Consultation Paper

CP11/30**

Financial Services Authority

Proposed Regulatory Prudent Valuation Return

FSA
Financial Services Authority

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Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 14 February 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_30_response.shtml.

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

ABS	Asset Backed Securities
AFS	Available for Sale
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
B/S	Balance Sheet
CAD2	Recognition of a VaR model for market risk capital purposes under Capital Adequacy Directive 2
CMBS	Commercial Mortgage-Backed Securities
CP	Consultation Paper
CVA	Credit Valuation Adjustment
DVA	Debit Valuation Adjustment
FO	Front Office
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
FX	Foreign Exchange
GENPRU	General Prudential sourcebook
IFRS	International Financial Reporting Standards
IT	Information Technology
PRDC	Power Reverse Dual Currency Notes
SUP	The Supervision manual
UK	United Kingdom
VaR	Value at Risk
VP	Vice President

1 Overview

1.1 Firms' accounting approaches to fair valuing assets vary substantially. The fair values in firms' annual reports do not provide substantial information on the degree of uncertainty in the valuations of financial instruments, such as derivatives.

1.2 The requirements of GENPRU 1.3 are for firms to use prudent valuation principles when valuing trading books (and other assets and liabilities held at fair value) and to disclose the difference between that prudent valuation and the fair valuation used in their financial statements. Based on review work following the August 2008 Dear CEO letter on Valuation and Product Control, firms were not disclosing these differences.

1.3 Consequently, starting with December 2010, relevant firms have been asked to produce quarterly reports that show these differences. These have been produced in a free format. However, to aid comparability between firms and over time, a consistent format for the return is required.

1.4 The major properties of this proposed return are to show the net and gross balance sheets for a defined list of asset classes, together with the potential downside and upside that could exist through the inherent uncertainty in the valuation process. The downside and upside will show the range of plausible values of the fair-value component of the B/S. In addition, to give a sense of the relative market risk of the positions, a VaR equivalent figure will also be disclosed for each asset class. Finally, a schedule will reconcile the net and gross B/S totals in this return to the net and gross values of all fair-value assets and liabilities in the financial statements.

1.5 For firms to be required to produce the proposed return, they should have on their last accounting reference date, gross B/S positions (i.e. the sum of the absolute value of each of the assets and liabilities) measured at fair value of greater than £3 billion. Any firm that has not previously produced any returns relating to prudent valuation and becomes required to produce the new return will have a three-month delay to produce the new return in which to ensure, with help from the FSA, that they appropriately address the prudent valuation requirements.

1.6 The consultation period for the Proposed Regulatory Prudent Valuation Return will last for two months and close on 14 February 2012.

2

Introduction

2.1 This paper sets out the Proposed Regulatory Prudent Valuation Return. This introduction should be read in conjunction with the Proposed Prudent Valuation Return (Example).

2.2 We intend that the proposed regulatory return is produced formally on a quarterly basis and the scope will include all fair-valued financial instruments.

2.3 The fair values of financial instruments are represented as point estimates for the purpose of the primary financial statements, whereas valuations are inherently judgemental. The choice of the point estimate used is influenced by a range of factors, including different market data points and/or methods of estimation. At the B/S date it is likely that there will be a plausible argument for a range of alternate estimates of the valuation of many financial instruments. While this range may reasonably be expected to be narrow in liquid and transparent markets, it may be broad in markets that are illiquid and lack transparency. The degree of market uncertainty in any one market may also be subject to variation over time as liquidity and other factors influencing valuation change.

2.4 Prudent valuation should assess, at a risk parameter/product level, the upper and lower ends of the range of plausible valuations at a defined confidence interval (e.g. 90th percentile), based on the judgement of management. This represents the uncertainty of the valuations on the B/S date, taking into account all available market data and based on market conditions at the B/S date, using valuation methods that could reasonably be deemed appropriate for each asset or class of assets. It requires a comprehensive view of the possible valuation range for the whole product and portfolio, including the effect of different valuation techniques and models.

2.5 The uncertainty assessments disclosed by asset class are the sum of the uncertainty measures calculated at a risk parameter/product level, before allowing for diversification/correlation benefits. As a result, the sum of the individual portfolio valuation uncertainty estimates will not necessarily reflect the aggregate-level valuation uncertainty the firm faces at the B/S date, as this does not allow for diversification benefits that will invariably exist. The diversification benefit represents the total benefit taken between portfolios when summing up for the regulatory prudent valuation return. There is currently no formal policy on the firm-wide aggregation of prudent valuation, so firms should determine an approach that will be reviewed by the FSA for reasonableness.

2.6 The 'Downside Valuation Uncertainty' in the return represents the amount by which the correct fair value might be lower than the 'Net B/S' figure supplied (that is, there is 90% confidence (or alternative confidence interval defined by the firm) that the actual value is greater than the 'Net B/S' less the 'Downside Valuation Uncertainty'). The 'Upside Valuation Uncertainty' similarly represents the amount by which the correct fair value might be higher than the 'Net B/S' figure supplied (that is, there is 90% confidence (or alternative confidence interval defined by the firm) that the actual value is lower than the 'Net B/S' plus the 'Upside Valuation Uncertainty').

