# **FBF – Answer to the EBA Public consultation on targeted amendments to the prudent valuation framework**

**April 16, 2024**

## The French Banking Federation (FBF) welcomes the opportunity to express the views of the French banking industry on the EBA public consultation on **targeted amendments to the Regulatory Technical Standards (RTS) on prudent valuation**. In this context, we herewith provide you with our responses to the questions listed in the Consultation Paper. We appreciate your consideration about our answers and remain at your disposal for further clarifications.

## In terms of general comments, we can say that the industry welcomes the work of the EBA to improve the framework and to ensure its harmonization at European level. However, the in-depth revision of the Prudent valuation RTS was not mandated by CRR apart from the definition and impact of the extraordinary circumstances to avoid pro-cyclical effect of capital measure (as mandated by CRR3 article 34). The EBA proposes a large number of substantial and unexpected changes to the 2016 RTS which, go far beyond mere technical choices and become a matter of strategic or political decisions, such proposals without prior impact assessment or political arbitration, appears therefore fundamentally inappropriate.

## The EBA QIS should reveal the tremendous consequences of these RTS proposals on major European players (for those who have been able to fulfil it properly). The assessment of their impact on the relevant asset classes (derivatives, structured products, private equity for example) needs to be done using an appropriate sample of banks. An inclusion of non-relevant banks in the analysis would minimize its impact considering that only a limited number of banks may be directly impacted by these proposals. However, it needs to be noted that they may represent most of the market in some products as recognized by EBA staff[[1]](#footnote-1).

It is also important to note that banks consider that the proposed amendments add complexity that will not make the application of the framework easier and more harmonized. Besides, banks estimate that these proposed changes will create unnecessary operational burden and be more penalizing in terms of cost of capital requirements. Finally, since this text will not be applied in the US and given that the UK has no plans to introduce it at present, it will create a level playing field problem for European banks and probably a transfer of relevant activities to US market players. This would also further increase the heterogeneity with other jurisdictions.

The industry is particularly concerned about the increasing use of the fall-back approach and the adverse impact this could have on certain activities in the banking sector, including private equity. Where on private equity, this uneven level playing field will also be emphasized intra between European players subject to prudent valuation and the other players and would simply remove from the landscape of some dedicated area of the banking industry the European regulated institutions.

## Equally concerning is the partial removal of diversification benefit resulting in multiple uncertainties being simply added, which no longer makes sense from a financial, statistical and a risk management point of view.

The harmonization objective pursued by the SSM used to justify the revision of the RTS and the proposed amendments is currently not being fulfilled. The new RTS leaves many unclear points open to interpretation and introduces discretionary choices, potentially causing important discrepancies between banks in their implementation. Finally, the proposal seems to favor a downward alignment in terms of risk sensitivity and expertise based on the practice of the least active banks in the financial markets. This approach would contribute to the decline in competitiveness of key European players.

The industry recommends a complete review of the proposal, based on the results obtained from the QIS and their responses to the consultation. The modifications supported by the SSM must be subject to a critical examination by the EBA and the costs and benefits must be subject to a thorough analysis. The industry wishes to be closely involved in this work and stands ready to make proposals to respond to the supervisor’s concerns, all while preserving the competitiveness of European banks.

**Q1. Calculation frequency of AVAs - Article 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.

There is no clarity as to what tangible benefits monthly calculation would bring. The volatility of AVA over time stays reasonable apart from specific case (such as Covid outbreak) but this can be tackled separately in exceptional circumstances without such strong and complex requirement.

Besides, while on trading books, Fair value is calculated and reported monthly, with a limited setup of controls and certifications, thus subject to a relevant industrialization, a monthly measure of AVA should be indeed theoretically possible (if banks could maintain this limited setup of controls and certifications). From principle’s perspective, AVA are mostly calculated from valuation exposures and confidence intervals charges. However, while on trading book positions the valuation exposures are calculated every day, the confidence interval charges cannot easily be updated monthly as this would require a full automation of market data gathering.

PVA core approach processes require the collection of a vast amount of risk and market data, numerous calibrations, it involves subsequent reviews and challenges as part of a robust governance, it need proper commentaries and finally result in multiple reporting and escalation. The overall PVA process is time consuming and therefore the cost/benefit of moving to a monthly calculation is not obvious and would be detrimental to the activity, with very little added value from supervisory or internal perspective.

