

ESBG response to the EBA consultation on Regulatory Technical Standards (RTS) on prudent valuation

ESBG (European Savings and Retail Banking Group)

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**Questions**

**Question 1: Are you able to calculate and report fair values and AVAs with a monthly frequency?**

***If not, please describe the challenges you face with regard to a monthly calculation, and the monthly reporting of fair values and AVAs (e.g. with the COREP templates). Please make clear if those challenges arise in general or with regard to specific positions (e.g. type of instruments), whether they arise for positions assigned to the trading or non-trading book, and whether they arise for positions treated under the simplified or core approach. Please describe any simplifications and/or assumptions you would have to apply to determine fair values and AVAs on a monthly basis.***

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| We acknowledge that a monthly frequency for fair values/AVA calculations and reporting is technically feasible and can be duly implemented by a number of credit institutions. However, we understand that these will increase the operational efforts for all involved parties, including internal departments delivering input to the calculation. Moreover, the potential merit of the monthly frequency is limited as other components of own funds are not reported on a monthly basis. |

**Question 2: Do you have any comments on the amendments to Article 3 in general, and specifically with regard to the threshold of ten contributors set out in paragraph 2, point (d)? If you consider a different threshold should be applied, please describe how to set it, and provide a rationale and evidence supporting your proposal.**

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| The proposed amendments create a movement of large amounts of the relevant portfolio to the expert-based approach, which in turn triggers additional reporting and validation requirements.  The threshold of ten contributors represents a disadvantage for positions held in regional markets, since by nature the number of available contributors cannot be above the threshold.  Moreover, it is often not possible to distinguish between indicative and tradeable quotes. As a result, reliable (originally tradeable) quotes can end up classified as indicative, therefore we find it undesirable to only allow indicative quotes under the expert-based approach.  Apart from markets where trading is fully automated, in many other markets, the standard practice is to quote indicative prices and interaction with a trading desk is required to confirm the prices. Limiting the usage to only tradable quotes will exclude valid market observations. Also, tradeable quotes can have negligible size and be not representative of the market.  In general, we would think this setup would result in practically all of MPU and CoC being classified as expert-based with a subsequent deluge of requests to regulators.  The number of contributors to a consensus is not always correlated with the quality of the consensus price. The market size of the contributors is a more important factor.  For many markets, there are fewer than 10 participants to a consensus as the main active players are fewer. The back testing criteria should be used rather than the number of participants.  In 3(2,c) tradable quotes are permitted from brokers and other market participants, but 3(3, b) only brokers' quotes are indicated. The exclusion of other market participants, e.g. banks and hedge funds, can neglect an important quota of a market.  It is not clear if own quotes tradable or indicative are acceptable. |

**Question 3: Do you have any comments with regard to the requirements proposed in Article 3a? If you consider that some of those requirements should be adjusted, please describe how you would revise them in order to meet the policy objectives that the proposed amendments try to achieve, and provide the rationale supporting your proposal.**

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| The limitation of market data to only the past month, limits the potential to use time series as part of the calculation inputs.  Furthermore, while allowing historic data (up to 1 month) would seem to increase the possible use of the ranged approach, the requirement 3a(2) point (c) to adjust them to reflect market evolutions makes it practically difficult (if not impossible) when a large number of points are in scope. Allowing, for instance, indicative brokers and other market participants quotes in the ranged method would seem to be a more robust way of improving the set of reliable market data points.  It is not clear what the adjustment to reflect market evolutions will be in the case of market events or news during the 1M period.  Furthermore, as regards 3a(3), it should be clarified how the regulator expect credit institutions to prove a negative. That is, how to demonstrate that there are no sufficient and reliable market data sources.  Lastly, for 3a(3), for certain markets, data could be available, but the cost of usage could be unreasonable. |

**Question 4: Do you agree with the proposed amendment to capture valuation risks stemming from fair-valued back-to-back derivative transactions and SFTs? Do you agree that this would restore alignment with the treatment under the core approach? If not, please describe how you would suggest to revise the amendment providing any rationale and supporting evidence.**