2.7 The prudent valuation assessment is not constrained by accounting standards. For example, the uncertainty created by large concentrated positions should be reflected in the return, whereas concentration adjustments to Level 1 positions are not allowed by accounting standards.

2.8 The asset class granularity selected for the main part of the table is at a high level to avoid making the return unduly lengthy or confusing. Where particularly significant, any additional disclosures should occur through narrative tied to the 'Portfolios of Particular Interest'.

2.9 The split between 'Vanilla' and 'Exotic' positions is defined in the same way that products are categorised for the purposes of CAD2 recognition. The definition of a portfolio type is based on the regulatory classes for CAD2 recognition, split by asset class. 'Vanilla' positions are those positions referred to in BIPRU 7.10.21 G (1) and (2) and include products with linear pay-offs in the underlying risk factor (whether securities or derivatives) and products with European, American and Bermudan put and call options (including caps, floors and swaptions). All other fair-valued positions are included within the 'Exotic' portfolios and the broad classes of positions are set out in BIPRU 7.10.21 G (3) and (4). BIPRU 7.6.18 R provides further granularity on the definitions used in BIPRU 7.10.21 G.

2.10 The asset class delineation should correspond to the way in which the instruments are traded. Where a portfolio is disclosed as 'Exotic', it may also include vanilla hedges. Although a traded portfolio should normally not be split between 'Vanilla' and 'Exotic', where a portfolio includes significant positions of a type that would normally be reported in the alternative classification and are not present to hedge other products in the portfolio, these positions should be included within that other classification.

2.11 This asset class split will be informative to the supervisors in determining or confirming the nature of the trading of different firms in terms of the complexity of products that make up their B/S. A number of alternative classifications were considered, including using the IFRS Level 1, 2 and 3 classifications, but none of these approaches were felt to achieve as much useful information or consistency between firms in terms of classification.

2.12 The 1-day 99% VaR equivalent measure is used in the return to give a sense of the relative market risk in different firms and portfolios and to provide important context to the valuation uncertainty measures. However, as this includes risks not in VaR and VaR on non-trading book positions for which the fair-value option has been chosen, it will not be directly reconcilable to the market risk measures shown in financial statements or the regulatory VaR. In addition, given that the VaR equivalent measure is only indicative of size and that it is difficult to fairly distribute the diversification benefit gained from trading across different asset classes, it may be provided on an approximate basis.

2.13 The gross B/S figures give a sense of the overall size of the positions, as large uncertainty and/or large VaR figures may otherwise appear inconsistent if the net B/S is small. The gross and net B/S figures should be the raw figures extracted from the front office systems, after fair value adjustments and adjustments taken following independent price verification, rather than the B/S amounts that would be produced under IFRS. The gross B/S figures allow a completeness check by reconciling back to the financial statements, which is set out in a separate table.

2.14 The 'Excluded Portfolios' section allows firms to scope out those portfolios where they feel that there is an absence of market data or there is some other reason why it is not possible to ascertain the plausible range of valuations with any confidence. This can be due to a one-way market in which there is limited ability to exit positions that have been entered into, although there may be other reasons. This portion of the disclosure is important as it clearly identifies portfolios for which there is extreme valuation uncertainty. For these portfolios, it may not be possible or even meaningful to disclose VaR figures, but the gross and net B/S positions being disclosed impart important information. For these portfolios, the firm should propose a suitable regulatory prudent valuation adjustment that would not benefit from diversification and would be assessed for reasonableness by the FSA.

2.15 The 'Portfolios of Particular Interest' section allows specific disclosures for portfolios where there is a general market interest at any particular time (as there was with ABS and monoline positions recently) and also allows firms the discretion to identify the portfolios that they feel constitute significant proportions of the valuation uncertainty disclosed for the asset classes. The responsibility for ensuring the appropriate selection of portfolios and the appropriateness of the disclosure for each of these portfolios rests with senior management of the firms. These portfolios form a subset of the information previously provided by asset class, rather than being in addition to the uncertainty disclosed by asset class.

2.16 It was considered whether to mandate thresholds for reporting portfolios with more uncertainty, but issues were identified with the possible methods. Mandating that a certain percentage of the overall uncertainty (e.g. 60%) be explained within 'Portfolios of Particular Interest' could result in a lengthy table with many granular entries, while mandating portfolios whose uncertainty was more than a certain percentage (e.g. 5%) of the overall uncertainty could allow gaming of the portfolios to avoid triggering such a materiality condition.

2.17 We considered whether to include this disclosure as an additional note within the financial statements. For several reasons we have not pursued this route at this time and a regulatory return has been assessed as sufficient.

