11 January 2013

European Banking Authority
e-mail: EBA-DP-2012-03@eba.europa.eu
Reference: EBA/DP/2012/03

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) Dated 13 November 2012

The Royal Bank of Scotland Group welcomes the opportunity to comment on the EBA Discussion Paper on Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR). RBS has contributed to the various trade association responses to which we are generally aligned.

Summary

RBS recognises that there are instances where there is an acceptable range of fair values which is incorporated within current accounting standards. We believe it is vital that any prudential valuation framework does not undermine the integrity of the financial statements and must be viewed as a purely regulatory initiative.

We support the concept of determining a range of valuation uncertainties. In complying with the FSA Policy Statement 12/7[1] we have focused on the valuation of subjective areas and inherent uncertainty across all products held at fair value as part of the formulisation of the prudential valuation process.

We believe prudential valuation should be focused on areas of significant uncertainty, in particular Level 3 assets and liabilities, to ensure those charged with governance are fully informed and that this is an input into the decision making process internally within firms. In our experience, the process of determining areas of uncertainty has helped senior management and the regulators.

The EBA proposal significantly extends the scope of prudential valuation as set out by the FSA and would ultimately result in an overly punitive capital charge.

Although we support the practice of better understanding areas of valuation uncertainty, we are concerned that assigning a specific value to it, given the subjective judgements required, may simply add another layer of uncertainty over the fair value.

We are concerned that an overly punitive approach in determining additional valuation adjustments will result in significantly larger transaction costs which will have a direct impact on the determination of fair value. As this would have a direct effect on the capital base it will be necessary to either pass this cost on to the client or face being unable to provide liquidity to the market place.

We would support the option of adopting an agreed aggregation approach that would be subject to challenge and approval by the regulators. The ability to adopt an agreed approach is crucial to ensure overall consistency of prudential valuation principles across the European banking industry. The regulators will need to work closely with firms to ensure a consistent outcome across firms rather than a consistent approach.

Response to EBA 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?**

[1] http://www.fsa.gov.uk/library/policy/policy/2012/12-07.shtml

There should be a threshold for institutions in determining if a prudential valuation adjustment should be calculated. The current FSA threshold seems appropriate - firms with balance sheet positions, measured at fair value, which exceed £3bn on a gross basis.

There should also be liquidity and materiality thresholds applied to positions within an institution for the assessment of prudent valuation.

Firms should be able to scope out areas which are liquid and have very little valuation uncertainty. Firms would have to prove this to the regulators periodically, and the proof should include evidence that there are reasonably large numbers of two way trades that do not have large entry/exit P&Ls. VaR as a measure may also be considered in determining areas to scope out.

Firms should also be able to scope out areas which are deemed to be immaterial from a valuation uncertainty perspective due to size of holding. Again, firms would have to prove this to the regulators periodically.

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.

Yes, we agree. An instantaneous sale price would be too strict and result in an overly conservative financial position. The exit price should avoid fire sale write downs. The exit price should be based on the same principles applied in determining fair value for accounting purposes.

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. As above, the exit price should be based on the same principles applied in determining fair value for accounting purposes.

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 level of confidence and believe a confidence level set somewhere between 80%-85% would be appropriate.

While we support the concept of a level of confidence, determining a level is a difficult task for all positions. The concept of a level of confidence should focus on the way of thinking about the process and in particular should be used as a method to encourage firms to consider the accuracy of valuation uncertainty.

An over-prescriptive approach is not practical. Confidence levels will be different in practice and the level of conservativeness needs to be consistently applied, although this may not be achieved by setting a specifically high confidence level.

We believe a confidence level between 80%-85% achieves the prudence sought yet also reflects the value of the position that is realisable within the current market conditions, at an agreed reporting date, given risk assumptions that are consistent with fair value.

A high predefined level of confidence will ultimately affect prices. All trades would be loss making if prudential valuation was set at 99% and most would be loss making at 95%. This would lead to changes in pricing and will affect market liquidity.

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?**

   As stated above, confidence levels are judgemental. Assigning 95% assumes an element of precision. We feel that a confidence level set somewhere between 80%-85% would be appropriate.

   It is also worth highlighting that at extreme levels it no longer reflects pricing and that fair value should directly reflect pricing.

   A simple read across from VaR techniques should be avoided as it is not appropriate for the application of fair value. At a 95% confidence level we would be within tail territory which is out of line from pricing.

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 judgemental approach being necessary?**

   As stated above, confidence levels are judgemental. Defining data points assumes firms would be able to precisely calculate and determine the confidence level.

   Too high a confidence level essentially involves guess work using extreme tail events only and forces firms to make judgements. Such judgements are reasonable only up to a certain confidence level.

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 judgemental approach where data is lacking**

   We support a consistent approach across areas where there could be differing levels in the availability of data. We would also recognize that the majority of our valuation uncertainty would be linked to areas of little availability of data.

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

   No, although this should be flexible to allow for new market prices to be introduced in the future and for existing sources to be scrutinized and potentially removed if no longer applicable.

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

   No. Even with the increase in description provided within this draft, there is still a large element of interpretation in determining an appropriate range of plausible prices. Firms will have access to different levels of information, therefore even if the EBA is more descriptive, discrepancies in results across firms will remain. There is also a risk of embedding service providers within the process which in turn could establish service provider monopolies.

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. As evidenced in this draft, discrepancies will remain regardless of the level of detail prescribed in the technical standards. This is an inherently subjective process. Regulators should work with banks to ensure consistent outcomes rather than a consistent approach or process.

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

Wide bid/offers observed in the market may also be considered in addition to collateral dispute information, although we would expect this to be included within the valuation uncertainty assessment.

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?

