

AIFIRM - Commissione Rischi di Mercato

Prudent Valuation: conclusione lavori

XI Convention AIFIRM
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Summary

1. Prudent valuation

- Overview
- History
- Key regulatory concepts
- AVAs
- Scope of application
- EBA QIS
- Simplified vs core approaches
- Hot topics
- Focus Funding Valuation Adjustment (FVA)

2. Commissione rischi di mercato

- Position paper
- Stato avanzamento lavori

3. Conclusions

4. References

1: Prudent Valuation

Overview

Prudent Land

Prudent measure
Price distribution
90% exit price
Capital



Q-Land

Q-measure
Pricing:
extrapolate the
present
Fair value
Profit and loss

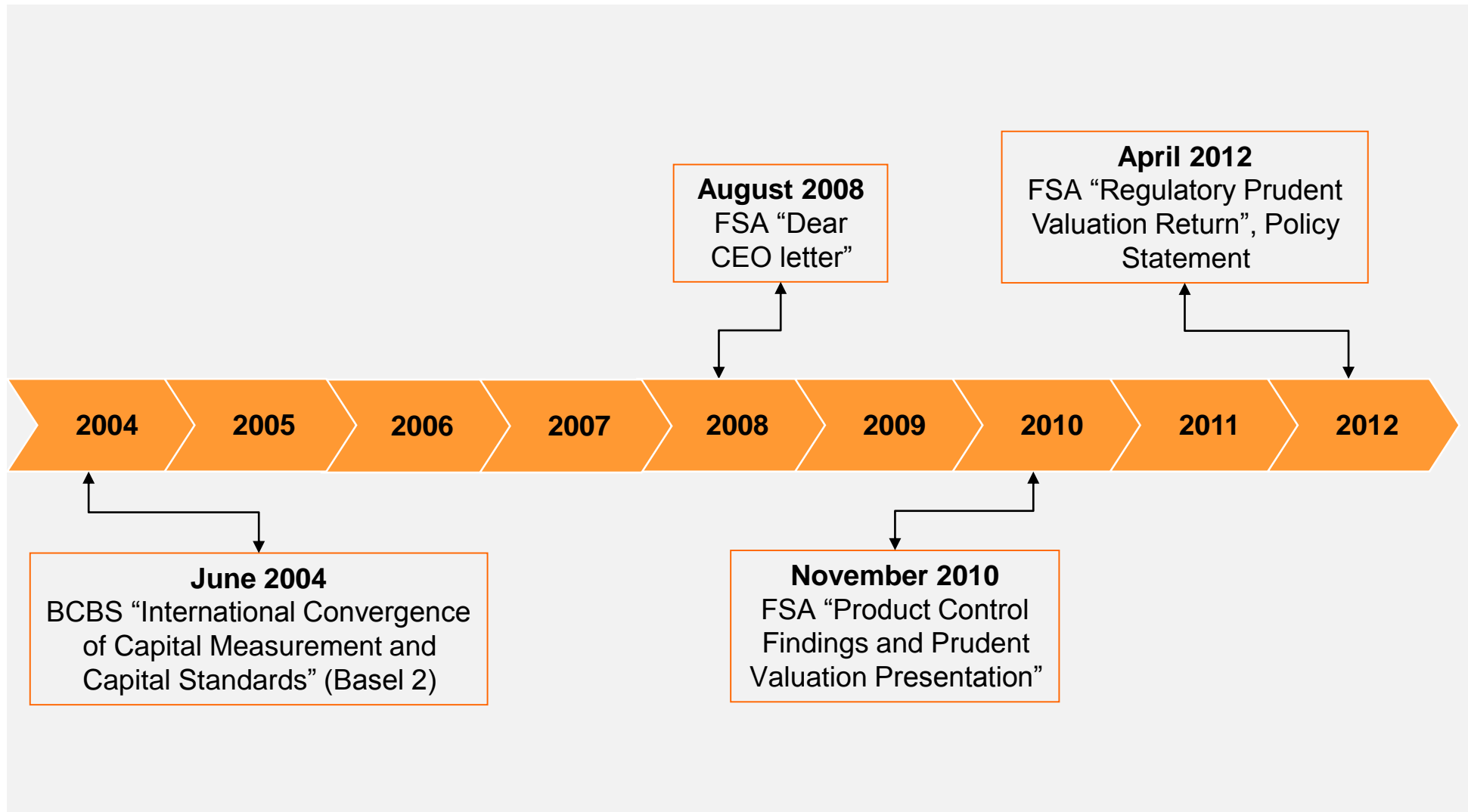
P-Land

P-measure
Risk: model the
future
Risk measures
Capital

See A. Meucci, “*P versus Q: Differences and Commonalities between the Two Areas of Quantitative Finance*”, GARP Risk Professional, pp. 47-50, February 2011, <http://ssrn.com/abstract=1717163>