3 Proposed Prudent Valuation Return (Example)

Proposed Prudent Valuation Return (Example)

Prudent Valuation Return

			A	B	C	D	E	F	G
			Gross B/S		**Net B/S**	**1-Day 99% VaR Equivalent**	**Valuation Uncertainty**		**Explanation**
			Assets	**Liabilities**			**Downside**	**Upside**	
	Portfolios Subject to Valuation Uncertainty Assessment								
1	Equities - Exotic		100	88	12	20	10	14	
2	Equities - Vanilla		200	189	11	4	10	12	
3	Rates - Exotic		500	470	30	60	15	41	
4	Rates - Vanilla		200	99	101	3	12	2	
5	Credit - Exotic		233	231	2	25	1	3	
6	Credit - Vanilla		250	101	149	5	1	1	
7	Commodities - Exotic		200	199	1	15	1	1	
8	Commodities - Vanilla		165	147	18	5	1	5	
9	FX - Exotic		66	61	5	10	3	6	
10	FX - Vanilla		71	69	2	5	3	2	
11	Emerging Markets		51	65	-14	11	8	7	
12	Hybrid Instruments		1	1	0	0	1	1	
13	DVA / CVA		20	35	-15	0	6	5	
14	Other Portfolios	1	10	15	-5	1	2	3	Other (to be specified by each firm)
15	**Aggregate Portfolios Included**		**2067**	**1770**	**297**		**74**	**103**	
16	Less Diversification Benefit						22	23	
17	**Total**		**2067**	**1770**	**297**		**52**	**80**	
	Portfolios Excluded due to Extreme but Unquantifiable Uncertainty						**Proposed Capital Add-On**		
18	Portfolios Excluded	1	50	0	50		40		PRDC (for example)
		2	20	30	-10		20		Other (to be specified by each firm)
19	**Total Portfolios Excluded**		**70**	**30**	**40**		**60**		
20	**Total Value of Fair-Valued Portfolios**		**2137**	**1800**	**337**				
21	**Total Prudent Valuation Adjustment**						**112**		
22	Portfolios of Particular Interest	1	100	0	100	5	2	1	Monolines (for example)
		2	200	0	200	8	5	4	CMBS (for example)
		3	150	200	-50	6	5	4	Other (to be specified by each firm)

Reconciliation to Financial Statements

		Gross B/S Assets	Gross B/S Liabilities	Net B/S	Explanation
23	**Total Value of Fair-Valued Portfolios**	**2137**	**1800**	**337**	
24	Reconciliation to Financial Statements Amounts 1	-512	-512	0	Netting of internal trades (for example)
	2	-156	-156	0	Counterparty netting agreements (for example)
	3	-100	-120	20	Other (to be specified by each firm)
25	**Fair-Valued Portfolios per Financial Statements**	**1369**	**1012**	**357**	

Detailed Explanations

26	Definitions of Portfolio Type	This additional information may be required for Emerging Markets, Hybrid Instruments and Other Portfolios the firm has chosen to disclose in the main section of the table, e.g. Emerging Markets trading is defined by the firm as …
27	Portfolios Subject to Valuation Uncertainty Assessment	The firms may choose to provide some narrative such as outlining the most material methodologies that underlie a significant proportion of the calculation of valuation uncertainty.
28	Portfolios Excluded due to Extreme but Unquantifiable Uncertainty	Information provided should include, but not necessarily be limited to, a description of the products and why an effective assessment of valuation uncertainty can not be performed, details of the extent to which the portfolio is classified as AFS or Fair-Value option in the Banking Book, a historical description of how the portfolio was built up together with a description of what the current strategy is for the portfolio (e.g. whether there is still new trading or whether this is a legacy portfolio being sold off over time).
29	Portfolios of Particular Interest	Information provided should include, but not necessarily be limited to, a description of the products, why it is of particular interest, details of the extent to which the portfolio is classified as AFS or Fair Value option in the Banking Book, the basis of the methodology used to calculate the uncertainty and a historical description of how the portfolio was built up together with a description of what the current strategy is for the portfolio (e.g. whether there is still new trading or whether this is a legacy portfolio being sold off over time). It would be expected that DVA/CVA uncertainty would be disclosed here. DVA/CVA is likely to remain a material source of valuation uncertainty and applies to all positions; therefore there should be additional disclosure around the assessment of DVA/CVA uncertainty. This may include information relating to the type of exposures e.g. the extent of collateralisation.
30	Reporting Currency	GBP

Annex 1
Cost Benefit Analysis

GENPRU 1.3 requires firms to communicate a prudent valuation assessment to the FSA. Although there are currently regular returns to facilitate this, there is currently no formal regulatory return, and we are proposing to introduce a formal regulatory return for prudent valuation to provide a standard and consistent way for firms to report to the FSA.

Scope

Approximately 20 firms (12 large and 8 medium) will be required to complete this return. Large firms are classified as those with more than £100 billion of fair-value assets.

Costs

We expect a small impact on firms, as most of the data necessary to fill the proposed regulatory reports should already be available because of the existing prudent valuation assessment requirements.

The incremental costs will be driven by the following changes in data-reporting requirements:

- **Reporting data for B/S size and potential downside –** A certain amount of data will have to be reformatted to fit the new format. The changes should not be too significant as much of the data is already produced for independent price verification and prudent valuation reports.
- **VaR equivalent –** It would require a lot of effort to split accurately the VaR figures between asset classes but this is only required as an approximation to help with comparability. Also, the large majority of VaR figures should already be covered by management VaR.

- **Potential upside** – Potential downside is currently produced for prudent valuation reports, but not necessarily upside, so this could require extra work. However, the methods for producing the potential downsides should be mostly applicable to also producing a potential upside.
- **Net B/S reconciliation to financial statements** – Reconciling the values in the FO systems to financial statements should already be a process carried out by firms. Therefore, we do not expect the reconciliation to require significant additional resources.
- **Senior management review** – We would expect there to be more senior management review for the first return with less required for future returns. Also, senior management should already be reviewing the current prudent valuation returns so the incremental effect should not be too onerous. We estimate the one-off costs and ongoing costs of our proposals to be as shown in Table 1.

