EBA Regulatory Technical Standards on prudent valuation: a framework for success

Banking & Capital Markets

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The European Banking Authority (EBA) first published its consultation paper on draft Regulatory Technical Standards (RTS) on prudent valuation in July 2013. Many banks still have work to do to ensure they meet all the EBA requirements and are ready to submit accurate returns by Q3 2015.

EBA requirements necessitate control departments to change

- Capital Requirements Regulation (CRR) requires financial institutions to apply prudent valuation to all fair value positions. The difference between the prudent value and the fair value, called additional valuation adjustment (AVA), is directly deducted from the Common Equity Tier 1 (CET1) capital.
- EBA RTS on prudent valuation defined new requirements for AVA calculations as well as the valuation and control framework supporting calculations.
- Organizations are adopting varied approaches to addressing EBA RTS as the guidance provides a framework and not a methodology.

- Many institutions have not yet fully implemented a prudent valuation framework. Typical weaknesses observed across the market include the following:
  - Policies and application guidelines outlining quantification methods, valuation hierarchies and calculation premises have not yet been fully defined.
  - Documentation of expert approaches applied is not complete.
  - Governance frameworks supporting prudent valuation have not been defined or integrated into existing governance mechanisms.
  - Periodic management reporting of AVA movements to provide understanding of exposure to valuation uncertainty has not been designed and implemented.
► Product inventories are not complete and have not been validated with front office or all relevant control departments.
► Internal audit has not been engaged on a group-wide basis in relation to proposed governance and policy for AVA calculation processes.
► Model review processes are not always adequate and thresholds for determining when valuation models are no longer sufficiently robust are not clearly defined.
► New product approval and new deal review policy and processes have not been revised in light of EBA requirements.

► In January 2015, the EBA published an amended version of the RTS on prudent valuation. The EBA RTS are currently pending approval from the European Commission and it is anticipated this will happen in Q3 2015. Thereafter, banks will be legally required to submit Prudent Valuation Returns in accordance with the new requirements.

Business benefits
► Banks that successfully deliver on the EBA RTS on prudent valuation can expect to benefit.
► Improved regulator confidence.
► Increased profitability will be created by improved capital management and incentivization.
► Improved valuation controls will result in an enhanced control environment.
Regulators want to see that institutions have put a demonstrable framework in place to support new prudent valuation requirements and enable effective decision-making.

1. Governance framework
   - Prudent valuation governance should be integrated into the existing valuation governance framework, which should be clearly defined at the firm-wide level and linked to capital management governance.
   - There should be clarity in roles and responsibilities across divisions and functions, in particular for monitoring, supervision and oversight activities.
   - Constructive challenge to AVA calculation approaches and expert judgment methodologies applied must be embedded within governance mechanisms.

2. Policy and application guidelines
   - Policy on prudent valuation should provide unambiguous interpretation of EBA RTS requirements and be aligned to existing fair value policy.
   - Application guidelines should specify product requirements and support accurate execution of policy.
   - Training sessions should be held to ensure impacted staff understand the new prudent valuation policy and how it is to be applied in practice.

Organizations need to consider their overarching valuation governance framework ... ...

as well as the effectiveness of specific valuation controls

- Valuation uncertainty appetite statement
- Valuation and prudent valuation committee
- Valuation policies and supporting policies
- Oversight
- Escalation and issue management
- Performance measurement (including management reporting & KPIs)
- Front-office valuation controls
- Internal audit

- Front-office valuation policy, controls and cross-functional management reporting
- IPV, model & Product control policies, controls and management reporting supporting the valuation framework
- Definition and implementation of new controls required to support prudent valuation and AVA calculations
EBA requirements combined with organizational complexity demand that careful consideration is given to the operating model required to support prudent valuation.

3. Valuation controls
   - The EBA RTS make some broad and specific requirements in relation to systems and controls. In particular, they prescribe that institutions must have effective controls related to the governance of all fair valued positions.
   - Institutions should reassess existing fair value controls, ensure they are able to demonstrate compliance, and develop remediation plans to address gaps within appropriate time frames.
   - Following the development of prudent policy and application guidelines, institutions should design and implement additional controls required to support prudent valuation. Control standards should clearly describe control requirements.
   - Furthermore, institutions need to implement specific controls defined within the EBA RTS. These include a validated firm-wide product inventory, mapping valuation positions to product definitions and valuation methodologies.