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**Question 5: Do you agree with the proposed amendments to the calibration of the fall-back approach? If you consider that a different range of percentages should be considered, or that the AVAs under the fall-back approach should be calculated in a different manner, please suggest a range or a methodology, as applicable, and provide a rationale and evidence supporting your proposal.**

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| While generally agreeing with the proposed amendments to the calibration of the fall-back approach, we would like to stress that prescribing a mandatory fall-back approach for all the unlisted shares ignores the peculiarities of the unlisted company. Indeed, unlisted shares which have a different share category listed should be treated differently. |

**Question 6: Do you have any comments in relation to the positions proposed to be subject to the fall-back approach? If you consider a different treatment should be applied to these positions, please describe how you would treat them in order to meet the intended policy objectives, and provide the rationale and any evidence supporting your proposal.**

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| First and foremost, we believe that moving some positions automatically into the fallback approach denies the possibility to develop an appropriate and defendable expert-based approach. Hence an automatic assignment should be avoided.  **A more conditional application would be preferred**. For instance, if the lack of IPV should lead to the use of the fall-back approach, in cases where only some valuation inputs cannot be covered by IPV, some materiality conditions should apply to determine if the valuation of the position falls under the fallback approach.  Moreover, under the new framework, an institution is supposed to apply fall-back approach to unlisted equities, which seems reasonable. Nevertheless, given the case that an entity should have in place a prudent valuation model for unlisted equities, under current framework, it should estimate AVA equal zero. Therefore, we understand that the most reasonable approach as a residual risk should be a 1% fall-back scenario.  Lastly, specific provisions to cover a position should be taken into consideration in order to reduce de notional subject to the fall-back approach, i.e., paragraph 4(i) should be [1% - 10%] of the notional value of the related financial instruments minus the specific provisions related to that position. |

**Question 7: Are the requirements included in Article 8 clear? If you consider them to be not clear or to be particularly challenging to meet in specific circumstances, please describe the issue you encounter and how you would address it in order to meet the intended policy objectives, and provide the rationale and any evidence supporting your proposal.**

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| The requirement included in Article 8 are not clear to us. It is difficult to understand what the modifications intend to address. More details on the policy objectives of Article 8 would be appreciated.  Particularly, the definition of the same pricing models (Article 8 paragraph 5) warrants clarification. For instance, a similar base model in two different pricing systems, e.g. BS in Calypso and Murex, which price identical trade is considered to be "the same model"? More guidance should be provided to determine the definition of the same model, for instance, a percentage (%) price difference to the notional.  Furthermore, Article 8(6) seems to introduce a mandatory quarterly calibration of model parameters. Some model parameters are determined via an exported base approach rather than a mathematical method. It is not clear if a review of the expert base approach which confirms the parameters as still relevant can be considered as an updated calibration.  Lastly, as regards Article 8(7), raises a requirement to substantiate that a sensitivity-based approach provides an accurate representation of the actual PnL. It would be more appropriate to compare a risk-based approach with the MTM PnL or Hypothetical PnL rather than the actual PnL as some components of the actual PnL are captured by risk measures. |

**Question 8: Do you have any comments with regard to the amendments to Article 9, 10 and 11? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

