

January 11, 2013

Sent by email to: [EBA-DP-2012-03@eba.europa.eu](mailto:EBA-DP-2012-03@eba.europa.eu)

European Banking Authority  
Tower 42  
25 Old Broad Street  
London EC2N 1HQ

Dear Sir or Madam,

**Re: Discussion Paper on “Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (CRR)” (EBA/DP/2012/03)**

This letter contains the response of the International Swaps and Derivatives Association, Inc. (“ISDA”), the Association for Financial Markets in Europe (“AFME”) and The British Banker’s Association (“BBA”) to the European Banking Authority’s (“EBA”) Discussion Paper on “Draft Regulatory Technical Standards on prudent valuation under Article 100 of the draft Capital Requirements Regulation (“CRR”)” of November 2012.

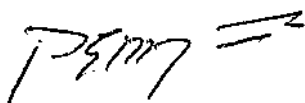
ISDA’s mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit [www.isda.org](http://www.isda.org).

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information, visit [www.afme.eu](http://www.afme.eu).

The British Banker’s Association (BBA) is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. It represents over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management. Members include banks headquartered in the UK, as well as UK subsidiaries and branches of foreign banks. Visit [www.bba.org.uk](http://www.bba.org.uk).

We look forward to working with the EBA to develop an approach that will ensure consistent and prudent valuations across the Industry.

Yours faithfully,



Peter Sime  
Head of Risk & Research  
ISDA



Michael Percival  
Director, Prudential Regulation  
AFME



Robert Driver  
Policy Advisor  
British Bankers' Association

**European Banking Authority (EBA) Discussion Paper**

**On**

**Draft Regulatory Technical Standards on prudent valuation  
under Article 100 of the draft Capital Requirements  
Regulation (CRR)  
(EBA/DP/2012/03)**

**Dated 13 November 2012**

**Response of the International Swaps and Derivatives Association, Inc.  
(ISDA),  
The Association for Financial Markets in Europe (AFME), and  
The British Banker's Association (BBA)**

**11 January 2013**

## A. Introduction

ISDA<sup>1</sup>, AFME<sup>2</sup> and the BBA<sup>3</sup> (“the Industry”) welcome the opportunity to comment on the above Discussion Paper (“the Paper”) issued by the EBA. The industry highlights below a number of overarching issues regarding the Paper, followed by answers to individual questions raised.

### **Overall Points:**

The Industry agrees with the need to specify how to apply the prudent valuation requirements in Article 100 of the draft CRR consistently and believes these aims are achievable. We recognise the importance of having both a comparable starting point for the calculation of regulatory capital resources, and confidence in the realisability of the valuations used within that calculation. However we do not believe the approaches currently laid out achieve this, and in fact are likely to worsen comparability as discussed further below. We therefore propose a consultation group, comprising industry, regulators and auditors, be set up to explore how these aims can be achieved.

The predominant concern with the proposal is that it attempts to address a perceived inconsistency in fair value (which is backed by trade levels, market quotes and supplemented by well defined price verification and auditor review) with a confidence level approach that is not backed by any of these and as such it is unrealistic to believe that improved consistency can be achieved at a threshold that is significantly less well defined. The proposed regulations would increase subjectivity and reduce comparability across firms.

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<sup>1</sup> ISDA, which represents participants in the privately negotiated derivatives industry, is among the world’s largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: [www.isda.org](http://www.isda.org).

<sup>2</sup> The Association for Financial Markets in Europe (AFME) advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society. AFME promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website, [www.afme.eu](http://www.afme.eu).

<sup>3</sup> The British Banker’s Association (BBA) is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. It represents over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management. Members include banks headquartered in the UK, as well as UK subsidiaries and branches of foreign banks.

The industry's preferred option is for an approach that supports and enhances the existing valuation methodologies and practices rather than creating a new and independent set of processes. The industry believes that the Competent Authorities should work with the institutions in assessing the quality of their practices and methodologies around the implementation, governance, validation and degree of challenge of the valuations process. Where these are viewed as insufficient to achieve the desired confidence around the prudence of the valuation further AVA's should be taken to achieve the desired confidence and to act as an encouragement to improve processes.