Separately, this cannot be done on the banking book positions where valuation for accounting and prudential requirements is only required on a quarterly basis. The specificity of the banking book, and in particular its own dynamic nature is to be respected in the RTS as mentioned in the CRR article105.1 *“Institutions shall in particular ensure that the prudent valuation of their trading book positions achieves an appropriate degree of certainty having regard to the dynamic nature of trading book positions and non-trading book positions measured at fair value, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of trading book positions and non-trading book positions measured at fair value.”*

## Arguments laid down in the consultation are also to avoid window dressing. However, as one can read in the consultation the prudent valuation objective is to ensure that valuation uncertainty is conservatively addressed in the own fund requirements. Contracts that may lead to window dressing if any, would be usually short-term and very liquid contracts, and would therefore not be subject to material valuation uncertainty.

## Furthermore, management awareness to valuation risk is already achieved through various accounting fair value adjustments that exhibit similar dynamics to AVAs, such as XVAs and bid offer FVAs; various markets volatility indicators are also indicative of potential price dispersion and provide real time information.

Finally, the COREP reporting cannot be produced on a monthly basis and is not mean to. However, in case this requirement is kept contrary to the industry's position, main criteria that will trigger a monthly calculation and/or COREP reporting should be more explicit, and text should clarify whether shock calibration and VRT tests shall be also updated monthly. Besides, it would also be worth clarifying whether the monthly calculation implies providing the reporting templates (C32.1-2-3-4) at the same frequency. Finally, level 1 text requires that reporting requirement shall be proportionate to the objective targeted by the requirement (see CRD 104.2).

**Q2. Data sources - Article 3**

**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.**

Regarding the use of consensus, banks agree that they should be robustly back tested like any other pricing source. This should be part of a systematic pricing source accuracy, reliability, tradability and eventually observability assessment. But the RTS should not be source specific as reliability assessment also applies to other sources, be comparable analysis, evaluated pricing or broker quotes.

The threshold of 10 contributors in consensus data seems arbitrary and is not justified. Moreover, if the number of participants in a consensus service was moving from 10 on one reporting date to 9 on the next reporting date, the industry wonders whether it should change the categorisation from range-based to expert based.

## It creates a wrong incentive for consensus providers to look for less active market participants to increase the number of contributors. The 10 contributors threshold would be also anti-competitive as it would favor established consensus services at the expense of emerging services: new entrants would be deterred. Conversely, it might create a wrong incentive for consensus services to aggressively look for a 10th contributor which may just deteriorate the quality of the service. Technically, there are curve or surface services where some risk points receive more than 10 contributions, some other less than 10 points, which would make the implementation very complex. We note that the 5 main dealers often account for 50% of market volumes /market shares (see [ESMA Derivatives markets 2023](https://www.esma.europa.eu/sites/default/files/2023-12/ESMA50-524821-2930_EU_Derivatives_Markets_2023.pdf)) which should be representative enough to calibrate an appropriate range of uncertainty. One may wonder if the split range based/expert judgment eventually just duplicate the fair value hierarchy assigned to valuation inputs.

## As a general concern, we also consider that excluding available data from the scope of eligible information to support range-based approaches is by definition a wrong approach as a large scope of potentially eligible information is the best way to support over the long term a reliable use of market information. The implementation, the weight given to the different information, and the prudence level in the utilization of data should then be applied when the quality of information (including if relevant the number of contributors) is reduced.

## Should this threshold be maintained despite the industry's arguments, it should be estimated consensus service by consensus service depending on the product complexity, the existence of the “reducing risk market” and the parameter’s intrinsic variance (e.g. if the whole market has the same view a limited number of active market participants may be sufficient).

## Finally, it is noteworthy that removing the indicative quotes from Article 3 paragraph 2 from the current framework may result in AVA calculations that are based almost solely on the expert-based approach.

**Q3. Data requirements - Article 3a**

**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.**

The one-month recency criterion is not manageable for banking book positions, they should therefore be excluded from this requirement.