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| The consultation paper proposes that the aggregation factor ‘alpha’ should set to zero, where the amount of accountancy adjustments made to fair value does not account for the risk other market participants would consider when measuring their own fair value. In our opinion, it seems reasonable to account for close-out costs risk to adjust fair value. In contrast, we do not agree with accounting for market uncertainty price risk to adjust fair value, except for Level 3 fair-valued assets and liabilities.  Therefore, the reconsideration of alpha factor should be narrowed to:   1. the absence of fair value adjustments for close-out costs (CoC) risk and; 2. the absence of fair value adjustments for market uncertainty price (MPU) risk, only in Level 3 fair-valued assets and liabilities.   As stated by IFRS 13, a fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). When measuring fair value, an entity uses the assumptions that other market participants would use when pricing the asset or the liability under current market conditions, including assumptions about risk.  Assumptions about risk translate into an adjustment to the fair value by a risk premium. When entering a transaction, this amount represents what market participants would demand as a compensation due to the uncertainty inherent in the asset or liability future cash flows (see paragraph B39 of IFRS13)  In the light of the above IFRS definitions, we think that to measure fair value, an entity should consider two kinds of adjustments:  a) **Credit and funding risks**. Fair value adjustments are done to account for market participants credit risk, and funding costs (adjustments already in place in our entity).  b) **CoC risk**. Paragraph 71 of IFRS13 clarifies market participants could make use of a mid-market price, or any other pricing fixing convention for measuring fair value, if the price is within a bid-ask differential. As such, given that other market participants could measure their fair value at a price within a bid-ask range, we agree they should adjust their fair value for close-out costs.  On the other hand, a fair value adjustment for MPU should not be done to the fair value. The uncertainty inherent in a deal coming from market prices is measured and agreed by market participants when entering that deal. Take for example an equity option between two entities (ignore for a moment risks a) and b), explained above). At trade date, the two parts would agree that the buying part pays the other a premium based on the relevant equity variable, and they would also agree the level of the volatility of the equity during the life of the deal. But in this two-parts agreement, the view of other market participants is implicit because otherwise, the deal would not be done. Regardless of the method used by an entity to set its exit price, the entity would select market variables that account other market participants expectations to set that price.  Moreover, any IFRS13-compliant entity would set their exit prices maximizing relevant quoted observable variables, and minimizing the use of non-observable variables, which reinforces the considerations we have made.  This MPU adjustment could make sense only for Level 3 fair-valued assets and liabilities, because of the nature of the variables used for fair value measurement. In fact, point 27 of EBA Consultation Paper, mentions that the proposed MPU and CoC fair value adjustments are consistent with paragraph 88 of IFRS13. Nevertheless, it is important to notice that this point of IFRS13 refers to Level 3 fair-valued variables.  In conclusion, in order to align different accountancy methods and meet the policy objectives, only fair value adjustments for CoC could have a reconsideration in its alpha factor, while for MPU it would only make sense for Level 3 fair-valued assets and liabilities.  Lastly, it should be noted that the benefit of the diversification factor appears to be conditional to IPV performed and adjusted in the ledger. This condition does not account for the cost of the process of adjusting the ledger. Some minor adjustments, (e.g. few dollars), would just increase the operational cost and risk without impacting the correctness of the balance sheet. |

**Question 9: Do you have any comments with regard to the amendments to Article 12? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

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**Question 10: Do you have any comments with regard to the amendments to Article 14 and 15? If you do not agree with the amendments, please describe how you would adjust or design the requirements to meet the policy objectives that the amendments try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

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**Question 11: Do you agree with the requirements set out in Article 19a and Article 19b? If you do not agree, please describe how you would suggest to revise those Articles and address the mandate on extraordinary circumstances outlined in Article 34 CRR. When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.**

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| Yes, it seems ok. |

**Question 12: Which of the two options presented do you consider more appropriate for the purposes of addressing concentration of UCS AVAs? When giving your answer, please provide the rationale and any relevant evidence supporting your proposal.**

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| Option 2 seems more appropriate from an economic standpoint. Indeed, both options would set a parameter of the calculation to zero and will therefore increase the prudent valuation capital charge. Under option 1, if the contribution of one counterparty to the total unearned credit spread is higher than 10%, the parameter is set to zero for all counterparties. The likelihood of this is very low, but if it were to happen, the impact on prudent valuation charges would be significant. Under option 2, however, the parameter is set to zero only for the top 5 counterparties, which would mean higher charges for these counterparties particularly, and not the remaining ones. |

**About ESBG (European Savings and Retail Banking Group)**

ESBG​ is an association that ​represents the locally focused European banking sector, helping savings and retail banks in 17 European countries ​​strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 871 banks, ​which together employ 610,000 people driven to innovate at 41,000 outlets. ESBG members have total assets of €6.38 trillion, provide €3.6 trillion loans to non-banks, and serve 163 million Europeans seeking retail banking services.

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