The Industry believes the current proposals are unnecessarily prescriptive and formulaic for liquid positions and offer little guidance particularly for illiquid and complex positions which involve a greater level of judgment and subjectivity. The Regulatory Technical Standards (RTS) should recognise the necessary balance between judgment and science in this area. Judgment is needed by firms, and by a supervisor assessing whether a firm is being sufficiently prudent. No formulaic approach can substitute for the use of judgment and a less prescriptive general approach, without a formulaic confidence level, should be proposed instead.

For liquid positions where a more prescriptive and formulaic approach is possible to implement, there is very limited analytical benefit and impact to capital of applying the approach proposed in the Paper. Liquid positions, where fair value is not materially different from prudent value, should be excluded from the full rigours of the proposed approach. Incorporating liquid assets in the framework will divert resources and attention that would be better spent on assessing the prudence of valuations for more complex and illiquid assets.

**More specifically, the Industry believes:**

**a. Confidence Level ('CL'):**

The proposals in the paper are overly prescriptive and may imply a spurious level of accuracy in the very areas which should be the focus of the prudent valuation regime. The CL should be set as a high-level benchmark, e.g. that assumptions used for more complex and illiquid positions are conservative (hence prudent) and the statistical measure of 95% seems inappropriate and unrealistic both because it is too high a level to be required for "prudence" and also because the positions where it is possible to attain this sort of statistical accuracy are those which are liquid enough that we should not be concentrating on them. A statistical measure (95% in this proposal) of confidence that the regulatory valuation does not or will not exceed the true realisable value can only be applied with any degree of accuracy to liquid instruments, where there is an abundance of observable data. However, these instruments are subject to very limited or non-existent valuation uncertainty risk, and the mechanically strict application of a 95% confidence interval to this population of instruments will involve significant costs but little benefit.

It is not possible to accurately target a very specific CL for more complex and illiquid positions, which should be the focus of the prudent valuation regime, and where AVA's will be more significant. Here, the desirable approach is for firms to demonstrate that their valuation has been calibrated at least to an overall 'benchmark' level, approximately equivalent to some level of statistical CL, without a formulaic confidence level.

A 'target' CL of 80% to 85%, roughly equivalent to 1 standard deviation from the mean, is prudent. This should be considered as the inflexion point, where there are strong levels of certainty that the value is realisable within the current market conditions, at an agreed reporting date. Using this non-formulaic benchmark as calibration for the framework would not imply the same spurious accuracy as the proposed 95% CL. Furthermore, given the procyclical nature of AVA's, a 'target' 80% to 85% CL is favoured as it would generate less procyclicality than a 95% CL.

#### **b. Testing for prudence of valuation:**

There are strong limitations to the proposed backtesting for prudent valuation:

- it is very dependent on the availability of good quality data, which is generally scarce for products likely to attract higher AVA's;
- it does not account for the fact that market volatility will often incorrectly cause positions to fail the test (see response to question 14); and
- it is operationally extremely complex to implement.

Therefore testing (effectively backtesting) as proposed in the Paper fails the cost-benefit test: it is only effective for more liquid positions, where sufficient data are available; but these positions will not generate material AVA's and their valuation uncertainty is very small. The test as proposed in the Annexes to the Paper is flawed, and operationally too cumbersome to implement. In terms of technology and infrastructure, it is an extremely demanding and resource-intensive task, and it does not properly address the main sources of valuation uncertainty, where trade data from bespoke transactions are not consistently available. For these reasons, the Industry believes the proposed testing of prudent valuation should not be a requirement.

As noted in a. above, a more proportionate 'benchmark' approach to CL would be preferable; in this case, mechanical backtesting becomes even less relevant. In addition, the Example in Annex 1 to the Paper includes overnight price moves in the back-testing process, effectively adding a market risk component to the definition of valuation uncertainty. A more appropriate definition should exclude market moves.

#### **c. Diversification benefit:**

The Industry's view is that diversification benefits should be allowed under the framework. Since methodologies may reasonably differ between firms (and indeed some less sophisticated institutions may choose not to apply diversification), institutions should be free to use their own approaches to calculation, subject to supervisory approval.

