European Banking Authority
Via e-mail to EBA-DP-2012-03@eba.europa.eu

Dear Sir or Madam,

**Regarding: EBA/DP/2012/03 – Draft Regulatory Technical Standards on Prudent Valuation under Article 100 of the draft Capital Requirements Regulation.**

Credit Suisse ("the Firm") welcomes the opportunity to comment on the Draft Regulatory Technical Standard on Prudent Valuation under Article 100 of the draft Capital Requirements Regulation (EBA/DP/2012/03) ("the Paper").

The firm believes that valuation risk is of paramount importance and fully supports the EBA's initiative to ensure appropriate controls and procedures are in operation to control and manage this risk. In accordance with this, the firm has implemented a comprehensive valuation governance and Independent Price Verification framework to ensure that valuation risks and uncertainties are appropriately understood, managed and raised to senior management. In addition, the firm has been submitting Prudent Valuation returns to the Financial Services Authority ("FSA") since Q4 2011.

The firm outlines below a number of high level observations around the paper below. This is followed by answers to the individual questions raised.

**Principles-based approach**

*Issue*

The paper currently focuses largely on defining prescriptive processes and procedures that can only apply to more liquid positions for which extensive, reliable data can be sourced and for which uncertainty (considered at an individual trade level) is limited.

This focus is to the detriment of the illiquid positions for which considerable judgment, subjectivity and subject matter expertise is involved in the establishment of an appropriate fair value and for which uncertainty (considered at an individual trade level) is more significant.

*Recommendation*

The firm believes that the preferred approach would be for the paper to appropriately acknowledge the judgment and subjectivity inherent in the valuation of illiquid positions and provide a harmonized set of standards that outline the appropriate governance processes required to meet prudent valuation standards whilst allowing individual firms flexibility in determining the appropriate methodology to best meet these standards.

**Leveraging existing Fair Value standards**

*Issue*

The Fair Value framework specified by IFRS13 (or equivalent principles of US GAAP) is utilized as the initial basis for capital calculation by the CRR. This Fair Value standard has been through an extensive process of industry consultation and interpretation by external auditors and represents a well-founded principles-based approach to determination of inventory valuation.

Whilst the firm acknowledges that Fair Value may not always be appropriate for regulatory purposes, Prudent Value should seek to be consistent with these principles wherever possible. This guarantees leverage of existing valuation principles laid out by standard-setters, maximizes the benefit to cost ratio and ensures clearer understanding of the requirements by senior management who have become accustomed to Fair Value concepts.

*Recommendation*
Given this, the firm feels that the Paper should not provide guidance in areas in which Fair Value has already established appropriate standards. Specifically:

- The basis of defining exit price is already laid out by standards and need not be considered at any additional length in these regulatory standards.

- Permissible data sources and valuation methodologies are already laid out in some detail by existing accounting standards and need not be repeated within the guidance here.

**Confidence Intervals**
*Issue*
The firm acknowledges that in order to ensure a consistent standard across firms it is necessary to establish an appropriate overall level for prudence within the guidance. However, the current approach to establishing this (the 95% confidence interval) is too inflexible and cannot be performed for the more complex and illiquid instruments which will contribute the material balance of the uncertainty. In addition, the firm believes that 95% is more reflective of a "worst case" level which is too high as a guiding confidence level for prudent valuation purposes.

*Recommendation*
The firm believes that an appropriate level of prudence should be established through a qualitative benchmark level. A statement such as the following (based on existing IFRS standards) would provide adequate guidance.

"Prudent Valuation should reflect positions at the lower value where changing one or more of the valuation assumptions to reflect reasonably possible alternative assumptions would affect fair value significantly."

If it was desired, this approach could be represented as approximately equivalent to a given confidence level in order to provide extra guidance to firms for more liquid positions. The firm would suggest that a confidence level of around 80-85% would be an appropriate level consistent with the above statement and incorporating considerable prudence in valuations.

In addition, the firm believes that the approach to backtesting outlined in the paper is not suitable for purpose as outlined in the answer to Question 14.

**Diversification**
*Issue*
Simple summation of the various prudent valuation levels does not provide a realistic view of an institution's uncertainty since it assumes perfectly correlated movements to the firm's disadvantage in all positions. More advanced, standardized approaches such as that proposed in Annex 4 are not practical to specify due to idiosyncrasies of firm's portfolios and systems.

