

Subject: EBA/DP/2012/13 - Prudent Valuation

The European Banking Authority's (EBA) focus on prudent valuation is important to the European banking market and to this end we have been engaging with our clients on the topic. We have discussed with them the practical and more theoretical interpretation issues both from the proposals in the EBA's discussion paper but also, where relevant, from the existing UK Financial Services Authority (FSA) requirements on Prudent Valuation. However, our own internal deliberation and our dialogue with our clients have identified a number of areas which the EBA might wish to take into consideration as it seeks to finalise its guidance on Prudent Valuation. The purpose of this letter is to outline these points of focus arising from these discussions.

Overall comments

We agree that a greater focus on valuation uncertainty (being the main constituent of Prudent Valuation) is important and that more insightful information on this will aid the effectiveness of both regulation and firms' internal decision making.

However, we also consider it important that a Prudent Valuation framework is implemented in a fashion that:

- adds value both to regulators and management;
- promotes consistency in methodology and application but also recognises the inherent uncertainties and therefore valid variability between firms for the setting of a Prudent Valuation methodology;
- takes into consideration the potential impact on accounting fair value; and,
- which acts as a tool to improve valuation processes by recognising the appropriate balance between operational cost and added value through a proportionate consideration of market data limitations.

As such we recommend that a proportionality threshold (both for firms and for specific portfolios) is applied and that firms are able to tailor their implementation within the framework outlined but which is then actively supervised (or open to external review) to ensure appropriate consistency.

Implications for Accounting Fair Value

We agree that price uncertainty exists in many markets and that having a framework designed to capture this uncertainty is beneficial. It is also clear that there are some areas of valuation, particularly the use of block discounts to reflect concentration risk, that are prohibited by accounting standards and therefore it is appropriate that this is captured by the Prudent Valuation framework.

However, consideration should be given as to how the Prudent Valuation framework will interact with accounting fair value. There is a clear overlap with some existing disclosure requirements, for example the IFRS 7 requirement to show the impact of reasonably possible alternative assumptions. The EBA initiative may help increase the level of consistency of the basis of these disclosures.

The recognition of valuation uncertainty, a key part of the Prudent Valuation proposal, remains a fundamental part of accounting fair value as it can be consideration in determining an exit price. As such firms will already incorporate valuation uncertainty into their accounting value for areas such as model risk. These natural offsets should be recognised within a firm's Prudent Valuation calculation.



Going forward it is not clear how the two frameworks will interact - for example, if a model uncertainty AVA is calculated should that also be considered for the accounting fair value as well? Will the creation of the investing and funding cost AVA lead to the booking of a Funding Valuation Adjustment for accounting fair value? It is conceivable that Prudent Valuation adjustments will themselves become part of accounting fair value as exit prices will be adjusted to reflect the cost of uncertainty arising from the additional capital required to be held against it. Therefore it is important the potential impact on accounting fair value is considered as part of the EBA's process of concluding upon the Prudent Valuation framework.

Proposed methodology and quality of data

One of the current challenges under the existing FSA Prudent Valuation framework is a lack of consistency between firms as to how they calculate and calibrate valuation uncertainty. That there is such inconsistency is not surprising given the nature of uncertainty and therefore it is appropriate that the EBA tries to mitigate this by being more prescriptive in its proposed Prudent Valuation framework. However, this should be balanced with an appreciation of the practicality of implementing a much more prescriptive methodology and process.

This is particularly relevant for illiquid exposures for which there will be limited data available but for which, proportionally at least, uncertainty will be greater than more liquid exposures. As such it will be difficult to apply a 95% confidence level or produce backtesting if the data to support it is not available. There is also the potential risk that in the search for more data, flawed or misleading data currently unutilised in the IPV process may be introduced in to the Prudent Valuation process. It will therefore become even more important for firms to critically assess the pricing data which they receive and generate. It will also be important that in assessing the implementation and production of the Prudent Valuation framework the EBA recognises the inherent data restrictions. This may include the acceptance of a lower confidence level or a less sophisticated method when faced with limited data.

Operational AVAs and offsets

There is a sub-set of AVAs which cover operational factors as compared to those covering valuation uncertainty. These AVAs, specifically on operational risks and balance sheet substantiation, should be covered by the existing operational risk charge and therefore their inclusion in the Prudent Valuation framework could create a double count. It is also unclear how any such AVA should be calculated due to their nature, making it difficult to provide a provable "prudent" assessment on them. We would therefore recommend that they are removed from the Prudent Valuation framework and proposed changes covered directly in the operational risk charge. This would allow the Prudent Valuation framework to more consistently focus on valuation uncertainty.

We would also recommend that other capital charge offsets are permitted - for example, the CVA VaR charge and the unearned credit spread AVA. This may not eliminate the need for certain AVAs to be taken or at least calculated. However, the use of appropriate offsets will allow firms to focus their assessment on those areas which will generate the more significant elements of their Prudent Valuation calculation. In addition by doing so on both a gross and net basis (ie before and after offsets), it will produce a cleaner and more supportable audit trail. This would also apply to where appropriate accounting fair value offsets should also be taken.

Aggregation of AVAs

The diversification benefit is a complex but necessary element of the Prudent Valuation framework. We recognise that the calculation of the diversification benefit has the potential to be subjective due to its nature. However, excluding the diversification benefit would overstate the overall Prudent Valuation



calculation as it would ignore a natural portfolio dynamic. It would also increase the risk of firms attempting to compensate within the gross AVA calculation if diversification is not allowed.

We also consider that a bespoke calculation created per firm and approved by their respective regulator is the more appropriate approach. The complexity of any calculation and the potentially individual nature of different firms' portfolios supports a more bespoke rather than uniform approach. This bespoke approach should also allow firm's to include AVAs they consider relevant depending on how that AVA is calculated. That could, for example, result in the inclusion of the investing and funding cost AVA in the diversification calculation.

Testing approach, documentation, systems and controls requirements

We agree with the EBA that a suitable testing approach, supported by appropriate documentation, systems and controls is essential in order to provide sufficient rigour and assurance around the process. In turn this would allow easier benchmarking and therefore help generate a greater degree of consistency. However, the same data restrictions referred to above, though, will also apply in testing and the corresponding process requirements. As such expectations about the level of testing, for example, should be set at realistic though still meaningful levels.

It is clear that firms will need incremental processes to meet their new requirements for Prudent Valuation. However, we consider that these new processes should look to leverage off and at least be aligned with existing processes such as Independent Price Verification. This is because we consider that this would one, help drive improvements in the IPV process; two, reduce data quality issues and therefore improve output; and three, help produce MI in a format that is aligned to the business and therefore inform management behaviour.

If you have any questions or would like to discuss this subject further we would be delighted to help. We wish you every success with the rest of the consultation process and we look forward to reading other responses and your subsequent analysis.

Yours faithfully



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