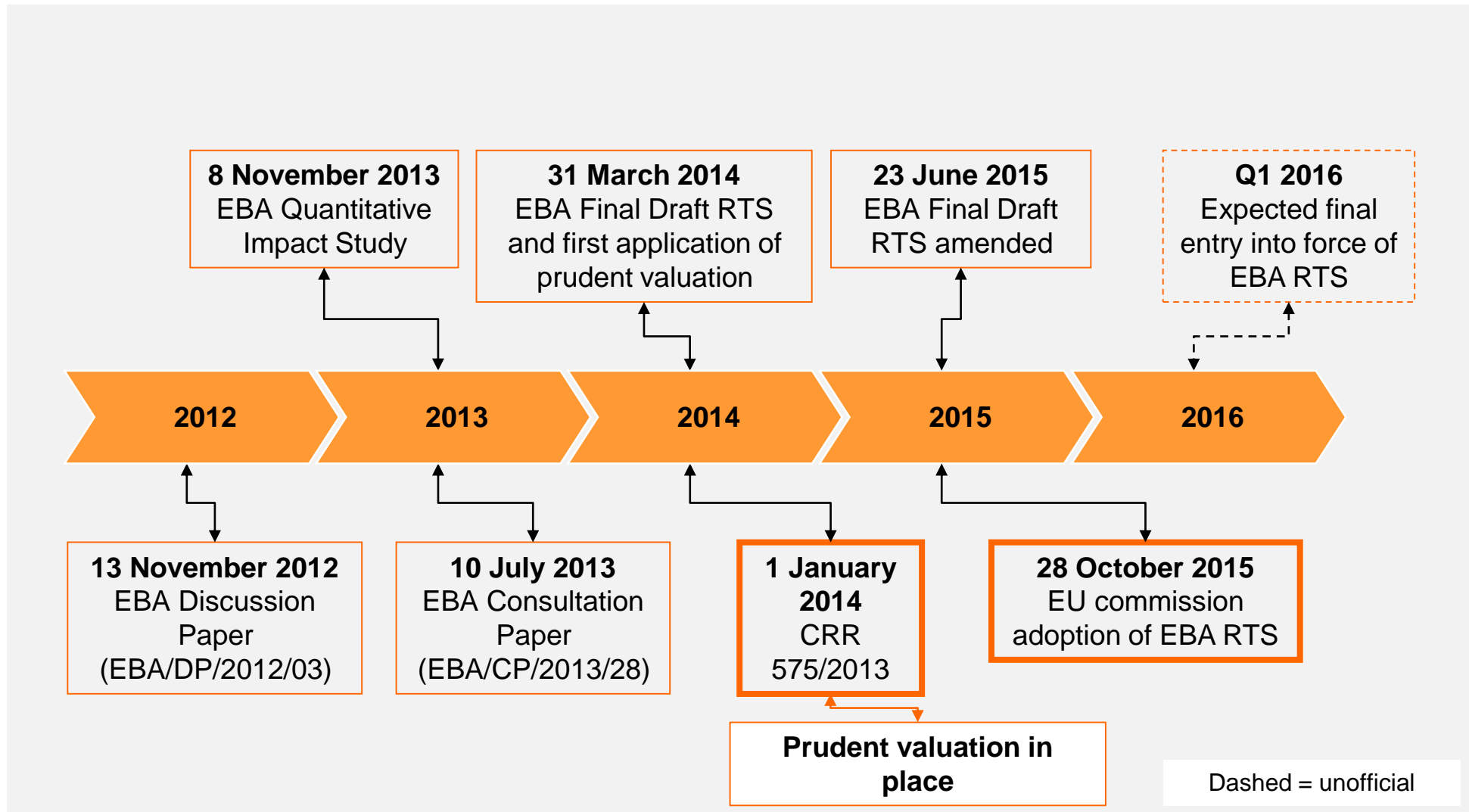
1: Prudent Valuation

History [1/2]