It is right that the valuation must be based on recent data reflecting the state of the market as of the reporting date. However, limiting historical data to one month is arbitrary and does not account for the difference in liquidity, potentially excluding good data for less liquid instruments.

When measuring confidence interval for uncertainty, an historical approach is often necessary to build a relevant distribution, provided that the distribution obtained is a fair representation of the uncertainty as of the reporting data. Judgement in the choice of suitable data is required.

Indeed, the period length should result from an historical analysis of the risk factor behaviour and the statistical consistency of the calibrated shocks.

Exception may be permitted in order to eliminate the volatility of AVA over time: for example, dispersion observed on the most recent day of the year may be not representative (e.g., liquidity tightening at the end of yearor quarter, market movement occurring on one single day) and may need some adjustment or the use of alternative set of data. Firms should have robust documentation as to why they depart from the “most recent data” guidance. Efforts to obtain reliable market data sources amenable to range base analysis should remain proportionate and not generate undue costs.

Finally, the proposed measure is likely to trigger a wide reclassification of risk factors from the range-approach scope to the expert-based approach, together with large solvency impacts. Indeed, this would be associated with a high degree of uncertainty as to the classification, from one month to another, and a large volatility of solvency measures.

**Q4. Threshold calculation - Article 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 revising the amendment providing any rationale and supporting evidence.**

No reply.

**Q5. Fall-back approach - Article 7**

**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.**

The multiple and vague conditions forecasted in the EBA proposal would likely lead a large scope of activities in the fall-back approaches, which would have very material impacts on solvency measures. They are also vague enough to be subjectively interpretated, leading to distortion between banks. As a rule, a fallback approach should only apply in rare circumstances when no clear methodology can be applied. Regulators may alternatively use the fall-back approach as a challenger model.

The only goal of the punitive fall-back is to act as an incentive for banks to invest in relevant uncertainty measure. The desired outcome is not to use any fall-back. A regulation that proposes an increase of use of fall-back as a good way to achieve level playing field would have totally missed its purpose.

Whilst providing an apparent standardization, the fall-back scope is also unnecessary subjective as it refers to “the usage of subjective pricing source”. Besides, according to the current proposal, the existence of immaterial untested parameters may also trigger the use of the fall-back approach which would result in an excessive degree of prudence.

In fact, we value the simplification in terms of calculation of the fall-back approach, with the disappearance of the net unrealised profit in the formula. However, the use of a percentage of notional for derivatives, especially the most complex ones that may be subject to the fall-back approach is not always a relevant measure of valuation uncertainty. Nothing can replace a sensitivity analysis with respect to the relevant risk factors. Some of these risk factors have boundary values (positive volatilities, correlations) that the notional based measure may not respect.

For non-derivatives, using a fixed percentage of MTM would ignore nuances across different markets, instruments, and counterparties. This would not level the playing field, as x% may be aggressive for one institution but conservative for another, depending on the composition of their portfolio.

A fundamental issue with an instrument-based approach as opposed to a net risk approach is that once a certain number of instruments are allocated to the fall-back approach, they are in theory no longer included in the core approach, so the vanilla risk exposure in the core approach becomes totally unbalanced as the fall-back deals are missing. The resulting Close Out Cost or Market Price Uncertainty becomes meaningless. Alternatively, allocating whole portfolios to the fall-back approach will inflate the total notional artificially. The result is that any instrument-based measure is bound to fail its objective. Imposing the fall-back approach to exposures which are continuously risk managed in the trading book and for which models are approved in the context of the market risk framework would be inappropriate. Disconnecting sharply as proposed the market risk capital computation from the Prudent Valuation one has no financial meaning.

For the industry, the point regarding the balance impact of removing a hedged structured product from AVA calculation while keeping its hedge is key. Therefore, the proposed fall-back approach is not applicable without considering this issue.

Besides, the range of charges (1%-15%) in Article 7(4) is not consistent with FRTB residual risk add-on (‘RRAO’) (0.1%-1%) for derivatives. We would suggest that consideration is given to introducing significance considerations. If risk not independently verified is immaterial, then there should be no fall-back requirement. If it is significant and a bank can demonstrate its framework is adequate to conservatively quantify capital charge, there should be no fall-back requirement. If the above does not hold, the fall-back requirement on Net Notional could be linked to RRAO charges of 0.1%-1%.

