ABI Associazione Bancaria Italiana

ABI comments on the EBA Consultation Paper Amending Draft Regulatory Technical Standards on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013

April 2024

Preliminary remarks

ABI welcomes the opportunity to express views on the EBA proposed changes to the Regulatory Technical Standards on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013.

The following comments are aimed to help striking the right balance between the objectives of the prudent valuation framework and not introducing overly penalising requirements that would severely affect banks' CET1 capital, notably with regard to that part of the changes that is out of the scope of the CRR3 mandate. In the responses to the following answers, ABI comments and alternative proposals are put forward accordingly.
Indeed, there are concerns that the proposed changes will not achieve the objective of improving the prudent valuation framework. Specifically, the excessive conservatism seen in the proposed changes and discretionary regulatory parameters and assumptions are not reflective of economic risk and require banks a significative and unjustified effort on the overall IPV (Independent Price Verification) process.
In particular, in ABI's view the RTS should not be instrument-specific nor overly prescriptive, but more principle based and, more specifically, should refer to a risk-based approach to reflect the real valuation uncertainty (while the current proposals show a high degree of standardisation). To this extent, the amendments to the fall-back approach are deemed not appropriate, and unduly penalising since they do not refer to relevant measures of valuation risk, particularly regarding the proposed application of a percentage of notional for derivative exposures and for unlisted equities.

Noteworthy, not only the possible impact of the proposed changes in terms of banks' ability to invest and distribute resources to the economy should be taken into account, but also the effects on the level playing field. The impact of the proposed measures on EU banks' CET1 would result in affecting EU banks' competitiveness, as the very strict prudent valuation framework envisaged in the RTS is only applicable in the European Union, while a homogeneous framework is not in place for US banks, and the proposed changes to the RTS are not expected to be applied to UK banks.

Moreover, the proposed timing for the implementation of the modified RTS raises serious concerns. Given the significance of the envisaged changes, the proposed entry into force of the modified RTS shortly after the publication in the Official Journal of the European Union (and partly on the date of application of CRR3, expected to be January 1st, 2025) appears unfeasible. In this regard, the management of the capital impacts should also be considered.

Responses to the questions for consultation

Article 1 – Calculation frequency of AVAs

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.

Monthly calculation of AVAs would be challenging and require huge economic and organizational efforts. Indeed, AVAs are mostly calculated from valuation exposures and confidence intervals charges. On trading book positions the valuation exposures are calculated every day but the confidence interval charges cannot easily be updated on a monthly basis, as this would require a full automation of market data gathering.

The main operational challenges identified can be summarized as follows:

i) additional effort for the functions involved in the calculation and reporting process;

ii) economic investments in order to further develop the automatization of computation and to speed up the process. The management of the process becomes even more complicated if it involves several legal entities which are required to send data to the holding company who has the responsibility of the calculation;

iii) higher costs for external info providers and operating effort for the management of the data collection process.

It has to be noted that this would require time. Hence, should monthly calculation be finally required, a reasonable time frame should be granted before the application date.

All in all, the cost and complexity of implementing monthly calculation would be detrimental to the activity and seems not outweighed by a corresponding added value from either supervisory or internal perspective. Indeed, the volatility of AVAs over time stays reasonable apart from specific case (such as Covid outbreak), and such exceptional circumstances can be tackled separately without introducing a general requirement for monthly calculation.

The COREP reporting cannot be produced on a monthly basis.

Article 3– Data sources

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.

While the aim of improving the criteria to identify AVAs computed under the range-based approach can be understood, the proposed criterion is not considered well-suited.

An approach based on the number of contributors appears judgmental and the threshold of 10 contributors arbitrary and far from market practice. Due to the intrinsic features of some financial products and their reference markets, in most cases consensus data are contributed by less than 10 contributors. This means that a significant part of AVAs would be computed under the expert-based approach and, considering that under the revised framework, the application of expert-based approach has direct and indirect impacts, this approach would bring to a potentially significant increase in AVAs. This would be exacerbated as the proposed approach could imply that for a certain risk factor / underlying some data are range-based while other are expert-based.