Table 1 reports the estimates of additional compliance costs arising from our proposals. We believe that the costs of producing the new regulatory report will be driven by additional staff time only and will not require material changes to IT systems.

Table 1 – Average cost by type of firm*

£000s	Large firms		Medium firms	
	One-off costs	Ongoing costs (Annual basis)	One-off costs	Ongoing costs (Annual basis)
Reporting data for B/S size and potential downside**	18	144	9	54
VaR equivalent**	14	54	7	27
Potential upside**	123	225	54	71
Net B/S reconciliation to financial statements**	14	54	8	23
Senior management review***	6	25	3	13
TOTAL	175	502	81	188

* These costs are based on estimates by the FSA product control specialists. They are upper-bound and do not take into account the fact that, in practice, some firms will have a smaller increase in their compliance costs.

** Based on the top yearly wage for a VP valuation analyst[1] plus 50% to adjust for overhead costs.

*** Based on the top yearly wage for a valuation director[1] plus 50% to adjust for overhead costs.

1 From the Morgan McKinley's London Financial Services 2011 Salary Survey (http://www.morganmckinley.com/sites/default/files/mm/ac/LondonFSSalarySurveyFINAL.pdf)

At the level of the industry, this would represent a total one-off cost of around £3 million and an annualised ongoing cost of around £8 million for producing the regulatory report quarterly for the 20 firms (12 large and 8 medium) that we anticipate will be required to produce the data that is currently not available and to complete the return.

Benefits

The proposed return seeks to provide consistent and clear reporting of prudent valuation assessments. Sufficiently robust and granular data will enable the supervisors to better understand firms' choices and methodologies regarding prudent valuation. The return will also aid in the identification of portfolios assessed across the industry as carrying high valuation uncertainty. In turn, this can help to ensure firms perform their prudent valuation assessments properly and consistently. Comparison between firms will also be easier as the information will be based on a prescribed template. Comparability of data between firms will improve our ability to assess systemic risk and to deliver effective supervision.

Annex 2

Compatibility with our objectives and the principles of good regulation

Introduction and statement of purpose

This annex sets out how the proposal for a new prudent valuation return is compatible with our objectives and the principles of good regulation.

Compatibility with our statutory objectives

Our planned implementation of the new prudent valuation return meets our statutory objectives of market confidence and financial stability.

Market Confidence

The new prudent valuation return seeks to reduce the risk of market disruption arising from financial failure of a large firm. We consider that producing the new return will contribute to promoting market confidence in the UK financial system by:

- helping us understand firms' choices and methodologies regarding prudent valuation and therefore the level of capital firms have available when prudent assumptions are made;
- helping firms understand the valuation uncertainty on their own books; and
- helping us to compare firms and therefore improving our ability to assess systematic risk and deliver effective supervision.

Financial stability

We expect that the enhancements made to the prudential framework for the largest firms as a result of the data available from the new prudent valuation return will help us to detect valuation issues and therefore uncertainty around the level of capital resources within high-impact firms. This should improve our ability to detect issues that could affect stability in the financial sector as a whole and contribute to the protection and enhancement of the UK financial system.

The draft Handbook text is not aimed particularly at promoting public awareness or at reducing financial crime and will not affect the degree of protection for consumers, but we do not believe that the proposals are incompatible with these three objectives.

Compatibility with the need to have due regard to the principles of good regulation

Section 2(3) of the FSMA requires that, in carrying out our general functions, we have regard to specific matters when carrying out our general functions. Those matters that are relevant to this CP are set out below.

Efficiency and economy

Our approach to designing the return has been to use, where possible, the work already done by firms and already-existing business splits for reporting the data. It should allow firms enough time to consider and implement the changes required to their already existing prudent valuation processes.

Role of management

The new prudent valuation return, by requiring consistent reporting of valuation uncertainty, should help firms' management to better identify, understand and therefore address the extent of the valuation uncertainty that exists on their books as a result of the trading and systems employed at that firm.

International character of financial services and markets and the desirability of maintaining the competitive position of the UK

The issue of ensuring compliance with prudent valuation principles is one that regulators around the world are looking at closely and is at different stages in different countries. We will work with other regulators and the European Banking Authority, with the aim of achieving the maximum convergence between these different regulatory approaches.

Need to minimise the adverse effects of competition that may arise from anything done in the discharge of the FSA's functions

Because of the small cost of our proposal, we believe that our proposals will not have material adverse effects on competition. However, we remain open-minded and would welcome responses from readers on this matter.

Equality and diversity issues

We have assessed that our proposals do not give rise to discrimination and the proposals are of low relevance to the equality agenda. We would nevertheless welcome any comments respondents may have on any equality issues they believe arise.

Annex 3

List of questions

Q1: Do you require additional guidance on completing the return?

Q2: Do you have any comments on our cost benefit analysis in relation to this CP?

Q3: Do you have any analysis or evidence that supports, contradicts or otherwise relates to this cost benefit analysis?