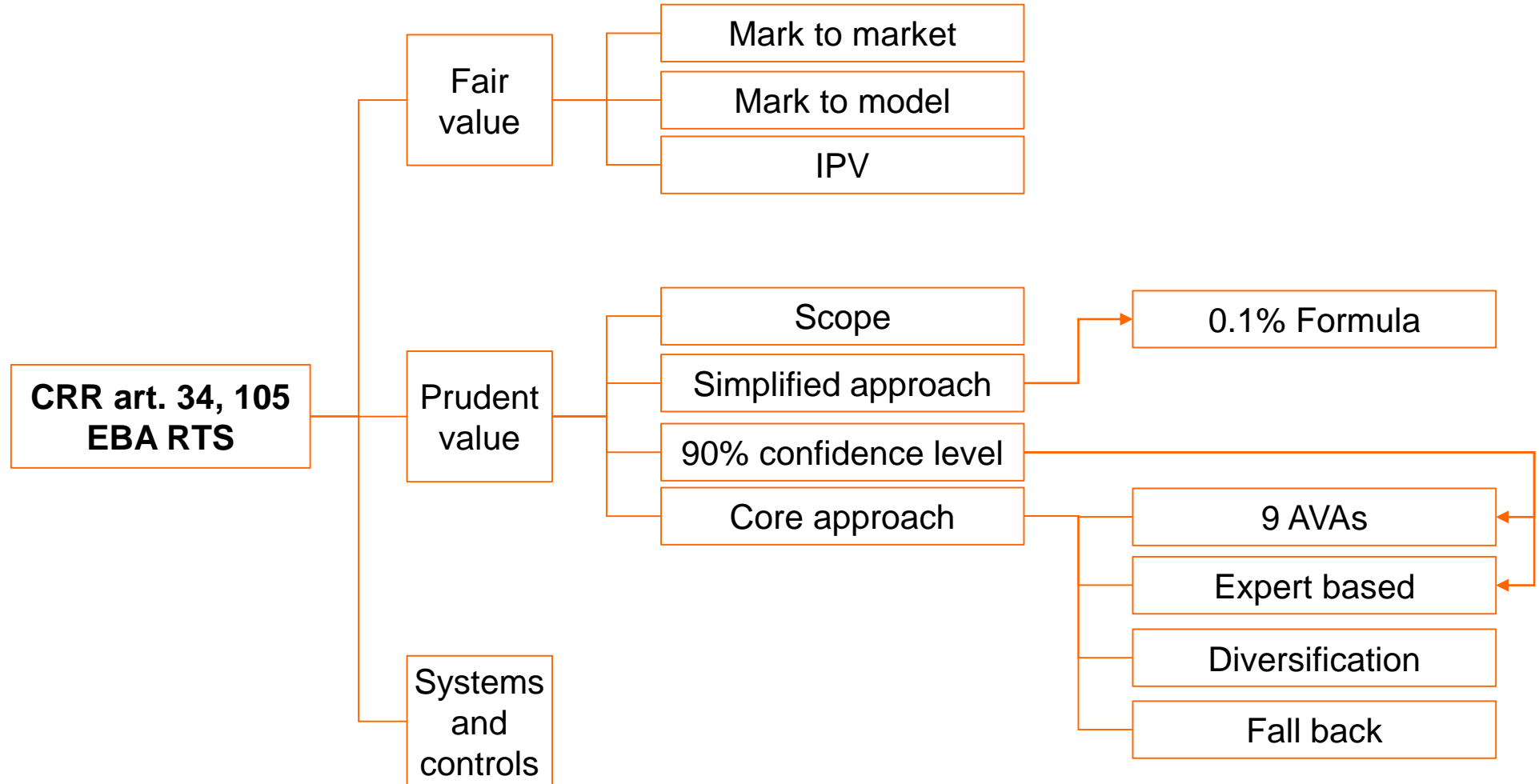
1: Prudent Valuation

History [2/2]