Balance sheet substantiation is not listed in Article 100, nor are concentration and liquidity

- Unearned credit spreads – Some approaches to CVA include an inherent interaction with DVA, therefore DVA should be considered to ensure a consistent approach across firms is adopted.
- Close-out costs – Interpretation of the netting methodologies described could carry significant implications and result in over-stating the exit costs.
- Operational risks – While operational risk is included in Article 100 it is already captured in the Operation Risk Capital Charge and represents an overlap in capital charges. Therefore this should be segregated from prudential valuation.
- Market price uncertainty –
  a. More flexibility required regarding usage of the prudent value level of confidence (EBA state 95%, we believe 80%-85% is more appropriate).
  b. Interpretation of the netting methodologies described could carry significant implications.
- Early termination – We believe this is an ancillary AVA which should not be required.
- Investing and funding costs – While we believe this is an area of uncertainty and inconsistency across institutions we do not believe an AVA requirement will achieve consistency in the market and will result in another layer of uncertainty over the fair value. Investing and funding costs methodologies should be challenged if and where appropriate by the regulators. In particular we disagree that the valuation adjustment should incorporate the institution's funding costs and benefits over the contractual lifetime of the trade. This contradicts paragraph 9 relating to the actual realisable value, which can also be defined as the sale price.
- Future administrative costs – We believe this is an ancillary AVA which should not be required.
- Model risk – These are appropriate. Note there is a potential overlap with the fundamental trading book review.
- Balance sheet substantiation – We believe this is an ancillary AVA which should not be required. We do not believe this requirement would fall under the definition of prudent 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?

While they may be material, the following items should not be included as they are beyond the scope of prudential valuation.

- Operational risks
- Early termination
- Future administrative costs
- Balance sheet substantiation

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?

No. We envisage the test and any data used within the test to be incorporated within the process of determining the valuation uncertainty, not as a test to the valuation uncertainty output. We would rather use the resources in determining a robust valuation uncertainty output rather than as a test of the output.

In addition, we question how this test can practically be achieved. It would require re-performing the valuation uncertainty calculation at the point in time of the executed transaction. Otherwise it will be too difficult to differentiate uncertainty from market movements.

Annex 2 does not provide a reasonable means of testing. The test would falsely highlight imprudent valuations which were due to market movements alone.

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 recommend excluding both Annex 1 & 2 as it provides little gain in the overall confidence of the prudential valuation adjustment.

Benchmarking as previously performed by the UK FSA or by consensus is more effective and informative. Comparative analysis against VaR and balance sheet, while limited, will enable regulators to pick areas where thematic reviews may be of more value or where questions may be asked of individual firms.

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?

No. Prudent value can be greater than fair value if we prove that we are beyond the prudent end of the range of observable data. We would be placed at an unfair advantage if we can demonstrate we are prudent across the industry, yet are unable to benefit from such prudence within this process. This may lead to firms adjusting books and records, diverging from a prudent approach.

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

Yes. Valuation uncertainty is a useful exercise when completed at a granular level as it can be incorporated into firms' existing IPV, reserving and P&L processes. When completed at a granular level, a natural consequence would normally be at least some level of diversification benefit when viewed at an aggregated level. We believe more focus should be spent on the granular level valuation uncertainties. With no diversification benefit, the aggregate figure ceases to be an accurate reflection of institutions' valuation uncertainty.

18. If you support the availability of diversification benefit, do you support creating a simplified standard approach, an example of which is shown in Annex 4? If you do, do you have alternative suggestions on how this standard approach should be specified? Are the suggested correlations in the example appropriate, if not what other values could be used?

We support the availability of diversification benefit although have reservations with supporting a standard aggregation approach. Given the guidance on the determination of the underlying valuation uncertainties/AVAs, we believe there remains a wide interpretation which may result in varying degrees of results. If the final stage in the calculation process, the aggregation, is standardized some firms may be unfairly penalized for adopting a more granular level approach in AVAs. In short, a standard approach needs to be standardized from the bottom up.

An agreed approach, consistent with that in practice for Market Risk, which is agreed between firms and regulators, would ensure a consistent end result to prudent valuation. If firms that are currently at the prudent end of fair value were unable to benefit from such a stance through the prudential valuation adjustment, they would be incentivised to move to a more aggressive fair value.

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 support an in-house approach of diversification benefit that is subject to approval by the regulator.

We would however not explicitly support the example provided in Annex 4 as it is too prescriptive and implies there is an optimal and consistent way of improving the computations efficiency across all institutions under different environments.

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)?

We believe that offsets against AVAs for overlaps with other Pillar 1 capital requirements should be permitted. Permitted offsets should include positions that are 100% capitalized, Operational Risk, and other Pillar 1 capital requirements that may fall within the current UK FSA guidance (whereby offsets are permitted for any regulatory capital adjustments, already taken for elements of valuation uncertainty or situations where the capital requirement for a position is already at a level such that a prudent valuation adjustment would imply a capitalisation of more than 100%).

21. 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?

Standards set out for systems and controls around the valuation process are too prescriptive. The requirements are highly demanding in terms of documentation, systems, control and reporting requirements.

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?

In general, costs estimated in the UK FSA's Consultation Paper 11/30[2] seem reasonable but may need to be expanded to compensate for the increase in scope in the EBA RTS proposal.

There are significant benefits associated with the determination of valuation uncertainty. Sound valuation uncertainty assessments inform the IPV, reserve and P&L processes and help senior management gain comfort with the valuation processes adopted within the firm.

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

We recommend the UK FSA's proposed Template in its Consultation Paper 11/30.

[2] http://www.fsa.gov.uk/library/policy/cp/2011/11_30.shtml