Q4: Do you agree with the categorisation of asset classes and further into Vanilla and Exotic components?

Q5: Do you agree with the inclusion of Gross B/S figures in addition to Net B/S figures?

Q6: Do you agree with the addition of 1-day 99% VaR equivalent figures?

Q7: Do you agree with the inclusion of an upside range of plausible values?

Q8: Do you agree with the concept of the Portfolios Excluded due to Extreme but Unquantifiable Uncertainty?

Q9: Do you agree with the concept of using the Portfolios of Particular Interest section to provide additional qualitative explanation of particularly material uncertainty?

Q10: Do you agree with the reporting requirement of within one month end of each calendar quarter?

Q11: Are any additional narrative boxes needed in the return to explain significant items in the data part of the return?

Appendix 1

Draft Handbook text

PRUDENT VALUATION INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 156 (General supplementary powers); and
(3) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The General Prudential sourcebook (GENPRU) is amended in accordance with Annex A to this instrument.

E. The Supervision manual (SUP) has been amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Prudent Valuation Instrument 2012.

By order of the Board
[*date*]

Annex A

Amendments to the General Prudential sourcebook (GENPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

General requirements: Valuation adjustments or reserves

…

1.3.35 G Reconciliation differences under *GENPRU* 1.3.34R should not be reflected in the valuations under *GENPRU* 1.3 but should be disclosed to the *FSA* in prudential returns. Those *firms* which are subject to the reporting requirement under *SUP* 16.16 should disclose such reconciliation differences in the Prudent Valuation Return which they are required to submit to the *FSA* under *SUP* 16.6.5R.

1.3.35A G *UK banks* and *BIPRU 730k firms* are reminded that they may, in respect of their prudent valuation assessments under *GENPRU* 1.3.4R and *GENPRU* 1.3.14R to *GENPRU* 1.3.34R, be subject to the requirement under *SUP* 16.16.4R to submit a Prudent Valuation Return to the *FSA*.

…

Core tier one capital: profit and loss account and other reserves: Losses arising from valuation adjustments (BIPRU firm only)

2.2.86 R (1) This *rule* applies to *trading book* valuation adjustments or reserves referred to in *GENPRU* 1.3.29R to *GENPRU* ~~1.3.35G~~ 1.3.35AG (Valuation adjustments and reserves). It applies to a *BIPRU firm*.

…

…

2.2.248 R *Trading book* profits and losses, other than those losses to which *GENPRU* 2.2.86R(2) (Valuation adjustment and reserves) refers, originating from valuation adjustments or reserves as referred to in *GENPRU* 1.3.29R to *GENPRU* ~~1.3.35G~~ 1.3.35AG (Valuation adjustments or reserves) must be included in the calculation of net interim *trading book* profits and be added to or deducted from *tier three capital resources*.

2.2.249 R *Trading book* valuation adjustments or reserves as referred to in *GENPRU* 1.3.29R to *GENPRU* ~~1.3.35~~ 1.3.35AG which exceed those made under the accounting framework to which a *firm* is subject must be treated in accordance with *GENPRU* 2.2.248R if not required to be treated under *GENPRU* 2.2.86R(2).

Annex B

Amendments to the Supervision manual (SUP)

In this Annex, all the text is new and is not underlined.

After SUP 16.15 insert the following new section.

16.16 Prudent valuation reporting

Application

16.16.1 R This section applies to a *UK bank* or a *BIPRU 730k firm* which meets the condition in *SUP* 16.16.2R.

16.16.2 R The condition referred to in *SUP* 16.16.1R is that, on its last *accounting reference date*, the *firm* had balance sheet positions measured at fair value which, on a gross basis, (the sum of the absolute value of each of the assets and liabilities) exceeded £3 billion.

Purpose

16.16.3 G (1) The purpose of this section is to set out the requirements for a *firm* specified in *SUP* 16.16.1R to report the outcomes of its prudent valuation assessments under the prudent valuation rules, in *GENPRU* 1.3.4R and *GENPRU* 1.3.14R to *GENPRU* 1.3.34R, to the *FSA* and to do so in a standard format.

(2) The purpose of collecting this data on the prudent valuation assessments made by a *firm* under *GENPRU* 1.3.4R and *GENPRU* 1.3.14R to *GENPRU* 1.3.34R is to assist the *FSA* in assessing the capital resources of *firms*, to enable the *FSA* to gain a wider understanding of the nature and sources of measurement uncertainty in fair-valued financial instruments, and to enable comparison of the nature and level of that measurement uncertainty across *firms* and over time.

Reporting requirement

16.16.4 R A *firm* to which this section applies must submit to the *FSA* quarterly (on a calendar year basis and not from a *firm's accounting reference date*), within one month of each quarter end, a Prudent Valuation Return in respect of its fair-value assessments under *GENPRU* 1.3.4R and *GENPRU* 1.3.14R to *GENPRU* 1.3.34R in the format set out in *SUP* 16 Annex 31AR.