1: Prudent Valuation

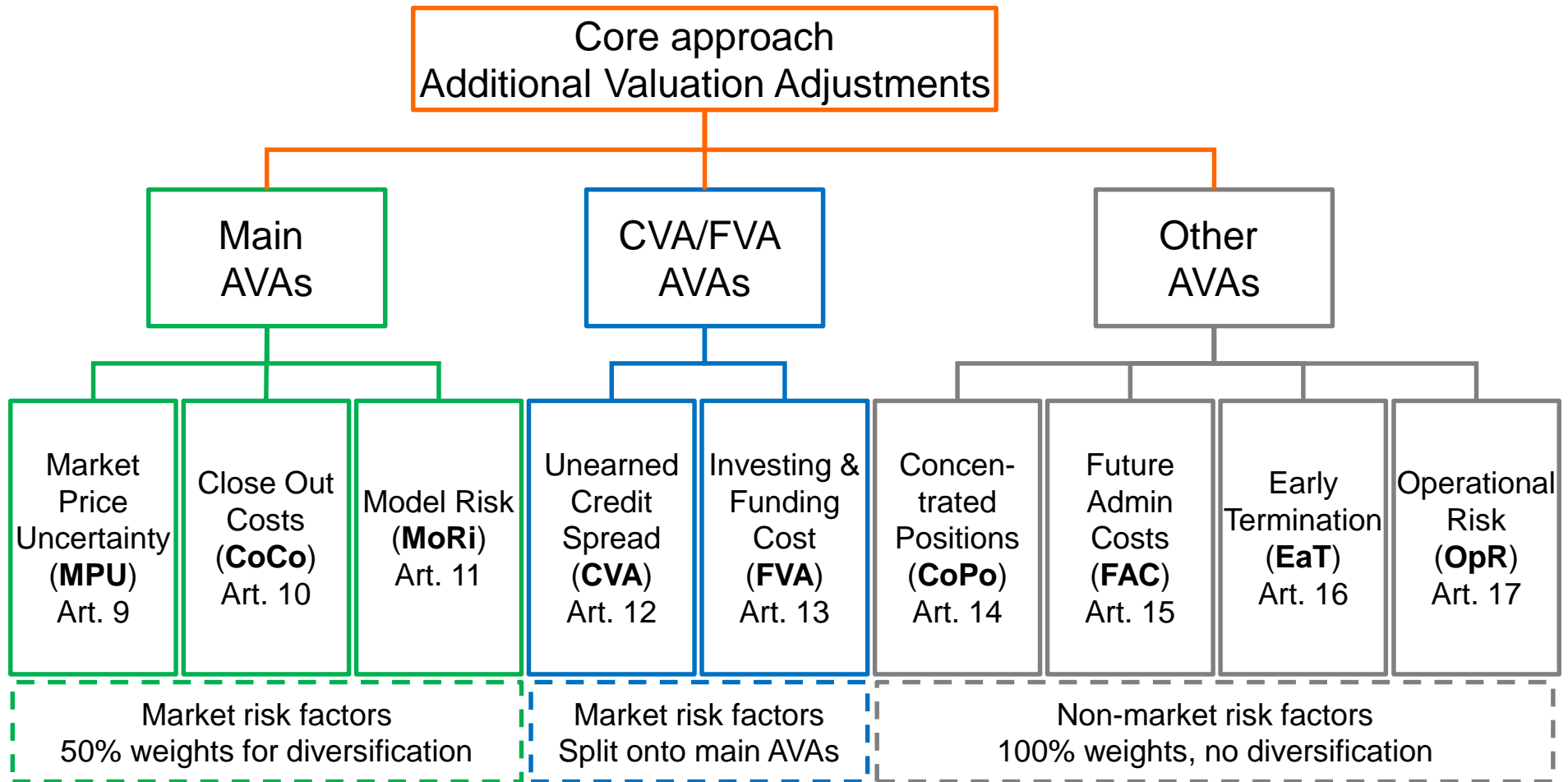
Key regulatory concepts



1: Prudent Valuation

AVAs [1/2]

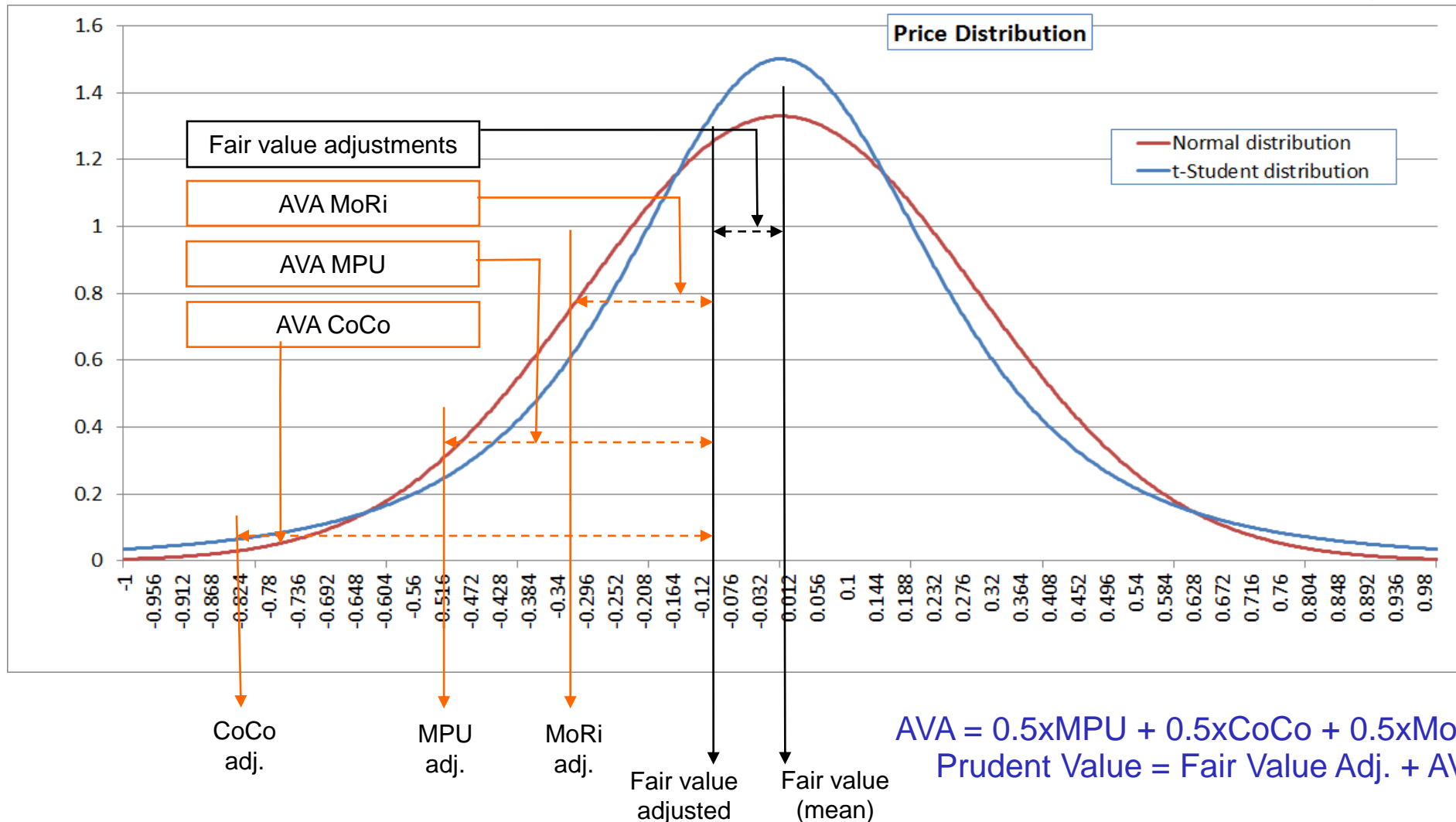
The AVA hierarchy



1: Prudent Valuation

AVAs [2/2]