Diversification must be included within the framework in order to arrive at an accurate overall AVA amount. In large and diversified portfolios, particularly those with both long and short positions, it is not reasonable to assume that all valuations will be wrong in the same direction at the same time. Risks and the associated valuation uncertainties are partially diversified away.

Diversification should be accounted for in a non-prescriptive way. The example in Annex 4 seems too prescriptive, and suggests that there is a single, optimal and consistent way of improving the computational efficiency across all institutions under different environments. This is not the case. An in-house approach that accounts for the idiosyncrasies of institution's portfolios should be allowed, as long

as it has been subject to supervisory approval. Regulators should assess the reasonableness of an institution's in-house diversification approach. Again regulator judgement, not prescriptive rules, is the only workable approach in assessing the appropriateness of valuations.

In respect of AVAs that are not eligible for diversification, it is not clear why concentration and illiquidity AVAs would not qualify, especially when analogous sources of uncertainty such as Close-Out Cost and Market Price Uncertainty are eligible for diversification. We recommend that all are included.

#### **d. Reliable data sources – consensus services:**

The Industry believes that it is not appropriate to exclude entirely the use of consensus services for illiquid markets, as they form one of the more useful data sources. However, it is reasonable to expect institutions to exercise care when relying on consensus service data in these markets.

The Paper suggests that a consensus service with sufficient quality should not represent a one-way or highly illiquid market. In reality, it is exactly in these types of market that consensus services tend to be the most valuable source, including for fair value purposes. Lacking actual transactions, broker levels or suitable proxies, consensus data should be used as an acceptable basis for the calculation of prudent valuation adjustments.

Whilst data used in consensus services for one-way or highly illiquid markets may be subject to bias or other issues, these would also likely affect internally-generated estimates. Hence institutions should be encouraged to exercise caution when relying on consensus services in these circumstances, and apply a degree of judgment when calculating AVAs based on such data, e.g. excluding data points if there is good reason to, or using a higher multiple of the dispersion than for the more liquid products. A blanket prohibition is not considered helpful by the Industry. It is though again worth noting that both defining what is considered illiquid and the size of multiplier applied will be judgemental so may impair comparability across institutions and so will increase the need for regulator judgement.

#### **e. Account for valuation uncertainty in risk management systems:**

The nature of AVAs does not lend itself to having such adjustments embedded 'systematically' in front office and/or risk management systems. If this is the intention of the Paper, the Industry believes this proposal should be reconsidered.

The Paper proposes a requirement which states that institution valuation and risk measurement systems should systematically recognise and account for valuation uncertainty (paragraph 73). It is not clear exactly what is intended here. If it means that all the different valuation uncertainty adjustments need to be embedded in the institution's front office / risk measurement systems, that would be an extremely complex, possibly unachievable task. It would introduce significant operational risk, effectively asking these front office systems to operate 'two sets of books'.

Further, it is of the utmost importance in order not to exacerbate the existing break between the accounting and regulatory definitions of capital, that the development of prudential valuation occurs in close cooperation with the development of relevant accounting standards.

There is a wide range of potential valuation uncertainty adjustments, following very distinct calculations and sources of data; 'systematising' all of these consistently is not realistic. Also, particularly for more

complex products, the adjustments may also incorporate a high degree of judgement and qualitative input, which simply cannot be 'systematised'. For these reasons the Industry believes that valuation uncertainty should be kept outside the risk measurement systems.

**f. Close-out costs, Market price uncertainty, Operational risk AVA's, Tax offset:**

Close-out costs and market price uncertainty AVA's exhibit significant overlap and should be combined. The operational risk AVA overlaps with the operational risk capital charge, and the EBA should clarify this overlap, particularly under the Basic Indicator and Standardised Approaches.

Although the Paper lists close-out costs and market price uncertainty as distinct adjustments, in reality they are analogous and often intertwined in the trading price or bid-offer spread. They all contribute to the level of uncertainty in the market price, particularly for complex and illiquid positions where these adjustments tend to be more relevant. Consequently, enforcing a clear-cut distinction between these two AVA's may lead to double-counting.

