Policy Statement

PS12/7

Financial Services Authority

Regulatory Prudent Valuation Return

April 2012

FSA®

Financial Services Authority

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Appendix 1: Made rules (legal instrument)

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This Policy Statement reports on the main issues arising from Consultation Paper 11/30 (*Regulatory Prudent Valuation Return*) and publishes final rules.

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Copies of this Policy Statement 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
CBA	Cost benefit analysis
COREP	Common reporting framework
CP	Consultation Paper
CVA	Credit valuation adjustment
DVA	Debit valuation adjustment
EBA	European Banking Authority
FINREP	Financial reporting framework
FS	Financial statements
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
GENPRU	General Prudential sourcebook
IFRS	International Financial Reporting Standards

IPV	Independent price verification
PRDC	Power reverse dual currency notes
PS	Policy Statement
PVA	Prudent valuation adjustment
SUP	Supervision manual
SYSC	Senior management arrangements, systems and controls
UK	United Kingdom
VaR	Value at Risk

1
Overview

Introduction

1.1 This Policy Statement (PS) contains feedback on the responses to the Consultation Paper CP11/30 *Proposed Regulatory Prudent Valuation Return*, and subsequent changes to the FSA's rules.

Who should read this paper?

1.2 This PS applies mainly to banks, building societies and certain investment firms with sizeable fair value portfolios that fall within the scope of the new reporting requirements (laid out in Annex B in Appendix 1).

Background

1.3 The broad aim of the changes in this PS is to enable the FSA to more effectively review firms' prudent valuation returns and aid comparability of data between firms.

1.4 In CP11/30, we consulted on changes to the GENPRU and the SUP. These will create a new reporting requirement to complete a regulatory return that will show, in a standardised format, the range of uncertainty that exists around the accounting fair values and the difference between those fair values and the regulatory prudent values.

Structure of this PS

1.5 The requirement to produce the new regulatory return will come into force on 30 June 2012 and the return will be required for reporting periods ending on or after that date.

1.6 Chapter 2 of this PS provides a summary of the responses we received to CP11/30. Chapter 3 provides a more detailed description of the responses to each question in the CP and other concerns raised by respondents.

Cost benefit analysis (CBA)

1.7 CP11/30 included a CBA of the new reporting requirement. We received no evidence from firms that would cause a significant change in the conclusions reached in the CBA; we do not think there will be any material increase in costs arising from the new rules, over and above those stated in the CBA. We also believe that there should not be any increase in costs arising from the small changes made to the policy originally consulted on or, if there will be any such increases, they will be minimal. Therefore, the CBA published in CP11/30 continues to apply.

Compatibility statement

1.8 CP11/30 included a compatibility statement that explained why we considered the proposals to be compatible with its general duties set out in section 2 of the Financial Services and Markets Act 2000 (FSMA) and with its regulatory objectives, set out in sections 3 to 6 of the FSMA. There have been no significant changes to the rules proposed in CP11/30, or to the CBA, and so we believe this statement is still valid.

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Summary of responses

2.1 We received 19 responses to CP11/30, for which we thank the respondents. There was a wide variety of responses with some respondents broadly agreeing with the overall approach and others raising a number of issues.

2.2 A summary of the responses is provided below, with the points that caused the most concern being dealt with first.

- The inclusion of a column to show the upside uncertainty in addition to the downside uncertainty provoked considerable comment. Many felt that the costs were greater than the benefit (which was considered to be poorly explained if at all) or that the concept was at odds to the stated aim of the return (prudent valuation that implies a greater interest in the potential downside). Our view is that making an estimate of the full range of downside to upside valuation uncertainty gives very useful context for the calculation of the prudent valuation and on where fair value lies within the range, and ensures that firms are analysing the full range of uncertainty.
- The inclusion of a column to show the 1-day 99% VaR equivalent figures also provoked comment. In terms of calculating the figures, several firms with only small fair value portfolios in their banking books pointed out the difficulty of producing any VaR numbers for a portfolio for which they are not currently produced at all. Regarding the usefulness of the VaR, it was pointed out that VaR does not bear any direct relation to valuation uncertainty and there will be considerable dispersion in the VaR methodologies, reducing its value for comparability. While it is recognised that VaR is not directly linked to valuation uncertainty, our view is that the figures are still essential to obtain an estimate of the overall size of the positions held as these can not be obtained from simple balance sheet (B/S) size figures, which may bear very little relation to the risk or the size of the positions held.
- There was a wide spread of comments on the asset class categorisation. Many firms agreed with the general proposal while others suggested that more use should have been made of the categorisation used in IFRS 7 disclosures or that more free-format categorisation should be allowed, to fit with firms' own hierarchies. Several respondents

