Nomura International plc

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)

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Nomura International Plc response

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Introduction

Nomura welcomes the opportunity to comment on the discussion paper (DP). The firm has also contributed to and endorses the ISDA/AFME/BBA industry response.
Nomura International plc is an international investment bank with a Japanese heritage operating in London and other offices in Europe. Our activities include:

- Trading and sales in fixed income and equity products, including related derivatives;
- Investment banking services;
- Asset and principal finance business; and
- Corporate finance and private equity.

There are a number of overarching issues which are highlighted below along with responses to the individual questions raised.

While recognizing that the EBA wishes to achieve a comparable starting point for the calculation of regulatory capital resources we believe that attempts to achieve this via a prescriptive approach using prescribed Confidence Levels will not be successful for the reasons we set out in this response.
The positions with the largest valuation uncertainty do not lend themselves to such an approach and those positions which are liquid enough to allow the calculation of Confidence Levels with a degree of certainty are those where uncertainty is low and resources would be best directed elsewhere. Similarly the prescriptive backtesting contained in Annex 1 and Annex 2 is flawed in both concept and design as detailed in the response to Q14 below.

The Regulatory Technical Standards (RTS) need to recognize that judgment will be required both by institutions and by the regulators themselves. No formulaic approach can substitute for the use of supervisory judgment and understanding of how individual firms operate in relation to valuations.

There appear to be many areas of overlap between this DP and other areas of regulatory capital requirements being developed internationally – some of these have been considered within the DP but others have not. Within the regulatory capital calculations for an institution there currently exist many capital add-ons by mean of multipliers or additional calculations in both Pillar 1 and Pillar 2 along with other proposals currently being discussed by regulators such as the Fundamental Review of the Trading Book. Nomura recommends that the EBA consider its overall approach to minimize the occurrence of such overlaps/double-counting in conjunction with the Basel Committee.

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?

Nomura believes that the EBA should introduce a proportionality threshold. For example, institutions with insignificant AVA's (e.g. less than x% of common equity tier one capital) might not be required to a) calculate the Prudent Valuations each period but should demonstrate to their regulator on a less frequent basis e.g. annually that the Prudent Value calculations would be immaterial; b) deduct AVA's from common equity tier one capital.

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.

Nomura contemplates this topic in relation with the 'normal course of business disposal'. Stepping back from the framework and looking at the purpose of the AVAs – it is to ensure that regulatory capital adequately reflects prudent valuations for fair valued assets – to ensure the solvency of a bank is appropriately calculated. No forced sale is required for these purposes: and the assumption of a going concern needs to be reflected and instantaneous sale is therefore not relevant. Only the value of the asset if disposed of in the normal course of business is relevant.

Nomura believes that the exit price used as the basis of prudent value does not necessarily need to be based on an instantaneous sale. The concept of instantaneous sale is difficult to assess particularly for complex and illiquid products.
For complex products we believe that rather than specifying an instantaneous sale it would be more beneficial to require that the exit price is established at the balance sheet date assuming that the other party involved had already had time to study the details around the product/position concerned, such that the only thing to do on the balance sheet date is to agree the final price and sign the agreement. E.g. when selling a bespoke product, an instantaneous sale would be difficult since a counterparty would first need to read and understand the documentation around the product.

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; the applicable time horizon to determine prudent valuation will depend on the instrument type / position. It is not appropriate to prescribe a time horizon as a general factor for the calculation of prudent value. Institutions should assess the appropriate time horizon where required – e.g. for the estimation of concentration adjustments. The comparison with VaR and other capital measures is spurious, since these other calculations are designed to calculate losses over a specified period, which therefore needs to be prescribed, whereas the assessment of prudent value should aim to capture exit price, whatever period that would take in reality.

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?

No, Nomura does not support the highly specific way suggested in the Paper as mentioned in the introduction to this response. The concept of a specified CL is only meaningful and possible to statistically assess for the types of position that are liquid and that have an inherently low level of valuation uncertainty (and hence relatively low AVA associated with them). For complex and illiquid positions, the CL can be very subjective and not statistically measurable. Hence, an approximate level of confidence should be specified only as a benchmark for high-level calibration of the framework.

We understand that the EBA aims at a harmonised and comparable set of measures. To serve this purpose, a predefined confidence level can be acceptable only if it is calibrated to a reasonable level and exclusively used as a benchmark and not a compulsory measure.

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?

Nomura does not support the use of a specified confidence interval for the reasons listed above however if one is imposed we do not support the use of a 95% level of confidence. A 'target' level of 80% to 85%, roughly equivalent to 1 standard deviation from the mean, would be more appropriate as a benchmark.

It should be simple for a competent regulator to assess the assumptions used and whether they are conservative or not. The higher the CL is, the higher the subjectivity and the uncertainty surrounding the calculation are likely to be given the limited sample of data. Therefore Nomura does not support a 95% CL. Furthermore, given the procyclical nature of AVA's, a 'target' level of 80% to 85% is more favourable as it would generate less procyclicality than a 95% CL.

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 judgmental approach being necessary?