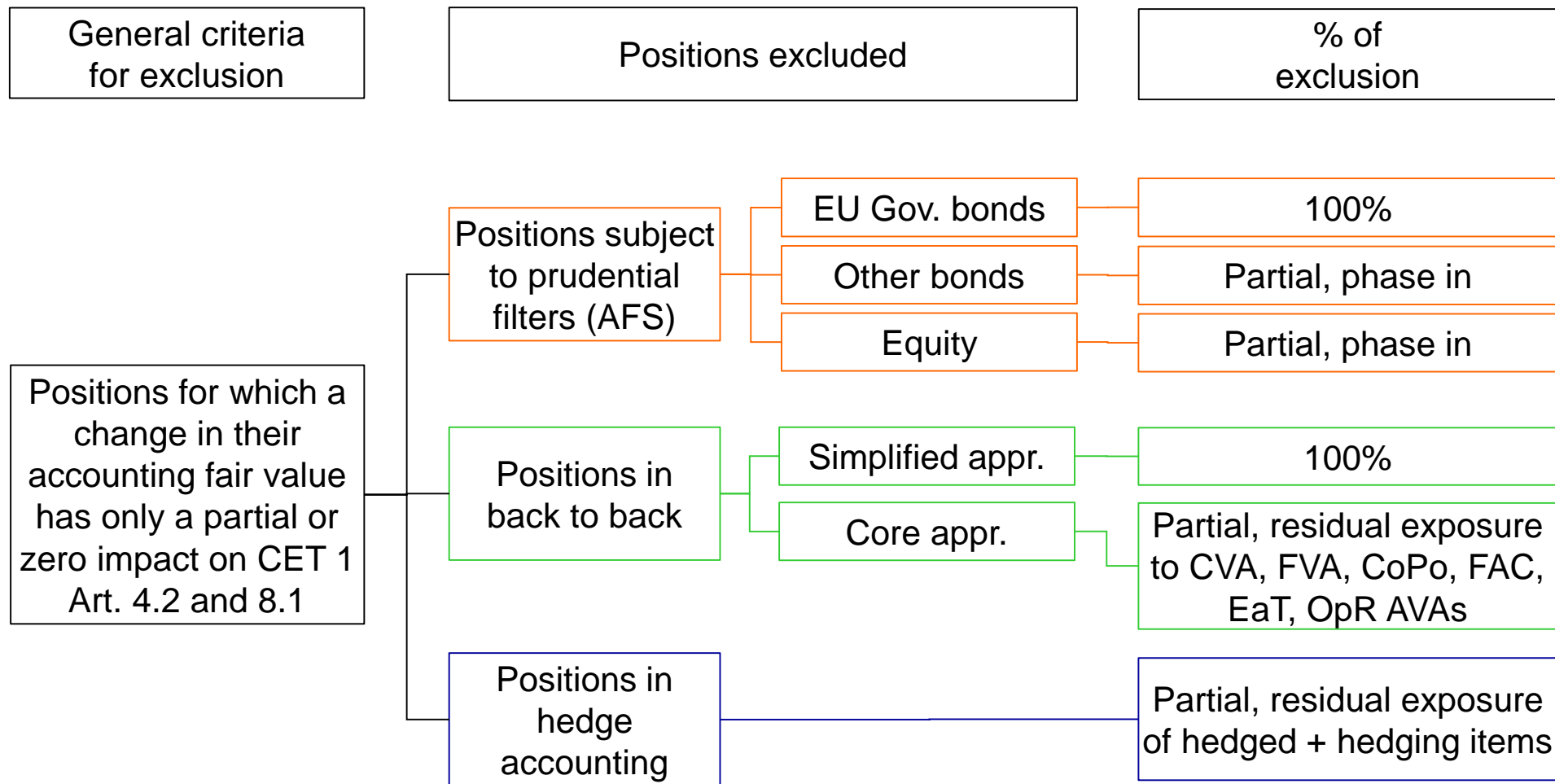
Relationships between AVA MoRi and AVA MPU, AVA CoC, fair value, fair value adj.



1: Prudent Valuation

Scope of application

EBA RTS Prudent Valuation scope: exclusions



1: Prudent valuation

EBA Quantitative Impact Exercise Nov. 2013

- The EBA conducted a QIS to estimate the total impact of the requirements of the RTS including 59 banks across 15 jurisdictions, with the following results.

	Number of Institutions
UK	16
France	4
Sweden	5
Austria	4
Belgium	2
Germany	2
Spain	2
Greece	4
Croatia	3
Italy	2
Norway	4
Lithuania	3
Latvia	1
Netherlands	4
Portugal	3
TOTAL	59

All amounts in €m	AVA €m	% of CET1	% of Fair Value Balance Sheet
Small	53	0.18%	0.10%
Medium	634	0.83%	0.10%
Large	12,743	1.57%	0.07%
Total	13,431	1.46%	0.07%



