintain an internal approach.

19. 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. In house approach supported. We would expect in-house methods to be appropriately documented and disclosed. But, would not expect the approach to require regulatory sign-off. It should be noted that there are many component parts to prudential valuation adjustment (e.g. combines in-house fair value, scoping, choice of uncertainty ranges and some form of diversification). To create regulatory approval for all of these is not practical. To single out diversification for separate approval would seem to be illogical
20. 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)?	Offsets not permitted No. Where practical, we would expect the prudential valuation framework to NOT overlap with other capital requirements. To the extent that there is overlap an adjustment to eliminate double-count should be applied Up-front agreement with regulator No. We do not think it practical that regulator undertakes individual up-front approval of methodology. Instead, this should form part of overall prudential valuation that regulator oversees, as opposed to specific sign off

21. 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?	No. Section 4.8 describes the systems and controls that one would expect to be in place for any valuation (fair or prudent) framework and as such should already be included within the sections of the regulations that refer to fair value. This should not be repeated her but merely referenced. There is a significant overlap between "fair value framework" and "prudential valuation framework" that we do not believe should form part of the prudential valuation policy, the following section should be removed Systems and controls - This section should be removed from documentation. - The detail in this section relates to processes used in assessment in fair value
22. 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?	**Part I – costs and benefits** Implementation of a unique AVA is neither practical, nor desirable – should not be adopted Prudential valuation adjustment is the balancing figure to adjust "fair value" to a "Prudent valuation level" for comparison across institutions. Rationale:- The additional valuation adjustment is the difference between two uncertain measurements (Fair value and Prudential value) that will differ bank to bank therefore it is not possible to design an up-front unique implementation that will give appropriate resultsacross a range of institutions. Fair-value consistency At its inception, the discussion paper acknowledges that there are different acceptable approaches to establishing fair value Therefore, by definition, there cannot be a "one-size-fits-all" additional valuation adjustment (since there will be different fair-value starting points for different institutions) Prudent-valuation consistency As noted previously in response,

	Prudential valuation adjustments will tend to be driven from instruments with combination of the following characteristics - Least pricing transparency - Least liquidity - Greatest complexity Judgment will be required in the assessment of the prudential valuation. It is not possible to pre-determine a solution across all potential asset classes. **Part II- reporting** Implementation of consistent reporting – should be adopted From a process perspective, there should be standardized formats for reporting. These should be high level. We have provided an illustrative example in response to question 23
23. If you agree with a reporting form being introduced, could you please provide a suggested template?	The existing UKFSA template is a reasonable starting point. An adjusted template based on this is included We would prepare based on meaningful business-hierarchy consistent with our internal management of risk. An example is attached, note the following points. *a) It should be by type of desk e.g. vanilla or exotic/structured equity/credit/rates/fx. This is aligned with the way that we manage our businesses and is therefore most relevant* *b) It should include only downside valuation uncertainty (remove upside) – since upside is not relevant for capital buffer purposes. Prudential valuation should relate to downside measurement only.* *c) It should highlight portfolios of extreme uncertainty and of interest boxes* *d) It should retain B/S and VaR for comparability purposes* *e) It should retain diversification benefit* *f) It should include a reconciliation to the financial statements*

EBA Discussion Paper Response

Portfolios Subject to Valuation Uncertainty Assessment

Business Line	Complexity	Gross Asset	Gross Liability	Net B/S	99% 1 day VaR	Downside Uncertainty
Equities	Exotic/ Structured					
	Vanilla					
Rates	Exotic/ Structured					
	Vanilla					
Credit	Exotic/ Structured					
	Vanilla					
FX	Exotic/ Structured					
	Vanilla					
Commodities	Exotic/ Structured					
	Vanilla					
Emerging Markets	Exotic/ Structured					
	Vanilla					
CVA						
DVA						
Other Portfolios						
Aggregate portfolios included		0	0	0	0	0
Less Diversification Benefit						
TOTAL		0	0	0	0	0
Total Downside Valuation uncertainty						0
Less Regulatory Capital offsets						0
Prudential valuation/ AVA adjustment						0

Reconciliation to Financial Statements		Gross Asset	Gross Liability	Net B/S
Total value of fair valued portfolios		0	0	0
Reconciling items	e.g. Collateral netting			
	e.g. Valuation adjustments			
	e.g. Liquid Asset Buffer			
	e.g. FAS133			
	e.g. GAAP			
Fair value per FS		0	0	0