As the Paper notes, there may be overlap between an institution's operational risk capital charge and any AVA taken against operational risks. Whilst the degree of overlap will vary between different firms which have adopted the Advanced Measurement Approach to calculating the operational risk capital charge, this will not be the case under the Basic Indicator and Standardised Approaches, where the degree of coverage of valuation risks will be identical for all institutions using the approach. The Industry believes that the EBA should therefore clarify for these latter two approaches the extent to which the relevant risks are covered and should not be duplicated in the AVA.

The Industry observes that there is no tax offset. We believe that tax offsets should be considered for the following reasons:

- Tax is a major consideration by market participants when valuing positions,
- If tax is not incorporated, valuation of the same financial instrument will be biased and market participants will be encouraged to shift trading activities outside of the EU,
- Incorporation of potential deductions in tax liabilities promotes symmetry of treatment between financial statements and regulatory capital calculations. This will aid investors who still rely heavily on regulatory capital to assess an institution's financial health.

## B. Responses to Discussion Paper Questions

**Q1. Do you believe that a proportionality threshold should be considered before requiring an institution to assess the prudent value of all fair value positions? If yes, how would you define the threshold?**

Yes. The Industry believes that the EBA should introduce a proportionality threshold. For example, institutions with insignificant AVA's (e.g. less than x% of Common Equity Tier One capital) might not be required to:

- a) calculate the AVA's each period but should demonstrate to their regulator on a less frequent basis e.g. annually that they would be immaterial;
- b) deduct AVA's from common equity tier one capital.

**Q2. Do you agree that the exit price used as the basis of prudent value does not necessarily need to be based on an instantaneous sale? If yes, provide argument to support your view.**

Yes. The Industry contemplates this topic in relation with the 'normal course of business disposal'. Stepping back from the framework and looking at the purpose of the AVAs – it is to ensure that regulatory capital adequately reflects prudent valuations for fair valued but illiquid assets – to ensure the solvency of a firm is appropriately calculated. No forced sale is required for these purposes and the assumption of a going concern needs to be reflected. Only the value of the asset if disposed of in the normal course of business is relevant. The only case where 'forced sale' might be considered is for a bank in resolution, which is not the case considered here.

**Q3. Should a specific time horizon for exit be set when assessing the prudent valuation? If so, how the time horizon should be set (e.g. the same time horizon for calculating Value-at-Risk (VaR), Credit Risk Capital Requirements, etc.), what should it be and how would it feed into the calculating of AVAs?**

No; the applicable time horizon to determine prudent valuation will depend on the instrument type / position. It is not appropriate to prescribe a time horizon as a general factor for the calculation of prudent value. The comparison with VaR and other capital measures is not valid, since these other calculations are designed to calculate losses over a specified period, which therefore needs to be prescribed, whereas the assessment of prudent value should aim to capture exit price, whatever period that would take in reality.

**Q4. Do you support the concept of a specified level of confidence to determine AVAs? If not, why? Are there any AVAs where the use of a specified level of confidence is not appropriate?**

No, the Industry does not support the highly specific way suggested in the Paper as explained in the introduction to this response (point a). The concept of a specified CL is only meaningful and possible to statistically assess for the types of position that are liquid and that have an inherently low level of valuation uncertainty (and hence relatively low AVA associated with them). For complex and illiquid positions, the CL can be very subjective and not statistically measurable. Hence, an approximate level of confidence should be specified only as a benchmark for high-level calibration of the framework.



We also draw the attention of the EBA to the fact that a predefined level of confidence, together with high degree of prescription in the required AVAs, will affect prices. That is because valuation adjustments are usually allocated to the desks and contribute setting the return hurdle for Front Offices. Hence, an extreme degree of prudence may result in bringing prices lower and lead to market illiquidity. Conversely, not allocating AVAs to the desks would raise the question of ownership and governance around the potential capital charge.

We understand that the EBA aims at a harmonised and comparable set of measures. To serve this purpose, a predefined confidence level can be acceptable only if it is calibrated to a reasonable level and exclusively used as a benchmark and not a compulsory measure.