*Recommendation*
The firm believes diversification benefit must be included in order to arrive at an accurate overall AVA amount since many types of positions simply cannot move simultaneously against the firm due to rela-

tions in underlying prices and since we have no reason to believe that certain types of valuation errors are heavily correlated.

The firm believes strongly that the best way to incorporate diversification is following a non-prescriptive approach with diversification methodologies established by firms and then being subject to appropriate supervisory approval.

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Finally, please find also attached our answers to the specific questions raised in the paper.

Thank you again for the opportunity to respond to the paper. We would be very happy to discuss any aspect of our feedback with the EBA at your convenience.

Yours faithfully,

Guy Seddon
EMEA Head of Product Control

**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?**
The firm believes that a proportionality threshold should be applied due to the high fixed cost of performing a prudent valuation calculation which will be disproportionately large compared to benefits for smaller institutions.

The firm considers that the size of the balance sheet positions measured at value on a gross basis would form an acceptable basis for the threshold (as currently implemented as part of the FSA guidance).

**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 framework specified by accounting standards outlines the appropriate procedures which should be followed in order to establish an exit price and these procedures should be used as the basis for prudent value also. This Fair Value standard has been through an extensive process of industry consultation and interpretation by external auditors and represents a well-founded principles-based approach to determination of inventory valuation.

Under such an approach, the standards outline the definition of exit price, the data sources to be used for determining such a price and the waterfall for those data sources. The result of this process is a distribution of possible exit prices. Both fair and prudent value should be based on this identical distribution – one reflecting the most representative estimate from the distribution and the other an appropriately prudent estimate from the distribution.

Creating a separate definition of exit price to be used within prudent value is unnecessary and will introduce additional complexity which is not required.

**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?**
No. As specified in the answer to Question 2, the same definitions of exit should be used for prudent value as used for fair value.

**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?**
The firm acknowledges that in order to ensure a consistent standard across firms it is necessary to establish an appropriate overall level for prudence within the guidance.

However, the suggested specified level of confidence can only be sensibly applied in situations where there is another availability to establish meaningful statistics around valuation error – and this will only happen in the most liquid of positions.

The firm believes that the most appropriate process is to use a qualitative benchmark supported by a confidence interval to which this benchmark is considered roughly equivalent. Specifically, the firm believes that the appropriate benchmark would (in line with IFRS) be something similar to:
"Prudent Valuation should reflect positions at the lower value where changing one or more of the valuation assumptions to reflect reasonably possible alternative assumptions would affect fair value significantly."[1]

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[1] This definition follows IFRS13 93 (h)(ii) "For financial assets and financial liabilities, if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes."

This could then be cross-referenced to an "equivalent" confidence interval which could be used in situations where appropriate data is available or when considering comparisons to IPV variances or to historical PVs.

Such an approach continues to leverage existing Fair Value standards (and so provides for greater benefit at lower costs) and provides an acceptable benchmark which can be applied to all positions (as opposed to just liquid positions).

**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?**
No. As outlined above the firm does not support the use of a specified confidence interval but instead supports a qualitative approach backed by an "equivalent" confidence level.

The objective of Prudent Valuation is to represent "an appropriate degree of certainty having regard to the dynamic nature of trading book positions, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of fair value positions" [CRR – Article 100 – 1].

The firm does not consider that this implies a 95% confidence level – such a level is more reflective of a "worst case" analysis and could involve considerable investigation of tail risk. A more reasonable "prudent" level would be in the 80-85% range – such a level ensures a considerable prudence in value and better compliance with the objective above.

**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?**
As noted above, the firm does not believe that a prescriptive confidence interval approach should be used. In any case, there should not be prescriptive guidance around the number of points necessary to establish that confidence interval.

Even calculations made with an abundance of data available require considerable judgment and market expertise to carry out correctly. For example, relevant data must be identified for the item under consideration and then this data must be filtered and interpreted as appropriate. Given such constraints, it is impossible to specify in any meaningful fashion the "number of data points" required.

**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?**
As outlined in the answer to question 4, the firm supports the use of a judgmental approach

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

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

**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. As outlined in the answer to Question 2, the firm believes that current Fair Value standards provide sufficient guidance on what sources are permissible for market prices and how these sources should be used to arrive at appropriate ranges of plausible prices. These standards should form the basis for prudent value also.