Furthermore, banks would like clarifications on how to handle interaction between UCS/IFC and General Scope MPU/COC/MR. For example, an issue in UCS credit LGD or credit spread related to a counterparty will impact all positions traded with this counterparty what is expected by the revised framework. Besides, they would like clarifications on whether for non-derivative cases “fair value” should include any FVA and IPV components as described in the example page 12.

**Q6. Fall-back approach - Article 7**

**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.**

We believe the RTS should not be instrument specific nor prescriptive, but more principle based. Notably, market transparency and information in relation to specific instruments may evolve over time and may depend on firms’ access to information.

More specifically, no explicit consideration should be made for unlisted equity. Various valuation techniques (comparables, dcf…) already exist that are described in [IPEV Valuation Guidelines](https://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202022.pdf) and practically implemented (see [IMF Valuation of Unlisted Equity](https://www.imf.org/-/media/Files/Data/Statistics/BPM6/approved-guidance-notes/d2-valuation-of-unlisted-equity.ashx)). These techniques should enable the derivation of appropriate uncertainty range.

Moreover, current RTS states that PVA should be aligned with IPV process. The proposed fall-back would contravene to this principle for the unlisted equity where a valuation technic is already used.

In addition, the imposed fall-back approach on unlisted share is risk insensitive and would not take into account the nature of the investments (some areas of Private Equity are riskier than others), the investment policy of the manager, and the way valuation is monitored in the vehicle (more or less conservative). Imposing a fixed percentage is then an incentive to invest in the riskiest investments which would attract the best return on equity (since equity required is the same regardless of the aspects mentioned above).

Illiquid positions requiring valuation inputs that cannot be easily calibrated to market information are those for which a valuation uncertainty measure is the most useful and Prudent value regulation aims is to achieve this. Resorting to an arbitrary fall-back approach in the case where a real uncertainty exists and requires judgment as to its quantification will miss the goal of such a regulation. This would be like saying that all credit risk capital or insurance risk capital (which are both not market based) should be measured with a forfeit like the old Cooke ratio. On the contrary, we think that risk sensitivity should be preserved as much as possible. A risk sensitivity-based calculation with more conservative defaulting shocks and a potential remove of diversification factor should be a better alternative.

For issues such as unavailability or non-reliability of IPV sources for some of the valuation inputs a materiality assessment is necessary before triggering the fall-back approach since in this case an expert-based approach on this non-material valuation input will very likely be more realistic than a fall-back approach.

Paragraph 3 (b) needs also to be clarified to eliminate potential ambiguity that may impact smaller institutions. These institutions conduct daily valuation directly through an independent unit, distinct from business trading units, with independent pricing sources. Although there isn’t an explicit IPV adjustment, their valuation positions are effectively IPV adjusted. The current proposal might lead them to believe that the fall-back approach must be applied on all their valuation positions.

Knowing all that, it would further increase the uneven level playing field with other major jurisdictions, the proposal would be a total showstopper. Finally, this will simply remove from the landscape of some dedicated area of the banking industry the European regulated institution. This will concern the private equity which will increase in the financing of the green economy and the offer to clients of complex products where some important players are in the EU. This uneven level playing field will also be emphasized intra between European players subject to prudent valuation and the other players.

To ensure that private equity and similar financing instruments at European level can continue to finance the real economy, and that it is not heavily penalized by what is suggested by the EBA, we are requesting a specific adaptation of the text for this kind of activities.

**Q7. General requirements under core approach - Articles 8**

**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.**

Article 8 still does not address the issue of offset between Day One Profit deferral (DOPD) and AVA. We understand that the offset prohibition stated by Q&A 2019\_4458 still stands but this is not justified given that DOPD and AVA can account for the same uncertainty due to unobservable valuation inputs. For this purpose, the words “Fair value” should be replaced by “accounting value” in lines 2 and 5 of paragraph 3, to avoid a double counting in the way the CET1 is computed. You will find in Appendix a proposed methodology by European banks to offset accounting adjustment from deferred Day One Profit to AVA.

The end of paragraph 3 is meant to impose a cap on the use of accounting adjustments that can be offset with AVA so that the same adjustments is not offset several times. This requirement is expressed in a complex and unclear way. Indeed, banks would need more precision and ideally an example or explicitly written in the Annex.

