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**Re: EBA/DP/2012/03**

Dear Sir/Madam,

Detailed below are our comments on the Discussion Paper, on Draft Regulatory Technical Standards (RTS) on prudent valuation under Article 100 of the draft Capital Requirements Regulation.

**General Comments / Overview**

We agree that firms bear valuation risk against which it is appropriate to hold capital. Whilst the additional guidance from regulators to quantify this capital deduction is welcome, we believe that the RTS as outlined in the Discussion Paper (DP) fails to sufficiently recognise that valuation is a judgement which is frequently made based on limited data availability. As such, the proposed prudent valuation framework does not achieve the objectives as set out in the DP and requires a number of significant enhancements that should be addressed prior to finalisation of the RTS. Specifically:

a. The RTS is overly prescriptive, and does not allow for institutions and their supervisory regulators to make appropriate judgements of valuation risk and prioritisation of resources.

b. Paragraph 8 of Article 100 requires institutions to focus on prudent valuation adjustments for the more complex and less liquid instruments/portfolios held at fair value. In contrast, the Discussion Paper focuses mainly on more liquid and vanilla instruments/portfolios, and therefore fails to give appropriate guidance and requirements for where valuation risk is highest.
In particular, we find the annexes to be particularly unhelpful in this respect and recommend their replacement with more relevant guidance for less liquid level 3 positions or portfolios.

c. The validation requirements are extremely onerous, and will effectively require institutions to maintain a parallel set of position marks at prudent levels and therefore a parallel set of books and records.
    i. The implementation and ongoing costs of maintaining a parallel set of books and records are prohibitively high compared to alternative approaches
    ii. Given the limited data availability, institutions will be forced to validate their prudent valuation against the same data set used to create the AVAs. Therefore the validation exercise as currently described cannot, by design, identify issues.

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d. The RTS fails to recognise that offsets/diversification benefits are absolutely required to deal with
   i. diversification of risk;
   ii. overlap with other requirements of the CRR;
   iii. the possibility that, for any given position, the sum of all AVAs is greater than the range of possible market prices;
   iv. the possibility that, for any given position, the sum of all AVAs is greater than the value of the position itself

e. The required confidence level of 95% is too high and impractical to implement.
   i. The confidence interval need not be numerically identical with VaR or other capital measures;
   ii. Setting the threshold too high will begin to overlap with other parts of the CRR;
   iii. Finding the 95% confidence interval from <20 data points requires extrapolation and therefore results in more subjectivity and judgment being applied, rather than less;
   iv. The higher the threshold, the greater the increase in pro-cyclicality of capital;
   v. 95% is beyond the descriptive threshold of "the range of reasonably possible values"

   We recommend using one standard deviation (equivalent to a confidence level of 84%) because:
   i. This would significantly reduce the operational risk and implementation costs since 1 standard deviation is generally already used in institutions' independent price verification (IPV) process
   ii. 84% is within a reasonable range of uncertainty
   iii. This confidence level would maintain the benefits of understanding a range around an institution's fair value marks.
   iv. The absolute confidence level chosen is not necessarily the most important input; also of importance are the data points included, the distribution chosen, etc. Aligning this with IPV would ensure consistency of approach across regulatory and accounting frameworks

We have also contributed to the industry response submitted jointly by AFME, ISDA and the BBA, and are supportive of the themes and points made in that response.

We have included our responses to the specific questions asked in the DP in appendix A. Should you wish to discuss these further, please do not hesitate to contact me.

Yours faithfully,

David Buckley
Chief Financial Officer
Morgan Stanley, EMEA

**Appendix A: Responses to Specific Questions**

*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?*

We would recommend considering a proportionality threshold at two levels:

1. At an entity level

Our view is that prudent valuation should be assessed on an individual entity basis; either once the size of the trading book reaches a certain size or complexity, or once the deduction from tier 1 capital would be material. For example, the thresholds could be:

- Value of gross assets held at fair value > €xx billions; OR
- Value of gross Level 3 assets in the trading book > xx% of total gross assets in the trading book

We also believe that that the application of the RTS at a consolidated group level would be overly onerous since it would require consideration of multiple immaterial entities and any interaction between them.

