Prudent Valuation: Aligning valuation standards across risk and accounting

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REPLY AVANTAGE

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On 23 January 2015, the European Banking Authority (EBA) published its revised final draft Regulatory Technical Standards (RTS) laying out the requirements related to prudent valuation adjustments of fair valued positions. These standards will be part of the EU Single Rulebook in banking aimed at enhancing regulatory harmonisation.

The RTS is likely to be approved by the European Commission in Q3 2015 but institutions are expected to anticipate implementation, as agreed upon with their supervisor.

The regulatory framework for prudent valuation applies to all fair valued financial instruments across banking and trading books, including OTC derivatives, real estate and private equity participations.

The inter-dependency between fair value and accounting requirements on the one hand, and prudent valuation and capital requirements on the other hand, is triggering institutions to develop a more holistic view on the valuation of financial instruments, re-think their existing valuation methodologies, policies and procedures and look for maximum efficiency.

Prudent valuation aims to align valuation processes and approaches which have evolved for different regulatory purposes. By integrating their response to the prudent valuation RTS with their approach to other valuation processes, institutions have the opportunity to optimise the outcome of their prudent valuation project. This will significantly increase the robustness, coherence and transparency of their valuation framework.

Regulatory Technical Standards (RTS) on Prudent Valuation

During the latest financial crisis the lack of a consistent and transparent valuation framework for illiquid assets – OTC derivatives in particular – increasingly was a discussion point for regulation. Consequently, fair value accounting rules came under increasing scrutiny in regards to being an accurate representation of risks.

Capital Requirements Regulation (CRR) article 105 aims to reduce the valuation uncertainty inherent within IFRS by providing minimum valuation standards, including the use of a range of prescriptive 'Additional Valuation Adjustments' (or AVAs). The underlying RTS, which was issued by the EBA in a final draft version in January 2015 provides further detail on these minimum standards and introduces the notion of prudent valuation for regulatory capital purposes.

From Fair Value to Prudent Value

IFRS13 defines fair value as '…the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal (or most advantageous) market at the measurement date under current market conditions'. This is also referred to as the 'exit' price. This definition allows institutions to apply a price within the bid-ask spread that is most representative of Fair Value.

To arrive at the Fair Value the initial market value of an asset (or liability) is lowered (or raised) with one or multiple so called 'fair value adjustments'.

With Prudent Value, fair valued financial instruments, must be valued against a 90% confidence level for which 9 Additional Valuation Adjustments (AVAs) have to be considered. When not already considered in the accounting Fair Value, these adjustments must be subtracted from Core Tier 1.

As visualised in the diagram below, by applying a stricter valuation framework, and hence ensuring that all valuation considerations are reflected for the purpose of regulatory capital to the same degree of certainty, the regulator now intends to establish a level playing field across the industry.

Figure 1: Creating a level playing field
(Source: DNB)

Two regulatory approaches

The RTS offers two different approaches depending on the size of the institution; the Core Approach and the Simplified Approach.

Institutions with consolidated absolute value of on- and off-balance sheet fair valued assets and liabilities exceeding EUR 15 billion are subject to a Core Approach that intends to provide a consistent framework for determining AVAs under a target level of 'prudence' or certainty of 90%. The most relevant features of this approach are:

- AVAs shall be considered for 9 different categories. A punishing 'fall back approach' is applicable when requirements cannot be met.
- Each AVA shall be calculated as the excess of Prudent Value over Fair Value.
- Where possible, the prudent value is based on statistical data and a target confidence level (90%). In all other cases, an expert-based approach is specified with a similar level of certainty.
- Excluded are positions for which a change in accounting valuation has a partial or zero impact on CET1 (i.e. subject to a prudential filter or offsetting).
- It allows for diversification effects for the main AVA categories when aggregating the AVAs calculated at exposure value level.

When institutions stay below the EUR 15 billion threshold, they are subject to the Simplified Approach, with the following main characteristics:

- AVA = 0.1% of the aggregate absolute value of all fair-valued assets and liabilities held by the institution.
- This absolute total includes liquid positions. Excluded are positions for which a change in accounting valuation has a partial or zero impact on CET1.No aggregation or diversification steps are applied.

Enhancing existing value adjustments

Under the Core Approach, nine value adjustments have to be considered.

