WKO BANK · VERSICHERUNG

European Banking Authority (EBA)

Division Bank and Insurance
Austrian Federal Economic Chamber
Wiedner Hauptstraße 63 | P.O. Box 320
1045 Vienna
T +43 (0)5 90 900-DW | F +43 (0)5 90 900-272
E bsbv@wko.at
W http://wko.at/bsbv

Your ref., Your message of	Our ref., person in charge	Extension	Date
	BSBV 115/Dr. Egger/We	3137	8 October 2013

EBA – CP Draft RTS on prudent valuation under Article 105 (14) CRR (EBA/CP/2013/28)

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the EBA Consultation Paper relating to Draft RTS on prudent valuation under Article 105 (14) CRR (EBA/CP/2013/28) and would like to submit the following position:

General Statements

We appreciate the positive amendments made on the preliminary views expressed in the Consultation Paper. In particular we agree with the reduction of the confidence level from 95 to 90 %. Moreover the simplified approach as an alternative to a more sophisticated core approach is welcomed.

Nevertheless we have some concerns regarding the calculation of the simplified approach. Using unrealized gains as a basis for the Additional Value Adjustment (AVA) leads to a double correction in the light of the current EBA discussion paper on possible treatments of unrealized gains measured at fair value under Article 80 of the CRR. If unrealized gains are used as an input factor for the AVA calculation we plead to reduce the specific applied percentage and instead increase the percentage of the aggregate absolute value of fair valued positions held by the institution, as this would generally reduce volatility

Concerning the core approach we would like to emphasize that this approach is extremely demanding with respect to methodological-, IT-, implementation- and validation efforts. Moreover the conditions of CEE-markets simply do not allow calculating the proposed requirements. Therefore we cannot take the example RTS as an inspiration for our prudent value calculations for subsidiaries. We propose that each bank should choose which method to use – simplified or core approach – as it is in the case of capital requirements in Pillar 1.

These RTS are based on Article 105 (14) CRR, which mandates EBA to specify the conditions according to which the requirements of Article 105 shall be applied for the purposes of paragraph 1.
Para. 1 sets out the requirements for prudent valuation exclusively for trading book positions.

Therefore the mandate of EBA is accordingly limited. Even if Art. 34 CRR references to Art. 105, embracing banking book positions in these RTS would exceed EBAs mandate defined in Art. 105 (14) CRR.
Therefore we would argue to exclude Banking Book Items from the Prudent Valuation Requirements. In addition we plead to exclude own debt from the prudent valuation requirement for two reasons.

- There is no intent of trading own debt.
- Own debt is already valued prudent.

There is no alignment with IFRS 13 (effective from 1 January 2013), mainly with the 3 levels categories of fair valued assets. The term “exit price” is a basis for definition of fair value in IFRS 13. It is also basis for the assessment of a prudent value which is based on a “realizable exit price”.
Referring to IFRS 13 the Level 1 and 2 in the fair value hierarchy shall be excluded from AVA, as they consist of quoted prices in active markets, namely the most reliable evidence of fair value; respectively quoted prices or at least observable market data.
Level 3 inputs are unobservable inputs for the asset or liability [IFRS 13:86]. Therefore an AVA calculation should only occur for Level 3 instruments.

In the case that a holding company should be subject to the core approach and the subsidiaries are allowed to use the simplified approach we would suggest that on holding level the simplified approach from the subsidiaries can be used and no core approach has to be calculated for them.

1. Prudent Valuation according to Article 105 (14) vs. IFRS:

Firstly it should be mentioned that Article 105 (14) CRR in connection with Article 34 CRR exclusively refers to treatment under IFRS. In this respect we want to put into question on how other accounting principles shall be considered under the prudent valuation approach and how the differences between different accounting principles could be measured and observed.

Secondly we want to point out that prudent valuation is not in scope of the global framework issued by BCBS in 2011. Therefore we doubt that using the prudent valuation approach for banks and banking groups within the EU in the pillar 1 is in line with the idea of a global level playing field.
Finally we want to underline that any differences between accounting treatment and prudential treatment compounds reconciliation from balance sheet to own funds within disclosure and would create additional lack of understanding and interpretation of the presented figures.