Section 8 also states that *“In addition, considering that accounting fair value adjustments are often determined at portfolio level, while AVAs are determined at the level of a valuation position, it should be ensured that institutions do not use one and the same accounting fair value adjustment to reduce more than one individual AVA. Therefore, this Regulation should specify a cap for the amount of accounting fair value adjustments that institutions can actually use to reduce AVAs*” and is equally confusing.

Likewise, in paragraph 6, banks are wondering whether this includes model pricing used for accounting valuation. Clarification would be welcome.

Finally, paragraph 7 does not have its place in this article. It is a justification requirement, specific to methodologies detailed in article 9 and 10 (sensitivity-based adjustments), that should better be stated in these articles themselves where the methodology is described.

**Q8. MPU, CoC and MR - Articles 9, 10, 11**

**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.**

Overall, articles 9 and 10 have become much more complex.

These articles combined with the Annex make the use of the reduction of the number of parameters of a valuation input through the variance ration test (VRT) conditional to the loss of the diversification benefit (alpha = 0). It seems that the distinct concepts of risk offsetting and diversification have been mixed by the authors of the revised framework. We remind that the former assumes high correlation between closely related risk factors (in particular within a valuation input matrix) and the latter assumes low correlation between unconnected uncertainties. The two effects coexist, so it is not logical at all to require having to choose one or the other effect. It is important to highlight that diversification factor is a way to handle the decorrelation effect between two uncertainties of different asset types which will no longer be taken into account with the new proposal.

The CP proposal fundamentally contradicts the letter and the spirit of the diversification benefit, as previously elaborated by the EBA:

*“The principle of allowing for a diversification benefit is based on the theory that an institution with many small valuation uncertainties may face a very different total valuation uncertainty when compared to an institution with one large valuation uncertainty” (see* [*EBA discussion paper on prudent valuation*](https://www.eba.europa.eu/sites/default/documents/files/documents/10180/41517/bfe685bc-c501-4569-a37c-4dcd360fd08e/EBA-DP-2012-03--RTS-on-Prudent-Valuation---Final.pdf)  *).*

“A*ny diversification benefit should in any case only apply to certain AVAs as some relate to uncertainty around the fair value of individual positions which could be positive or negative (and which would not all be expected to be at the bottom of the range of plausible values at the same time) while others relate to reserves that are required for particular reasons that are only negative*.”

Article 9 required firms to “*calculate individual market price uncertainty AVAs on valuation exposures related to each valuation input that the institutions used in the relevant valuation model to determine that exit price. Each of the valuation inputs shall be treated separately*”.

Care should be taken to avoid any double counting as the calibration errors observed on one single input may capture other inputs uncertainties as well.

Besides, the revised framework no longer allows securities with quoted prices to be treated as a curve (like a government bond often managed together with interest rate swaps) and specifies that each point of a curve/surface must be treated as autonomous valuation inputs. This would not allow measuring the uncertainty of the marking of a curve/surface as a whole by analysing dispersions of quotes of whole curves/surfaces that are provided by consensus services for the purpose of measuring MPU. Indeed, curve/surface cannot be distorted in erratic way by moving each point in the adverse direction of the exposure (long or short). This would result in AVAs unfounded and beyond reasonableness.

Banks consider it important to keep the possibility of defining a global curve or surface as a global valuation input especially when it is issued from a validated calibrated data model and for which curve or surface scenarios will be used to model plausible 90th percentile uncertainties.

Current revised framework, lead to an inconsistency of the valuation input definition between:

* art. 9.1: valuation input = “*every parameter in the matrix”, and*
* art. 9.4(b): “*where the value of a parameter is extrapolated from parameters of the same valuation input”*. In this case we understand that the matrix is the valuation input.

Art 9.9: “*Any weakness in the methodology applied shall be addressed by including a margin of conservatism in the determination of the estimate*”. Some details and illustrative examples on the definition of such margin of conservatism would be also welcome.

Finally, under the revised framework, it is mentioned under article 9 paragraph 11 that institutions that apply the expert-based approach should report the largest individual MPU AVAs determined based on that approach. Is this reporting compatible with a sensitivity-based calculation as this would imply calculating the AVAs at valuation exposure level instead of position level?

