German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

EBA-CP-2024-01 Prudent Valuation Framework

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks.

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General comments:

The suggested changes are far reaching and lead to high implementation burden. Therefore, an implementation period of at least 6 months between publication in the official journal and application should be foreseen.

5.2 Overview of questions for 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.*

The monthly calculation would significantly increase expenses, associated with higher personnel requirements and more challenging substitution arrangements, leading to substantial secondary expenses, especially in times of skilled labour shortages. Moreover, higher costs for market data can be expected, which now must be obtained much more frequently. An increase in reporting frequency could cause overlaps in the process chain, potentially extending the process for creating COREP templates, which currently takes up to 30 working days. Additionally, there is the generally high cost of collecting data for both trading and non-trading book positions (including extra data for COREP, e.g., granular breakdowns) and for preparatory work before the respective reporting date.

To date, fair values, fair value adjustments, nor prudent value adjustments for the total portfolio of non-trading book positions have been calculated on a monthly basis. Determining these values requires significant effort, particularly for non-trading book institutions, or is initially not feasible, as some data is only available quarterly, such as for credit and unlisted equity positions, for which fair values are calculated quarterly for FINREP purposes. A simplification could be the extrapolation of the quarterly calculated fair values.

Furthermore, the turnover rate for portfolios is sometimes very low for various banks due to their strategy. In this case, the benefit of more frequent calculation seems limited. The management of valuation uncertainty also takes place over a longer term than that of market risks, meaning that monthly management impulses from prudent valuation would be of little use or even detrimental due to increased complexity.

The RTS already prescribes stricter regulations that prevent "window dressing," for example. This renders monthly reporting redundant for this purpose.

It would be very difficult for banks to calculate AVA for dates in the past. It should therefore be clarified that the regulator can only require banks to calculate AVA on a monthly basis starting from the date of the request but not retrospectively for dates in the past. Otherwise, banks would need to modify their infrastructure for such a retrospective calculation what would result in significant costs.

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.*

The exclusion of indicative broker quotes and consensus service data from the range of market data sources for the range-based approach would produce significant challenges. The current proposal would lead to a dominance of the expert-based approach as, for example, proof of tradability for broker quotes is rarely possible. This would result in significantly increased effort in terms of validation, back-testing and reporting, which can even pose methodological difficulties.

We do agree that, in terms of data quality and reliability, indicative quotes and consensus data are to be placed between executable quotes and proxy data. It remains to be decided where to draw the line between the range-based and the expert-based approach. While it seems plausible to make that decision based on the perceived quality of the data (one may still argue that indicative quotes are usually of high quality), we feel that it is more appropriate to make this decision based on the consequences of that decision. The following examples shall outline these:

Example 1: Consensus data (Totem) is frequently used as source for swaption volatilities. The number of contributors may occasionally drop below 10 and therefore the data may become expert-based. Article 9, point 9 states that in this case an independent unit "shall verify the adequacy of the assessment made and the methodology applied". Such an audit seems inappropriate as the consensus data will be processed in exactly the same way as range-based consensus data.

Example 2: Bonds are traded almost exclusively in an OTC market (the volume traded at exchanges is usually insignificant by comparison). Market makers provide quotes in this OTC market with the intention to trade at that price at that point in time. Yet these quotes are not legally binding as brokers prefer to keep a last look option for the very rare case of disruptive external events (like an earthquake). Article 9, point 10 states that "[institutions] shall notify the competent authority of the methodology used to determine the largest individual market price uncertainty AVAs under that approach, representing at least 20% of the total individual AVAs determined on the basis of that approach." With indicative quotes as expert-based input, this list will often be dominated by government bonds.

Example 3: Especially non-trading book institutions without the capacity to participate in consensus service data processes would be affected by the proposed adjustments. In such institutions, sources according to letters (c) and (e) of RTS 2016/101 Art. 3.2 are primarily used in the construction of a range of quotes. Due to the tradability vs indication fluctuation of a quote throughout the day and in the absence of a clear and historised flag from market data providers such as Reuters or Bloomberg a quote would when in doubt be categorised as indicative due to the missing flag whereas it would actually be tradable. Consequently, this would lead to a significant amount of valuation exposures (even very liquid and tradable valuation exposures such as EUR ESTR) being allocated to an expert-based approach.

Based on these examples, we suggest a broader approach towards using indicative broker quotes and consensus service data for the range-based approach.