2. Prudent Valuation vs. treatment on unrealized gains:

We want to express our concerns regarding double-counting related to the simultaneous application of the prudent valuation approach and the treatment of unrealized gains.
Article 468 CRR states that unrealized gains are not available within own funds during 2014. It is also a requirement to fully or at least partially exclude unrealized gains during the years 2015-2017 based on the transitional provisions according to Article 468 CRR depending on the transitional provisions to be defined by the local competent authority. At least for the transitional period, it should be ensured that any potential double counting is avoided.

In this respect we want to point out, that both, the prudent valuation and the prudential filter on unrealized gains should be covered by provision clearly defining on how interdependencies should be considered and how double-counting is avoided. Applying the prudent valuation principles under Art. 105 CRR exclusively to trading book positions, while applying the treatment of unrealized gains to banking book positions, would help avoid any double counting and would

at the same time be more consistent with the wording of Art. 105.
Anyway, as mentioned previously, we believe that due to full exclusion of unrealized gains at least in 2014 neither prudent valuation nor the requirements according Article 80 (4) CRR should be required before the year 2015.

3. Questions regarding consideration of prudent valuation in other requirements defined within the CRR:

Since the prudent valuation will also impact other topics covered by the CRR we want to highlight that a further need of clarification is given regarding the following issues:
How to consider prudent valuation in the calculation of eligible minority interest?
Which approach should be used for determination of eligible minority interest in case simplified approach is used on solo-level and core-approach is used on group-level?
Is it appropriate to exclude the whole amount that is excluded from CET 1 based on prudent valuation also from the capital base of the leverage ratio?

Overview of consultation questions

Q1. Do you agree with the minimum list of alternative methods and sources of information defined above for expert based approaches? If not, what others could be included, or which points from the current list should be removed? State your reasons.

The “natural bound of an instrument” as stated in Art. 3 (3) c should be specified.

Q2. Do you agree with the introduction of a threshold below which a simplified approach can be applied to calculate AVAs? If so, do you agree that the threshold should be defined as above? State your reasons.

The alternative application of the core or the simplified approach should be available for all institutions. As certain incentives to apply the core-approach exist, those institutions able to implement such an approach and to meet the administrative burdens and costs, should have the opportunity to do so. However mandatory application of an approach does not seem to be the ideal solution.
It should also be clarified, that in case the core approach is used on a parent institution level while the simplified approach is applied beneath, the parent institution is allowed to aggregate the data calculated with the simplified approach.

Q3. Do you believe there are any practical issues with a parent institution being required to apply the ‘core approach’ to all fair value positions whilst a subsidiary is allowed to apply the simplified approach? State your reasons.

We support the idea that subsidiaries are allowed to use the simplified approach for their local reporting. Nevertheless differences in the amount of AVA can be substantial. Especially if the subsidiary has a high positive P&L the simplified approach may lead to a much higher AVA than the core approach.

The core approach does not have to be applicable for the subsidiary for consolidation.
We propose to solve this as follows: Each bank within the group should choose the method of AVA calculation based on its own discretion, not based on some threshold or based on the method chosen by the parent company also for consolidation purposes. The consolidation than would contain both simplified and core approach results. This would solve both ad 1.) and ad 2.)

Q4. Do you agree with the proposed simplified approach? Do you think the risk sensitiveness of the approach is appropriate? Are there alternative approaches that you believe would be more appropriate? State your reasons.

In principal we do agree with a simplified approach, although double-counting has to be avoided. The disadvantage for institutions with a high amount of unrealized gains is substantial. Reducing the percentage from 25% and instead increasing the percentage of the overall fair valued assets and liabilities might be a less volatile alternative.

We do not understand the rationale for using also the unrealized profit as the base for the calculation (and presumably the more important one). It implies that instruments whose FV has decreased since their initial valuation actually lower the AVA costs (and vice versa, instruments with increasing FV increase AVA costs). In reality, there is no reason to think that the types of risk covered by this regulation have any connection to the upside/downside development of fair value of any individual instrument. We would agree with increasing the weight towards the total value of FV priced instruments. Further it might make the AVA provisions less volatile and unpredictable given the size of the portfolio.