As noted in the answers to 4 and 5 above, there should not be a statistically-calculated CL prescribed. There should certainly not be a specified number of data points used to calibrate the CL, since the number of data points would be dependent upon judgements made around the quality and quantity of the data available for each type of transaction. Since the judgment approach used will utilise available information in order to reach a prudent conclusion it would utilise available data points and so the question seems redundant.

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 judgmental approach where data is lacking?

Again, see answers to questions 4, 5 and 6 above. Where data is lacking, there will be no possible approach other than use of judgment. Given the relative materiality of AVAs for complex and/or illiquid instruments and positions, which will tend to be relatively lacking in available data, such a judgmental approach is preferred for calibration of the framework more generally.

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

The RTS already provides scope ("including but not limited to") to add other data sources, so it is not necessary to attempt to list these prescriptively. Also, such data sources develop over time therefore trying to capture a complete list at a point in time is not appropriate.

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

No, it should not be required. Institutions should use appropriate methodologies, to be challenged if and where appropriate by regulators. Indicative description may be useful for smaller participants but should not be binding for Tier 1 banks.

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, Nomura believes that it is not possible to be prescriptive in these circumstances, which will require judgment to be applied, taking into account the nature of the instruments and positions concerned. Here again, institutions should use appropriate methodologies, to be challenged if and where appropriate by regulators.

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

No, we do not believe additional items 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?

We feel that close-out costs and market price uncertainty could be treated jointly, and the Operational risk charge should not be included in this framework as it duplicates part of the Operational risk capital charge. This Paper also introduces a new adjustment which was not required by the level 1 text: balance sheet substantiation. The Balance Sheet substantiation requirement is not an appropriate source of valuation uncertainty. Additionally the concentration and liquidity horizon are already captured and capitalised in Pillar 2. This accounts for another area of double counting which should be eliminated. Liquidity horizons are also already part of the Basel Committee's Fundamental Review of the Trading Book.

Below are any specific comments on the AVA's mentioned in section 4.4:

Close-out Costs:
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 materially 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.

Operational Risks:
Operational risk does not appear to be a part of valuation uncertainty. The Operational risk is either in overlap with other requirements, or is not per se an operational risk. We note that the deliberate choice of a model that turned out to be incorrect is not an operational risk but is a model risk, while the unintentional use of wrong model or bugs in code are operational risks. The latter should be clearly segregated from the prudent valuation, while the former should be captured through model risk.

Market Price Uncertainty:
There is a clear overlap between bid / offer close-out costs and market uncertainty which is not captured within the DP.

Early Termination:
The Early Termination AVAs are primarily driven by client relationship which includes profits from further trades and should not be material to the valuation in normal course of business. When under stress, the decision to preserve client relationship conflicts with the necessity to survive.

Future administrative Costs:
Nomura believes that the requirement for this AVA is over-punitive. This provision makes the prudent value depart from the announced objective of realization of value in an on-going concern basis, by assuming full exit of the entire activity. It also seems to us that from a market participant perspective,

the future administrative costs that might be charged are mainly incremental charges because it is very likely that such market participant has already an active running book. Therefore, we would propose a less strict requirement in the form of the incremental administrative costs from market participant stand point.

Model risk:
The description in the paragraph 45 makes sense. However this is also an overlap with the on-going fundamental review of trading book which will require a capital add-on.

Balance sheet substantiation:
This is out of place. It is not an appropriate source of valuation uncertainty and is outside the scope of the Basel recommendations.

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 no additional material causes. As described in the response to Q12 above it is felt that there are flaws in a number of the approaches mentioned, that operational risk and balance sheet substantiation are not appropriate sources of valuation uncertainty and that balance sheet substantiation is outside the scope of the Basel recommendations.

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?

Nomura believes that the approach proposed is not useful. This approach could only be properly implemented for the more liquid, low uncertainty instruments, where the AVAs will be relatively low. As mentioned previously, even for liquid positions, the proposed approach is flawed, since positions would fail due to intra-day market moves and it would fail properly to identify sources of imprudent valuation. The example used in Annex 1 for transaction 1 concludes that a position which is sold at 100.05 a day after it was marked at 100.15 is an imprudent valuation. The traded price is 0.1% away from the prior day close. This is equivalent to an annualised volatility of less than 2% (which is a very low level). It in no way demonstrates an imprudent mark and in itself shows why the approach suggested by annex 1 and annex 2 is not useful. It is a disproportionate use of resources for no return on measuring prudent 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, Nomura believes that the RTS should not be prescriptive with regards to validation techniques and as per the response to Q14 the validation techniques suggested in Annex 1 show that the approach is flawed. Portfolio benchmarking as previously performed by the UK FSA or recently introduced by consensus services are more effective and informative.

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?

Generally, it is correct to say that prudent value should never be greater than fair value, including fair value adjustments at the entity level. However, there might be exceptions, at the position level as whilst prudent value is likely to be at least as conservative as fair value at a position level, no systematic rule may be established:

1) Distressed assets are often marked to very defensive levels and have often embedded value. E.g. where a portfolio of distressed assets has the overall portfolio value considered but some of the assets may be undervalued e.g. written off to zero when there would be some value then it should be possible to consider the overall portfolio value which could mean the same impact as writing these undervalued assets up.