**Q5. If you support a specified level of confidence, do you support the use of a 95% level of confidence? What practical issues might arise or inconsistencies with other parts of the CRR when using this level of confidence?**

The Industry does not support the use of a specified confidence interval for the reasons listed above however if one is imposed then the industry does not support the use of a 95% level of confidence (see point b in the introduction to this Response). A 'target' level of 80% to 85%, roughly equivalent to 1 standard deviation from the mean, is more appropriate as a benchmark, reflecting the approximate level at which the accuracy of the estimated confidence becomes larger. The higher the CL is, the higher the subjectivity and the uncertainty surrounding the calculation are likely to be given the limited sample of data. Furthermore, given the procyclical nature of AVA's, a 'target' level of 80% to 85% is more favourable as it would generate less procyclicality than a 95% CL.

**Q6. How prescriptive do you believe the RTS should be around the number of data points that are required to calculate a 95% level of confidence without any more judgmental approach being necessary?**

As noted in the answers to 4. and 5. above, there should not be a statistically-calculated CL prescribed. There should certainly not be a specified number of data points used to calibrate the CL, since the number of data points is dependent upon judgements made around the quality and quantity of the data available for each type of transaction. Any calculation will require a degree of judgment: assumptions are necessary regarding the distribution of underlying data (Gaussian law, uniform law etc.). Observations must also be interpreted and filtered. Since the judgment approach used will utilise available information in order to reach a prudent conclusion it will utilise available data points and so the question appears redundant.

As a result, the Industry believes that a judgmental approach is preferable, combined with requirements to build robust independent price verification (IPV), and model risk assessment processes.

**Q7. If you support a specified level of confidence, do you support the explicit allowance of using the level chosen as guidance for a more judgmental approach where data is lacking?**

See answers to questions 4., 5. and 6. above, along with points raised in a. and b. in the introduction to this response. The Industry believes that, where data is lacking, there will be no possible approach other than use of judgment. Given the relative materiality of AVAs for complex and illiquid instruments, which

will tend to be relatively lacking in available data, such a judgmental approach is preferred for calibration of the framework more generally.

**Q8. Should any additional possible sources of market prices be listed in the RTS?**

The RTS already provides scope (“including but not limited to”) to add other data sources, so it is not necessary to attempt to list these prescriptively. One may for example consider both valuations provided by central counterparties and valuations observed in trade repositories. Also, such data sources develop over time therefore trying to capture a complete list at a point in time is not appropriate.

**Q9. Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?**

No, it should not be required. Institutions should use appropriate methodologies, to be challenged if and where appropriate by regulators. Indicative description may be useful for smaller participants but should not be binding for Tier 1 banks.

The Industry believes that the waterfall of sources has to be defined in accordance with IFRS13, which contains guidance on fair value hierarchy, and has been the result of extensive effort of clarification from the IASB, FASB alongside a comprehensive interpretative documentation from the accountancy profession. The waterfall of sources has to be documented and should be associated with an appropriate governance structure to cope with complex situations. Supervisors have access to the documentation and should review its adequacy.

**Q10. Should the RTS be more prescriptive on how to use the various alternative methods or sources of data to obtain a range of plausible prices where there is insufficient observable data to determine the range by direct statistical methods? If so how?**

No, the Industry believes that it is not possible to be prescriptive in these circumstances, which require judgment to be applied, taking into account the nature of the instruments and positions concerned. Here again, institutions should use appropriate methodologies, to be challenged if and where appropriate by regulators.

**Q11. Are there any other indicators of large market price uncertainty which should be included?**

No, the industry does not believe that additional items should be included.

**Q12. Do you believe the approaches set out above are appropriate for each of the adjustments listed in Article 100? If not, what approaches do you believe would be more relevant?**

The Industry commented this in point f. in the introduction to this Response. Close-out costs and market price uncertainty should be treated jointly, and the operational risk charge should not be included in this framework as it duplicates part of the operational risk capital charge. Where the degree of overlap is

common across institutions should be clarified in the RTS for the non-AMA approaches to the operational risk capital charge.