2. At a portfolio level within an entity

Within any institution there may be portfolios of liquid assets for which the prudent valuation is similar (if not identical) to the fair value. For example, any portfolio consisting entirely of any combination of the below assets or characteristics in "normal" market size, would be considered highly liquid.

- Cash equities traded on major exchanges; OR
- Highly rated government or agency debt (e.g. G7 government debt or covered bonds)
- Contracts with possible daily cancellation by either party with no penalties (e.g. equity swaps)
- Vanilla interest rate swaps traded in standard maturities

The final RTS, in line with paragraph 8 of Article 100, should recognise that including such portfolios leads to an insignificant capital deduction, whilst requiring an onerous burden of analysis and back-testing.
An institution should therefore be allowed to de-scope these portfolios, either by designation within the RTS or by agreement with their supervisory regulator. Some initial identification and on-going monitoring would be required, which should be relatively simple to perform. For instance, an institution would need to consider a prudent valuation capital deduction for these portfolios where:

- They contain significant concentrations in individual securities, underliers or tenors; OR
- A trend of day1 entry or exit p&l identifies significant size of p&l

*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.*

We would agree. We believe that the language should be clear that prudent value assumes going concern and does not consider the requirement for a "fire-sale" price (i.e. that the time horizon is not too short). We are concerned that using terms like "instantaneous sale" might lead institutions to interpret these as fire-sale prices when this should not be the intention.
Conversely, the language should be equally clear that prudent value does not need to incorporate possible market moves from a prolonged sale period (i.e. that the time horizon is not too long).
We believe that consistency with the fair value time horizons would be most appropriate, since prudent valuation is a measure of uncertainty of fair value.

*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 specific time horizon should be set: we would suggest that the wording is not prescriptive and is consistent with fair value. Different markets will have differing liquidity and conventions, and prescriptive wording may not necessarily capture this.

It is important to note that prudent valuation is fundamentally different from (for example) VaR, since prudent valuation is a measure of uncertainty in the fair value at the balance sheet date, whereas VaR is a market risk metric capturing the risk that the market might move against you in a given time-frame. Therefore, it is clear that the horizon in prudent valuation need not align with VaR.
By extension, it becomes apparent that the time horizon for prudent valuation can be independent of other capital calculations, and should align with the time horizon(s) used for estimating fair value.

*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?*

We support the concept of a specified confidence interval, in order to allow different institutions to approach the requirements in a similar way. However, we believe that the specified confidence interval should be for guidance only: in practice it is not possible to show that a value is at a specified confidence interval for the majority of risk positions. In cases with greater valuation risk, there is generally insufficient data to come up with a statistical measure. Frequently judgment needs to be applied, and this requires that the confidence interval is a guide.

We believe that the only AVAs where a confidence level is appropriate are market price uncertainty, close-out, concentration and liquidity costs and funding costs.

*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?*

We believe that specifying the confidence level at 95% is too high, for the following reasons:

a. The confidence interval need not be numerically identical with VaR or other capital measures, since these are capturing fundamentally different risks, as discussed in our response to question 3;
b. Setting the threshold too high will begin to overlap with other parts of the CRR – e.g. it is feasible that a prudent value (as derived according to the RTS) at the extreme end of the fair value range may also capture a reasonable market movement that the market risk framework is designed to capture. In principle, the prudent valuation framework should not be used to capture future price volatility
c. Where a range of market data is available, there are frequently <20 data points, and in areas of high subjectivity, there are frequently <10 data points. Thus finding the 95% confidence interval becomes an issue of extrapolation. This results in more subjectivity and judgment being applied, rather than less, which we believe the RTS to be trying to avoid;
d. The higher the threshold, the greater the increase in pro-cyclicality of capital as a result of this capital deduction;
e. Prudent valuation should capture the range of reasonably possible values within a range, and 95% is far beyond that descriptive threshold.

