

European Banking Authority

Via web-form at <http://www.eba.europa.eu/regulation-and-policy/market-risk/draft-regulatory-technical-standards-on-prudent-valuation>

Dear Sir or Madam,

Regarding: EBA/CP/2013/28 – Draft Regulatory Technical Standards on Prudent Valuation under Article 105(14) of Regulation (EU) 575/2013 Capital Requirements Regulation.

Credit Suisse (“the Firm”) welcomes the opportunity to comment on the Draft Regulatory Technical Standard on Prudent Valuation under Article 105(14) of Regulation (EU) 575/2013 Capital Requirements Regulation (EBA/CP/2013/28) (“the Paper”).

The firm would like to emphasise that it has been heavily involved with the industry-wide AFME/ISDA response and agrees with the points made therein. The firm’s specific response seeks to emphasise the firm’s main areas of concern within these points as well as provide additional clarity where possible within these responses.

A number of high level observations are outlined below. This is followed by answers to the individual questions raised.

- **Extent of Diversification** : The firm is pleased that the guideline acknowledges that diversification is an important component of the Prudent Valuation approach. However, the firm believes that the scope of diversification in the current guidance should be extended to Model Risk AVA since such risk is subject to similar diversification effects as the Market Price Uncertainty AVA due to the uncorrelated nature of the model uncertainty..
- **Netting Requirements** : The current netting requirements in Article 8(4b3) and Article 9(5b3) are highly prescriptive but have no obvious benefit. Additionally, from a theoretical perspective a ratio of 0.1 would correspond to 99.5% correlation between inputs which would prohibit almost all existing netting. In addition, the cost of meeting these requirements will be prohibitive and require significant investment. We would recommend that these requirements were replaced with text which was more principles-based.
- **Approach to positions for which AVA cannot be calculated** : The current prescriptions in Article 5 are highly punitive and have the potential to cause serious issues in situations where existing portfolios become difficult to estimate uncertainty for due to stressed market conditions. We would recommend that these requirements be reassessed and suggest a replacement in our answer to Question 6.
- **Ongoing Monitoring** : The approach described in Article 20 continues to suffer from many of the issues observed in the “back-testing” approach from the discussion paper. The firm would recommend that the most appropriate mechanisms for ongoing monitoring of the adequacy of data sources for valuation are those already in place such as Independent Price Verification (“IPV”), P&L explain/attribution and New Deal Review.

- **Regulatory Offsets** : We would note that in the UK Prudent Regulatory Authority ("PRA") guidance allowance (SUP16.16) is made to not report AVA when it can be demonstrated that other elements of the regulatory framework adequately account for them. It is suggested that this should be included in the technical standard.
 - **Tax Offset** : We would also note that within the UK PRA guidance for Prudent Valuation (SUP16.16) an allowance is made for the offset of tax liability reductions if the prudent value were used in place of the fair value. Again, it is suggested that such an offset is included in the technical standard.
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Finally, please find also attached our answers to the specific questions raised in the paper.

Thank you again for the opportunity to respond to the paper. We would be very happy to discuss any aspect of our feedback with the EBA at your convenience.

Yours faithfully,



Guy Seddon
EMEA Head of Product Control

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 firm feels that the current list of items is reasonable.

However, the firm would note that the regulation as currently worded can be interpreted as requiring all items to be explicitly calculated whenever they are available. This problem also relates to the Article 3(2). The firm would propose that these articles should be reworded to make it clear that data sources only need to be explicitly included when relevant.

For example – the wording of Article 3(3) should be changed to
“For case where an expert-based approach is applied for the purpose of Articles 8 to 10, alternative methods and sources of information shall be consider, including **where relevant:**”

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 firm believes that a threshold is appropriate due to the high fixed cost of performing a prudent valuation calculation which will be disproportionately large compared to benefits for smaller institutions.

Such a threshold needs to be simple to calculate in order to ensure minimal workload for smaller institutions. As such, the firm considers that any threshold should be easily derivable from existing calculations performed for the purposes of financial statements. The firm therefore suggests that off-balance sheet assets and liabilities should be excluded from this calculation.

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.

No.

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 having 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)?

The main requirements for the simplified approach are that

- It is simple to calculate in order to ensure that small institutions are not unnecessarily burdened.
- It is sufficiently prudent so as not to afford small institutions any advantages over the core approach.

On the first point, the firm (as stated in the answer to Question 2) believes that the calculation should rely on existing values reported in the Financial Statements. The fair value balances would seem to be most appropriate for setting the level of Prudent Valuation. In particular, the inclusion of unrealized profit and off-balance sheet items would appear to introduce a level of calculation complexity which is not required.

On the second point, the firm assumes that this would be an output of the calibration exercise and does not feel it would therefore be appropriate to comment on the appropriate multipliers and sensitivities.

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.

The proposed approach is highly punitive to such a degree that it is doubtful that any institution would adopt the approach or choose to trade products which required the approach to be adopted.

Whilst the firm acknowledges that this was the intention of the article, the firm considers that the current wording fails to address circumstances when it becomes necessary to adopt this approach due to stressed market conditions. In such a circumstance the required capital will be very large (driven by the 10% of gross notional requirement) and highly procyclical with potentially severely damaging results.