The Paper introduces a new adjustment which was not required by the level 1 text: balance sheet substantiation. This requirement is about audit failure and its inclusion in prudent valuation is not relevant for a technical standard on the valuation of fair valued assets; it is not an appropriate source of valuation uncertainty.

Additionally, the concentration and liquidity horizon appear to be an overlap with the market and counterparty risk RWA approach. This accounts for another area of double counting which should be eliminated. Liquidity horizons are also already part of the Basel Committee's Fundamental Review of the Trading Book.

#### **Covering each of the AVA's mentioned in section 4.4 in turn:**

##### **Unearned Credit Spreads:**

The industry has no comment on this section.

##### **Close-out Costs:**

We note that the requirement that the risk netting is "consistent with, or demonstrably more prudent than, the most accurate hedging of the risk available using tradable instruments" is extremely onerous and risks over-stating the exit costs for a given portfolio. For example, options on the Eurostoxx50 equity index are tradable at every 50 index points. However, it is not necessary to manage a whole portfolio of such options down to this strike level. Where these options are either in- or out-of the-money (and especially as the contracts become close to expiry), the difference in risk is small for 2 contracts with strikes 50 index points apart, and so no institution would manage the risk down to this level of granularity, despite there being different hedging instruments available. This requirement should therefore be re-worded to be less prescriptive, but still to ensure that an institution considers a prudent and appropriate level of risk aggregation within its close-out costs.

##### **Operational Risks:**

This section deserves more clarity. We note that the deliberate choice of a model that turned out to be incorrect is not an operational risk but is a model risk, while the unintentional use of wrong model or bugs in code are operational risks. The latter should be clearly segregated from the prudent valuation, while the former should be captured through model risk.

##### **Market Price Uncertainty:**

There is a clear overlap between bid / offer close-out costs and market uncertainty which is not captured

##### **Early Termination:**

Early Termination AVAs are primarily driven by client relationships which anticipate profits from future trades and should generally not be material to the valuation in normal course of business. When under stress, the decision to preserve client relationship conflicts with the necessity to survive a measure that is grounded on past experience is not necessarily relevant.

##### **Investing and Funding Costs:**

Prudent valuation should take investing and funding costs into consideration.

**Future Administrative Costs:**

We believe that this requirement is over-punitive. This provision makes the prudent value depart from the announced objective of realization of value in an on-going concern basis, by assuming full exit of the entire activity. It also seems to us that from a market participant perspective, the future administrative costs that might be charged are mainly incremental charges because it is very likely that such market participant has already an active running book.

**Model Risk:**

The description in the paragraph 45 makes sense. However this is also an overlap with the on-going Fundamental Review of the Trading Book which will likely require a capital add-on.

**Balance Sheet Substantiation:**

The industry believes this is a pure operational risk and its inclusion in prudent valuation is not relevant for a technical standard on the fair valuation of assets; it is not an appropriate source of valuation uncertainty and is outside the scope of the Basel recommendations.

**Q13. Are there any other material causes of valuation uncertainty that the RTS should describe an approach for? Or are any of the adjustments listed above not material and should not be included?**

No.

**Q14. Do you believe that the testing approach in Annex 2 represents a useful tool to test for prudence of valuation? If not, what weaknesses make it unsuitable?**

No, the Industry believes that the approach proposed is not useful. See comments made in point b. in the introduction to this response. This approach could only be properly implemented for liquid, low uncertainty instruments, where the AVAs will be relatively low. As explained previously, even for liquid positions, the proposed approach is flawed, since positions would fail due to intra-day market moves and it would fail properly to identify sources of imprudent valuation. The example used in Annex 1 for transaction 1 concludes that a position which is sold at 100.05 a day after it was marked at 100.15 is an imprudent valuation. The traded price is 0.1% away from the prior day close. This is equivalent to an annualised volatility of less than 2% (which is a very low level). It in no way demonstrates an imprudent mark and in itself shows why the approach suggested by Annex 1 and Annex 2 is not useful. It is a disproportionate use of resources for little return on measuring prudent valuation.