seemed not to have understood that, except in exceptional circumstances, a portfolio should be designated in one category as a whole, which removes issues around hedges on complex trades being separated for the return. The IFRS 7 disclosures, if used in the way that most respondents suggest (which is to use firms' existing systems for allocation to the correct level) will bring back these issues around hedging positions. Our view is that the IFRS 7 categories also have issues around consistent use and deal with the visibility of market data rather than the complexity of trading. Use of free-format categorisation of portfolios would remove the potential for comparability between firms.

- The portfolio category named 'Excluded due to Extreme but Unquantifiable Uncertainty' was considered by many respondents to be unnecessary as it would not be used by firms or ill-judged because it would be used inconsistently due to the terminology. Accordingly, we have amended the terminology and will ensure its consistency and use via supervisory guidance on which portfolios should be included.
- Around half of the respondents stated that the reporting timelines were too short after each quarter-end, particularly for the reconciliation of B/S figures to the financial statements (FS), and should be lengthened, due to resource and systems issues, especially at year-end. We agree and have lengthened the reporting deadline.
- Around half of the respondents stated that one-off systems costs had been under-estimated, while the other half did not contest the estimate. The estimates were based on a firm with a sound and robust control environment in compliance with senior management arrangements, systems and controls (SYSC) requirements. As the costs of complying with our SYSC requirements have already been estimated and are not related to the proposals in CP11/30, we do not believe that the one-off systems costs have been underestimated.
- Nearly half of the respondents also asked for more detailed guidance on how to calculate the valuation uncertainty and diversification benefits. More detail will be provided in technical guidance to be issued through the European Banking Authority (EBA). In the meantime, we will provide bilateral feedback to firms on the validity of their chosen approaches.

2.3 As a result of the responses received and subsequent deliberation by the FSA, several changes have been made to the policy changes detailed in CP11/30.

- The reporting requirement timeline has been extended from one month after the reference date to six weeks.
- The portfolio category named 'Portfolios Excluded due to Extreme but Unquantifiable Uncertainty' has been renamed 'Portfolios Excluded due to Extreme Valuation Subjectivity'.
- A box has been added immediately before the total prudent valuation adjustment (PVA) row to allow for any offsets to be shown that would reduce the amount of the

PVA subtracted from capital (including potential tax liability reductions that would occur if valuations were at more prudent levels or offsets with other risk capital such as 100% capitalised positions).

- In certain circumstances, a firm that does not produce VaR for a portfolio may request to use an alternative risk measure.
- The single row for credit valuation adjustment (CVA) and debit valuation adjustment (DVA) has been split into two.
- While there are no other changes to the requirements, a number of other adjustments to the text have been made that aim to improve the explanations of the requirements.

3 Detailed feedback

3.1 This chapter outlines the responses to each of the questions set out in CP11/30, the FSA's feedback to those responses, and any adjustments to the policy changes in CP11/30 made in the final policy proposals.

3.2 In addition to addressing responses received to the specific questions set out in CP11/30, feedback is also provided to other responses received related to the trading book rule changes where clarification is believed to be of benefit to a wide range of firms. Other responses were received, not related to specific questions in CP11/30, which were specific to individual firms and in these cases it was not considered appropriate to provide feedback in this PS. For these queries firms are recommended to contact their supervisor for individual guidance.

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

3.3 11 of the 19 respondents provided responses on the subject of additional guidance. Seven requested more guidance on the details of what valuation uncertainty methodologies are acceptable and/or how to calculate diversification benefits. Other requests for guidance were generally only asked by one or, occasionally, two respondents and are listed below:

a. Does this return apply to the UK subsidiaries of foreign branches?

b. Are the asset class categories shown in the return fixed or for example purposes?

c. Should CVA have a separate line from DVA given differing capital treatments? Should available for sale (AFS) positions be included at all?

d. Are inter-desk trades included in valuation uncertainty calculations?

e. Should a banking book position be included as an Other Portfolio?

f. Would 'financial instruments fair-valued through profit and loss' be a clearer definition than 'all fair-valued financial instruments'?

g. Are back-to-back positions with no valuation uncertainty included?

h. How should the capital add-on field for excluded portfolios be used?

i. Is methods documentation required?

