# Consultation paper Draft Regulatory Technical Standards (RTS)

# On prudent valuation under Article 105(14) of Regulation (EU) 575/2013 (Capital Requirements Regulation - CRR)

General comment

We understand and welcome the intention of the European Regulator to introduce prudent valuation in order to build up additional capital buffer for the valuation uncertainty. However we would like to underline that the prudent valuation regime should not enlarge the complexity of capital ratio management and the whole system of capital adequacy requirements should remain harmonized.

Since there are no exact explanations of prudent valuation principles in the EU Regulation on prudential requirement, the Technical standard is expected to bring more light on prudential valuations regime and not only to give a methodological guideline, but also to explain underlying high level logic. We should admit that unfortunately we have not found this in the current version of document, some aspects of prudent valuation approach remained unclear and unexplained. In this feedback we were following our own understanding of the topic. We were also lacking more clear instructions from the technical point of view for the valuation adjustment calculation. Thus, in articles dedicated to certain Additional valuation adjustments (AVAs hereafter) it is stated that institution is supposed to use expert based approaches (where market data is not sufficient), without any basic principles and roadmaps. Another important gap in the presented document is missed definitions of valuation adjustments itself, which may cause misunderstanding and mistreatment of certain AVAs among different institutions.

We have summarized our ideas about prudent valuation approach not only in the answers to the proposed questions, but also in the *Proposals about Prudent valuation treatment and Valuation adjustments calculation* (Proposals hereafter). In this section we have tried to express our understanding of prudent valuation adjustment nature as well as bring some ideas about AVAs calculation. Answers can be found in the next section.

We would be pleased if our ideas may be used in order to improve the introduction of prudential valuation regime.

# Proposals about Prudent valuation treatment and Valuation adjustments calculation

Thinking about prudent valuation and valuation adjustments we understand it as adjustment for covering **risk** connected with non-precise or inaccurate valuation of positions caused mainly by the following factors:

* *Product complexity* (which implies market price uncertainty, model risk and operational risk);
* *Position liquidity* (caused both by market specifics or evens as well as by institution related situation like concentration and implying market price uncertainty as well as close out costs, model risk).

Thus to evaluate the necessity for the additional valuation adjustment, as well as to quantify the valuation adjustment all positions should be examined against above mentioned factors (as it is mentioned in the on *Regulation on prudential requirements for credit institutions and investment firms,* article 105, paragraphs 11-13).

Having in mind stated in the *General comment* necessity to keep the capital requirement system harmonized and to avoid additional complexity we think it would be appropriate to introduce along with a core approach **the standard approach of additional valuation adjustments calculation as well as advanced approach** for some valuation adjustment, where the gradual complication of calculation logic is appropriate and to let institutions decide which methods fits the best to its business model and allocated internal resources. We also believe that introduction of widely accepted standard approach will help for the local supervisory process, make the AVAs comparable along different credit institutions and contribute to the more smooth change of valuation regime.

Market price uncertainty

Market price uncertainty is a state when market price cannot be defined precisely due to market-specific situations or event. Market price uncertainty should be identified based on the liquidity of the underlying market on the *valuation input level*. Market price uncertainty does not depend from the institution related situations like concentration.

*Example 1.* Low liquidity of the long term interest rate market in Russia implies exposure of Russian rubble swap rates to the market price uncertainty.

*Example 2.* High liquidity of German government bonds implies absence of market price uncertainty for positions in German government bonds.

*Example 3.* Position in private placement bonds of European corporate issue XXX is exposed to the market price uncertainty, although the corporate bonds market is rather liquid.

Under the **standard approach** institutions are asked to estimate market price uncertainty AVA as net notional value of financial instrument multiplied by:

* 100[[1]](#footnote-1) basis points in case of non-derivative instrument
* 10 basis point in case of derivative instrument

if and only if the financial instrument is *denominated, indexed or depends in any other way from currency, which is not home currency for countries, representing Advanced economies according to the IMF classification*.