In addition, when unwinding less liquid exposures, institutions already perform comparative analysis against Fair Value Adjustments (FVA's). Institutions should have their own methods for assessing the adequacy of their valuation approaches, including prudent valuation, which regulators should assess as and to the extent necessary.

**Q15. Do you believe that the RTS should be prescriptive with respect to validation techniques? If not, how do you believe that comparable levels of prudence should be ensured for the valuations across institutions? Are there other validation techniques that you believe should be detailed in the RTS?**

No, the Industry believes that RTS should not be prescriptive with regard to validation techniques and, as set out in the response to question 14 the validation techniques suggested in Annex 1 show that the

approach is flawed. Regular portfolio benchmarking as previously performed by a regulator or recently introduced by consensus services are more effective and informative.

**Q16. Do you support the concept that prudent value can never be greater than fair value including fair value adjustments at both the individual position and the legal entity level? If not, what would be the reason to justify your view?**

Yes, generally, the Industry agrees. It is correct to say that prudent value should never be greater than fair value, including fair value adjustments at the entity level. However, there might be exceptions, at the position level examples of which are supplied below:

- 1) Distressed assets are often marked to very defensive levels and have often embedded value. E.g. where a portfolio of distressed assets has the overall portfolio value considered but some of the assets may be undervalued e.g. written off to zero when there would be some value then it should be possible to consider the overall portfolio value which could mean the same impact as writing these undervalued assets up.
- 2) Any Day One profit holdouts may also need to be considered for offset against the AVA. Day One P&L reserve would be mechanically released if and when a firm effectively closes out a level 3 exposures (at prudent value) so it should be considered as a legitimate offset to AVA's.
- 3) At the portfolio level fair value may have been reached with a model or surface which overvalues some positions while undervaluing others. It is possible that some of the positions which are undervalued and conservative may potentially have a higher prudent value than their fair value. This will be offset by the larger difference between the prudent and fair value of the positions which were overvalued. To disallow this would be unreasonable.

**Q17. Would you support the availability of a diversification benefit within the aggregation of position-level AVAs? Please explain the reasons and justification why, providing any evidence available to support your arguments**

Yes, the Industry believes that diversification benefit makes sense, see point c of the introduction to this Response. An acceptable approach may be that the scaling factor be calibrated from a companywide diversification factor allowing a reallocation of prudent value to different business lines.

An important point with regard to diversification (mentioned in Annex 4 of the Paper) is that it is likely that fair value already incorporates a substantial part of the prudence required by the CRR. It is important to note that in large portfolios, with both long and short positions, it is not reasonable to assume that every single position will move adversely together, likewise with risks across different positions and markets. Risks and the associated valuation uncertainties are partially diversified away.

**Q18. If simple aggregation better reflect your assumptions and practices or would you support the availability of diversification benefit, do you support creating a simplified standard approach, an example of which is shown in Annex 4? If you do, do you have alternative suggestions on how this standard approach should be specified? Are the suggested correlations in the example appropriate, if not what other values could be used?**

As noted in the answer to question 17, the Industry believes that it is very important to include diversification benefit, but it should not be stipulated as a prescriptive approach which all firms have to follow. Regulators should assess the reasonableness of the institution's diversification approach.

It may be possible to specify a simplified standard approach, which those institutions without an internally-developed approach to diversification could choose to adopt. The proposed simplified approach in Annex 4 appears to be very punitive and would be complex to calculate. The industry suggests that the consultation group proposed in the introduction look at a potential simplified methodology that could be used. Similarly, where institutions choose not to model diversification (under any approach), they could be permitted to adopt an approach with no diversification benefit assumed.

**Q19. If you support the availability of diversification benefit, do you support allowing an in-house approach which should be subject to approval by the regulator, an example of which is shown in Annex 4?**

Yes the Industry believes that an in-house approach, subject to regulatory approval, is the preferred option – see answers to questions 17. and 18. above.

The example in Annex 4 is too prescriptive, and implies that there is an optimal and consistent way of improving the computational efficiency across all institutions under different environments. This is simply not the case. The regulator should review whether or not a firm's in-house approach is satisfactory.