16.16.5 R Where a *firm* to which *SUP* 16.16.4R applies is a member of a *UK consolidation group*, the *firm* must comply with *SUP* 16.16.4R:

(1) on a solo-consolidation basis if the *firm* has a *solo consolidation waiver*, or on an unconsolidated basis if the *firm* does not have a *solo consolidation waiver*; and

(2) separately, on the basis of the consolidated financial position of the *UK consolidation group*. (*Firms'* attention is drawn to *SUP* 16.3.25G regarding a single submission for all *firms* in the *group*.)

continued

After SUP 16 Annex 30GD insert the following new annexes.

16 Annex 31AR Prudent Valuation Return

Prudent Valuation Return

		A	B	C	D	E	F	G
		Gross B/S		Net B/S	1-Day 99% VaR Equivalent	Valuation Uncertainty		Explanation
		Assets	Liabilities			Downside	Upside	
	Portfolios Subject to Valuation Uncertainty Assessment							
1	Equities - Exotic							
2	Equities - Vanilla							
3	Rates - Exotic							
4	Rates - Vanilla							
5	Credit - Exotic							
6	Credit - Vanilla							
7	Commodities - Exotic							
8	Commodities - Vanilla							
9	FX - Exotic							
10	FX - Vanilla							
11	Emerging Markets							
12	Hybrid Instruments							
13	DVA / CVA							
14	Other Portfolios 1							
	…							
	n							
15	**Aggregate Portfolios Included**							
16	Less Diversification Benefit							
17	**Total**							
	Portfolios Excluded due to Extreme but Unquantifiable Uncertainty					**Proposed Capital Add-On**		
18	Portfolios Excluded 1							
	…							
	n							
19	**Total Portfolios Excluded**							
20	**Total Value of Fair-Valued Portfolios**							
21	**Total Prudent Valuation Adjustment**							
22	Portfolios of Particular Interest 1							
	…							
	n							

Reconciliation to Financial Statements

		Gross B/S Assets	Gross B/S Liabilities	Net B/S	Explanation
23	**Total Value of Fair-Valued Portfolios**				
24	Reconciliation to Financial Statements Amounts 1				
	…				
	n				
25	**Fair-Valued Portfolios per Financial Statements**				

Detailed Explanations

26	Definitions of Portfolio Type	
27	Portfolios Subject to Valuation Uncertainty Assessment	
28	Portfolios Excluded due to Extreme but Unquantifiable Uncertainty	
29	Portfolios of Particular Interest	
30	Reporting Currency	

16 Annex 32AG Guidance notes for data items in SUP 16 Annex 31AR

This return provides the *FSA* with a point-in-time estimate of the valuation uncertainty around a *firm's* fair-value positions in the context of the size and risk of its positions. The value of the positions at the downside end of the spread of valuation uncertainty will be equivalent to the prudent valuation of the *firm's* positions as determined using the *rules* laid out in *GENPRU* 1.3.4R and *GENPRU* 1.3.14R to 1.3.34R.

The fair values of financial instruments are represented as point estimates for the purpose of the primary financial statements, whereas valuations are in fact inherently judgemental. The choice of a point estimate is influenced by a range of factors including different market data points and/or methods of estimation. At the balance sheet (B/S) date it is likely that there will be a plausible argument for a range of alternate estimates of the valuation of many financial instruments. While this range may reasonably be expected to be narrow in liquid and transparent markets, it may be broad in markets which are illiquid and lack transparency. The degree of market uncertainty in any one market may also be subject to variation over time as liquidity and other factors influencing valuation change.

Valuation

Firms should follow their normal accounting practice wherever possible when reporting the gross and net B/S.

Consolidation

When reporting on a *UK consolidation group* basis, *firms* should where possible treat the consolidation group as a single entity (i.e. line-by-line) rather than on an aggregation basis.

Currency

Firms should report in the currency of their annual audited accounts e.g. Sterling, Euro, US Dollars, Canadian Dollars, Swedish Kroner, Swiss Francs or Yen. Figures should be reported in millions.

Data Elements

These are referred to by row first, then by column, so data element 2B will be in row 2 and column B.

Prudent Valuation Return

Column A-C Gross B/S Assets, Gross B/S Liabilities and Net B/S

The gross B/S assets, gross B/S liabilities and net B/S will be the raw figures extracted from the front office systems, after fair value adjustments and adjustments taken following independent price verification, rather than the B/S amounts that would be produced under IFRS. They nevertheless allow a completeness check by reconciling back to the total fair-value positions on the B/S as set out in the 'Reconciliation to Financial Statements' table. Both assets and liabilities are input as positive balances.

Column D 1-Day 99% VaR Equivalent

The VaR equivalent measure is used in the return to indicate the relative market risk in different *firms* and portfolios and to provide important context to the valuation uncertainty measures. However, as this includes risks not in VaR and VaR on non-Trading Book positions for which the fair-value option has been chosen, it will not be directly reconcilable to the market risk measures shown in financial statements or the regulatory VaR.

The split of the VaR equivalent measure between the different asset classes may be on an approximate basis due to the difficulty in fairly distributing the diversification benefit gained from trading across those asset classes.

Column E/F Downside/Upside Valuation Uncertainty

Prudent valuation will constitute an assessment at a risk parameter/product level of the upper and lower ends of the range of plausible valuations at a defined confidence interval (e.g. 90th percentile) based on the judgment of management. This represents the uncertainty of the valuations on the B/S date taking into account all available market data and based on market conditions at the B/S date, using valuation methods which could reasonably be deemed appropriate for each asset or class of assets. It requires a comprehensive view of the possible valuation range for the whole product and portfolio, including the impact of different valuation techniques and models.