Our response

Binding technical standards are currently being discussed at the EBA so details will be supplied through these when they are issued. However, in the interim, supervisory guidance will be used. Responses to the other requests for guidance are listed below:

a. This return applies to a UK bank or a BIPRU 730k firm that meets the relevant materiality criteria (and, where a member of a UK consolidation group, any such UK bank or BIPRU 730k firm will also need to comply with the return on the basis of the consolidated financial position of that UK consolidation group).

b. The asset class categories given are fixed though there is the option to add others in the Other Portfolios section (mainly for cross asset class portfolios that are very separate from the rest of the business) or explain points of interest in the Portfolios of Particular Interest section.

c. The use of an additional box for offsets where capital treatments are different is discussed elsewhere in this feedback. The treatment of AFS will change in CRD4 so that AFS positions will be treated like any other fair value position. We prefer to avoid a change in the structure of this return that will be superseded in the near future.

d. Inter-desk trades will mostly be hedges to reduce risk. If they were removed, each of the portfolios might show high total uncertainty. The inter-desk trades should therefore be left in. The reconciliation of the B/S figures to the FS will show the gross value of the inter-desk trades as one of the reconciling items.

e. A banking book should not be included as an Other Portfolio but should instead be included in the portfolio that is most suitable for the business in the book. For example, a banking book portfolio may be lending possibly hedged with derivatives. This should be classed as a vanilla credit portfolio for the purposes of this return.

f. The definition ‘all fair-valued financial instruments’ is preferred as it includes AFS.

g. Back-to-back positions are included in gross B/S but firms may identify these as having zero valuation uncertainty (except for the effect on the CVA that is shown elsewhere on the return).

h. The calculation method for the capital add-on field in excluded portfolios will be proposed by the firm and be subject to approval by the FSA.

i. An outline of methodologies is requested in the narrative boxes but firms should internally maintain sufficient detailed documentation to describe their calculation methodologies. This may be analysed in detail during discussions between the FSA and the firm.

Q2: *Do you have any comments on 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?*

3.4 These two questions were answered together in most responses so they have been grouped together in this feedback.

3.5 11 of the 19 respondents gave responses directly related to the CBA. Eight of the respondents indicated that one-off costs, especially of systems, had been underestimated.

3.6 Two argued that the benefits were over-estimated given the work that had already been carried out on IFRS 7 disclosure and that the upside is not included in the benefits when this is the most costly piece of work.

3.7 Two more respondents asked whether small non-trading book fair-value portfolios could be excluded on the grounds of immateriality.

Our response

Regarding the level of one-off costs, the FSA has tried to estimate the upper-bound costs to the standard firm that has a sound and robust IPV environment, which includes estimating the level of confidence the firm has in the valuations on its books and records. While it is recognised that not all firms are at this level, we would expect these firms to have remediation plans in place.

We do not regard IFRS 7 disclosure as having covered the benefits that will be achieved through the use of the new return, especially due to its limited scope. The specific benefits of providing upside uncertainty will be addressed in feedback to question seven.

Immateriality is an allowable reason to exclude a portfolio from the uncertainty calculations for any portfolio. However, a documented test would need to be put in place to ensure that the portfolio continued to be immaterial for future returns.

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

3.8 17 of the 19 respondents gave responses related to the categorisation of assets. Six of these broadly agreed with the proposal. However, another six stated that their preference would be for a categorisation that, rather than using the BIPRU categories to split portfolios into vanilla and exotic, used instead the levels 1, 2 and 3 splits defined in the IFRS 7 disclosures. Two more respondents also suggested more complex use of levels 1, 2 and 3 using additional columns. Two respondents expressed concern that hedging issues would mean that the metrics shown for each category would become meaningless.

3.9 Three respondents stated that their preference would be for more ability to define portfolios themselves or for other splits related to trade complexity.

3.10 A number of other responses came from one respondent each. One respondent would prefer to remove the vanilla/exotic split while another would prefer to remove the 'significant positions' reason which prompts a portfolio to be split. Two other respondents would prefer to use additional portfolio definitions for asset-backed securities (ABS) separate from the rest of credit or for legacy positions in businesses in which the firm is no longer active.

Our response

The return asks for portfolios to be designated as one asset class and as either vanilla or exotic, depending on the dominant trading type of the portfolio (with exceptions only in very significant and unusual circumstances). The reason for the use of whole portfolios, rather than designating each asset individually as levels 1, 2 or 3, is to allow hedge trades to be grouped with the trades they are hedging, without which the splits would be rendered meaningless. In addition, the use of IFRS 7 disclosures shows considerable inconsistency and we therefore prefer to replace it with a regulatory definition.