Moreover, this criterion could entail volatility in AVA measures, as, if the number of participants in a consensus service was moving from 10 on one reporting date to 9 on the next reporting date, a change in the categorisation from range-based to expert-based would occur.

An alternative approach is therefore proposed, i.e. a criterion based on the existence of possible two-way market transactions, supported by backtesting analysis.

Otherwise, the proposed approach could be made less stringent, for example dropping the threshold to 6 contributors, which is the minimum level of contributors considered by the leader market provider for the publication of the standard deviation of data (and is in line with the US NIST - National Institute of Standards and Technology - methodology); the threshold should be verified for the most relevant inputs.

Last but not least, in case such approach is retained, in order to define comparable criteria among different players a more detailed definition of "consensus service data" would be needed.

Article 3a – Data requirements

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.

The requirements described in Article 3a paragraphs 1 and 2 are intended to limit the use of historical data where they don’t reflect market conditions as of the date of calculation of AVAs.

Anyway, when measuring confidence interval for uncertainty, an historical approach might be necessary to build a relevant distribution (i.e. data over one month old might be needed to build distributions with sufficient data). An observation window up to three months should be allowed provided that, subject to expert judgement in the choice of suitable data, the distribution obtained is a fair representation of the uncertainty as of the reporting date.

Article 4 – Threshold calculation

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.

(no comments)

Article 7 – Fall-back approach

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.

ABI does not agree with the proposal to calculate the AVAs for derivatives under the fall-back approach as a percentage of the notional value. This approach is not considered appropriate for several reasons.

It should be highlighted that the notional:

- represents a static measure, which does not reflect market movements and therefore is not affected by valuation;
- does not represent a measure used in risk management nor in accounting;
- does not allow to take into account the fact that the bank already calculates some IPV and FV adjustments on the position (while in all other cases – computation of category level AVA and fall-back for non-derivative instruments – accounting adjustments contribute to the reduction of AVAs);
- could give rise to deductions from CET1 that could hypothetically be higher than the value of the exposure, which is in contrast with general capital absorption principles.

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 deemed a relevant measure of valuation uncertainty and cannot replace a sensitivity analysis with respect to the relevant risk factors. Some of these risk factors have boundary values (positive volatilities, correlations, out of the money options with negligible fair value) that the notional based measure may not respect.

Moreover, 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.

The proposed approach based on the notional value of derivatives would therefore also fall short of the objective to tackle the challenges faced by supervisors when requesting institutions to move positions under the fall-back approach from the range-based or expert-based approaches, due to the sizeable impact on capital.

The alternative approach which is considered more appropriate is using the absolute sensitivities to each valuation input the position is exposed to.

Only in case an approach based on sensitivities was deemed not acceptable by the Authority, a solution based on the absolute fair value of the instruments should be considered (as it would be aligned with fall-back for non-derivatives and the simplified approach).

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.

Referring to the scope of application, the reviewed version of the RTS requires the use of the fall-back approach for:

- valuation positions consisting of unlisted equities (for which a precise definition, referencing to the prudential or accounting framework, should be provided);
- valuation positions where independent pricing sources are not available or pricing sources are more subjective (i.e. where the bank is not able to perform an IPV process)

These categories are broad and include different types of positions characterized by different levels of valuation risk.

In ABI's opinion, risk sensitivity should be preserved as much as possible. Therefore, banks should be left more space to identify positions that should fall within the scope of the fall-back approach, depending on the real exposure to valuation risk.

More precisely, among unlisted equities there are different types of exposures (e.g. long-term investments, speculative investments, etc.) that will receive different treatments under the revised CRR (see new Article 133 CRR3). Different approaches (e.g. expert-based approach) should be applicable for long term investments and / or those investments where market practices related to the valuation are more established. The fall-back approach should therefore be required only in those cases where the valuation is more subjective.