As a rule, articles 9 and 10 have become much more complex and many aspects will require further assistance on its expected application. This complexity will most likely generate discrepancies among peers regarding the implementation of the norm, thus obtaining contrary results to the objective of the RTS. For this mean, the authorities should aim to incorporate strict definitions, accompanied by multiple examples for different cases which illustrate how the guidelines should be interpreted.

**Q9. UCS - Article 12**

**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.**

The changes to the calculation of AVA UCS will add a lot of operational effort and methodological difficulties, while the impact on the AVA would be very limited. Therefore, we suggest allowing institutions to use materiality thresholds based on CVA amount or CVA sensitivity to the credit curve.

The perimeter extension to SFTs is not consistent with other capital measures, for example FRTB CVA allows for the exemption of FV SFTs subject to a materiality, US NPR exempts all SFTs, and the UK PRA significantly limits the scope. We suggest removing this requirement.

In article 12 paragraph 4, the requirement to set the margin period of risk to be equal or greater than that employed for the purposes of determining the own funds requirements for CVA risk may create a double count of capital requirement. If there is a default, there is indeed a value slippage risk leading to insufficient collateral posted leading to a real counterparty risk. However, at the current date when default has not materialised, valuation is about the purchasing price offered by a willing market participant. Default risk is rarely considered in the interbank market for fully collateralised derivatives or SFT.

As correlations between risk factors used for the risk factor diffusion are usually not hedgeable and often calibrated historically, clarifications on what kind of AVA is expected for such risk factor (MPU, COC, MR, CP) would be welcome by the industry.

**Q10. CP and FAC - Articles 14, 15**

**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.**

In article 14, the use of the liquidity horizon set by article 325 bd of CRR below which no concentrated position AVA is required is a welcome amendment that compensate for increased market risk charge when liquidity horizon is longer for less liquid risk factors and avoid double counts.

This amendment is consistent with the [2013 EBA CP on prudent valuation](https://www.eba.europa.eu/sites/default/files/documents/10180/336425/bf20c680-6e46-4de7-a5c4-19c1942cc478/EBA_CP_2013_28.pdf) that stated “*Concentrated positions AVA is only required where the prudent exit period exceeds the time horizon for the market risk measure used to calculate own funds requirements as defined in Article 365 of Regulation (EU) 575/2013*.”

In article 15, the precisions added in paragraph 1 are useful but:

- sub-paragraph 1(b) does not provide a definition of tradable instruments

- sub-paragraph 1(c) can be misleading as all option positions require some form of dynamic re-hedging even when these options are actively traded and all risks could be exited with a measurable CoC, MPU and CP. There should be a precision that dynamic re-hedging to maturity of the position is the only possibility as there is no competitive market price for exit of the risk.

**Q11. Extraordinary circumstances - Articles 19a, 19b**

**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 revising 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.**

Taking into account extraordinary circumstances with a mechanism to avoid a pro-cyclical effect of AVA is a welcome addition. The use of the aggregation factor alpha is simple.

Article 19a provides examples of market factors to take into account to trigger the state of “extraordinary circumstances”. We agree that there should not be an automatic trigger from quantitative factors as no pre-set criteria will ever account for all possible cases and an element of human judgement is required. However, the regulation does not tell who makes the ultimate decision of declaring the state of “extraordinary circumstances”. It is written “EBA shall assess”. Does EBA act as an advisory body or as a decision body? It is unlikely that EBA has an executive decision and enforcement power given its regulation setting power and the principle of separation of powers. We understand that the ultimate decision lies in the European Commission. This regulation should precise this aspect.

**Q12. Aggregation factor for UCS - Annex**

**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.**

For the purpose of valuation positions deemed concentrated on certain counterparties, **option 2** appear simple to implement but is totally arbitrary as being part of the 5 largest UCS AVA has no relationship with concentration. The 5 counterparties may simply have a slightly larger AVA than others.

**For option 1**, the rule is that the loss of diversification benefit (alpha = 0) occurs if at least one of the counterparties exceeds the 10% threshold. This can lead to a huge cliff effect, which may also depend on how the AVA is calculated.

