Prudent Valuation

RVS response to the EBA consultation document

Date:	11 January 2013
Version number:	V1.0
Status:	Final

Table of contents

1 Executive summary

We are pleased to submit this document as our response to the European Banking Authority Discussion Paper on the draft Regulatory Technical Standards (RTS) on prudent valuation under article 100 of the draft Capital Requirements Regulation (CRR).

Since its inception in 2009, RVS has been actively engaged with the financial services industry to create a series of transparent, End of Day benchmarks on a daily basis for use in Risk, Capital, P&L and other calculations on a centre by centre basis “following the sun”. The RVS philosophy has been based upon accuracy, transparency and independence. These principles have been broadly endorsed by the industry, Self-Regulatory Organisations and Authorities.

RVS endorses and agrees with the overarching principles described in the RTS regarding appropriate methodologies for the calculation of Additional Valuation Adjustments (AVAs). One of the central themes we believe should be stressed is that facilities currently exist to ensure OTC derivative transactions can be effectively valued using benchmarking techniques and transparent, open benchmarking methodologies, which makes best use of both evidential transaction data and other sources where no trades are in evidence. The process should be automated and based upon an agreed set of independently validated Rules. The Rules and approach should be governed by an advisory panel of eminent independent experts.

RVS has broad experience in the construction of such benchmarks. A more detailed description of our services can be found in Appendix 1.

2 Response and commentary

(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?

No, we believe that there should be no such threshold.

(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 that the exit price does not need to be based on instantaneous sale on the basis that certain, more complex, assets by definition need to be exited at a slower pace, although the size and scale of the financial institution holding the asset should also be taken into account. SIFI, D-SIFI or G-SIFI organisations should be able to exit an asset faster than other kinds of financial institution and different exit prices would apply to them.

Also, the exit price will be affected by firm and position size relative to the market in general and the underlying liquidity for the specific risk-position. This can be achieved through evidential benchmarking facilities and open valuation rules based on market and regulator consensus. Should the exit price be based on a non-instantaneous sale, RVS would be able to provide daily standard-deviation price-data to assist in the valuations.

(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?

Standardisation of prudent valuation assessment techniques across the market is necessary so that regulators and shareholders are able to assess risk on a consistent basis between firms. The actual time horizon may vary depending on the specific market and instrument complexity but should be consistent across all market participants. A one-size-fits-all approach, which ties the measure to an artificially short (e.g. 10 day VaR) or long (EPE – n years) time scale, would potentially not provide real insight into firms' positions.

(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?

Yes we support the use of specified levels of confidence to determine AVAs but we acknowledge that where AVAs are calculated using more judgemental processes, the use of a 95% confidence level, for example, is not particularly meaningful. This may apply to operational risk in particular.

(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 do support a specified level of confidence but we recommend the use of a 90% level of confidence, based on our opinion that a 95% confidence level is not going to be achieved realistically in illiquid assets within the context of Prudential Valuation.

(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?

We suggest there is not necessarily a direct correlation between the number of data points and the number of contributing banks. In liquid markets it may be legitimate to prescribe a minimum number of

data points but in instances when markets are less liquid, data relating to the trading of those instruments is, quite naturally, less reliable. However, we note that confidence levels can remain at 90%, further to our response to Q5, if financial institutions are able to provide non-statistical evidence that they can be confident about their ability to exit their positions.

On balance, we feel that the volume of individual rate points and their variance in liquidity, numbers of expert traders, creditworthiness-dependency and other attributes mean that prescribing numbers of data points will be impractical.

(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*

Where data is lacking within an appropriate recent time period, any indicative guidance is better than nothing. On that basis, a judgemental approach can be applied using the approach outlined in response to Q6 above.

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

It may be possible to use the pricing of similar instruments in other markets to infer a price for the instrument which is actually being priced. Such a price construction would, necessarily, bear a lower likelihood of accuracy.

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

We believe the description is sufficient to allow clear understanding of what will be expected of financial institutions.

(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?*

We believe that firms should decide their own approach, subject to appropriate levels of regulatory oversight.

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

Another indicator to be considered is the level of observable transaction data. A lack of recent market activity is a strong indicator of price uncertainty (please also note our responses to Q2 and Q3).

(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?*

Yes we believe the approaches are appropriate.

(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?*

There will be specific sources of valuation uncertainty in some markets which do not apply in others. This level of detail is probably inappropriate in the RTS itself and should be dealt with at a market level with appropriate input from local regulators and industry participants. We believe that one of the best ways of ensuring that the rules supporting these details are defined in an open and transparent manner

is through the use of an independent advisory panel comprising local regulators and industry participants.

These rules for calculation and application of risk factors should be regulator approved and then applied consistently across all market participants.

(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 are not clear that the same approach used to measure market risk is appropriate when calculating price uncertainty. The valuation certainty at one point in time for a particular asset may be different at another point in time for the same asset. So back testing assets does not seem to provide great insight when assessing current price uncertainty.

(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?