The firm would suggest that a transition approach should be considered for such circumstances based on multiples of previously calculated uncertainty with the prescribed approach in Article 7 only becoming necessary if it continues to be impossible to calculate uncertainty for an extended period.

A proposed draft wording is listed below with the factors left blank to allow appropriate values to be filled in as part of the calibration exercise.

"4. Institutions shall calculate category level AVAs by applying Articles 8 to 16 or, where that is not possible, they shall identify the related financial instruments and calculate an AVA as follows:

- (a) If appropriate category level AVAs under Articles 8 to 16 have never been calculated or have not been calculated for the last year as the sum of
 - (i) 100% of the net unrealized profit on the related financial instruments; and
 - (ii) 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 (i) of the related financial instruments in the case of non-derivatives
- (b) If appropriate category level AVAs under Articles 8 to 16 have been calculated within the last quarter, <FACTOR> the value previously calculated.
- (c) If appropriate category level AVAs under Articles 8 to 16 have been calculated within the last half year but not within the last quarter, <FACTOR> times the value previously calculated.
- (d) If appropriate category level AVAs under Articles 8 to 16 have been calculated within the last year but not within the last half-year, <FACTOR> times the value previously calculated."

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.

Broadly, the firm agrees that the approaches defined are appropriate. However, the firm is particularly concerned with two specific aspects of the defined approaches.

- The current methodology described in Article 8(4b) suggests that all assessment of uncertainty must start at the individual input level. However, the appropriate place at which to define the "valuation input" is not necessarily the individual input and using this approach will lead to unrealistic curves and surfaces. In practice, many institutions will use the range of inputs to determine reasonable alternative surfaces or curves and calculate uncertainty based off these alternatives. The firm believes that the detailed methodology description should reflect this.
 - Article 8(4b3) and Article 9(5b3) are not appropriate. Reduction of the number of valuation inputs is a critically important part of the Prudent Valuation calculation and the firm agrees that clear controls
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need to be in place around this. However, the work which would be required to conduct the analysis suggested for every surface and curve within the firm would be impossible without significant technological development and cost.

In addition, it is not clear at present what the suggested test is designed to prove and why a value of 0.1 is considered acceptable. In particular, the firm would note that a 0.1 ratio would correspond to 99.5% correlation between inputs which is an overly onerous criteria and would result in the prohibition of almost all netting.

The firm believes that this requirement should be removed and replaced with principles-based criteria which would avoid these issues.

- If a Market Price Uncertainty AVA has been calculated to an exit price (as opposed to a mid-price) this should exempt the requirement to consider a Close-Out Cost AVA. However, currently Article 9(2) only exempts this requirement in the case of "tradeable prices". The wording of this article should be modified to widen this requirement to all cases where Market Price Uncertainty AVA is calculated using an exit price.

We would be happy to work with the EBA in developing alternative wording which achieves the required regulatory objectives whilst avoiding the issues outlined above.

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.

The firm would like to comment on the approaches for Future Administration Costs and Operational Risk.

- Future Administration Costs : We believe that in many cases an alternative measure for the Future Administration Costs would be the incremental costs which would be incurred by another market participant if they were to take on the portfolio. We would suggest this is included as an alternative procedure for calculation of this AVA.
- Operational Risks : We continue to believe the Operational Risk is already adequately included in other elements of the capital framework and do not think that inclusion of a material provision in this standard is appropriate. We believe that any institution who is able to demonstrate that "operational risk relating to uncertainty in valuation is fully accounted for by existing capital reserves" should be exempt from this requirement.

Furthermore, specifically, relating to the wording in Article 16, it should be made clearer that Article 16.3 represents the entire charge for Operational Risk and no additional calculation under Article 16.1 is required.

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

No. The firm does not believe there is a need to further define circumstances within which zero value AVA's are permitted.

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.

The firm agrees that the recognition of diversification is an important component of any sensible approach to Prudent Valuation and if a firm-specific approach validated by regulators is not considered acceptable

(as suggested in our previous response) agrees with the simple multiplier approach defined by the draft standard.

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.

The firm notes that unobservable parameters can often be considered as either market data or as modeling assumptions with equal validity and hence the same approach should be adopted for Market Price Uncertainty and Model Risk. Therefore, the firm suggests Model Risk AVA should also benefit from the diversification factor of 0.5.

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.

The firm does not believe that the approach suggested is an appropriate ongoing monitoring tool. This is for two reasons.

Limited Applicability

The approach suggested could only be applied to a limited subset of the components which are proposed to make up the AVA and would only be practical for subsets of those components for which significant data is available – precisely the component expected to have the smallest individual AVA.

Difficult in comparison

The current proposal still requires interpolation in order to compare parameters at the monitoring date with those used for the calculation of the AVA. Such interpolation generally creates uncertainties as large as those it is seeking to measure and therefore cannot provide any useful backtesting information.

Complexity of implementation

The approach suggested would be complex and expensive to implement.

If the aim is to understand the adequacy of the data sources used for valuation the firm would suggest relying on controls already in existence at firms such as IPV, P&L Explain and New Deal Review.