We believe that the confidence interval should be consistent with Independent Price Verification (IPV), which assesses an acceptable tolerance from fair value. Generally across most institutions, IPV applies a one standard deviation tolerance, equivalent to a confidence interval of 84.13%. We believe aligning the confidence interval with IPV to be most appropriate because:

a. This would significantly reduce the practical implementation, operational risk and costs of implementing the prudent valuation framework as described in the Discussion Paper
b. 84% is within a reasonable range of uncertainty
c. This would help to improve & standardize the implementation of IPV across relevant institutions
d. This confidence level would maintain the benefits of understanding a range around an institution's fair value marks.
e. It would ensure that the review of the confidence interval and the range of data being used are captured within each institution's external audit on an ongoing basis, rather than being subject to regulatory review only
f. The absolute level of CI chosen is not necessarily the most important input; also of importance are the data points included, the distribution chosen, etc. Aligning this with IPV would ensure consistency of framework across regulatory and accounting frameworks

*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?*

We do not believe that prescriptive requirements would be helpful. Valuation is by its nature a judgmental exercise and so we believe that the requirements should avoid being prescriptive to this level of detail. Judgment is critical to all aspects of these requirements, whether this is in the quality of the data points being included within the analysis, the shape of the statistical distribution being used, or whether the end result meets the desired target of the required confidence level.
The final RTS should require institutions to actively make these judgments within a given framework, rather than to avoid pertinent issues through the unquestioning following of a prescriptive rule

*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, we support this statement: in fact, this is the only practical approach to fulfilling the requirements of Article 100. As discussed in our responses to questions 4 and 6, in cases with greater valuation risk, there is generally insufficient data to come up with a statistical measure, and so judgment is required in arriving at a coherent result. The final RTS should require institutions to actively make these judgments within a given framework, rather than to avoid pertinent issues through the unquestioning following of a prescriptive rule.

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

We would suggest that the following additional data sources could be considered:

- Central clearing houses
- Composite pricing services
- 3rd party price vendors
- Fundamental analyses

but note that the discussion paper includes the phrase "including but not limited to" and so a comprehensive list of data sources is not required.

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

Within the decision tree included in paragraph 18 in the Discussion Paper, we believe that the description of how to use the various sources of market prices to obtain a range of plausible prices is adequate and sufficient. We do not believe more description is required.
We do not believe annex 3 to add any value since it appears to be purely a written description of the decision tree in paragraph 18. We recommend that annex 3 is replaced with worked examples of application of the framework for a sample of less liquid or level 3 positions with different principal markets and data availability.
In general within the Discussion Paper, we believe that that requirements are too prescriptive, and do not account for the fact that in many situations, very little data exists to demonstrate an exact confidence interval has been reached. We believe that the final RTS should recognize that judgment is critical, and provide a framework within which each institution can make those judgments as appropriate to their individual circumstances.

*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, we do not believe that the RTS should be more prescriptive. In line with our general comments and the responses to previous questions, we believe that where there is insufficient data, it is imperative that expert judgment is applied. Valuation is by its nature a judgmental exercise and so the requirements should avoid being prescriptive, so as to require institutions to actively make these judgments, rather than to avoid pertinent issues through the unquestioning following of a prescriptive rule.

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

In our view, 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?*

For the "Close-out Costs" AVA, we note that the requirement that the risk netting is "consistent with, or demonstrably more prudent than, the most accurate hedging of the risk available using tradable instruments" is extremely onerous and risks over-stating the exit costs for a given portfolio.
For example, options on the Eurostoxx50 equity index are tradable at every 50 index points. However, it is not necessary to manage a whole portfolio of such options down to this strike level. Where these options are either in- or out-of the-money (and especially as the contracts become close to expiry), the difference in risk is small for 2 contracts with strikes 50 index points apart, and so no institution would manage the risk down to this level of granularity, despite there being different hedging instruments available.
This requirement should therefore be re-worded to be less prescriptive, but still to ensure that an institution considers a prudent and appropriate level of risk aggregation within its close-out costs.

The "Balance Sheet Substantiation" AVA should be removed from the specific requirements of the final RTS.

- Balance sheet substantiation" is not included within the scope of Article 100
- Balance sheet substantiation risk is not a market pricing input and so is not relevant to the RTS definition of prudent value in paragraph 16 ("prudent value should reflect exit prices at which the institution can transact")
- Balance sheet substantiation is already controlled through internal controls, SOX404 and statutory audits, and is subject to capital requirements through Operational Risk frameworks.

The "Operational Risk" AVA should be removed from the specific requirements of the final RTS.