The additional obligations that come with the expert-based approach seem most appropriate when actual expert judgement is employed. This is not the case for consensus data with less than 10 quotes that is still processed identically to consensus data with more contributors, or for external, indicative quotes that are not formally binding. At the same time, the additional obligations would increase institutions' operational cost and there is a risk that the reporting is diluted.

We particularly propose to include indicative broker quotes in the list of sources of market data listed in Art. 3.2 for the purposes of the range-based approach. With the additional requirements on market data sources in Art. 3a, in particular the requirement of regularly updated data in Art. 3a.2a, as well as the requirement of Art. 3.2 to use reliable market data, we are of the opinion that the accuracy and reliability of indicative broker quotes is for most cases ensured. For cases where indicative broker quotes might not meet the criteria they would in most cases be excluded in the process of market data collection leaving only a very minor portion of quotes that might enter the range-based approach while being unreliable. In our view this false inclusion of indicative quotes is outweighed by the possibility to apply the range-based approach to a broader range of valuation exposures and limiting the usage of expert-based approaches.

The classification of historical data that dates back more than 1 month as expert judgement will effectively increase the portion of AVA classified as expert judgement despite the existence of reliable data. As a consequence, banks are forced to favour non-binding consensus rather than actual traded prices. Therefore, we propose to allow the use of transaction pricing data for up to 3 months in "Data Range" approaches with necessary adjustments if market conditions at the reporting date are materially different from those 3 months earlier.

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.*

Significant additional expenses are to be expected to provide evidence for the use of the expert-based approach or to prove the absence of relevant market data for the core approach. It might be necessary to license additional market data, the costs of which do not proportionately reflect the quality improvement of the AVA calculation. Furthermore, smaller institutions that calculate the AVA using the core approach are at a significant disadvantage compared to larger institutions with broader access to market data.

The end of the year, as the most crucial reporting date, coincides with the period of the least liquid market data. Specifically, here, it seems sensible to rely on data from an alternative cut-off date without the necessity for subsequent adjustments.

This leads to increased expenses due to the obligation for evidence and documentation, potentially shifting further activities to periods that are already heavily burdened (shortly after the year-end). We generally request the provision of criteria that would constitute an acceptable (reasonable) effort to obtain data from sources as per Article 3.2.

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.*

NA

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.*

The expansion of the scope and the calibration of the charge result in various issues. For instance, the notional-related charges for derivatives are not reflective of the actual economic risk. Moreover, the framework lacks the concept of significance for risks that could not be independently verified / price-tested and thus removes banks' ability to assess & capitalise the economic risk. Moreover, the range of charges (1-15%) is not consistent with the FRTB RRAO (0.1%-1%) for derivatives.

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.*

NA

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.*

A major existing shortcoming of the core approach is the partial double counting of risks with respect to Day One Profit Deferrals under IFRS. We urge the EBA to rectify this issue by allowing a partial offset subject to the following safeguards:

- Banks need to map the deferred Day One Profit reserves directly to the corresponding AVA for the respective valuation uncertainty drivers.
- The amount that can be offset is generally capped at the AVA.

The requirement of Art. 8.7 of inclusion of convexity and cross-order effects is challenging and requires significant effort of implementation and introduces a significant layer of computational burden with limited expected effect from a mostly plain vanilla portfolio. Gamma/x-gamma risks require large moves to become material, which is more relevant for VaR / stressed VaR calculations rather than valuation uncertainty. Therefore, this requirement should be dropped.

In case this requirement is not dropped, could the EBA please elaborate in which manner a demonstration might be achieved and how frequent such demonstration would be required? Please also provide guidance if such cross-order effects in sensitivities should be recognized solely in the VRT or in the AVA calculation itself when using a sensitivity-based approach.

The requirement to calibrate end-of-day models quarterly means an unnecessary operational burden, as institutions already use these models to demonstrate marking to market (Fair Value). We propose to drop this requirement.