If we consider PL as a source for AVA calculation, we do not comprehend why AVA is calculated from net realized profits and not from both net realized profits and losses.

In case the parameters used for calculation (25% and 0.1%) are outputs from a calibration exercise we think the RTS should describe how they were derived.

Q5. Could a differentiated treatment for some asset/liability classes be considered, for example with regard to their liquidity? Please state the pros and cons of such a differentiation. How would you define the degree of liquidity of an asset/liability class (e.g. fair value hierarchy, eligibility for the LCR, other)?

In our opinion we would exclude instruments which are central bank eligible. Those instruments can be used as collateral for immediate cash and therefore reduce the pressure to close the position. For the liability side we would differentiate between liabilities which are valued using the own funding curve and liabilities valued using a market implied CDS curve.

Q6. Do you agree with the approach defined above to calculate an AVA where the approaches in Article 8 and 9 are not possible for a valuation exposure? If not, what other approach could be prescribed? Explain your reasoning.

No.
The provisions do not appear consistent from a systematic point of view.
This approach would lead to an extremely high additional value adjustment. If institutions are not able to calculate a single valuation exposure they should use a percentage of the aggregate absolute value of fair valued positions. The percentage should be retrieved from other banks which are able to calculate this AVA figure.

Q7. Do you agree with the approaches defined above to calculate AVAs for market price uncertainty, close-out costs, and unearned credit spreads? If not, what other approach could be prescribed? State your reasons.

In principle the calculation is understandable, although a possible double-counting might occur. Furthermore the ongoing calculation on a regular basis implies a high amount of methodological, implementation, IT and validation efforts. It should be considered to apply already available tools, e.g. the VaR approach or the Bloomberg/Reuters scores for market depth.

Further the source of uncertainty mentioned in Art. 10 would already be covered by the Credit Valuation Adjustment.

Q8. Do you agree with the approaches defined in Articles 11 to 16 to calculate the various categories of AVAs? If not, what other approach could be prescribed for each AVA? State your reasons.

For concentrated positions the information on the liquidity of a certain instrument is not always available. Those articles are very general, there is not much to comment on (especially the investing and funding AVA could me elaborated in more detail).
Neither the reason for including administrative costs in AVA is obvious, nor how it should be done.

Q9. Are there cases where the above AVAs may have a zero value that could be defined in the RTS? If yes, please specify.

1.) We propose to set AVA equal to 0 in case the asset is in Level 1 or Level 2 IFRS class.
2.) We propose to set administrative costs AVA equal to 0 for very standardized and liquid instruments.
The capital requirements for OpRisk are already specifically met, independent from any AMA.

Q10. Do you agree with the approach defined above for the aggregation of valuation exposure level AVAs within the market price uncertainty and close-out cost AVA categories? If not, what other approach could be prescribed? State your reasons.

We welcome the possibility to reduce the aggregated total amount of AVA to 50 %.

Q11. Do you agree that category level AVAs described in Articles 11 to 16 within the core approach should be aggregated as a simple sum? If not, what other approach could be prescribed? State your reasons.

A precise answer cannot be delivered without knowing the exact methodology for the calculation of individual components nevertheless a simple sum might lead to double counting and should be avoided.

Q12. Do you agree with the requirement for institutions using the core approach to implement the above ongoing monitoring tool as an indicator of the adequacy of data sources of valuation inputs used to calculate the AVAs described in Articles 8 to 10? If not, what other approach could be prescribed? State your reasons.

This will depend on the fact if the core approach will be extended to each subsidiary of a parent institution using the core approach or if the parent institution will have the possibility to aggregate data calculated on basis of the simplified approach (see Question 2). Otherwise the implementation costs would be substantial.

Q13. Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?

N/A

Kindly give our remarks due consideration.

Yours sincerely,

Dr. Franz Rudorfer
Managing Director
Division Bank & Insurance
Austrian Federal Economic Chamber