Besides, equity exposures to central banks, given their very peculiar nature, should be left out of the scope. It should be considered that central banks are not corporates subject to business uncertainties; the price of central banks shares is driven by specific dynamics more linked to public policies than to the financial market, and banks' holdings of central banks shares are held for institutional reasons and not managed as other financial assets. It is worth noting that such unique features are acknowledged in the new Article 133(6) CRR3, which assigns to these exposures a 0% risk weight under the credit risk framework.

Also, among positions, where the bank is not able to perform an IPV process, it is possible to identify different situations which should receive different treatments in the prudent valuation framework. In particular, there are some illiquid instruments (e.g. securitizations, CLOs, etc.) where it is not possible to find alternative and independent quotes on the market, but nevertheless, the bank can perform some independent checks on the price estimated by the Front Office. In these cases, banks should be allowed to apply different approaches (e.g. the expert-based approach).

Additionally, the request to move under the fall-back approach instruments as soon as the institution is not able to determine the magnitude of a necessary IPV for just one valuation input is considered overly burdensome. In ABI's opinion a materiality criterion should be applied, i.e. the bank should be allowed to assess the materiality of such input before considering the entire instruments under the fall-back approach.

Article 8 – General requirements for the calculation of AVAs under the core approach

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.

There are two aspects of this Article that appear difficult to understand and may lead to different interpretations by different institutions, and for which clarification would be welcome.

The end of paragraph 3 seems to be meant to impose a floor on the use of accounting adjustments that can be offset with AVA, so that the same adjustments is not offset several times. The way this requirement is expressed in the draft RTS is complex and could benefit form more clear explanation.

In addition, draft paragraph 7 requires institutions to '*demonstrate to the competent authority that the sensitivities used in the computation provide an accurate representation of the actual profit and loss, including convexity and cross-order effects'*. Clarification would be needed about what banks are expected to do to be considered compliant with such "demonstration". More precisely, ABI would seek confirmation that a process based on the validation of pricing model and sensitivities is considered suitable.

Articles 9, 10, 11 – MPU, CoC and model risk AVAs

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.

First, it has to be noted that the revised framework no longer allows to offset exposures of securities with quoted prices (‘no use of valuation model’) with their interest rate risk hedge (‘use of valuation model’), as in the case of a government bond, often managed together with interest rate swaps.

Another aspect to be noted is that Article 9, paragraph 4(a) does not define tradable instruments. Articles 9 and 11 indicate that the exposure shall be mapped to tradeable instruments, and it is not clear where the expert-based or the fall-back approach can be applied.

Considering market price uncertainty and close out cost AVAs, the regulation allows the possibility to reduce the number of parameters. However, several requirements must be met and the new RTS presents new requirements. Some of the new requirements introduce interpretation difficulties, in addition to severe operational constraints.

For example, according to the new RTS, institutions may calculate the individual market price uncertainty AVAs based on a reduced set of parameters, for the parameters of the valuation input the value of which is derived from available and reliable data sources listed in Article 3(2). According to our interpretation, this means that for certain valuation inputs (e.g. EURO STOXX vega) banks need to identify ex ante which strike-maturity combinations are contributed by more than 10 contributors and are back-tested and can then apply the Variance Ratio Test to a reduced set of parameters including only this type of combinations. This requirement, in addition the new stricter requirements for the range-based approach, limits too much the Variance Ratio Test application.

The choice of a minimum amount of 10 contributors seems discretional, while also a more limited number of contribution could represent a good statistical measure.

Moreover, the institution must be able to demonstrate that there is sufficient liquidity to exit the valuation exposure associated to the reduced set of parameters, and that the selection of the reduced set of parameters is based on an exit strategy commonly used by the institution or observed in the market. These requirements are not clear and could be interpreted in different manners according to different institutions / business models / instruments. It is also difficult to support these statements with evidence.