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.*

Significantly higher expenses are anticipated in the determination of the MPU and the chain of custody. Regarding the market data utilized (in accordance with Article 3/3a), the expert-based approach is predominantly applied. This leads to substantially increased efforts in terms of validations, verifications (e.g., conservatism), documentation, and the establishment of an additional independent unit for the annual validation of the methodology. (Points 9, 10, 11)

Concerning the penalization of the used market data (indicative broker quotes), this may result in the elimination of various zero AVA positions, thus leading to an unjustifiably significant increase in the MPU (CoC). (Point 3)

In model-based approaches with a reduced parameter set, significantly higher expenses are incurred due to verifications, validations, variance ratio tests, and the establishment of an additional independent unit. (Points 7, 8)

Additionally, this results in the loss of the diversification factor, leading to significantly higher AVAs. (Annex 2(a)(ii)(2))

The changes with regard to the Variance Ratio Test disincentivise hedging because they penalises hedging strategies not matching exactly end-of-day risk buckets. This increases dispersion of capital across banks, subject to each bank's risk bucket definition and choice of hedges. Moreover, it is Inconsistent with other capital requirement measures (e.g. FRTB NMRF), where the prescribed bucket reduction does not penalise aggregation. Therefore, we suggest to remove the alpha factor requirement and instead introduce targeted restrictions on the VRT application:

- Minimum number of buckets, e.g. no fewer buckets than the amount used for the purpose of determination of corresponding liquidity adjustments.

- Requirement of liquidity of selected buckets and replicating instruments to be supported by market data.

The proposal to make Fair Value reserves subject supervisors horizontal reviews expand prudential supervisory discretion to accounting Fair Value although proper accounting practice is a responsibility of the bank and its auditors enforced by ESMA. Banks are penalised if they do not attribute their Fair Value based on the ECB's view. Reducing alpha for the entire AVA category to zero seems too punitive, given the fact that the problem above will most likely affect a small part of the portfolio. Moreover, the framework/principles required to ensure no adjustment to alpha factor are unclear and, thus, banks will have to assume the worst case in pricing, increasing competitiveness gap versus banks from third countries. We propose to drop this requirement or at least consider scaling the alpha reduction according to some estimate of the extent of the actual problem.

Significantly higher efforts are incurred by the model AVAs due to additional annual verifications and submissions to the supervisory authority regarding the adequacy of the models used.

Banks are forced to book all IPV variances to avoid punitive AVA outcome, resulting in:

- Removing the concept of risk appetite for valuation uncertainty.
- Removing the 1st Line / 2nd Line segregation of duties for Fair Value Recognition in P&L of adjustments linked to subjective or uncertain pricing sources, potentially reducing the quality of reported earnings.

In order to avoid these unintended consequences, we suggest to maintain the 0.5 aggregation factor capitalise for Group level net aggressive unadjusted IPV variance for reliable independent pricing sources identify via a systematic assessment the unreliable subset where the asymmetric approach is to be followed for subjective independent pricing sources.

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.*

Significant expenses will be incurred, especially in the analysis and implementation of the newly added requirements related to model risk and MPU, but increased expenses are also expected in ongoing operations. In particular, the CVA scope extension to Fair Value SFTs is disproportionate. FV CVA is not relevant when trading SFTs and no accounting adjustments for CVA are applicable. Moreover, the scope extension is inconsistent with other capital measures: FRTB CVA allows for the exemption of FV SFTs subject to materiality considerations. US NPR exempts all SFTs and UK PRA significantly limits the scope. Therefore, the CVA scope should not be extended.

Also, the alignment of the MPOR to be used with that used for regulatory is inappropriate and will lead to unjustified additional conservatism. There is no evidence corroborating such an alignment. Moreover, it is inconsistent with the definition of the prudent value:

"[…] the value at which institutions are 90% confident that they will exit a position based on the applicable market conditions at the time of the assessment […]"

Using a floored MPOR in in contradiction to applicable market conditions and adds a further layer of conservatism that is also not justified from a conceptual point of view in our opinion.

Another driver of unjustified operational burden is the requirement to take into account CVA correlations due to the prescribed granularity of application, without a necessarily meaningful change in outcomes. This requirement should be dropped as well.

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.*

While requirements of Art. 15.1 letters (b) to (d) are clear, the EBA is asked to provide guidance on an applicable criterion for market price uncertainty, close-out cost and concentrated positions AVAs to be considered fully exiting the exposure in light of requirement in letter (a) of mentioned article.

All non-linear positions are impacted, including liquid vanilla options. Additional charges will occur, even if the backtesting of PruVal charges is successful. In addition to that, the discounting rate will be disconnected from the cost of capital. We suggest to remove this requirement if PruVal is successfully backtested and to limit the application to portfolios with products that are in scope of the RRAO. Moreover, the discount rate should be linked to the cost of equity of the institution.

