



11/01/2013

EBA-DP-2012-03@eba.europa.eu

Discussion paper relating to draft regulatory technical standards on prudent valuation under article 100 of the CRR

General comments

The Swedish Bankers' Association appreciate to have this more detailed discussion regarding the requirements in Articles 31 and 100 and the opportunity to give input in this stage of the process. We also appreciate the initiatives to specify the difference between Fair Value and Prudent Value. The RTS is valuable for setting the basis for a level playing field and point out potential weakness in valuation procedures, where the prudent value might deviate from the positions under the fair value accounting standards.

However, the requirements as included in the discussion paper must be considered in parallel to other regulatory changes and the use of thresholds where significance and level of details are balanced. It is also of importance that the accounting standards relevant are considered whereas some adjustments are already more or less covered in the fair value requirement in IFRS (as example unearned credit spreads, some market price uncertainty, model risk when relevant) but still there are considerable room left for interpretation in the definition of Fair Value in IFRS 13. We would like to point out that it will be confusing with "parallel" frameworks for valuate positions and where the values in accounting statements are indirectly questioned.

The Discussion Paper is very much focused on quantification of valuation uncertainty. There is a danger that this will lead to banks ignoring all non-quantifiable contributors to valuation uncertainty, and thereby provide false security about the actual uncertainty in the Fair Value estimations. We believe that a judgemental approach is actually the basis for assessing the valuation uncertainty. For the majority of the contributors listed in 4.2 a quantitative approach is not possible. We fear that these Prudent Value guidelines will result in a quantification exercise and thereby risk that the non-quantifiable contributors to valuation uncertainty are being ignored.

At this discussion stage the guidelines provided in the discussion paper leave very



much room for interpretation. Some part in forthcoming RTS needs to be carefully specified/clarified (as example "instantaneously" and "exit cost" in question 2 or "time horizon" as in question 3)

In several places in the document there are references to different "sections" without any such headlines. To facilitate understanding of the references to different sections it would be easier with the number of sections used in headlines.

Detailed comments

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?

In principle, there should not be any threshold. However, materiality always applies. If the work of setting up a model for measuring prudent valuation will turn out to be very burdensome, then a threshold for reporting Prudent Value is appropriate. The definition of such a threshold needs to be very clear to avoid misunderstanding and speculation in the threshold. The word "significant" is not enough. Guidelines to how to measure the threshold are needed.

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.

Since the prudent Value is defined as the uncertainty in the Fair Value estimation, the outset for the Prudent Value should be the same as the basis for Fair Value. There is a need for clarifying the meaning of "instantaneous" and where it would be applicable. Neither is the meaning of "exit price" perfectly clear in this context.

Also, it may not be relevant to calculate an exit price on some positions, for example under Fair Value Option. If the exit price is not to be based on an instantaneous sale then we believe that the exit price can be represented by the fair value.

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?

It is difficult to define an appropriate time horizon covering all types of positions. As mentioned under Q2 we believe that it is essential that the definitions of Fair Value and Prudent Value are aligned.



The question about time horizon will affect the calculation of AVA's for concentrated or illiquid positions. Therefore it is important that the definition of time horizon leaves no room for interpretation.

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?

Basically, a well established process and valuation routines should secure a confident outcome and the use of specified level can be discussed. However, we do not support this highly quantitative approach. The existence of a confidence level could lead to wrong interpretations and provide false security. Instead it would be preferable to have the EBA expressing in words the level of conservatism that they are asking for.

Q5. 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?

This aspect is difficult to answer if the concept hasn't been implemented and running for some time covering different scenarios (also covering stressed conditions). If a confidence level were to be introduced a low one is to be preferred, as this would demand less data. We must, however, stress that introducing a complex valuation uncertainty model built on confidence levels gives rise to model risk.

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?

This aspect are difficult to answer if the concept hasn't been implemented and running for some time. However, and independently of the scope of this final RTS, the criterion for testing the confidence needs to be clear for being valid. It will, however, not be possible to avoid a judgemental approach.

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 support the explicit allowance approach but only as fall-back to observable data.



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

The guideline should be more focused on given the preconditions for using different sources for collecting market prices. The RTS should not define the actual sources. If the source are defined in the RTS an additional possible sources of market prices, see paragraph 4 on page 11; should be supplemented with a new number "IV"); Indicative quotes from financial data vendors. Remaining numerations are moved a step forward. Also, clarification is needed on the meaning of current 4 iv) Consensus service concerns.

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?

The decision tree seems most appropriate for market parameter uncertainty and less appropriate for the other contributors to valuation uncertainty mentioned in the discussion paper (unearned credit spreads, close-out costs, early termination, future administrative costs etc.). Also, concentration risk seems to be missing in left part of the tree, as this will also be present for marked-to-market positions with sufficient range of bid-ask quotes.