Additionally, the combinations are already tested by the Variance Ratio Test (VRT) and combinations that do not adequately capture the P&L variance are already excluded. Therefore, there are reasonably overlapping between the different requirements.

Overlaps are also present between these requirements and the calculation of the Concentrated Position AVA.As regards the alpha factor, the purpose of removing the alpha factor when using the variance test is not straightforward, as there is no overlapping between the effects, because they represent different aspects (the variance test addresses the overlapping of adjustment in highly correlated risk factors, versus the diversification effect which addresses the overlapping of AVA adjustment in a portfolio with enough granularity due to these being diversified enough, this is, uncorrelated in greater terms).

In Article 9 paragraph 9, it is not clear how to prove that the level of certainty of the prudent value estimated under the expert-based approach is equivalent to that targeted under the range-based approach. ABI suggests removing this part or replace with a more feasible consistency check of this approach, such as using other available valuations like those coming from the collateral management process and corresponding controls on the valuation differences with counterparties. Moreover, it should not be necessary to include a margin of conservatism in the determination of the expert base estimate, since it is already addressed by not applying the Variance Test.

The proposed VRT calculations raises concerns. Calculating MPU (Market Price Uncertainty) on a matrix input by matrix input basis does not account for the very high correlation that will exist between each input which reduces valuation uncertainty.

Article 12 – UCS AVAs

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.

While understanding the importance of incorporating all sources of uncertainty into UCS (Unearned Credit Spreads) AVA, considering the risk factors in draft Article 12(3) in the calculation would pose challenges, adding operational effort and methodological difficulties, while the impact on the AVA would be very limited. Therefore, ABI suggests deleting this statement or allowing banks to use materiality thresholds (e.g., based on CVA amount or CVA sensitivity to the credit curve) and consider these sources only if material:

- Article 12 (3)(a) *Dependency between the exposure and the probability of default of the counterparty*: including these considerations in the calculation is deemed appropriate only when there is clear evidence of Wrong-Way Risk;
- Article 12 (3)(b) *Correlations between risk factors taken into consideration to generate the exposure profile*: this requirement imposes operational burdens without enhancing the quantification of valuation uncertainty associated with CVA.

Regarding the introduction of a measure addressing concentration in UCS AVAs, the rationale behind linking the concentration of UCS AVA on specific counterparties to the questioning of the aggregation factor is not clear and appears questionable since no clear relationship is identified between the concentration of UCS AVA on specific counterparties and the aggregation factor.

Articles 14 and 15 – Concentrated positions AVAs and FAC AVAs

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.

The amendment to Article 15 introduces four extremely stringent conditions for the computation of the future administrative costs (FAC) AVA which are based on principles regarding the uncertainty of the valuation inputs, illiquidity of positions and existence and feasibility of dynamic hedging strategies.

A double counting is deemed to result, of prudential requirements for FAC AVA that are already considered in the computation of MPU, CoC, Model Risk and Concentrated Positions AVAs. In ABI's opinion, only positions that are hard to liquidate because of the existence of legal or regulatory hurdles that prevent the institution from exiting the positions should be subject to future administrative costs AVA.

For these reasons, ABI suggests the draft RTS should specify that the FAC AVA is an incremental AVA to the MPU, CoC, Model Risk and Concentrated Positions AVAs where there are obstacles to exiting the valuation exposure (e.g., valuation exposures requiring client consent; valuation exposures with a tailored legal set-up; valuation exposures subject to regulatory holding hurdles).

