Deloitte.

Belgium
Financial Services

Prudent valuation
EBA's Consultation Paper

August 2013

On the 10th of July 2013, the European Banking Authority (EBA) has published a new consultation paper on Draft Regulatory Technical Standards (RTS) aiming to define the requirements relating to Prudent Valuation.

This consultation paper specifies the conditions under which Articles 105 and 34 of the Capital Requirements Regulation (CRR, European translation of Basel III adopted on 28/06/2013) shall be applied.

Institutions have until October 8th to respond to the questions stated in the Consultation paper. In addition, a Quantitative Impact Study (QIS) will also be organized by the EBA. The final version of the Technical Standards should be finalized in Q2 2014.

The consultation paper can be found here.

Consultation Paper's key principles

The additional value adjustment (AVA), defined as the difference between the prudent valuation and the value recorded in accounting, will be deducted from Common Equity Tier 1. The prudent valuation requirements apply to all positions recorded at fair value on the balance sheet including all positions whether they are held in the trading book and/or in the banking book (classified as AFS).

A simplified approach for smaller institutions

Below a certain threshold, based on the size of the positions recorded at fair value (the sum of the absolute value of on- and off-balance-sheet fair valued assets and liabilities is less than 15bn EUR), institutions may apply a "simplified approach" which consists of the sum of:

- 25% of the net unrealized profit on financial instruments held at fair value; and
- 0.1% of the sum of the absolute value of on- and off-balance-sheet fair valued assets and liabilities which are not demonstrated to contain matching, offsetting assets and liabilities.

This threshold needs to be computed on both solo and consolidated level basis. If this condition is not fulfilled for two consecutive quarters, institutions must inform the relevant authority and determine a plan for the implementation of the core approach within the following two quarters.

A core approach for larger institutions

The core approach consists of calculating a series of adjustments on the fair value of positions based on a specified target confidence level (90%). The EBA stated that, although it is not possible for all positions to achieve a statistically predefined confidence level, the determination of a quantile seems preferable to ensure the closest possible harmonized interpretation of the concept of "Prudent Value".

The CP specifies that institutions shall use for their calculations of value adjustments, the same market data they use in their Independent Price Verification (IPV) process.

The market data used for the core approach include a full range of available data sources such as:

1) Exchange prices in a liquid market;
2) Trades in the exact same or very similar instrument;
3) Tradable quotes from brokers and other market participants;
4) Consensus service data;
5) Indicative broker quotes; and
6) Counterparty collateral valuations.

In case the calculation of AVA under the core approach is not feasible, the AVA amount is set by default, corresponding to the sum of:

a) 100% of unrealized gains on the related financial instruments; and
b) 10% of the notional value in the case of derivatives or 25% of the market value reduced by the amount determined in a) in case of non-derivatives.

Documentation, systems and controls

Institutions should ensure that there is appropriate documentation, systems and controls in place to enable the relevant authority to assess whether the requirements of the RTS relating to prudent valuation are properly implemented. Internal reporting requirements are also defined, especially towards senior management.
The process of calculating the prudential value (AVA) should be controlled and monitored by an independent control unit and should be subject to an internal audit on a regular basis. Finally, a specific process must be put in place to monitor the quality of data sources used to calculate the AVA in number 1-3 explained below (uncertainty about market prices, bid-offer spread and uncertainty about CVA accounting).

Core approach for the determination of AVAs

The consultation paper specifies how the 9 additional value adjustments shall be calculated under the core approach:

1) Market price uncertainty: the available range of values for a valuation parameter is assessed in order to calculate a conservative market value with a 90% confidence level (90% confident that the entity can exit at that price or better). This additional value adjustment may be zero if the institution has firm evidence that the instrument is highly liquid and that the uncertainty is not material.
2) Range of bid-offer spreads: if the market price uncertainty is calculated from executable quotes, this adjustment may be zero. Otherwise, the adjustment is half of the 90% percentile of the bid-offer range (the bid-offer spread at which the entity is 90% confident it can exit at that price or better).
3) CVA accounting uncertainty: this AVA is determined as the sum of an AVA for market price uncertainty related to the expected losses due to counterparty credit risk and an AVA for model risk related the CVA model used. Regarding methodology, reference is made to point 1 and 4.
4) Model risk: for instruments valued using a valuation model, alternative appropriate modelling or calibration approaches applied by other market participants or expert based approaches can be used to estimate the model risk AVA with a confidence interval of 90% (90% confident that the entity can exit at that price or better).
5) Concentrated positions: this is to estimate an exit period for relatively large positions taking into account the liquidity in the relevant market. If this prudent exit period exceeds the time horizon for the market risk

measure used to calculate own funds requirements, then an AVA shall be estimated taking into account the volatility of the valuation input, the volatility of the bid-offer spread and the impact of the hypothetical exit strategy on market prices.

6) Investing and funding costs: for strongly-collateralized derivatives, an adjustment is calculated by assessing the uncertainty on its valuation framework; for partially or not collateralized derivatives an adjustment is calculated by including funding costs and benefits of financing over the contractual lifetime of the instrument (similar to a FVA, Funding Value Adjustment).
7) Administrative costs: they reflect the administrative costs and future hedging costs discounted at the risk free rate over the expected life of the valuation exposure.
8) Risk of early termination: the adjustment measures potential losses related to the non-contractual early terminations of client transactions, calculated based on the frequency of trades that were historically terminated and the related costs incurred.
9) Operational risk: the institutions applying the AMA (Advance Measurement Approach) for operational risk may report a zero adjustment if the calculated measure takes into account the operational risk related to the valuation process. For other institutions, the AVA is equal to 10% of the sum of AVA No. 1 (uncertainty about the market price) and No. 2 (bid-offer spread).

After determination of the above adjustments, the EBA suggests an additive aggregation, without the benefit of diversification. One exception concerns AVA No. 1 (uncertainty about the market price) and No. 2 (bid-offer spread) when they involve several valuation parameters. In that case, only 50% of the sum of the calculated AVA is retained.

Conclusions

Although the general philosophy of this consultation paper is close to the Discussion Paper published in November 2012, the second publication of the EBA provides more details about the methodology for calculating the AVAs by categories, the aggregation approach, the documentation and controls requirements.

The EBA also introduces a threshold below which a “simplified approach” can be used to calculate AVAs. Once this threshold has been exceeded, the “core approach” shall be introduced.

As the introduction of the confidence interval (95%) when estimating the AVAs was negatively received by the financial institutions, EBA has decided to lower the confidence interval to 90% and to allow a greater part to "expert judgment".

However, EBA still maintains the same principle, motivated by the desire to improve the homogeneity of practices.

Finally, the link between IPV process (Independent Price Verification) and the estimation of AVAs has been clarified:

- Firstly, institutions must use the same market data in both exercises; and,
- Secondly, a formal and well-documented IPV process is required and must be included in the control process implemented by the institution.

It seems that institutions that have developed robust and automated IPV processes (analysing tool and associated report) can probably respond faster to requirement requests related to Prudent Valuation.

Contacts

Arno De Groote
Partner, Financial Services Industry
+32 475 90 44 11 | **adegroote@deloitte.com**

Nicolas Castelein
Director, Financial Services Industry
+32 498 13 57 95 | **ncastelein@deloitte.com**

Roeland Baeten

Senior Manager, Financial Services Industry

+32 497 23 38 39 | **rbaeten@deloitte.com**

Julie Noel

Manager, Financial Services Industry

+32 475 90 02 46 | **junoel@deloitte.com**

Berkenlaan 8b,
1831 Diegem
Belgium