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8th October 2013

Dear Sirs,

Response to EBA Consultation Paper on Prudent Valuation under Article 105 (14) of Regulation (EU) 575/2013

I enclose The Royal Bank of Scotland Group's ('RBS') response to the above consultation paper and welcome the opportunity to comment. RBS has been an active participant in the preparation of the response from AFME.

RBS supports the European Banking Authority in its objectives in creating a single set of harmonised prudential rules for financial institutions throughout the EU. We are however concerned with certain aspects as detailed in the Draft Regulatory Technical Standard ('RTS') which we comment on in further detail below.

The concerns are described and illustrated in further detail in the Appendix to the letter. We would be happy to elaborate further on any of the points made in this response and look forward to engaging with you on this topic. In the first instance, please address any queries to myself.

Yours faithfully



Rajan Kapoor
Group Chief Accountant

Appendix

General Observation

Scope

The explanatory text under Article 5 states the AFS assets are to be excluded from the calculation under the Simplified Approach, given current capital treatment. There is, however, no explicit guidance as to whether the Core Approach should mirror this treatment.

In addition we would welcome clarification around treatment of AFS designated assets under any transitional arrangements for the purposes of calculating AVAs.

Response to EBA questions contained within the Consultation Paper

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.

We consider that the market data sources listed in Article 3 (Paragraph 2) currently represent appropriate sources of information for both independent price verification and establishing ranges of plausible valuation uncertainty.

We would propose that the wording should reflect that all of these sources of data may not be available for all exposures on a continual basis.

Therefore we consider that the wording in Article 3 (Paragraph 2) should be amended to "*The market data used to determine a prudent value should make use of a range of reliable data sources including some or all of the following, as appropriate*".

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.

We support the application of a threshold below which a simplified approach can be applied.

Although we recognise there has to be a trade off between simplicity and accuracy we believe that a properly calibrated threshold based on the IFRS13 fair value hierarchy would provide a more accurate threshold than one purely based on balance sheet size.

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 do not consider 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

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.

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)?

We do not consider that there is a link between prudent valuation and unrealised profits. The use of unrealised profits will produce inconsistent prudent valuations across institutions which have the same exposure dependent on their timing of purchase.

In our view a properly calibrated approach based on the fair value hierarchy would provide a stronger link to uncertainty in valuations

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.

We recognise the need for an alternative approach when those set out in articles 8 to 16 are not possible for a valuation exposure.

Although we recognise that an alternative approach should be at least as prudent as those set out in articles 8 to 16, the approach set out in the discussion paper would result in an AVA many times higher than one calculated under articles 8 to 16. Applying 10% to the notional of a medium sized derivative portfolio would result in a deduction many times the existing Core Tier 1 capital of a firm.

In our view a properly calibrated approach based on the fair value hierarchy should form the basis of an alternative approach.

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.

Market Price Uncertainty:

Inputs:

The application of market data uncertainty for derivatives based on the valuation exposure to each parameter within a matrix will result in a prudent valuation significantly greater than the 90% confidence level.

The resulting market data matrices do not represent a realistic view of market levels. The allowable netting approach only partially mitigates these issues and will still lead to in our view a significant overstatement of the market price uncertainty.

In our view data from a single identifiable source should be viewed as a single valuation input and applied to the whole matrix and not the individual points in the matrix. A valuation range should be calculated using a number of individual sources to allow the calculation of the 90% confidence level.

Where single sources are not available we accept that an alternative approach may be necessary.

Netting:

We are supportive of the reduction of parameters of valuation inputs but have the following concerns about the approach as detailed.

- 1) Our analysis indicates that a volatility ratio of 0.1 allows a level of netting that is not reflective of market trading and pricing practises.
- 2) Given the mathematical relationship between variance and volatility (being the square root of the variance), the quoted volatility ratio of 0.1 translates to a ratio between the variances of 0.01. This implies a correlation between reduced and unreduced valuation inputs of approximately 99.5%
- 3) The calculation is difficult for multi dimensional market data.

We believe that the EBA & national regulators should continue dialogue with the industry to refine these methodologies.

Close Out Cost Uncertainty:

We agree that institutions should have a strong governance framework for testing and approving close out cost methodologies.

We believe that close out costs should reflect an individual market's trading practise and we are concerned that a prescriptive rule may not be able to capture this dynamic. This may lead to a prudent valuation greater than the 90% confidence level.

We consider that the governance framework around close out methodologies should be subject to review by the national regulator as an alternative to a prescriptive test for close out cost AVAs.

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.

Article 11: Calculation of Model Risk AVA

We agree with this approach for the calculation of model risk AVA

Model uncertainty is closely linked to Market data uncertainty and should be included in the aggregation methodology to recognise the impact of diversification within model risk.

Article 12: Calculation of Concentrated positions AVA

We agree with this approach for the calculation of concentrated positions AVA.

Article 13: Calculation of Investment and funding costs AVA

We are concerned that this will create an imbalance in the capital treatment of the funding of derivative trades that are not strongly collateralised and the fair value of debt issuance used to hedge these exposures. The asymmetric tier 1 capital deduction of own credit on issued debt used to hedge derivative exposures will result in a volatility in tier 1 capital which is not reflective of an institutions net position. We believe that this will introduce instability in tier 1 capital.

We also believe that "contractual lifetime" should be amended to "expected contractual lifetime" to clarify that the prudential valuation should reflect the expected risk neutral maturity of options

Article 14: Calculation of Future administration costs AVA

We agree with this approach for the calculation of future administration costs AVA.

Article 15: Calculation of Early termination costs AVA

We agree with this approach for the calculation of early termination costs AVA.

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

We are not aware of any general case where the AVA set out in Articles 11 to 16 would have a zero value. We would expect that any specific case would be reviewed by the institution's national regulator.

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 agree with the suggested approach for the aggregation of valuation exposure level AVA for market price uncertainty and close out cost AVA.

We believe that fair value adjustments should be offset after the aggregation of market price uncertainty and close out costs to ensure consistency across institutions. Applying an offset prior to aggregation penalises institutions that have more conservative fair values. This in turn could lead to less conservative fair valuation for that institution.

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.

As stated above we view that Model Risk AVAs should also be included within the aggregation approach to recognise the overlap with market price uncertainty and the impact of diversification.

We agree with the simple sum approach across the other categories.

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.

We agree that institutions should monitor their trading activities to assess both fair and prudent valuations.

Institutions have developed P&L explain and Day 1 controls to review fair values. Since prudential valuation is as at least as conservative as fair value any pattern of aggressive marking relative to trade value will be identified. An institution should only review their prudential valuation approach when there are losses under a fair value measure.

We believe that this approach would provide an adequate level of monitoring without the additional resources required in setting up a largely duplicative process for prudential valuations.

Furthermore Article 3 requires that trade data is used to assess prudent values so we believe that this article would not add additional control.

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?

We have not been able to quantify the compliance costs but we consider that both initial investment in technology and the ongoing maintenance would be considerable. In addition there is a limited resource pool across the industry to implement this and other competing Regulatory changes.

We would specifically highlight the increased resources required to:

- Demonstrate that the "reduced parameters" approach for market price and close out costs satisfies the requirement set out in Articles 8 & 9.
- Ongoing monitoring of trades against prudential valuations adjusted to reflect market moves set out in Article 20.