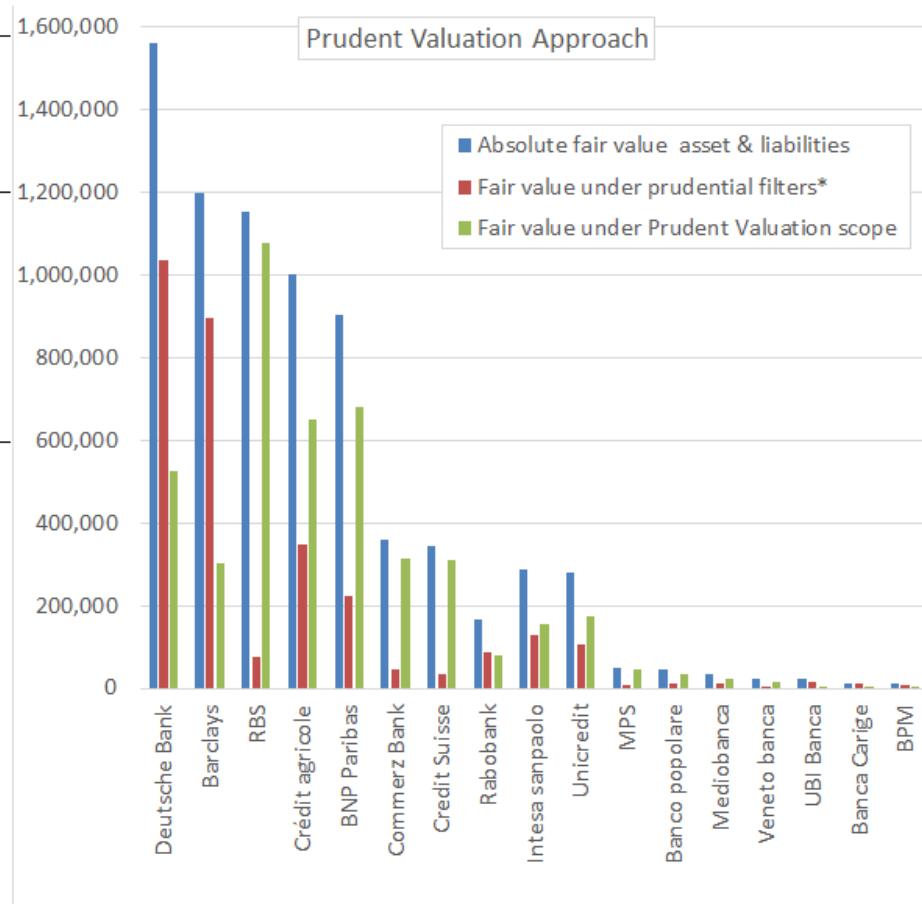
Average
227 €mln
per bank

- Small banks: < EUR 15 billion
- Medium banks: between EUR 15 bln and EUR 100 bln
- Large banks: > EUR 100 billion

1: Prudent Valuation

Simplified vs core approaches

Region	Bank	Prudent valuation approach			AVA approach
		Absolute fair value asset & liabilities	Fair value under prudential filters*	Fair value under Prudent Valuation scope	
Major banks in EU	Deutsche Bank	1,562,214	1,036,346	525,868	Core Approach
	Barclays	1,200,240	895,793	304,446	Core Approach
	RBS	1,153,457	75,659	1,077,798	Core Approach
	Crédit agricole	1,000,282	349,592	650,690	Core Approach
	BNP Paribas	905,472	224,128	681,344	Core Approach
	Commerz Bank	360,900	45,900	315,000	Core Approach
	Credit Suisse	345,859	35,913	309,946	Core Approach
	Rabobank	165,723	86,255	79,468	Core Approach
Major banks in Italy	Intesa sanpaolo	287,095	130,426	156,669	Core Approach
	Unicredit	279,518	104,205	175,313	Core Approach
	MPS	51,054	6,091	44,963	Core Approach
	Banco popolare	46,959	12,389	34,570	Core Approach
	Mediobanca	32,484	10,357	22,127	Core Approach
	Veneto banca	20,891	5,187	15,704	Core Approach
	UBI Banca	20,887	16,227	4,661	Simplified Approach
	Banca Carige	12,831	11,128	1,703	Simplified Approach
	BPM	11,725	8,616	3,109	Simplified Approach
	Popolare dell'Emilia	11,090	6,672	4,418	Simplified Approach
	Credito emiliano	10,765	8,329	2,437	Simplified Approach
	Popolare di vicenza	10,297	4,644	5,653	Simplified Approach
	Popolare di Sondrio	6,676	3,406	3,270	Simplified Approach
	Iccrea Holding	5,309	3,742	1,566	Simplified Approach
Credito valtellinese	4,137	4,045	93	Simplified Approach	



*Applying prudential filters in place for 2014 and considering positive AFS reserve.

Values in mln/€ at 31-12-2013. Source: public balance sheets releases.

FV under prudent valuation scope = FV asset & liabilities – FV under prudential filters