Under the **advanced approach** the institution should develop internal definitions of market price liquidity (liquidity grades) and map all valuation inputs to the market liquidity grades from 1 to 5, where:

1 – very liquid

2 – liquid

3 – less liquid

4 – not so liquid

5 – illiquid

The definition should be constructed in a way, that valuation inputs mapped to liquidity grades 1 and 2 are representing *active market* according to the IFRS13 term. The market price uncertainty AVA is then to be calculated as net notional value of financial instrument multiplied by:

0 – if financial instrument depends only from valuation inputs with assessed liquidity level 1 or 2

10 basis points – if the lowest market liquidity class of valuation inputs which financial instrument depends from is 3 and the financial instrument is not derivative;

1 basis point – if the lowest market liquidity class of valuation inputs, which financial instrument depends from, is 3 and the financial instrument is derivative;

50 basis points – if the lowest market liquidity class of valuation inputs, which financial instrument depends from, is 4 and the financial instrument is not derivative;

5 basis points - if the lowest market liquidity class of valuation inputs, which financial instrument depends from, is 4 and the financial instrument is derivative;

100 basis points – if the lowest market liquidity class of valuation inputs, which financial instrument depends from, is 5 and the financial instrument is not derivative;

10 basis points – all other instruments.

Under the **core approach** the institution should develop internal definitions of market price liquidity and map all valuation inputs to the market liquidity grades from 1 to 5, identically to the standard approach. For each market liquidity class the *uncertainty factor* of market price should be defined based on the institution experience on the market.

*Example*: interest rates in Ukraine are usually defined with exactness of 50 basis points, thus the market uncertainty factor for UAH interest rates is 50 basis points.

The respective AVA should be calculated as a sensitivity of portfolio market value to the valuation input shift by the defined market uncertainty factor. The direction of shift should be the one, where the sensitivity is higher.

Close out costs

Close out costs are costs which appear in case of position liquidation under the circumstances different from the normal market circumstances. In other words, close out costs appear if the liquidation of position is influencing the market price. Thus, close out costs are relevant for concentrated positions and for position where the originally intended holding period is exceeded.

*Explanation:* we differentiate between market liquidity and position liquidity. In a liquid market the position kept by the institution can be illiquid due to the concentration.

Under the **standard** approach the close out costs AVA should be calculated as net notional value of financial instrument multiplied by

* 100 basis points in case of non-derivative instrument
* 10 basis point in case of derivative instrument

if and only if the financial instrument is recognized in the any of groups of *concentrated exposures*. The group of concentrated exposures is defined as group of financial instruments with the same customer / issuer / counterpart, where the sum of book values of such instruments exceeds 5% of institution’s equity tier 1.

Under the **advanced** approach the institution should define the concentration from the credit risk prospective and allocate financial instruments to one of the categories:

1 – position can be liquidated within 5 working days

2 – position can be liquidated within 20 working days

3 – more than 20 working days are needed for the liquidation of position.

The AVA should be calculated as net notional value of financial instrument multiplied by

* 5 basis points in case of non-derivative instrument from the 1st category;
* 1 basis point in case of derivative instrument from the 1st category;
* 10 basis points in case of non-derivative instrument from the 2nd category;
* 5 basis point in case of derivative instrument from the 2nd category;
* 100 basis points in case of non-derivative instrument from the 3rd category;
* 10 basis point in case of derivative instrument from the 3rd category.

Under the **core** approach the institution should allocate all concentrated positions into the groups according the number of days needed for the position liquidation and calculate respective valuation adjustment as a Liquidity Value-at-Risk for the respective liquidation period.

Unearned credit spread

Unearned credit spread reflects the possibility of losses because the counterpart fails to execute its payment obligations and is applied to derivatives transactions. This risk is reflected by the institution in the Credit Value Adjustment (CVA). The CVA calculation bears market price uncertainty risk, thus AVA connected with unearned credit spread should be defined in the same manner as AVA for market price uncertainty and using the same approaches.