Four of these adjustments can be seen as refinements of existing fair value adjustments already recognized under IFRS:

- Comparable with existing bid-offer adjustments under IFRS, the RTS introduces AVAs for Close-Out Costs and Market Price Uncertainty which reflect the uncertainty in the bid offer spread and mid-price respectively. Where the overlap of both concepts can be demonstrated the regulator allows one adjustment instead of two.
- Furthermore, AVAs are recognized for Model Risk and Unearned Credit Spread, which can be linked to existing Model Risk and CVA/DVA adjustments on derivative positions.

The RTS recognizes the following 5 new adjustments:

- Operational Risk – covering the uncertainty in valuation processes. This AVA can potentially be covered through the Advanced Measurement Approach (AMA), when applicable.
- Concentrated Positions - covering illiquidity due to entity specific concentrations that take more than 10 days to close or hedge.
- Investing and Funding Costs - investing and funding costs AVA to reflect the valuation uncertainty in the funding costs used when assessing the exit price under the current accounting framework. This funding element is to be calculated under the adjustments for Market Price Uncertainty, Close-Out Costs, and Model Risk.
- Future Administrative Costs - covering additional costs to hold specific positions. This is required when Close-Out Costs do not already fully cover position exiting costs.
- Early Termination - covering additional costs from non-contractual terminations of contracts (e.g. for reputational or commercial reasons). This AVA is to be considered based on an impact assessment of non-contractual terminations.

Implementation challenges

As a consequence, this RTS forces banks to revise and prepare a wide range of methodologies, policies, processes and procedures:

- Documented methodologies to calculate AVA;
- Revised policies covering internal standards and clear governance related to:
  - calculation of value adjustments and AVAs;
  - preferences of market data sources;
  - price testing (also known as *Independent Price Verification* or IPV);
  - internal reporting and disclosure;
- Processes and procedures covering:
  - review of data sources;
  - documentation and review of expert based assumptions and valuation inputs;
  - identification of concentrated positions which take more than 10 days to unwind;
  - periodic assessment of early terminated contracts;
  - detailed calculation and booking steps.

Furthermore, for the Market Price Uncertainty, Close-Out Costs, and Model Risk adjustments, institutions shall notify their supervisor and share their methodologies where expert-based approaches are applied. Depending on the expectations of the ECB and/or the local supervisor, this may take the form of a formal waiver.

The impact of the RTS on Prudent Valuation in terms of internal organization, costs and reccurring workload is significant, and raises the question of how institutions can come to an efficient, coherent and consistent valuation framework.

Ideally, a single approach could meet both the regulatory requirements of IFRS and the CRR. What is relevant in this perspective is that EBA recognizes the interdependency between fair and prudent valuation, as it mentions the possibility of future amendments in the RTS due to future accounting requirements that would alter the approach for determining a fair value. The RTS also states that institutions are expected to limit the implementation burden by using data from the Independent Price Verification (IPV) process. IPV is typically already available as the foundation of the approach.

A holistic and integrated approach

The forthcoming workload and interaction between fair and prudent valuation approaches triggers banks to re-think and strengthen their methodologies, policies and procedures in Risk and Accounting.

Due to the similarity in objectives, the processes for fair and prudent value can, where possible, be aligned. Logically, prudent values and AVAs can be determined as part of the IPV, as explained above, making use of the existing infrastructure and governance. The reasons for any deviation between fair and prudent value shall be fully understood and documented as part of this process.

We notice that within the boundaries of IFRS, a 'prudent' measurement of fair value is being sought by industry at a target level of 90% confidence including adjustments for Close-out Costs, Market Price Uncertainty and Model Risk. Such an alignment of concepts between fair and prudent valuation could minimise the workload and need for Additional Valuation Adjustments (AVAs). This would then leave AVAs to remain in those areas where IFRS and the CRR do not allow further integration (e.g. Concentrated Positions). As a result, for many requirements under the CRR, one process can be applied satisfying both IFRS and the CRR.

To facilitate the alignment of valuation processes, including the use of same data sources and combined adjustments, and to ensure a consistent institution-wide valuation approach across banking and trading book, a clear, coherent and comprehensive policy & governance framework is required. Such a framework should explain how asset valuation, regulatory capital (AMA, Concentration Risk) and accounting fair values (including disclosures on valuation uncertainty under IFRS 13) are interconnected within the institution.

In addition, a central governance body and risk appetite framework for valuation uncertainty including both qualitative statements and quantitative measures should ensure central oversight.

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