2024-04-15 European Banking Authority

Consultation on Regulatory Technical Standards on prudent valuation

Answers to specific questions in the consultation

Articles 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.*

Answer
As the prudent valuation framework consists of many different AVA types with separate calculations, a monthly calculation of AVAs will require significant additional resources. Additionally, for some banking book positions, valuations are only available on a quarterly basis, implying that a monthly calculation of the valuation uncertainty will not be possible without relying on expert judgements.

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.*

Answer
Our experience is that it is often not possible to distinguish between indicative and tradeable quotes. It is common that an indicative quote becomes tradeable when a FO/Broker is contacted. As a result, reliable quotes, which can be tradeable upon request, can end up classified as indicative, therefore we find it undesirable to not

Besök (Visit):
Blasieholmsgatan 4B
Stockholm
Sverige (Sweden)

Post:
Box 7603
SE-103 94 Stockholm
Sverige (Sweden)

t: +46 (0)8 453 44 00

e: info@swedishbankers.se
www.swedishbankers.se

allow any indicative quotes under the range-based approach. This will artificially increase the recourse to expert base approach.

Apart from markets where trading is fully automated, in many other markets, the standard practice is to quote indicative prices and interaction with a trading desk is required to confirm the prices. Limiting the usage to only tradable quotes will exclude valid market observations. Also, even tradeable quotes can have negligible size and be not representative of the market.

The number of contributors to a consensus is not always correlated with the quality of the consensus price. The market size of the contributors is a more important factor.

For many markets, including the Nordic markets, there are fewer than 10 participants to a consensus as the main active players are fewer. The back testing criteria should be used rather than the number of participants. However, the way the back testing requirement has now been included, it is not clear what the exact requirements are.

Nordic market participants note that consensus services are not as widely available in certain markets, including for many instruments denominated in Scandinavian currencies, limiting the availability of contributors and tradeable quotes.

In 3(2, c) tradable quotes are permitted from brokers and other market participants, but 3(3, b) only brokers' quotes are indicated. The exclusion of other market participants, e.g. banks and hedge funds, can neglect an important quota of a market.

In general, the proposed changes, would result in practically all current MPU and CoC AVA methodologies being classified as expert-based with a subsequent requirement to produce a large number of "independent assessment" reports every year for the competent authority (per paragraph 10 and 11 in the revised Articles 9 and 10). By raising the bar for range-based approaches, to the extent that creating range-based approaches may even be impossible, there is a risk that the incentive for banks to improve on existing methodologies will be significantly reduced.

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.*

Answer

While allowing historic data (up to 1 month) would seem to increase the possible use of the ranged approach. The requirement 3a(2) point (c) to adjust them to reflect market evolutions makes it practically difficult (if not impossible due to enormous amount of work required) when a large number of points are in scope. Allowing for example indicative brokers and other market participants quotes in the ranged method would seem to be a more robust way of improving the set of reliable market data points.

It is not clear what the adjustment to reflect market evolutions will be in the case of market events or news during the 1M period. This unclarity will cause different methodologies being applied or applied only by some participants.

For 3a(3), how does the regulator expect us to prove a negative? (How do we demonstrate that there are no sufficient and reliable market data sources?)

For 3a(3), for certain markets, data could be available, but the cost of usage could be unreasonable. This will be particularly onerous when the materiality of the exposure is negligeable.

For 3b, how can expert based methodologies and their sources of information be demonstrated as accurate, sufficient and reliable? In the context of expert-based approaches these requirements seem difficult to meet. It seems the requirements stated in Article 9.9 "that the level of certainty of the prudent value estimated under that approach is equivalent to that targeted under the range-based approach" would be sufficient.

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.*

Answer

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.*

Answer
A fall-back measure based on the notional value for derivatives, will result in a very crude measure that will not correspond to the actual valuation risk in the related instruments.

Prescribing a mandatory fallback approach for all the unlisted shares ignores the particularities of the unlisted company. Unlisted shares of a large company which have a sperate listed share class should be treated differently than e.g shares in a small start-up company.

Furthermore, unlisted equity valuations commonly incorporate a discount for lack of liquidity and/or marketability in line with IPEV guidelines. This is important to consider in the calibration of the fallback approach, to avoid that such assets are treated overly harsh.

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.*

Answer
The term unlisted equity should be further clarified.