The 'Downside Valuation Uncertainty' in the return represents the amount by which the correct fair value might be lower than the 'Net B/S' figure supplied (that is, there is 90% confidence (or alternative confidence interval defined by the *firm*) that the actual value is greater than the 'Net B/S' less the 'Downside Valuation Uncertainty'). The 'Upside Valuation Uncertainty' similarly represents the amount by which the correct fair value might be higher than the 'Net B/S' figure supplied (that is, there is 90% confidence (or alternative confidence interval defined by the *firm*) that the actual value is lower than the 'Net B/S' plus the 'Upside Valuation Uncertainty').

The prudent valuation assessment is not constrained by accounting standards. For example, the uncertainty created by large concentrated positions will be reflected in the return, whereas concentration adjustments to Level 1 positions are not allowed by accounting standards.

Column G Explanation

There are a number of rows where the *firm* has a choice of whether and how many rows to add. In this case, a short description of the row will be required and this should be included in column G.

Row 1-12 Asset Class Granularity

The asset class granularity selected for the main part of the table is to avoid making the return unduly lengthy or confusing. Where particularly significant, any additional disclosures should occur through narrative tied to the 'Portfolios of Particular Interest' in row 22.

The split between 'Exotic' and 'Vanilla' positions is defined in the same way that products are categorised for the purposes of CAD2 recognition. The definition of a portfolio type is based on the regulatory classes for CAD2 recognition, split by asset class. 'Vanilla' positions are those positions referred to in *BIPRU* 7.10.21G(1) and (2) and include products with linear pay-offs in the underlying risk factor (whether securities or derivatives) and products with European, American and Bermudan put and call options (including caps, floors and swaptions). All other fair-valued positions are included within the 'Exotic' portfolios and the broad classes of positions are set out in *BIPRU* 7.10.21G(3) and (4). *BIPRU* 7.6.18R provides further granularity on the definitions used in *BIPRU* 7.10.21G.

This delineation corresponds to the way in which the instruments are traded. Where a portfolio is disclosed as 'Exotic', it may also include vanilla hedges. Although a traded portfolio should normally not be split between 'Vanilla' and 'Exotic', where a portfolio includes significant positions of a type that would normally be reported in the alternative classification and are not present to hedge other products in the portfolio, these positions should be included within that other classification.

Row 13 DVA/CVA

DVA and CVA are adjustments that may be made at a *firm* rather than portfolio level. Consequently, the B/S and valuation uncertainty figures may be reported on a separate line.

Row 14 Other Portfolios

There may be other cross-portfolio fair-value reserves or other portfolios not represented in rows 1-13. Additional lines should be included for each of these numbered 1 to n as shown. The figures for columns A-F should be included as for rows 1-13 and a short description of the portfolio included in column G.

Row 15 Aggregate Portfolios Included

The sum of the B/S and valuation uncertainty figures from rows 1-14.

Row 16 Less Diversification Benefit

The uncertainty assessments disclosed by asset class are the sum of the uncertainty measures calculated at a risk parameter/product level, before allowing for diversification/correlation benefits. As a result the sum of the individual portfolio valuation uncertainty estimates will not necessarily reflect the aggregate-level valuation uncertainty the *firm* faces at the B/S date as this does not allow for diversification benefits that will invariably exist. The diversification benefit represents the total benefit taken between portfolios when summing up for the regulatory Prudent Valuation Return. There is currently no formal policy on the *firm*-wide aggregation of prudent valuation; hence *firms* should determine an approach that would be assessed by the *FSA* for reasonableness.

Row 17 Total

The 'Aggregate Portfolios Included' from row 15 less the 'Diversification Benefit' from row 16.

Row 18 Portfolios Excluded due to Extreme but Unquantifiable Uncertainty

The 'Portfolios Excluded' section allows *firms* to scope out those portfolios where they feel that there is an absence of market data or there is some other reason why it is not possible to ascertain the plausible range of valuations with any confidence. This can be due to a one-way market in which there is limited ability to exit positions that have been entered into (e.g. PRDCs), although there may be other reasons. This portion of the disclosure is important as it clearly identifies portfolios for which there is extreme valuation uncertainty. For these portfolios, it may not be possible or meaningful to disclose VaR figures, but the gross and net B/S positions being disclosed impart important information to the users of the accounts. The *firm* should therefore propose a suitable regulatory prudent valuation adjustment that would not benefit from diversification and will be assessed for reasonableness by the *FSA*.

Additional lines should be added here for each of these portfolios numbered 1 to n as shown. A short description of the portfolio should be included in column G.

Row 19 Total Portfolios Excluded

The sum of all excluded portfolios from row 18.

Row 20 Total Value of Fair-Valued Portfolios

The sum of the gross B/S and net B/S figures in columns A-C from row 17 and row 19.

Row 21 Total Prudent Valuation Adjustment

The sum of the downside valuation uncertainty in column E from row 17 and row 19.