Additionally:

- Condition a) is ambiguous and vague. It is unclear how institutions can demonstrate that MPU, CoC and Concentrated Positions AVAs already imply fully exiting the exposure (i.e. back-testing: exit prices vs APVA = α · (FV − PV) or other methods?)
- Condition b) does not provide a definition of tradable instrument. Please note that the fact the exposure cannot be mapped to tradable instruments does not imply additional future administrative costs since there are market practices that provide guidelines in the valuation process. In our opinion, condition b) is meant to assess the uncertainty related to the potential existence of a range of different valuation techniques that are used by market participants to value bespoke and tailor-made contracts. This requirement is already considered when computing the Model Risk AVA.
- Condition c) ("*the valuation exposure does not require dynamic re-hedging activities*") should be revised or deleted, considering that the hedging (or re-hedging) strategies are defined by the Front Office, according to several variables, like for example the type of product, the specific underlying, the market conditions, the Bank risk appetite, etc. In general, institutions that are market-makers dynamically re-hedge their books because the outstanding notional might change over time and can adjust the bid/ask spreads to reflect current market conditions in the future. It is therefore not possible to know ex ante/ex post if a certain exposure meets the requirements or not.

Articles 19a and 19b – Framework for extraordinary circumstances

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.

(no comments)

Annex – Aggregation factor for UCS AVAs

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.

Option 1 is considered more appropriate because, while it may not provide an absolute proof of concentration, by isolating counterparties based on the dominance of AVA, it offers a more inherent approach compared to the simplicity of Option 2.

Indeed, Option 1 defines valuation positions as concentrated on certain counterparties if the following ratio is equal to or higher than 10% for at least one counterparty i:

$$\frac{UCS\ AVA_i}{\sum_{i=1}^{N} UCS\ AVA_i}$$

In this way, if a certain institution is characterized by a granular portfolio where all counterparties generate an UCS AVA lower than 10% of the total UCS AVA it is able to show that no counterparties are concentrated.

On the other hand, according to Option 2 all institutions would have 5 concentrated counterparties even if they represent a very limited portion of the entire portfolio, conducting to a misrepresentation of the concentration.

Question 13. 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.

Regarding the need to reintegrate unadjusted IPV difference into the CET1 measure through the AVA, the logic can be understood but there are two 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; 2) Only considering the negative unadjusted IPV differences may lead to a large negative adjustments as, even if these differences are a form of valuation noise, the cumulative negative noise may be important when the total noise is not. At the end, it is fairer to simply record all IPV differences in fair value than the proposed AVA treatment.

Among the requirements to be met to apply an "alpha" factor equal to 0.5, ABI would suggest deleting:

- the need to demonstrate that eligible accounting fair value adjustment is commensurate with the adjustment other market participants would consider when determining the reference fair value of the position, since this is already required by accounting principles (IFRS 13) and it is difficult to support these statements with evidences (e.g. institutions are not required to disclose this kind of information);
- the requirement related to the reduction of parameters, considering that this option is applicable only in very specific cases and it is subject to several requirements that are aimed at ensuring that combinations used are the most liquid ones and do not affect the ability of the institutions to close the position.

As already said in the response to question 8, regarding the dimensionality reduction set out in Art 9 & 10, the purpose of removing the alpha factor when using the variance test is not straightforward, as there is no overlapping between the effects, because they represent different aspects (the variance test addresses the overlapping of adjustment in highly correlated risk factors, versus the diversification effect which addresses the overlapping of AVA adjustment in a portfolio with enough granularity due to these being diversified enough, this is, uncorrelated in greater terms).

Question 14. 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.

As highlighted above, certain aspects of the draft modified RTS raise concerns as they introduce stricter rules, likely to have a severe impact in terms of capital deductions, which does not appear fully justified by inherent risk. It has to be considered that the direct impact of the proposed measures on EU banks' CET1 would result in affecting EU banks' competitiveness, as the very strict prudent valuation framework envisaged in the RTS is only applicable in the European Union, while an homogeneous framework is not in place for US banks, and the proposed changes to the RTS are not expected to be applied to UK banks via similar update of the framework.

Moreover, the proposed timing for the implementation of the modified RTS raises serious concerns. Given the significance of the envisaged changes, the proposed entry into force of the modified RTS shortly after the publication in the Official Journal of the European Union (and partly on the date of application of CRR3, expected to be January 1st, 2025) appears unfeasible. The management of the capital impacts should also be considered.