It is not clear if the lack of IPV should lead to the use of the fallback approach, in the case of a material valuation input is covered by IPV.A materiality condition should be applied to determine if the position falls under the fallback approach. For instance, it seems not reasonable to apply a fallback approach for a position where only an immaterial risk is not subjected to IPV. It is proposed that materiality thresholds are set against defined sensitivity-based shifts to enable a consistent and unambiguous implementation in this regard.

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.*

Answer
The proposed Article 8.3 section three and its sub-sections (a) and (b) are unclear and difficult to understand.

Article 8 paragraph 5, the definition of the same pricing models is not clear. For instance, a similar base model in two different pricing systems, e.g. BS in Calypso and Murex, which price identical trade is considered to be "the same model"? More guidance should be provided to determine the definition of the same model. for instance, a % price difference to the notional.

8(6), seem to introduce a mandatory quarterly calibration of model parameters (in EOD valuation). Some model parameters are determined via an expert-based approach rather than a mathematical method. It is not clear if a review of the expert-based approach which confirms the parameters as still relevant can be considered as an updated calibration.

8(7), raises a requirement to substantiate that a sensitivity-based approach provides an accurate representation of the actual PnL. It would be more appropriate to compare a risk-based approach with the MTM PnL or Hypothetical PnL rather than the actual PnL as only some components of the actual PnL are captured by risk measures.

The requirement to also capture convexity and cross-order effects in the variance test, seems overly complex and unnecessary, given all other requirements that have been proposed to constrain the usage of risk factor reduction (please also refer to the responses to questions 8 and 13).

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.*

Answer
The benefit of the diversification factor appears to be conditional to IPV performed and adjusted in the ledger. This condition does not account for the cost of the process of adjusting the ledger. Some minor adjustments, e.g. few dollars, would just increase the operational cost and risk without improving the correctness of the balance sheet.

While the listed requirements in Article 9 and 10 for applying a reduced set of risk parameters, seem sensible seen in isolation, the cumulative effect of all proposed new requirements aimed at constraining the usage of risk factor reduction (including the changes to Article 8 and the changes to the Annex) seems unreasonable and beyond the stated policy objectives. We think that the new requirements in Article 9.4(c) and 10.4(c) (ii) “to ensure that valuation exposures associated to parameters that are not in the reduced set of parameters are mapped to the nearest parameters of the reduced set of parameters" and the latter part of (iv) "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" are useful clarifications which would be sufficient to meet the policy objectives.

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.*

Answer
The definition in the proposal is preferable to the one in the current technical standard. However, it is practically difficult to carry out the calculations.

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.*

Answer
As we understand it, the intention of the proposal is to clarify the provision. However, the proposed text still contains significant ambiguity in terms of the scope.

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.*

Answer
No comments.

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.*

Answer
The requirement to calculate and consider concentrations in calculated UCS AVA seems overly complex. In particular when combined with restrictions on the application of the diversification factor. It is unclear to us how this proposal contributes to the stated objective of increased convergence in implementation.

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.*

Answer
In relation to the requirement that the FV includes eligible accounting fair value adjustments in accordance with Article 8.3 and that these are "commensurate with the adjustment other market participants would consider", we do not find it clear how banks are supposed to evidence this.

Additionally, we do not think that there is currently consensus on the application of a market price uncertainty adjustment in fair value and question whether this is in line with IFRS 13 accounting standards.

As stated in relation to question 8 we find that the cumulative effect of all proposed new requirements aimed at constraining the usage of risk factor reduction seems unreasonable and beyond the stated policy objectives. We think that the new requirements in the proposed article 9.4(c) and 10.4(c) (ii) "to ensure that valuation exposures associated to parameters that are not in the reduced set of parameters are mapped to the nearest parameters of the reduced set of parameters" and the latter part of (iv) "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" are useful clarifications which would be sufficient to meet the policy objectives.

However, we do not think that the application of risk factor reduction should affect the diversification factor. In this context we note that the diversification factor aims to capture the lack of correlation in valuation uncertainty across different risk factors, whereas risk factor reduction aims to capture the frequently high correlation of different inputs within a specific risk factor. Hence, we do not see the logic of making the application of the diversification factor dependent on the non-application of risk factor reduction.

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.*

Answer
While the stated objective of the revision is to provide further clarification and thereby reducing the variability of implementations across banks, we find that the consultation paper introduces several new concepts, which opens up room for new interpretation. The newly introduced concepts appear to deviate from the objective of the revision. Additionally, we note that proposed changes are very significant and would require significant time and resources for review of all the related methodologies and its market data inputs.

SWEDISH BANKERS' ASSOCIATION

Johan Hansing | Maria Olin