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INTRODUCTION

Thank you for the opportunity to provide comments on behalf of Grant Thornton on the EBA Discussion Paper of Draft Regulatory Standards on Prudent Valuation, published 13 November 2012.

We agree with the concept of ensuring Assets and Liabilities reflect the most appropriate valuations, supported by exit prices as negotiated by knowledgeable counterparties in normal markets. This concept is supported and further defined within the various accounting and regulatory guidelines.

The Capital Requirements Regulation (CRR) for Prudent Valuation (PV) is designed to address those situations where accounting Fair Value (FV) rules do not meet the requirements as specified by the CRR. When such a situation exists then Additional Valuation Adjustments (AVA) would be calculated and taken as Capital deductions.

The EBA Discussion Paper outlines a number of processes and considerations that should be assessed in applying an AVA. These considerations and AVA categories are also shared in the formulation of the accounting FV approach and so in applying the AVAs it is important to ensure that duplication of adjustments is avoided. Thus there should be a clear delineation between the rationale for taking AVAs versus the FV approach.

Current market leading practice in deriving FV takes into consideration the proposed list of AVA factors as outlined in the discussion paper. We would anticipate minimal additional AVAs where this level of control is already in place. We fully support the concepts that enforcing the AVA principles through additional capital charges may contribute to raising standards across the industry with regard to FV application consistency. We would recommend though a period of observation to gauge the impact of these changes and only if they have a material impact should these rules be considered a necessary part of the supervisory calculation. We believe it is preferable to reach an outcome where industry practice is enhanced such that there is ultimately little AVA impact.

The Pillar 2 option should also be considered to enforce this consistency and drive AVAs when material gaps in the FV approach are evident.

On this basis we have responded to the listed questions in the discussion paper and have highlighted in our responses where there may be potential for overlap in applying AVA versus the FV regime.

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?

Response: We believe that a threshold is appropriate before the application of AVAs. Although the idea behind the AVA proposal is to close the perceived gap to FV, consideration should be given for the considerable amount of market debate which has taken place to arrive at the accounting FV approach. Accounting FV has experienced many market stresses that have refined the approach to something that is pragmatic and understandable. Therefore in arriving at the PV care needs to be exercised to ensure that overlap of adjustments does not occur and that the AVA approach is achieving its stated targets of closing a perceived gap between accounting and regulatory valuations.

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.

Response: Yes. Exit price does not necessarily need to be based on an instantaneous sale. Other than for liquid transactions where an instantaneous price would apply, less liquid markets can have observable transactions that are not necessarily representative of a sale price between knowledgeable counterparties in an otherwise normal market.

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?

Response: The accounting FV regime requires the book to be marked at exit price. This price would incorporate liquidity through its various drivers, one of which is period to unwind. This period would be particular to the position concerned and not necessarily reflect the generic liquidity periods covered by either the VAR/CRR, etc structures. Judgement would need to be applied rather than a 'standardised' period.

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?

Response: The concept of a Confidence Level in developing AVAs is conceptually sound. However as previously mentioned, this proposal is attempting to close the gap between a perceived difference between an accounting FV and PV market approach. Unless the AVAs are covering an identified shortfall then there is going to be a level of judgement and estimate in arriving at the AVA. Applying a confidence level to estimates over and above the accounting FV may be perceived as applying precision around a process that is ultimately judgemental.

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?

Response: See question 4

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?

Response: See question 4

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?

Response: See question 4. However this point raises a conceptual issue with the application of the RTS. It would seem more beneficial for the RTS to provide a principles based guidance approach rather than prescription given that the types of transactions concerned require a level of judgement that would be difficult to combine under a banner of specification.

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

Response: Given the constant market developments in availability of data, it would seem that the RTS would need to be continually updated to maintain relevance. As part of their governance process professional valuation control functions should be continually monitoring the market for all available pricing sources.

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

Response: It could be beneficial for the RTS to provide guidance around the application of prices and market sources in developing the fundamentals of a valuation process. Again focusing the RTS on a principles approach would provide the market with standards of application rather than detailed specifics that may not apply to all markets and jurisdictions.

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?

Response: See question 9

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

Resonse: No. The FV approach to valuation shares concepts with the PV approach. Given the FV concept has been a mainstay of valuation for a number of years including a stress test through the recent credit crisis, this period in particular did not identify 'Adjustment Categories' that are not already listed in the EBA paper.

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?

Response: See question 11

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?

Response: See question 11. However through guidance principles the RTS could focus institutions on ensuring that PV is the main goal. Therefore whatever adjustment is required to arrive at that result should be incorporated into the process. As mentioned in our response to question 11, the current set of adjustment categories seem to provide a relatively comprehensive approach.

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?

Response: No. Statistical tests such as these do not fully encapsulate some of the qualitative judgements incorporated in arriving at an FV or PV. The danger in applying a statistical approaches to what is already based on judgemental factors creates the illusion of certainty around an uncertain process. An academic exercise for its own sake does not necessarily add value.

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?

Response: Given the level of technical judgement required within each institution in arriving at the most appropriate FV/PV, which are in themselves based on long standing valuation concepts, the value add from RTS must be to enhance this process. RTS could provide principles and guidance as well as specific examples given the more esoteric transaction types that RTS is addressing. The RTS should provide, through its principles, consistent guidance in making sure that control functions have considered all relevant issues.

It should also be noted that Basel Pillar 2 is intended to ensure that institutions apply the regulatory guidelines consistently and appropriately. Pillar 2 should be used as a tool to enforce standardisation within the RTS principles.

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?

Response: No. It is unlikely that the PV will ever be greater than FV. This would be due to the fact that the FV process takes into account all valuation considerations and therefore it would be highly unlikely that another valuation adjustment would reverse the assumptions within these considerations.

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

Response: The concept of PV is to align those instances where FV does not equate to this approach. This would mean therefore that AVAs would be mostly specific and not general and so a diversification factor would most times not be applicable. However, if a situation did arise where AVAs were applied to transactions across an institution that did exhibit a correlated profile, then potentially a diversification factor could be considered.

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?

Response: As noted in question 17, if a diversification factor was applicable, it would more than a likely be bespoke to the particular transactions involved. Therefore the RTS could be focused more on guidance and supporting examples rather than specifying a particular 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?

Response: See question 18

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)?

Response: AVAs are applied in arriving at a PV, therefore there should be no overlap with other Pillar 1 capital requirements. If overlaps did exist then these should be eliminated in the regulatory capital calculations otherwise the capital regime becomes confused.

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?

Response: As stated in our Introduction, appropriate valuation of assets and liabilities should be the goal of all institutions. Principles provided by accounting requirements and regulation, overseen by control functions, both internal and external provides a framework aimed at ensuring this goal is met. We see the CRR regulations (and supporting RTS) as a key component of this framework however we would see the design of the RTS to provide principles and guidelines rather than detailed specifics, supported by the Pillar 2 regime as a tool for standardisation and enforcement.

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?

Response: The costs of implementing such a process within control functions should be marginal given that it is an addendum to FV and it would be expected that AVAs would be only taken in exceptional circumstances. If the benefits are measured in a more robust valuation process then these would outweigh the costs.

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

Response: There should be no reason to derive a new template as the existing supervisory template should be sufficient.