- Operational Risk is not a market pricing input and so is not relevant to the RTS definition of prudent value in paragraph 16 ("prudent value should reflect exit prices at which the institution can transact")
- Operational Risk is already captured through each institution's existing operational risk capital deductions

We have no specific comments regarding each of the other individual AVAs. However,

1. It is clear that by summing each individual AVA for any given position, the result will be significantly greater that the overall prudent value when considering the available exit prices for that position.
   We believe that this clearly shows that the so-called "diversification benefit" is required to ensure that there is no over-statement of the prudent value and that there is no overlap with other capital requirements.
2. We have significant concerns that a feedback loop will be created between prudent value and fair value. AVAs are likely to be assigned to trading businesses or trading desks in order to measure return on capital. As a result, they are likely to become incorporated into fair value and charged to clients, increasing client costs. Prescriptive AVAs which then force prudent value to be lower than

fair value will create a feedback loop as the additional AVAs become incorporated once more into fair value.

*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?*

In our view, there are no other material causes of valuation uncertainty that should be included.

Rather, we note that

- Capital deductions are already held against some of the suggested AVAs (e.g. there is overlap with Operational Risk capital deductions, or with capital held against stressed VaR scenarios)
- "Balance Sheet Substantiation" is not included within the scope of Article 100 and we suggest it is removed from the list of AVAs within the RTS. Balance sheet substantiation risk is not a market pricing input, is already controlled through internal controls, SOX404 and statutory audits, and is subject to capital requirements through Operational Risk frameworks.
- Operational Risk is not a market pricing input and is already captured through each institution's existing operational risk capital deductions.

We believe that the "Balance Sheet Substantiation" and "Operational Risk" AVAs should be removed from the specific requirements of the final RTS.

We also believe that it is clear that the so-called "diversification benefit" is required to ensure that there is no over-statement of the prudent value and that there is no overlap with other capital requirements.

*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?*

We do not believe that annex 2 is useful. We believe it is within the capabilities of each institution to use the most appropriate statistical test relevant to the position type, principal market and available price data.

*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, we do not believe that the RTS should be prescriptive with respect to validation techniques. Being overly prescriptive can result in errors or misaligned results caused by differences in product types, principal markets and data availability.

We believe annex 1 to be inconcise, unclear and unreflective of market dynamics. For instance, in the example given in annex 1, trade prices for a given security on a given day are compared with the prior day's closing price, without any consideration given for market moves during the day's trading. Failing to control for the impact of market risk will lead to significant over-statement of the capital deductions an institution must make if the final RTS does not evolve considerably from its current state. The limitations found within annex 1 adequately demonstrate that judgment is critical to developing a coherent framework for prudent valuation.

In addition, the Discussion Paper appears to require back-testing to take place on a daily basis across all positions. This requirement is extremely burdensome in its application: effectively each institution will be required to run a parallel set of books & records with a parallel set of marks for each position. The cost of implementing this infrastructure will be a significant amount, with ongoing costs of an estimated 25-40% increase in product control staffing levels. There will also be further costs within the front office and within risk control departments. The benefit derived from these costs will be limited, since the majority of data

that will be available on a daily basis is for liquid, vanilla instruments with limited valuation risk. The RTS in its current form should be reconsidered to eliminate these excessive costs.

In an ideal scenario, an institution would need different data sets from which to create and then independently validate the AVAs. Since this is not possible (since the valuation uncertainty is caused by the lack of available market data), any "validation" process will not identify any outliers. We would urge the EBA to reconsider both the requirement itself and the extent of the required process. We would recommend that the focus is kept on the original requirements and the prudent value framework.

The final RTS should require institutions to actively make well-reasoned judgments within a general framework, rather than to avoid pertinent issues through following prescriptive rules. This will result in a more rigorous approach, so that any validation testing should be appropriate to each situation.

*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 support this assertion.

*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*

A "diversification benefit" is absolutely required in order to prevent extensive duplication of AVAs and to ensure appropriate aggregation at portfolio and entity levels.
This is simply justified based on the example given in paragraph 60 of the discussion paper – i.e. "that an institution with many small valuation uncertainties may face a very different total valuation uncertainty when compared to an institution with one large valuation uncertainty".
This is especially apparent in a diversified portfolio with many different long and short positions – in this instance not every single position will be valued aggressively in monetary terms.

*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?*

Firms with an advanced market risk framework will be able to incorporate diversification, although we understand that some smaller firms may not have the desire or need to follow this, and so we do not believe this should be compulsory.