In answer to Question 10 specifically, it should be noted that the current accounting standards acknowledge that such situations require the judicious application of subject matter expertise which should then be appropriately validated and challenged.

**Q11. Are there any other indicators of large market price uncertainty which should be included?**
No, the firm does not believe additional indicators should be included.

**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?**

**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?**
The firm does not believe that there are additional causes of material valuation uncertainty beyond those outlined in the paper. This is to be expected, since these causes cover both uncertainty in parameters and uncertainty in models.

The firm believes that the following adjustments should not be included.

- Operational Risk: The firm does not believe that operational risk issues should be mixed up with valuation risk issues within this approach and hence this segment should not be included. If modifications are required to the operational risk framework to properly capture potential risks around pricing and valuation processes then they should be made within this framework.

- Balance Sheet Substantiation: The firm does not believe that this segment should be included. This is an operational risk and not a valuation risk and as such should be covered by the operational risk framework as appropriate.

The firm believes that the following adjustment will not be material.

- Early Termination Costs: The firm believes that such items are (in accordance with accounting standards) appropriately reflected in Fair Value at portfolio level where they are material. Any remaining items will therefore not be material.

For the remaining adjustments, the firm believes the approaches are broadly appropriate with the following exceptions.

- Market Price Uncertainty: The firm would wish the guidance in paragraph 31 to be modified to make it clear that the use of lower quality consensus services is permitted to determine prudent value when utilized in tandem with other data sources.

**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?**
No. The firm does not believe that the proposed backtesting approach is fit for purpose. This is for three main reasons

**Limited Applicability**
The approach suggested could only be applied to a limited subset of the components which are proposed to make up the AVA and would only be practical for subsets of those components for which significant data is available – precisely the component expected to have the smallest individual AVA.

**Complexity of implementation**
The approach suggested would be complex to implement since institutions do not currently routinely and mechnically capture transactions across all relevant markets which could be used in this mechanism.

**Confusion of market moves and valuation prudence**
The suggested approach – even when it is applicable and economical to implement - compares the previous days close to a transaction price during the following day and uses differences in price to imply prudence (or lack of prudence). Such an approach mixes up intra-day market moves and valuation prudence and is inappropriate to test prudence in valuation.

**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?**
No. The firm notes that appropriate formulaic validation techniques which can be uniformly applied across firms and across all positions (or even across selected subsets of positions) do not currently exist. As such specification of prescriptive validation techniques, whilst it may be desirable, is not possible.

The firm believes that a principles-based approach to validation of the prudence of valuation should be sufficient to ensure comparability of valuation levels when supported by effective valuation governance frameworks as well as continued regulatory read-across and supervisory review.

**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?**
Yes, the firm agrees that, in general, prudent value can never be greater than fair value. It should be noted that in certain cases fair value positions may be subject to additional holdbacks on the balance sheet (for example Day 1 deferral under IFRS13) and that this can lead to instances when balance sheet value is less than prudent value.

**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**
Yes, the firm would support the availability of diversification benefits made amongst AVA applied due to valuation uncertainty (specifically the model and parameter risk AVA).

The diversification benefit arises because of a lack of perfect correlation between uncertainties observed in two different fashions.

- Closely-related uncertainties (such as items on the same curve, or uncertainties across tightly related parameters (e.g. bond vs CDS)) have relationships which allow us to be sure that any inaccuracies in one estimate will necessarily be reflected by opposite moves in other estimates.

  Ideally, such relationships would be directly modeled in the calculation of uncertainty (taking place at portfolio level) – but in practice uncertainty is often calculated at individual position level and then this effect is represented by the netting of uncertainties or by allowing partial diversification between uncertainties through a "sum of squares" method or a simple diversification factor.

- Distantly related uncertainties (such as estimates of uncertainty on two distinct parameters, for example, FX Correlation and Equity Vega) should not be assumed to have perfect correlation. The firm's historical analysis of IPV results and of historical uncertainty calculations has shown low levels of correlations between such uncertainties and this should be reflected in the diversification approach.

**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?**
The firm believes it is of great importance to include diversification benefit within the calculation of the AVA in order to ensure an accurate and meaningful answer. The firm believes strongly that the best way to incorporate diversification is following a non-prescriptive approach with diversification methodologies established by firms and then being subject to appropriate supervisory approval.