Under these conditions, option 1 makes no sense. For example, if a bank is below the 10% threshold with a portfolio containing a very large number of counterparties, but not so insignificant. Market movements could push a counterparty above the 10% threshold, and suddenly the UCS AVA would increase by a very material amount.

Therefore, banks believe that both options cannot answer the raised concentration issue.

More fundamentally, both option 1 and 2 subjectively measure “inner” concentration and are irrelevant from a valuation perspective, be accounting, regulatory or in a resolution context.

Market participants/Valuers would not factor in these metrics when pricing individual or aggregated XVA exposures not to mention that 10% threshold / 5 most significant counterparts are arbitrary and without justification.

Alternatively, the question of “outer” concentration (i.e. the extension of article 14 to article 12) may be raised despite comments in footnote 5.

In conclusion, the intention of this amendment is not clear for the banking industry.

**Q13. Annex**

**Do you have any comments with regard to the amendments introduced in the Annex? 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.**

We disagree about the rationale leading to the removal of the method 2 of aggregation. Banks using method 2 are the most sophisticated with significant trading activities. The proposed alignment is to require the treatment followed by the majority of banks, (by construction including also the less sophisticated ones). As shown in the 2023 EBA Staff paper “EU regulatory framework for market risk and prudent valuation: are the rules too procyclical?”, the AVA is concentrated on only few institutions, out of which 15 hold more than 80% of total AVA. The report also shows that 33.5% of total diversification benefits are held by banks applying method 2. Hence, contrary to what is stated in the consultation, the removal of method 2 will actually have an impact on banks with more developed trading activities (see Fig.35 of the EBA Staff Paper).

Furthermore, to method 1, method 2 leads to a CET1 level independent from the choice of Fair value methodology and level of conservativeness embedded in Fair value. Method 2 relies on a precise definition of the Expected Value (EV) that is insufficiently defined in the current framework in particular for CoC (expected exit cost for Prudent value vs principal market exit cost for Fair value). However, for MPU and Model Risk, Expected value is clearly defined as the value obtained with valuation models without conservative layer (valuation theory defines the value as the expectation of future cashflows).

With the use of method 1, the effect well explained in figure 1 page 9 of the consultation paper (impact of absence of fair value adjustment) leads the revised framework to propose a form of penalty (alpha = 0) when fair value adjustments are deemed insufficient (defined as *not* *commensurate with the adjustment other market participants would consider when determining the reference fair value*). This may lead to inconclusive challenges by the supervisory authority as to whether fair value adjustments are insufficient as there are no objective criteria for this. Setting an appropriate level of EV in method 2 with more regulatory guidance would lead to better EU level playing field in the determination of CET1 without the need to challenge each firm’s accounting practice with subjective judgement. Indeed, the accounting fair value in IFRS 13 does not require a precise confidence interval (even if a 50% confidence and above is deemed acceptable by accounting firms) and EBA is overstepping its mission when making an assessment of insufficiency. Such competency of judgement lay down to the audit firms signing on the accounts of institutions and having such conflict of competency is not seen as an appropriate one.

The revised framework is too subjective with a potential high impact on AVA amounts that each bank cannot anticipate since it will depend on other bank’s FVA amounts and policies. It would be better to link this point to internal and/or external review conclusions regarding the consistency of the FVA amounts in regard with the bank’s positions and valuation policies.

Again, the diversification benefit has been designed to account for the structural de-correlation between uncertainties across all sources and when measured at a conservative confidence level. There is no theoretical rationale for adjusting it to offset various flaws or bias in the FVA or PVA framework.

EBA could alternatively expand the hypothetical portfolio exercise for IMA benchmarking to assess consistency in FVA and PVA calibration across firms.

The use of tenor dimension reduction with the Variance ration test (VRT) and loss of diversification benefit (alpha = 0) is discussed with question 8.

Regarding the need to reintegrate unadjusted IPV difference into the CET1 measure through the AVA, we can understand the logic but there are 2 elements to consider:

1) If IPV is not adjusted because the independent source is not proven to be more reliable than the trader marking, there is no more reason to adjust CET1 than Fair value apart from recognising that this is a source of uncertainty that should benefit from diversification benefit. For very liquid valuation inputs such as standard yield curve, equity spot and fx spot, an IPV with accounting P&L impact may be considered as not necessary as long as an independent control ensuring that FO mark is consistent with mid-market values or when marks are automatically fed from a validated source. For such cases banks would like to still benefit from the current AVA formula.