Model risk

Model risk is the risk of losses due to incorrect valuation caused by wrongly used or wrongly calibrated valuation model. Model risk is increasing with a complexity of product and therefore should be identified depending from the product complexity.

Under the **standard** approach the institution should calculate model risk AVA as net notional value of financial instruments multiplied with

* 100 basis points in case of non-derivative instrument
* 10 basis point in case of derivative instrument

if and only of the respective instrument is priced using the valuation model and is allocated to complex products according to MiFiD classification[[2]](#footnote-2).

Under the **advanced** approach the institution should categorize into following froups:

* non-complex valuation models with fixed parameters
* complex valuation models with fixed parameters
* complex valuation models without fixed parameters.

For all portfolios of products measured with models with fixed parameters the price of model parameter change by 1 basis point should be evaluated, respective results are to be sum up. The valuation adjustment for complex products are to be defined on the level of net notional value of financial instruments multiplied with

* 50 basis points in case of non-derivative instrument
* 5 basis point in case of derivative instrument

Under the **core** approach the institution should categorize all valuation models according to their complexity and dependency from fixed parameters in the following categories:

* Valuation models with fixed parameters (1)
* Valuation models without fixed parameters: non-complex (2), rather complex (3), complex (4), very complex (5).

For all portfolios of products from the category 1 the price of model parameter change by level justified by the institution should be evaluated, respective results are to be sum up. For all products valued with models 2 to 5 the model risk AVAs is to be calculated as a difference of between product price in Front Office / Accounting systems and product price in Risk management systems if any. If products are not priced in the risk management systems separately, the respective different should be set to 1 basis point of net notional value for each valuation model category. The AVA should be calculated as derived difference multiplied by:

1 basis point for valuation models from 2nd category;

2 basis point for valuation models from 3rd category;

5 basis point for valuation models from 4th category;

10 basis point for valuation models from 4th category.

Whenever the valuation model is not accomplished by the appropriate documentation, it is a subject for additional model risk valuation adjustment in amount of net notional value of respective financial instruments multiplied with

* 100 basis points in case of non-derivative instrument
* 10 basis point in case of derivative instrument

This adjustment is to be added in top of defined above model risk AVAs.

Investing and funding costs

Investing and funding cost is a cost of borrowing or investing funds required or produced due to the cash flows mismatch during the lifetime of derivative transaction. Investment and funding costs therefore is connected with market price uncertainty of collateralized transactions. The respective valuation adjustment should be calculated as market price uncertainty AVA for collateralized derivatives (defined within standard, advanced or core approach) multiplied by the funding costs in the reporting currency and scaled for 5 working days horizon.

Future administrative costs

Future administrative costs reflect the costs of transactions servicing. These costs include in particular system costs, payments processing costs as well as costs for preparing and revising documentation and legal costs. The future administrative costs therefore depends from the fact whether standard or nonstandard processes are associated with certain products as well as from the complexity of the product.

In the **standard** and **advanced** approach institution should assess future administrative costs as notional amount of non-ISDA derivative transactions multiplied by 0,1 basis point.

Under the **core** approach the volume mentioned can be reduced, if the institution can justify the availability of standard processes for non-ISDA derivative transactions support.

Early termination costs

Early termination costs are additional costs which institution should bear in case of early termination of transaction. Examples of these costs are unearned interested income or administration fee and costs of hedging of open positions which arise because of early termination. The risk of early termination is higher in client business.

Under the **standard** approach the institution should evaluate valuation adjustment as net notional value of client transactions multiplied with 0.1 basis point. Under the **advanced** approach the institution should categorize its customer products into the following categories:

* Early termination / prepayment is highly probable (1)
* Early termination / prepayment is less probable (2)
* Early termination / prepayment is not possible (3)

The respective valuation adjustment should be calculated as net notional value of client transactions multiplied with

* 0.1 basis point for products from 1st category.
* 0.01 basis point for products from 2nd category.