4. Operating model definition and implementation
   - Institutions should perform an assessment to understand the changes required to the operating model arising from EBA prudent valuation requirements. The following key areas should be considered:
     - Design of new processes, handoffs and reporting outputs
     - Revisions required to existing policies and processes to support prudent valuation
     - Identification and implementation of new market data sources, as well as improvement initiatives to enhance existing data
     - IT solutions to automate identification, measurement methodologies and AVA calculations
   - Resource and skills requirements to support business as usual (BAU) prudent valuation
   - Performance measurement framework to assess prudent valuation processes and outputs
   - Cross-functional and divisional collaboration is required to ensure a cohesive and consistent firm-wide operating model is designed and implemented to support prudent valuation.
   - Strong central coordination is required to provide appropriate oversight and ensure complete and accurate EBA Prudent Valuation Returns are produced within reporting deadlines.

5. Management reporting
   - The EBA requires management reporting for senior management to provide an understanding of the level of valuation uncertainty to which the firm is exposed.
   - Management reporting should be designed to provide insight into AVA movements and rationale for drivers. It should also provide transparency where expert-based approaches have been applied, and highlight AVA calculation processes requiring management attention or instances where policy or regulatory requirements have not been met.
   - In addition, where appropriate, management reporting should link the fair value hierarchy, Level 3 disclosures and fair value reserves.
   - Management reporting should be used by senior management to incentivize the right behavior and drive the optimal use of capital. To help achieve this, consideration should be given to how uncertainty results for AVA categories such as operational risk could be apportioned to business lines.

6. Documentation
   - Institutions are required to document prudent valuation methodology, as well as methodology applied where an expert-based approach has been adopted.
   - A standardized approach should be developed for documentation, and organizations should invest time up front to ensure documentation meets EBA requirements. Additionally, consideration should be given to how organizations will maintain high-quality up-to-date documentation on an ongoing basis.

7. AVA optimization
   - Institutions should also consider how they can move beyond prudent valuation compliance toward optimization to manage the impact of capital deductions. Key areas to be explored include:
     - Refining current AVA calculation methodologies, tailoring approaches to specific exposures across categories
     - Increasing the number and quality of market data sources used to reduce reliance on proxies and application of expert-based judgment
     - Validating and enhancing the level of netting applied when calculating AVAs through implementation of a robust process to perform the 100-day netting test
     - Reviewing the potential availability of capital offsets that could be adopted to reduce the final AVA number
EY has extensive experience of prudent valuation and redesigning operating models to support regulatory change.

We are able to assemble global multidisciplinary teams that possess in-depth subject matter knowledge and are able to deliver a strategic response.

EY has strong links with regulators and industry participants, allowing us to provide perspective on both regulatory expectations and the response of market participants. Notably, we have recently undertaken an industry-wide survey on prudent valuation to understand approaches currently adopted across the market.

In particular, we can help you with:

Policy and application guidelines
- Interpreting the EBA RTS and developing prudent valuation policy and application guidelines

Documentation
- Gathering and challenging documentation to evidence that the policy and control framework have been appropriately executed and AVA calculations can be supported

Operating model definition, governance and reporting
- Defining the operating model required to deliver timely, accurate and complete EBA Prudent Valuation Returns
- Establishing an integrated governance framework for prudent valuation, appropriately designed to address risks and responsibilities

- Developing management reporting to ensure senior management have an appropriate understanding of exposure to valuation uncertainty, as well as to assist with incentivizing the right behavior

Control framework enhancement
- Assessing existing valuation controls and developing prioritized remediation plans to address control gaps
- Addressing specific EBA control requirements; for example, support developing and internally validating a product inventory
- Designing and implementing additional controls required to meet the control objectives of the prudent valuation policy and application guidelines; for example, controls required in relation to 100-day backtesting
For a confidential conversation on readiness, please contact a member of our team today.

We can bring together professionals from across our services, ranging from extended assurance, financial accounting advisory and performance improvement.

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