2) Only considering the negative unadjusted IPV differences may lead to a large negative adjustment as even if these differences are a form of valuation noise, the cumulative negative noise may be important when the total noise is not. The cumulative negative IPV would be also dependent on the granularity at which the IPV is performed /recorded. At the end, it is fairer to simply record all IPV differences in Fair value than the proposed AVA treatment. The mathematical formula to be used in order to reintegrate the unadjusted IPV amount must be clearly defined with a mathematical formula in the Annex in order to avoid any misunderstanding. Based on the example p.12 we understand that the proposed formula is just a way to reintegrate “exactly” in the AVA amount the unadjusted IPV. In this case all the IPV shall be reintegrated and not only the negative part.

A more cosmetic point to highlight is that the Annex should precise that the alpha values of 0.5 or 0 should only apply in normal circumstances when the condition of article 19a and 19b are not triggered (extraordinary circumstances).

Finally, on the format of the annex, we think that all these conditions for setting alpha = 0, if they are adopted, should be set in the RTS articles themselves and the annex should only contain the aggregation formula as it is the case in the current framework.

**Q14. Other comments**

**Do you have any other comments on this consultation paper? If you do not agree with any of the proposed requirements, please describe how you would adjust or design them in order to meet the policy objectives that the proposals try to achieve. When giving your answer, please provide the rationale and relevant evidence supporting your proposal.**

**Operational risk AVA:**

This is a double counting of the operational risk RWA on valuation, as the full AMA risk is replaced by the Standard Approach of Operational risk. Adding another dedicated Operational risk charge will duplicate what was earlier in AMA and now in the Standard Approach.

**General comments:**

The revision of the Prudent valuation RTS was not mandated by CRR apart from the definition and impact of the extraordinary circumstances to avoid pro-cyclical effect of capital measure (as mandated by CRR3 article 34). It appears that the highest motivation for this proposed revision is to create a better EU level playing field as there seems to be a diversity of application of the current framework. The revised framework is indeed more prescriptive but is so complex and open to interpretation, it is unlikely that it will lead to a better harmonisation of application.

Furthermore, the cost in term of capital requirements and operational complexity is considered prohibitive by members. Adding that this will not be implemented in the US and also that the PRA has not expressed any will to follow the same road for the UK, it is foreseen that this proposal will be a driver of supremacy of the non-European players on the European market.

Prudent value regulation is only applicable in the European Union. It means that US banks that are the main competitors of the largest European banks are not affected by it. In addition, the revised framework will also not apply to UK banks given that EBA regulation has no longer effect in the UK, apart from existing ones integrated in UK law. We are not aware that PRA intends to copy this revised framework in the UK regulation. This is contrary to the level playing field intention at international level.

Besides, the industry is particularly concerned about the increasing use of the fall-back approach and the adverse impact this could have on certain activities in the banking sector, including private equity. If for the goal of EU harmonisation, a fall-back approach is meant to be used whenever an economic method would require subjective judgements, this is probably not the right way to motivate financial institution to analyse their valuation uncertainty with a critical mind. A method that may be challenged by supervisory authorities is always better than an arbitrary forfeit unless harmonisation and simplicity are the only goal.

As the result of all these comments, we do think that the revised framework wasn’t requested, it is inappropriate and should be completely revised. The RTS must focus on the mandate given by CRR through article 34.

**Comments related to the EBA QIS:**

For the banking industry, responding to the QIS was complicated, and they consider that the results will be approximate given that they did not always have the tools at their disposal to quantify the new demands and the very structuring changes to the framework requested by the EBA. A new QIS would be required if EBA wants to propose / keep changes beyond the definition of extraordinary circumstances.

***Appendix: Proposed methodology to offset accounting adjustment from deferred Day One Profit to AVA***

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1. See the 2023 EBA Staff paper “Eu regulatory framework for market risk and prudent valuation: are the rules too procyclical?”: the AVA is concentrated on very few institutions, out of which 15 hold more than 80% of the total AVA. [↑](#footnote-ref-1)