Under the **core** approach the institution should categories its customer products according to the categories mentioned above and define valuation adjustment as an estimation of potential loss over the 1 year horizon given the expected prepayment / early termination of respective category.

Operation risk

Risk of mispricing of position due to operational risk related event (human or system mistake). Operational risk is attached to the each particular activity and is covered on general by capital requirement for operational risk. Thus operational risk normally should not be included into the valuation adjustments.

# Answers on proposed 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.*

No, we do not agree. As of alternative **methods** we propose to use approaches based on the one defined in the IFRS 13 *Fair Value Measurement*, namely:

* Market approach, including the usage of proxies for the valuation;
* Cost approach;
* Income approach.

Each of the methods stated can be enhanced to reflect the prudential consideration (for example, the entity can use market approach with prudential shifts of the valuation inputs).

Consequently alternative **sources of information** may include:

* Market indexes, interest rates and yield curves, benchmark curves, market estimation of default probabilities (CDs curves), implied volatilities;
* Historical volatilities;
* Statement about credit worthiness of issuer / counterpart, including internal/external rating and financial statements of issuer / counterpart;
* Probabilities of default attached to internal / external ratings;
* Statement about creditworthiness of issuer / counterpart industry sector / country, their internal / external ratings and probabilities of default.

*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.*

Yes, we believe that institutions which do not have significant exposures measured at Fair Value should apply the simplified approach. From the other side we found more reasonable to define a threshold as a percentage of total assets OR minimum absolute value. (For example: the simplified approach cannot be applied of the sum of absolute values of on- and off-balance sheet fair value positions is more than 25% of total assets or more than EUR 15 bn.)

*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 see any issues here.

*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.*

No, we do not agree. As we have stated in the section *Proposals* we understand valuation adjustments as adjustments needed to cover the risk connected with non-precise or inaccurate valuation of positions caused by product complexity or illiquidity. Therefore we do not see any connections of abovementioned factors with unrealized profit or market value of underlying positions. According to the proposed approach the position with unrealized loss will not produce any valuation adjustment which is not logical on our opinion. We would notice that position with significant unrealized losses quite often represents illiquid positions, subject to market uncertainty. To summarize, the proposed simplified approach on our view will lead to distorted estimation of valuation uncertainty in the institution’s balance sheet.

As an alternative approach we would propose to use the following (similar to the standard approach for *market price uncertainty* in our proposals) algorithm: notional netted value of financial instrument multiplied by:

* 1 basis points in case of non-derivative instrument;
* 5 basis point in case of derivative instrument

If and only if the financial instrument is attributed to the Fair Value Level 2 or Level 3 according to IFRS 12 Fair Value management Hierarchy.

Although the proposed approach is very simple, it is covering the most essential valuation uncertainty risks – products and model complexity (via differentiation between non-derivative and derivative positions and Fair value levels) as well as indirectly liquidity, via Fair value hierarchy.

*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)?*

On our opinion the liquidity is one of the essential inputs to the valuation uncertainty. However for the simplified approach we would recommend to keep the algorithm rather simple, and count the liquidity of position in the indirect way via Fair Value Hierarchy. According to the IFRS 13 Fair Value management Level 1 of Fair Value position means positions valued with observable inputs without any adjustment, which implies high liquidity of the valuation inputs and less valuation uncertainty. Please look at our comment to the previous question.