**Q20. Would you agree that offsets against AVAs for overlaps with other Pillar 1 capital requirements should not be permitted? If not, what offsets might be appropriate and under what conditions might they be allowed (e.g. individually assessed by the institution and agreed with the regulator rather than specified in the RTS)?**

The Industry believes that offsets should be permitted where AVAs and capital requirements overlap. This appears to be the case for operational risk, where the RTS should clarify the position for Basic Indicator and Standardised Approaches to the Pillar 1 capital calculation. Where institutions can demonstrate other areas of overlap, offset should also be permitted and should not be restricted to Pillar 1 charges only.

There are clearly some overlaps that need to be quantified and for which deductibility should be sought:

- Var/stress Var already capture already to some extent data uncertainty. The proposed move to Expected Shortfall under the Fundamental Review of the Trading Book will strengthen this
- The Incremental Risk Charge also addresses illiquidity and concentration risks

- The RTS should also address tax deductibility

**Q21. Do you believe the above requirements are appropriate? If not, what other requirements could be necessary and what requirements stated above are considered not to be relevant?**

The Industry supports the aims of the Paper but believes that the requirements as laid out are too prescriptive. They also appear to suggest a degree of ‘systematisation’ which is inappropriate and likely impossible for a framework which necessarily requires extensive use of judgment and subjective assessment. The requirements are highly demanding in terms of documentation, systems, control and reporting requirements which in principle appears to be reasonable but unrealistically difficult to implement.

For example, paragraph 73 says that institution valuation and risk measurement systems should systematically recognise and account for valuation uncertainty. If this means that all the different valuation uncertainty adjustments need to be embedded in the institution’s front office / risk measurement systems, that would be an extremely complex, possibly unachievable task. It would introduce significant operational risk, effectively asking these front office systems to operate ‘two sets of books’. Also, valuation uncertainty based on Balance sheet substantiation ineffectiveness is theoretically debatable and practically unachievable. Valuation uncertainty linked to operational risk is redundant.

**Q22. What would be the sources of costs and benefits of requiring (a) the implementation of a unique AVA methodology and (b) a consistent format for reporting AVA? Do you agree that the benefits of such requirements outweigh the costs associated with them?**

A unique AVA methodology ensures comparability between entities and certain degree of cushion in the system for risks that can only be ensured by setting reserves. Initial capital cost might be high if some punitive elements are maintained or if diversification is not allowed. However, the AVA framework is somehow auto-realizing and will be incorporated to a large extent into fair value (to the extent this is admissible in such measurement) and into pricing guidelines. Also, additional non-fair value capital charges are likely to be allocated to trading desks. This may substantially increase the entry hurdle cost and conversely lower the exit hurdle cost. The benefits in the approach as currently documented certainly do not outweigh the associated costs.

The potential effect is therefore that the cost for clients will increase for the products that embed large model risk or measurement uncertainty or that have high operational cost. We stress that the highly prescriptive nature of the proposed methodologies is such that the operational cost associated with the implementation is very high even for banks that already have solid valuation framework and long tradition of prudent valuation and so is likely to have an effect on costs passed to clients.

As far as consistent format is concerned, we believe that as long as the information is intended for the sole purpose of supervisors, and as long as there is clear disclosure of the diversification effect, there is some benefit in defining a consistent reporting format. If there should be any harmonisation of reporting, that will need to be decided at the international level.

We would not object to a common (external) reporting form under COREP being introduced to cover prudent valuation, or the addition of prudent valuation information to an existing COREP template. But regulatory specification of an internal reporting form would not be appropriate, as it would detract from

the institution's ability to determine the information required by its own management, thus weakening internal controls.

**Q23. If you agree with a reporting form being introduced, could you please provide a suggested template?**

A template for reporting on prudent valuation does exist already. It has flaws, particularly in the split of information by asset class, and the inclusion of extraneous data such as upside valuation uncertainty and VaR numbers (which many institutions, particularly those without CAD2 approvals, would struggle to break down by asset class with any accuracy). A simpler and more intuitive version of this form, for example allowing institutions to provide data by business line/division (rather than asset class), could provide a reasonable basis for a common form and allow the regulators to decide where to target thematic reviews.