Article 17 – OpRisk AVAs

The AVA size is not a good indicator of Operational Risk. As the AVA is applicable to all products, regardless of their complexity, it penalises conservative business models such as market making. Therefore, we suggest to limit the application to desks/books where operational losses linked to valuation processes have occurred during the last 5 years.

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.*

The proposed relief measure will only be applicable in the event of a major market stress but there is no provision for market dislocations on significant, short-term market stress events (e.g. CS/SVB, Russia/Ukraine war), We propose to introduce a relief measure for significant but not yet major market stress events with an alpha factor set at 0.58%.

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.*

Both options have methodological weaknesses and lead to inappropriate UCS AVAs. Isolated UCS AVAs do not seem to be appropriate to measure diversification in general throughout all AVA components. For example, an institution with many counterparties with collateral and only a few without would be negatively impacted by the proposed options compared to institutions with many counterparties without collateral, which seems an unintentional outcome.

Specific issued with the two proposed options are:

- In Option 1 the whole portfolio gets an alpha of 0 if one counterparty has a weight of above 10%, but this counterparty is uncorrelated with the other counterparties in the portfolio which might be perfectly diversified. One counterparty (that might even oscillate around 10%) influencing all other positions seems unreasonable.
- In Option 2, even if the portfolio is perfectly diversified the top 5 counterparties receive an alpha of 0, which is also not appropriate and could, for example, lead to mismanagement especially if the list of top 5 counterparties changes regularly.

In order to account for concentrated positions, we propose to set alpha to 0 only for those counterparties that have a weight above a certain threshold (e.g. 10%).

Furthermore, the use of a portfolio-based approach for components of UCS AVAs would lead to excessive burdens for such banks in both cases as they would have to redistribute the portfolio-based components to individual counterparties. A diversification factor of 0 for individual counterparties would be impossible to implement under such circumstances both technically and functionally. Hence, we ask to take into account such portfolio-based approaches in case of a revision of these options.

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.*

In light of the amendments to the aggregation factor for MPU- and COC-AVA the EBA is asked to clarify whether the implied amendments to the aggregation factor affect the aggregation factor of AVAs calculated according to Art. 12 and 13 (Unearned Credit Spread and Investing and Funding Costs) as well due to the implied reference of Art. 12 and 13 to Art. 9 and 10 whereby, in case amendments are considered to be applicable for Art. 12 and 13 as well, the implication would be that a fair value adjustment (e.g. COC) to a fair value adjustment (e.g. CVA) should be estimated which is not considered market practice or required in current accounting standards.

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.*

Significant expenses are expected to increase due to the proposed regulations. This is partly due to the monthly determination and partly due to the significantly heightened requirements for providing evidence, validations, documentation, etc., which are largely attributable to a penalization of the market data to be used (especially consensus data and indicative broker quotes) and a resulting more dominant expert-based approach.

In the section 'Absence of fair value adjustments for market price uncertainty and close-out costs', noted from paragraph 23 onwards, an unequal treatment is discussed that ostensibly arises if no fair value adjustments are made for an AVA category. This also refers to paragraph 88 in IFRS 13. It is suggested that the aggregation factor 'alpha' be set to zero if no corresponding fair value adjustment exists.

We particularly do not understand the rationale behind the use of an additional market price uncertainty discount in the context of fair value measurement.

Normally, fair value is considered a price that a third party is willing to pay. In practice, within the context of fair value, when using a market parameter, either an average value or a median is employed. The most favourable (in terms of the most aggressive) liquid market parameter for the institution at the time of measurement is not used as a basis, implying that a certain type of market price uncertainty is already included in the model value.

As we understand, paragraph 88 of IFRS 13 refers to Level 3 inputs, that is, unobservable inputs. Depending on the significance of this parameter for the measurement of an instrument, this leads to the categorization of the entire instrument as Level 3 and thus also to the creation of an additional Day One P&L.

With the additional consideration of a market price uncertainty discount, we see the risk that aspects of prudent valuation are already included in the accounting, which are not reflected in the 'fair' pricing of a transaction.

In absence of clear guidance from accounting standards the EBA is asked to propose the scope, purpose and extend an MPU fair value adjustment should fulfill to be an eligible fair value adjustment.