*Q6. Do you agree with the approach defined above to calculate an AVA where the approaches in Articles 8 to 16 are not possible for a valuation exposure? If not, what other approach could be prescribed? State your reasons.*

No, we do not agree. We assume that either the wording of Article 6 paragraph 4 is unclear, or, if to understand the statement literally, the big room for the manipulation is available. We would propose to consider as an example the core-approach relevant bank with only non-derivatives positions (bonds), measured at fair value; an assumption also is that there is no profit out of these positions, but only losses. Following the wording the mentioned paragraph:

* *100% of the net unrealised profit on the related financial instruments* – is 0, since there is no profit;
* ***Either****: 10% of the notional value of the related financial instruments in the case of derivatives,* ***or*** *25% of the market value reduced by the amount determined in (a) of the related financial instruments in the case of non-derivatives* – is also 0, since the institution may claim to measure AVA based on the first option, although the exposure in derivatives is 0.

Assuming that in the second statement not *either.. or* is meant, but *end*, we find proposed volumes of AVAs too big and the dependency of AVAs from unrealized profit as not proved. As an alternative approach we would propose the standard approach for AVA measurement for each valuation adjustment separately. Please refer to section *Proposals* for more details.

*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.*

No, we do not agree. We would state that proposed approach under the condition of sufficient market data is rather artificial and can be rarely applied in the practice, since the necessity of the valuation adjustments is increasing with a decreasing of market and position liquidity. As we mentioned in section *Proposals about Prudent valuation treatment and Valuation adjustments calculation* we would propose institution to decide between standard, advanced and core approach for the AVAs calculation and would set the clear dependency between respective AVAs and market liquidity of valuation input and concentration of position. Please refer to the respective paragraphs in section *Proposals.*

*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*.

We do not agree in general, since we do not see any clear guideline on AVAs calculation in the mentioned articles. Please refer to section *Proposals* regarding our view of respective AVA calculation.

Moreover we do not agree with a separation of Concentration positions AVA into a different category, as we see the concentration risk as an integral part of close out costs.

*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 do not find appropriate to mention any specific cases when 0 AVA can be assessed, since usually it is financial institution specific and market specific.

*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 do not agree with a proposed aggregation approach, as well as we do not agree to the proposed methodology of respective AVA calculation. On the valuation adjustment level risks related market price uncertainty / unearned credit spread and close out costs have different origination, thus respective AVAs can be summed up. Our view on the aggregation within the AVA category is prescribed in the respective part of section *Proposals.*

*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.*

We agree that valuation adjustments related to model risk, operational risk, investment and funding costs, future administrative costs and early termination have an independent nature and are therefore additive. We do not agree with a separation of concentrated position AVA in a separate valuation adjustment, and consequently do not agree with summing up respective AVA value. Please refer to paragraph *Close out costs* in section *Proposals.*

*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 the calculation of prudential valuation adjustments should be back tested on a regular basis. We would also notice that not only AVAs mentioned in Articles 8 to 10 are relevant for back testing check, but also model risk and other.

We would generalize the requirement: for the institution applying core approach prudent values of At Fair Value positions should be properly documented and back tested using actual exit prices for the institution. In case of significant back testing violations results should be reported to management and adjustment in the calculation should be done if necessary.

*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 agree with stated costs and benefits in general; however we think it is important to notice also the following:

* **Indirect costs – ineffective management:** the new increasing complexity of capital requirements calculation may lead to less effective bank management. Prudent valuation regime following the good intention of the regulator to protect taxpayers against hidden valuation distortion in bank’s balance sheet should be therefore introduced smoothly, gradually and in the consistent way. We would underline once more that unfortunately in the current version of Technical standards we did not find a clear guideline about the calculation of AVAs.
* **Indirect costs – unattractive markets:** introduction of AVAs for less liquid positions will make investment into developing and emerging markets less attractive, which can contribute to the slowdown of respective economies development speed. Charging AVAs for complex products may also decrease the innovation on the financial markets and will not help customers to solve their financial needs.

1. All proposed multipliers are rather indicative and are subject to review for the Supervisor. We would recommend to access the level of multipliers during the accomplishing of Quantitative Impact Study. [↑](#footnote-ref-1)
2. MiFID complex and non complex financial instruments for the purposes of the Directive’s appropriateness requirements [↑](#footnote-ref-2)