1: Prudent valuation

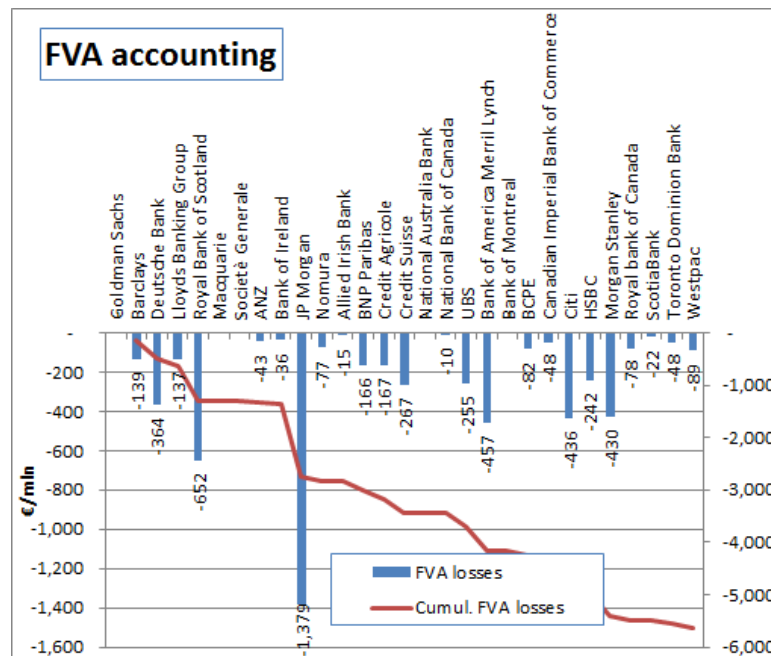
Hot topics

- The CRR is in place since 1st Jan. 2014, and EBA RTS are in the final phase of approval, so **prudent valuation is mandatory**.
- The **practical application** of the EBA RTS requires a lot of **expert judgment**, in particular to achieve the required **90% level of certainty** in the prudent value.
- **P&L variance test** for AVA market price uncertainty and close out costs is rather difficult and controversial.
- AVA Investing & Funding cost is **FVA**, so **banks still not accounting FVA in their balance sheets must account the full FVA in the prudent valuation**, with the benefit of the diversification factor 0.5. Banks already accounting FVA must calculate a prudent FVA, e.g. stressing the funding curve.
- New regulation and **lack of standard market practices** allows for widely different applications of the same rules across different institutions. It is reasonable to expect **follow ups from Regulators**.

1: Prudent valuation

Focus Funding Valuation Adjustment (FVA)

- Il tema del FVA è da tempo oggetto di dibattito all'interno della comunità finanziaria (cfr. ad es. ref. [1] - [11]). La presenza di diversi possibili approcci metodologici e l'assenza di uno standard di mercato universalmente accettato si è tradotta in **comportamenti e scelte molto differenti** da parte degli operatori del mercato.
- A partire dalla fine del 2011 molte banche hanno iniziato a riportare la voce **FVA a conto economico, come aggiustamento del fair value, registrando le corrispondenti perdite**, fra cui spicca quella da 1.5 mld USD di JP Morgan (ref. [8] - [10]).
- Altre istituzioni, invece, sulla base dei limiti evidenziati da questo approccio, non hanno riconosciuto a conto economico tali valori.



Risk.net
Financial Risk Management News and Analysis

The black art of FVA, part III: a \$4 billion mistake?

[/risk-magazine/feature/2402050/the-black-art-of-fva-part-iii-a-usd4-billion-mistake](http://risk-magazine/feature/2402050/the-black-art-of-fva-part-iii-a-usd4-billion-mistake)

02 Apr 2015, Lukas Becker, Nazneen Sherif, Risk magazine



A \$6.2 billion loss that 24 banks have collectively racked up since the end of 2012 may have been a mistake. **new thinking suggests** – it should never have been reported as a loss, and should have been smaller. Perhaps by as much as \$4 billion.

2: Commissione Rischi di Mercato

Position paper



Prudent Valuation Position Paper

Authors	AIFIRM Market Risk Committee
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INTRODUCTION (M. BIANCHETTI, R. TUBALDI)

Prudent valuation can be identified in the combined provisions of the EU Capital Regulation 575/2013 (L), articles 34 and 105, and of EBA Regulatory Technical Standard for L. CRU article 34 states the general rule of the game "Institutions shall apply prudential rules to all their assets measured at fair value when calculating the amount of their own or from Common Equity Tier 1 capital the amount of any additional value adjustments. It disciplines the additional valuation adjustments intended to achieve an appropriate EBA RTS (13) allows two approaches to prudent valuation. The simplified approach, financial institutions (with total absolute fair-valued assets and liabilities less than 15 billion) may use a very simple Additional Valuation Adjustment (AVA) of 0.1% of the total fair value. The core approach, for institutions above the 15 billion threshold, prescribes the calculation of AVAs, taking into account valuation uncertainty, as the success of valuation adjustments required to value with 90% level of confidence. Three AVAs for market price uncertainty, close-out netting, and double counting effects into account. Such a change in their fair value effects only partially the CET1, may be partially excluded from the calculation.

The paper aims to help both the financial industry and the regulators around the practical application of the prudent valuation regulation. On one side, financial institutions will be able to interpret and apply the rules in a variety of case studies. On the other side, regulators will be able to interpret and apply the rules in a variety of case studies. The paper also aims to help both the financial industry and the regulators around the practical application of the prudent valuation regulation. On one side, financial institutions will be able to interpret and apply the rules in a variety of case studies. On the other side, regulators will be able to interpret and apply the rules in a variety of case studies.