In general, we support a simplified, standard approach, but this should not be prescriptive, for reasons discussed in previous responses. An institution should not be required to follow the approach in annex 4: each institution should be able to develop an approach that is more appropriate for its own individual risk exposures, sophistication and circumstances. Guidance should be given in a framework that should be described in the final RTS, but it is imperative that this allows expert judgment to be applied.

We believe that any proposed solution would benefit from industry input or consultation, to which we would be happy to contribute.

*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?*

We fully support allowing an in-house approach. We suggest that the final RTS allows regulatory approval of an institution's overall framework and approach, rather than requiring regulatory approval for individual components within that framework.

*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)?*

If prudent valuation is calibrated correctly, there should not be a need for offset. However, as set out in our prior responses, we do not believe it will be possible to achieve this result by following the RTS in its current form. In these circumstances, it is clear that offsets should be allowed at a product or position level to the extent that the risks or deductions overlap. If offsets are not permitted, then the result from summing each individual AVA for any given position will be significantly greater that the overall prudent value when considering the available exit prices for that position.
Diversification is fundamental in other areas of the CRR, benefiting more diversified firms. Firms with an advanced market risk framework will be able to incorporate diversification, and it is clearly appropriate to do this within a prudent valuation framework.

*21. Do you believe the above [system and controls] requirements are appropriate? If not, what other requirements could be necessary and what requirements stated above are considered not to be relevant?*

Yes, we believe that these requirements are appropriate.

*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?*

The costs of implementing prudent valuation as outlined in the DP will be prohibitively high, with small benefit since the current requirements force the focus onto vanilla products. Costs can be substantially reduced by aligning with existing IPV processes and infrastructure as much as possible.
Sources of significant costs are:

- The requirement for parallel marks and books & records
- The requirement for daily back-testing
- The additional capital requirements if the diversification benefits and offsets with overlapping capital requirements are disallowed
- The risk that AVAs are incorporated into fair value and a feedback loop of ever more conservative valuations takes hold

Consistent reporting gives benefits of comparability and we support this.

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

Our proposed reporting format is similar to the FSA's existing return, as required under policy statement PS12/7. Please see the attached document.

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# Prudent Valuation Return

| | | A | B | C | D | E | F |
|---|---|---|---|---|---|---|---|
| | | Gross B/S | | Net B/S | 1-Day 99% VaR Equivalent | Valuation Uncertainty Downside | Explanation |
| | | Assets | Liabilities | | | | |
| **Portfolios Subject to Valuation Uncertainty Assessment** | | | | | | | |
| 1 | Equities - Exotic | | | | | | |
| 2 | Equities - Vanilla | | | | | | |
| 3 | Rates - Exotic | | | | | | |
| 4 | Rates - Vanilla | | | | | | |
| 5 | Credit - Exotic | | | | | | |
| 6 | Credit - Vanilla | | | | | | |
| 7 | Commodities - Exotic | | | | | | |
| 8 | Commodities - Vanilla | | | | | | |
| 9 | FX - Exotic | | | | | | |
| 10 | FX - Vanilla | | | | | | |
| 11 | Emerging Markets | | | | | | |
| 12 | Hybrid Instruments | | | | | | |
| 13 | CVA | | | | | | |
| 14 | Other Portfolios | | | | | | |
| | 1 | | | | | | |
| | 2 | | | | | | |
| 15 | **Aggregate Portfolios Included** | 0 | 0 | 0 | | | |
| 16 | Less Diversification Benefit | | | | | 0 | |
| 17 | **Total** | 0 | 0 | 0 | | | |
| 18 | Less Regulatory Capital Offsets | | | | | 0 | |
| | 1 | | | | | | |
| | 2 | | | | | | |
| | 3 | | | | | | |
| 19 | **Prudent Valuation Adjustment** | | | | | 0 | |
| 20 | Portfolios of Particular Interest | | | | | | |
| | 1 | | | | | | |
| | 2 | | | | | | |
| | 3 | | | | | | |
| | 4 | | | | | | |
| | 5 | | | | | | |

## Administrative Information

| | | |
|---|---|---|
| 21 | Reporting Currency | |
| 22 | FSA Firm Reference No | |
| 23 | Reporting Basis | |
| 24 | The Reporting period end date | |