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?

There are many non-quantifiable contributors to valuation uncertainty, which are not addressed in the RTS. An example is the choice of revaluation curves. Choosing the wrong curve will have significant impact on the valuation. However, it is difficult to quantify the impact. We believe it is important that banks assess all types of contributors to uncertainty.

Balance sheet substantiation should not be included since it is not a part of the scope of prudent valuation according to article 100.10 of the draft CRR. (It's not reasonable that the completeness of accounts should be dealt with prudential valuation adjustments.)

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?

Introducing statistical tests might lead to banks focusing too much on the products where there is plenty of data and very little uncertainty, and ignore the illiquid products where the uncertainty is much bigger. Hence, we do not see any value in setting up tests as described in Annex 2.



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?

It is our view that the EBA could further clarify their expectations on the outcome of the Prudent Value assessment in the banks. Instructive examples would also make it more clear what is expected. Both initiatives would increase the alignment across institutions.

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?

We interpret the Prudent Value to be equal to the sum of the Fair Value and the reservations made for valuation uncertainty (the AVA's). Thereby we believe that the prudent value can never be above the fair value (as based on relevant accounting standards), at least not at an aggregated level.

Q17. 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?

Instinctively, it seems correct that a well-diversified portfolio has less valuation uncertainty than a portfolio consisting of a few very large positions. On the other hand it is difficult – or almost impossible – to estimate correlations between uncertainties, and it adds complexity to the model and could lead to the impression of an exact model for estimation of valuation uncertainty. Perhaps it would be better if it would be allowed to use netting.

Q18. 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?

As mentioned above we would prefer to operate with netting rules instead of correlations between uncertainties. However, if the EBA decide to allow for diversification effects then we prefer the correlations between uncertainties to be provided by the FSA's.



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?

The intention in the RTS is to reduce overall judgemental in the valuation process. As it not possible to establish an RTS covering all aspects of a diversification following the aggregation and since this might be differently approached by different institution, we would like to see an opening for an internal model approach. However, allowing an in-house approach leaves room for interpretation and could lead to big differences between banks. On the other hand it makes sense to allow for using an in-house model if such one exists and is regarded as being more correct than the standard approach. It is difficult to see how the regulators should be able verify the correctness in different approaches for calculating diversification effects. We would suggest that some experience with the concepts is needed before allowing for internal models.

The diversification effect raises the justification of the correlation between uncertainties which is not an observable data and the approval process of regulator would still be based on a judgmental in-house process. There is a difficulty to calculate correlations between different valuation uncertainties, and therefore one should be cautious about applying diversification rules. Since it is, by nature, very difficult to quantify valuation uncertainty, the model for doing it should preferably be very simple. A complex model will only increase the uncertainty in the estimation of the valuation uncertainty.

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)?

We believe that overlaps to other Pillar 1 capital requirements should be permitted for off-setting, but we also believe, besides the operational risks, that overlapping requirements should not occur if the prudent valuation is correctly applied. Also, paragraph 63 requires clarification and several examples need to be provided. For example where offsets against AVA ought to be applicable is when CVA-adjustments have to be made on derivatives.



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?

The requirements stated here are all appropriate as a general ambition. It seems like the focus is more on ensuring an adequate prudent framework for valuation, e.g. a sound valuation governance structure, high control standards, exhaustive documentation etc. This should conceptually be in place already.

Still, we find the requirements stated under documentation, system and controls and reporting requirements to be very burdensome if not considered as recommendations pointing out the ambition rather than strict requirements.

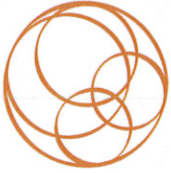
Q22. What would be the sources of costs and benefits of requiring (a) the implementation of a unique AVA methodology and (b) a consistent format for reporting AVA? Do you agree that the benefits of such requirements outweigh the costs associated with them?

It is our belief that it is important for banks to assess their valuation uncertainty, and we also support external reporting of Prudent Value. However, we support that the methodology for the reporting should be kept simple. The objective for the RTS should be to ensure a level playing field. The instructions on how to calculate the Prudent Value would require extra IT developments and reporting. If this is going to add value to the banks it needs to be in agreement with how the banks assess valuation uncertainty internally.

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

The AVA will by the regulation and the RTS be incorporated in the internal risk governance process and a part of the already existing internal risk reporting. The AVA's are already considered in the pillar I reporting templates.

It is our view that there should be more focus on the FSA's reviewing of the general valuation set-up within banks to ensure that appropriate governance structure, valuation controls etc. are in place and that the banks are assessing the valuation uncertainty.



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