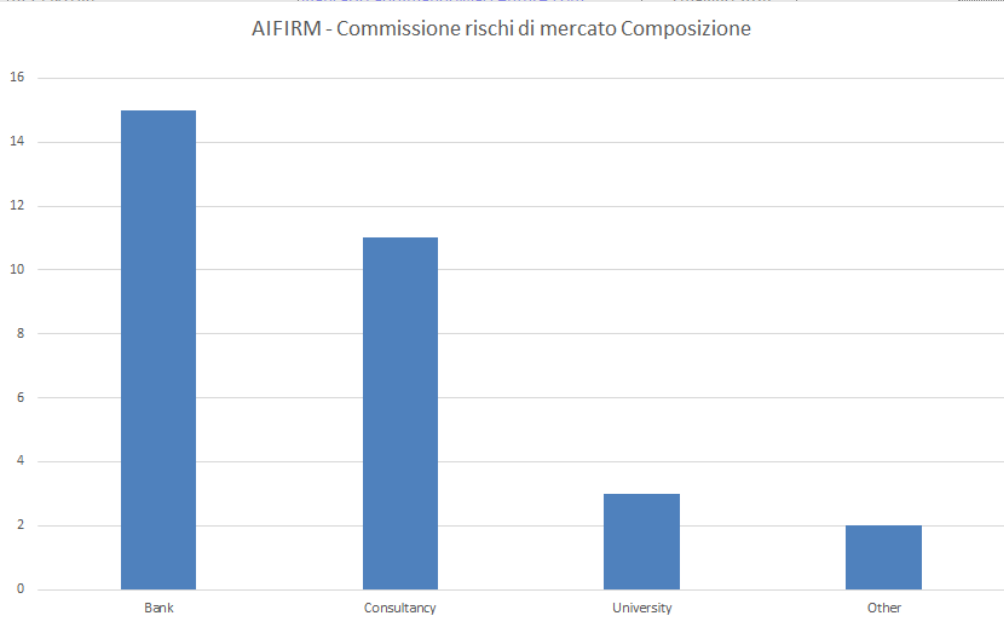
The paper is structured as follows. After the introduction in section 2, section 3 recovers the prudent valuation framework under the simplified approach, while section 4 recovers the prudent valuation framework under the core approach. Here we have elaborated a simplified approach to the AVA calculation under the core approach. Here we have elaborated a simplified approach to the AVA calculation under the core approach. Here we have elaborated a simplified approach to the AVA calculation under the core approach. Here we have elaborated a simplified approach to the AVA calculation under the core approach.

Il Position Paper contiene una serie di linee guida, regole e casi di studio che costituiscono, nel loro insieme, una base di partenza per la creazione di una **pratica di mercato** per la Prudent Valuation.

2: Commissione Rischi di Mercato

Stato avanzamento lavori

Commissione Rischi di Mercato - Prudent Valuation						Meetings					
#	Nome	Cognome	Organizzazione	E-mail	Data Iscrizione	Aggiornamento nov. 2015	7 febbraio 2014	14 marzo 2014	17 aprile 2014	26 maggio 2014	27 giugno 2014
1	Giancarlo	Addimando	ACCENTURE	giancarlo.addimando@accenture.com	8 maggio 2014						
2	Emanuele	Bianchi						X	X		
3	Maurizio	Busetti							X	X	
4	Armando	Capone									
5	Antonio	Castagna							X		
6	Alessandro	Castelluc					X	X	X		
7	Salvatore	Chianese									
8	Vito	Damato					X				
9	Carlo Enrico	De Berna							X		
10	Rodolfo	Dozio									
11	Floriana	Filippini									
12	Matteo	Forment							X	X	X
13	Carlo	Frazzei									
14	Matteo	Guastini									
15	Emilio	Maffi							X	X	X
16	Marco	Marrosu							X	X	X
17	Andrea	Monaco					X	X	X	X	X
18	Antonino	Morchio					X				
19	Sabrina	Mulinacc									
20	Edgardo	Palombi					X				
21	Marco	Pecetto					X	X			X
22	Antonello	Pignatar					X	X		X	X
23	Marco	Ricci					X				
24	Silvia	Romagn									
25	Giacomo	Scandolc									
26	Valerio	Sullo									
27	Marco	Tarenghi									
28	Marcello	Terranec									
29	Luigi	Terzi	BANCO POPOLARE	Luigi.Terzi@bancopopolare.it	20 gennaio 2014						
30	Vincenzo	Tetti	BCC TONIOLO	vincenzo.tetti@bcctoniolo.it	28 maggio 2014	OK					
31	Stefano	Tiraboschi	UBI BANCA	Stefano.Tiraboschi@ubibanca.it	3 febbraio 2014	OK	X			X	
							17	11	12	9	5



Termine dei lavori: dicembre 2015.

Questions & Answers

References

Regulations

- 1) Financial Services Authority, “Dear CEO Letter: Valuation and Product Control”, August 2008, <http://www.fsa.gov.uk/pubs/ceo/valuation.pdf>
- 2) Financial Services Authority, “Product Control Findings and Prudent Valuation Presentation”, November 2010, <http://www.fsa.gov.uk/pubs/other/pcffindings.pdf>
- 3) Financial Services Authority, “Regulatory Prudent Valuation Return”, Policy Statement 12/7, April 2012, <http://www.fsa.gov.uk/library/policy/policy/2012/12-07.shtml>
- 4) R. Brar, “A Regulatory Perspective on Prudent Valuation and Best Practice in Product Control”, in “Managing Illiquid Assets”, E. Takagawa editor, Risk Books, 2012.
- 5) Regulation EU N.575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation EU N.648/2012, 26 June 2013
- 6) EBA final draft Regulatory Technical Standards 31 March 2014 (EBA/RTS/2014/06)
- 7) International Accounting Standards Board, International Financial Reporting Standards 13 – Fair Value Measurement, 1° Jan. 2013, www.ifrs.org