Independent validation of all models used in regulatory reporting is desirable and should be mandatory. A prescriptive approach however could create a "tick the box" mindset among those charged with carrying out the validation. A standard set of validation techniques is a useful guide but individuals, such as an internal quant group or external auditors, who are charged with the responsibility of performing the independent validation should have the authority to examine all aspects of the valuation approach and report any shortfalls.

We suggest that, given consistency across all participants is a desirable outcome, any shortfalls are discussed at an industry level so that issues can be examined and any corrections made on a wholesale basis.

(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 do support this concept.

(17) Would simple aggregation better reflect your assumptions and practices or 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

RVS supports the approach of reporting on both a diversified and undiversified basis.

(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?

Yes we do support the creation of a simplified standard approach as that will create greater transparency in the marketplace and enable greater consistency of approach across jurisdictions.

(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?

Yes we do support in-house approaches and agree they should only be supported if they receive appropriate regulatory oversight.

Also, we note that the output of the model will be greatly enhanced if externally validated sources of data are used for valuation, such as appropriate, well-governed consensus-based pricing mechanisms and benchmarks.

(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)?

Yes we agree that they should not be permitted in general. However, if there are circumstances which are identified where they are deemed appropriate we would urge that these should be agreed by the regulator for broad application and not just individually assessed by a particular financial institution.

(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?

Yes we do.

(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?

Again, we believe that standardisation in this area will ensure greater consistency across jurisdictions. If such methodologies and reporting formats are endorsed by the EBA, we strongly recommend that representation is made outside Europe to assist other jurisdictions to have international consistency. This may be achieved via the FSB, IOSCO or other supra-national bodies.

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

We understand that much resource has been dedicated by the UK's Financial Services Authority (FSA) in creating a template for utilisation within its jurisdiction. We would suggest using this existing template in order to minimise compliance costs for banks.

3 Appendix 1 - RVS QED Benchmarks

Key characteristics

RVS has created a global industry benchmark service for independently and transparently validating End of Day (EoD) rates and curves – it was designed to be the single industry source for EoD rates for all time zones and centres. The service has been incubated in Australia prior to a global roll out in which started in 2012.

Rate Validation Services Qualitative Evidential Data (RVS QED) Benchmarks have the following key characteristics to ensure complete accuracy and transparency:

1. The daily Benchmarks are, as much as possible, based upon actual transaction or evidential data.
    a. RVS software pulls the economic elements of confirmed trade data directly from bank systems (i.e. fully automated thereby removing opportunities for manipulation) in real-time.
    b. Each benchmark is created using industry-agreed Rules, Conventions and Policies which are signed off by an independent panel.
    c. The independent panel may be made up of industry experts, academics, regulators and other eminent individuals depending on the characteristics required by the jurisdiction.
    d. The service is independently audited on a regular basis to ensure that the construction of all benchmarks is in accordance with the agreed Rules, Conventions and Policies. The audit is made available to regulators and market participants to ensure complete transparency.

2. If transactions are not available for the particular market segment on any given day, previous transactions as well as indicative price quotes are included according to the industry-agreed Rules. Distinction is made between the likely accuracy of benchmarks supported by transaction evidence and those based purely on submitted quotations.

3. Liquidity metrics are published on all benchmarks for analysis by both banks and regulators.

4. Benchmarks can be constructed from differing submission panels according to the characteristics and requirements of different markets.

5. The construction of the benchmarks based upon Rules and Conventions and the Rules and Conventions themselves are completely transparent but individual bank contributions are currently only accessible to regulators, in order to protect the privacy of the contributing banks.

6. Industry-standard curves are created to assist with collateral settlement and OTC Central Clearing initiatives.

7. All data is retained indefinitely in order to facilitate both investigations and back-testing.

In summary, RVS QED uses both quotation and transaction-data extracted directly from bank systems, ensuring the integrity of all data. The Rules, Conventions and Policies governing each benchmark are set by the independent expert board and approved by a separate independent panel which may also include the local regulator.

We believe RVS QED ensures the accuracy required and provides the transparency of the collection, calculation and governance of each benchmark which can then be factored into the Prudential Valuation calculation.

4 Document control

If you have any queries regarding the information in this document, please contact:

Contact	John Crowley-Clough | Director | Regulatory Affairs Rate Validation Services Pty. Ltd. 69 Old Broad Street, London EC2M1QS Email: *john.cc@ratevs.com*

4.1 Distribution

Date	Version	Recipient(s)
Dec 2012	V0.1	First draft prepared by John Crowley-Clough (JCC) and Graeme Austin (GA).
Jan 2012	V0.2	Completion of all questions. Update based on feedback.
Jan 2012	V0.3	Feedback from Bob Newstead (BN)
Jan 2012	V0.4	Further feedback from BN and Stewart Evans (SE)
Jan 2012	V0.5	Feedback from JCC
Jan 2012	V0.6	Further feedback
Jan 2012	V0.7	Further feedback
Jan 2012	V0.8	Final