The firm believes this since at this stage, the setting of a standardized approach is unlikely to be practical due to the diversity of practice around the industry and the difficulty in developing an approach which can cover all risks and asset classes. For example, the approach in Annex 4 raises questions around the granularity of the maturity and strike dimensions, correlations across different underlyings and so on. Even simple aggregation requires specification of the granularity of uncertainty calculations down to the individual point on curve and surface level to ensure a consistent 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 this is a preferred option.

We would note specifically the following with relation to Annex 4.

- The stipulation of a maximum of 3 stages of aggregation is both difficult to interpret and enforce.
- As outlined in the answer to Question 18, we do not believe a standardized approach (even simple aggregation) can be specified without significant effort and so comparisons with this would not be possible.

**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)?**
No. The firm believes that appropriate offsets should be permitted in two specific circumstances.

- Instances in which there are overlaps between the AVA and other capital requirements. For example, except in exceptional circumstances, it is to be expected that the Operational Risk requirement under Article 100 will be covered by the Operational Risk capital requirement.

- Instances in which adjustments would be required if the firm was to experience a scenario in which accounting valuations were at prudent levels.. For example, a reduction due to the effects of the decreased profits due to realization of prudent value in place of fair value on tax 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?**
No. The firm would like to note that many of these requirements – in particular Paragraph 73 relating to the incorporation of uncertainty measurements within valuation and risk measurement systems are highly complex to implement and introduce significant operational overhead in terms of documentation, systems and control/reporting requirements.

The net result of this is that these requirements fail the cost-benefit test - considerable investment would be required to deliver relatively small overall benefits or improvements in the regulatory prudence.

**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**
The most obvious benefit of a unique AVA methodolodgy is that it would ensure direct comparability between firms.

However, as we have discussed in this response, we do not believe that it is possible in any practical fashion at this stage to specify a unique methodology. Specification of such a methodology would require a large amount of detail at the individual data point level and across multitudinous of different types of position. The result would be prohibitive implementation costs for both regulators and firms.

We favour as an alternative a principles-based approach with appropriate read-across by the regulators.

**(b) Consistent reporting format**
The main benefit of a consistent format for reporting AVA is improved ease of comparability by the regulators of returns submitted from various parties. This will increase the ease of performing the read-across which will be essential to ensuring comparability in the principles-based approach suggested in this response.

The additional cost will represent the requirement for each institution to carry out appropriate procedures (in addition to any internal reporting) to fill out the required format. As long as the format is specified in such a way that existing accounting disclosure procedures can be leveraged, so that the format differs as little as possible from likely internal reporting and so that excess information is not required, then additional costs should be minimal.

With an appropriately specified reporting format (see our answer to Question 23) the benefits to a consistent format will outweigh the related costs.

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

The firm believes that a slightly modified version of the current FSA return would provide a suitable basis for a consistent reporting form.

The return has been modified to:

- Improve consistency with firm's organizational structures (through modification of the form to reflect businesses rather than product types).
- Enhance comparability with current accounting disclosures (through replacement of the Vanilla/Exotic requirements with Level 1,2 and 3).
- Remove VaR since this is not useful as a comparability measure due to difficulties such as the treatment of Risks Not in VaR.
- Remove Prudent Valuation Upside Uncertainty since this is not necessary to meet the requirements of Article 100.

## Prudent Valuation Return

### Businesses Subject to Valuation Uncertainty Assessment

| | A | B | C | E |
|---|---|---|---|---|
| | Gross B/S | | Net B/S | Valuation Uncertainty |
| | Assets | Liabilities | | Downside |
| Equities - Level 3 | | | | |
| Equities - Levels 1 and 2 | | | | |
| Rates - Level 3 | | | | |
| Rates - Levels 1 and 2 | | | | |
| Credit - Level 3 | | | | |
| Credit - Levels 1 and 2 | | | | |
| Commodities - Level 3 | | | | |
| Commodities - Levels 1 and 2 | | | | |
| FX - Level 3 | | | | |
| FX - Levels 1 and 2 | | | | |
| EMG - Level 3 | | | | |
| EMG - Levels 1 and 2 | | | | |
| CVA/DVA - Level 3 | | | | |
| CVA/DVA - Levels 1 and 2 | | | | |
| Other .. (as specified) | | | | |
| **Aggregate Portfolios Included** | | | | |
| Less Diversification Benefit | | | | |
| **Total** | | | | |
| Applicable Offsets | | | | |
| **Additional Valuation Adjustment** | | | | |