2) Any Day1 profit holdouts may also need to be considered for offset against the AVA.

3) At the portfolio level fair value may have been reached with a model or surface which overvalues some positions while undervaluing others. It is possible that some of the positions which are undervalued and conservative may potentially have a higher prudent value than their fair value. This will be offset by the larger difference between the prudent and fair value of the positions which were overvalued. To disallow this would be unreasonable.

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, Nomura believes that allowing diversification benefit is essential.

An important point with regard to diversification (mentioned in annex 4 of the Paper) is that it is likely that Fair Value already incorporates a substantial part of the prudence required by CRR. It is important to note that in large portfolios, with both long and short positions, it is not reasonable to assume that every single position will move adversely together, likewise with risks across different positions and markets. Risks and the associated valuation uncertainties are partially diversified away.

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 noted in the answer to Q17, Nomura believes that it is very important to include diversification benefit, but it should not be stipulated as a prescriptive approach which all firms have to follow. Regulators should assess the reasonableness of the institution's diversification approach.

It may be possible to specify a simplified standard approach, which those institutions without a credible internally-developed approach to diversification could choose to adopt. The proposed simplified approach in Annex 4 appears to be very punitive and would be complex to calculate. Nomura would suggest that a consultation group as proposed in the ISDA/AFME/BBA joint industry response look at a potential simplified methodology that could be used.
Similarly, where institutions choose not to model diversification (under any approach), they could be permitted to adopt an approach with no diversification benefit assumed.

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, Nomura believes that an in-house approach, subject to regulatory approval, is the preferred option – see answers to questions 17 and 18 above.

The example in Annex 4 is too prescriptive, and implies that there is an optimal and consistent way of improving the computational efficiency across all institutions under different environments. This is simply not the case. The regulator should be competent enough to review whether an in-house approach is satisfactory.

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)?

Nomura believes that offsets should be permitted where AVAs and capital requirements overlap. This would appear to be the case for Operational risk, where the RTS should clarify the position for Basic Indicator and Standardised Approaches to the Pillar 1 capital calculation. Where institutions can demonstrate other areas of overlap, offset should also be permitted and should not be restricted to pillar1 charges only.

There are clearly some overlaps that must be quantified and for which deductibility should be sought for:

- VaR/stress VaR capture already to some extent data uncertainty

- The Incremental Risk Charge (IRC) also addresses illiquidity and concentration risks

- The RTS should also address tax deductibility

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?

Nomura supports the aims of the paper but believes that the requirements as laid out are far too prescriptive. They also appear to suggest a degree of 'systematisation' which is inappropriate and likely impossible for a framework which necessarily requires extensive use of judgment and subjective assessment. The requirements are highly demanding in terms of documentation, systems, control and reporting requirements which in principle appears to be reasonable but unrealistically difficult to implement.

For example, paragraph 73 says that institution valuation and risk measurement systems should systematically recognise and account for valuation uncertainty. If this means that all the different valuation uncertainty adjustments need to be embedded in the institution's front office / risk measurement systems, that would be an extremely complex, possibly unachievable task. It would introduce significant operational risk, effectively asking these front office systems to operate 'two sets of books'. Also, valuation uncertainty based on Balance sheet substantiation ineffectiveness is theoretically debatable and practically unachievable. Valuation uncertainty linked to operational risk is redundant.

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 ensures comparability between entities and certain degree of cushion in the system for risks that can only be ensured by setting reserves. Initial capital cost might be excessively high if some punitive elements are maintained or if diversification is not allowed. The benefits in the approach as currently documented certainly do not outweigh the associated costs.

EBA should realize that the highly prescriptive nature of the methodologies is such that the operational cost associated with the implementation is very high even for banks that already have solid valuation framework and long tradition of prudent valuation and so is likely to have an impact on costs that is passed on to clients.

As far as a consistent format is concerned, we believe that as long as the information is intended for the sole purpose of supervisors, and as long as there is clear disclosure of the diversification effect, there is some benefit in defining a consistent reporting format. If there should be any harmonisation of reporting, that will need to be decided at the international level.

We would not object to a common (external) reporting form under COREP being introduced to cover prudent valuation, or the addition of prudent valuation information to an existing COREP template. But regulatory specification of an internal reporting form would not be appropriate, as it would detract from the institution's ability to determine the information required by its own management, thus weakening internal controls.

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

The UK FSA has a template for reporting on prudent valuation. It has some flaws, particularly in the split of information by asset class, which prevent the numbers calculated being useful internally and the inclusion of extraneous data such as upside valuation uncertainty and VaR numbers (which many institutions, particularly those without CAD2 approvals, would struggle to break down by asset class with any accuracy). A simpler and more intuitive version of this form, for example allowing institutions to provide data by business line/division (rather than asset class), could provide a reasonable basis for a common form and allow the regulators to decide where to target thematic reviews.

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