Row 22 Portfolios of Particular Interest

The 'Portfolios of Particular Interest' section allows specific disclosures for portfolios where there is a general market interest at any particular time (as there has been with ABS and monoline positions previously) and also allows *firms* the discretion to identify those portfolios that they feel constitute significant proportions of the valuation uncertainty disclosed for the asset classes (e.g. CVAs). The responsibility for ensuring the appropriate selection of portfolios and the appropriateness of the disclosure for each of these portfolios rests with senior management of the *firms*. These portfolios form a subset of the information previously provided by asset class, rather than being in addition to the uncertainty disclosed by asset class. As for rows 14 and 18, additional lines should be added for each of these portfolios numbered 1 to n as shown. The figures for columns A-F should be included as for rows 1-13 and a short description of the portfolio included in column G.

Reconciliation to Financial Statements

Row 23 Total Value of Fair-Valued Portfolios

The 'Total Value of Fair-Valued Portfolios' is copied directly from row 20 for columns A-C.

Row 24 Reconciliation to Financial Statements Amounts

There may be a number of reasons for differences between the gross and net B/S figures taken from front office systems, after fair value adjustments and adjustments taken following independent price verification, that were used in the valuation uncertainty disclosure and the gross and net B/S figures in the financial statements. The *firm* should report the reconciliation amounts and briefly state the reason for the difference. An additional line should be included for each major class of reason, for example, netting of internal trades or counterparty netting agreements.

Row 25 Fair-Valued Portfolios per Financial Statements

The sum of the 'Total Value of Fair-Valued Portfolios'; in row 23 and the differences to the financial statements shown in row 24. The figures for 'Gross B/S Assets', 'Gross B/S Liabilities' and 'Net B/S' (columns A-C) should equal the total fair-valued assets and liabilities respectively in the *firm's* financial statements.

Row 26 Definitions of Portfolio Type

This is a narrative box which allows the *firm* to define the positions that are included in certain portfolios, e.g. Emerging Markets, Hybrid Instruments or Other Portfolios the *firms* has chosen to disclose in row 14.

Row 27 Portfolios Subject to Valuation Uncertainty Assessment

This is a narrative box allowing *firms* to choose to provide some narrative such as outlining the most material methodologies that underlie a significant proportion of the calculation of valuation uncertainty.

Row 28 Portfolios Excluded due to Extreme but Unquantifiable Uncertainty

This is a narrative box which allows the *firm* to provide details of each 'Portfolio Excluded due to Extreme but Unquantifiable Uncertainty'. Information provided should include, but not necessarily be limited to a description of the products and why an effective assessment of valuation uncertainty cannot be performed, details of the extent to which the portfolio is classified as AFS or fair-value option in the Banking Book, a historical description of how the portfolio was built up together with a description of what the strategy is for the portfolio for the future (e.g. whether there is still new trading or whether this is a legacy portfolio being sold off over time).

Row 29 Portfolios of Particular Interest

This is a narrative box which allows the *firm* to provide details of each 'Portfolio of Particular Interest'. Information provided should include, but not necessarily be limited to a description of the products, details of the extent to which the portfolio is classified as AFS or fair-value option in the Banking Book, why it is of particular interest, the basis of the methodology used to calculate the uncertainty and a historical description of how the portfolio was built up together with a description of what the strategy is for the portfolio for the future (e.g. whether there is still new trading or whether this is a legacy portfolio being sold off over time).

Row 30 Reporting Currency

This is a box in which the *firm* should declare the reporting currency used.

Internal Validations

Validation Number	Data Element		Data Element(s)
1	1C	=	1A-1B
2	2C	=	2A-2B
3	3C	=	3A-3B
4	4C	=	4A-4B
5	5C	=	5A-5B
6	6C	=	6A-6B
7	7C	=	7A-7B
8	8C	=	8A-8B
9	9C	=	9A-9B
10	10C	=	10A-10B
11	11C	=	11A-11B
12	12C	=	12A-12B
13	13C	=	13A-13B
14	14C	=	14A-14B
15	15A	=	1A+2A+3A+4A+5A+6A+7A+8A+9A+10A+11A+12A+13A+Sum(14A)
16	15B	=	1B+2B+3B+4B+5B+6B+7B+8B+9B+10B+11B+12B+13B+Sum(14B)
17	15C	=	15A-15B
18	15E	=	1E+2E+3E+4E+5E+6E+7E+8E+9E+10E+11E+12E+13E+Sum(14E)
19	15F	=	1F+2F+3F+4F+5F+6F+7F+8F+9F+10F+11F+12F+13F+Sum(14F)
20	17A	=	15A
21	17B	=	15B
22	17C	=	17A-17B
23	17E	=	15E-16E
24	17F	=	15F-16F
25	18C	=	18A-18B
26	19A	=	Sum(18A)
27	19B	=	Sum(18B)
28	19C	=	19A-19B
29	19E	=	Sum(18E)
30	20A	=	17A+19A
31	20B	=	17B+19B
32	20C	=	20A-20B
33	21E	=	17E+19E
34	22C	=	22A-22B
35	23A	=	20A
36	23B	=	20B
37	23C	=	23A-23B
38	24C	=	24A-24B
39	25A	=	23A+Sum(24A)
40	25B	=	23B+Sum(24B)
41	25C	=	25A-25B

External Validations

There are no external validations for this data item.

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