Free format use of portfolios or more extensive use of text boxes to explain issues would not satisfy the requirement for more comparability between firms and over time.

We regard the split of more vanilla portfolios from exotic as adding a useful context to the uncertainty figures reported. The 'significant positions' reason to split a portfolio is necessary where a portfolio has been built up that truly trades as two separate books but is expected to be very rarely used.

ABS and legacy positions are examples where we would not wish to set them as standard portfolios when they are important at present but may not be in the future. The preferred method to show them as separate would normally be

to include an extra split out of these positions in the 'Portfolios of Particular Interest' section but if they were truly run as separate businesses, they could be included in the 'Other Portfolios' and removed from the other categories that they would otherwise be included in.

Q5: *Do you agree with the inclusion of gross B/S figures in addition to net B/S figures?*

3.11 15 of the 19 respondents gave responses related to the inclusion of gross B/S figures. While ten of these broadly agreed with the proposal, five saw no link between gross B/S and valuation uncertainty. Five also requested clarification that the gross B/S figures are before all netting and if so, how they aid reconciliation to the FS.

Our response

It is agreed that there is no direct link between B/S size and valuation uncertainty. However, gross B/S size is needed along with the other measures of size of position to gain some context for the valuation uncertainty figures. The return asks for both gross and net B/S figures to be reconciled to the FS to provide confidence that the figures used in the return can be linked to the final audited accounts and that the reasons for differences are understood.

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

3.12 15 of the 19 respondents gave responses related to the inclusion of VaR figures. While five of these broadly agreed with the proposal, five pointed out that the drivers of valuation uncertainty and VaR are not the same. Six expressed concern around inconsistencies in interpretation between firms and the fact that the figures will be approximate, reducing the benefit. Two argued that the costs would therefore be higher than the benefit.

3.13 Four respondents state that they would not expect to calculate VaR for positions where it is not currently calculated (e.g. banking book positions held at fair value) or where prices are supplied by third parties.

Our response

We agree that there is no direct link between VaR and valuation uncertainty. However, VaR is needed along with the other measures of size of position to gain some context for the valuation uncertainty figures. Acceptance of the use of approximate figures and potential inconsistencies in the use of VaR between firms will certainly reduce its use in calculating detailed ratios to compare firms' returns. However, there is no other available single metric that will enable the FSA to obtain a sense of the size of derivative positions.

We understand the concern around calculating VaR figures for portfolios for which VaR is not currently calculated. The final policy changes have been adjusted to allow firms in exceptional circumstances to request that an alternative metric is used.

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

3.14 16 of the 19 respondents gave responses related to the inclusion of upside valuation uncertainty. Six of these broadly agreed with the proposal but ten argued that the costs (shown in the CBA to be greater than those for producing the other metrics) would outweigh the benefits and eight argued that the inclusion of upside valuation uncertainty was at odds with the stated concept of prudent valuation where the only interest is in the downside valuation uncertainty. One respondent also felt it was not clear what the information would be used for.

Our response

If downside valuation uncertainty is being fully analysed, many of the metrics and judgements used will be directly applicable to also calculating upside valuation uncertainty. Making an estimate of the full range of downside to upside valuation uncertainty gives far more context for the calculation of the prudent valuation and on where fair value lies within the range, and ensures that firms are analysing the full range of uncertainty.

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

3.15 11 of the 19 respondents gave responses about the use of excluded portfolios. Three of these broadly agreed with the proposal but eight felt that it would be largely unused for a mixture of reasons including that it is always possible to give a range of plausible

valuations (as shown by the evidence of the disclosures resulting from IFRS 7) and that firms will be reluctant to use it because of the impression it gives, both to the FSA and their external auditors. Six also felt that its use will be too subjective so inconsistent approaches will appear.

Our response

The use of the excluded portfolios will be decided in discussion between firms and the FSA along with the proposed capital add-on. It is expected to be used where standard processes for determining valuation uncertainty are insufficient. This section has also been renamed "Portfolios Excluded due to Extreme Valuation Subjectivity" to cater for the fact that firms may still have some estimate of uncertainty, albeit with limited evidence.

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

3.16 13 of the 19 respondents gave responses related to the use of 'Portfolios of Particular Interest'. Eight of these broadly agreed with the proposal. 'Of the five who disagreed, three did so on the basis that the detailed work on IFRS 7 is sufficient and ad-hoc or judgemental elements increase the costs of production, three on the basis that it will never be possible in the return to give sufficient detail so supervisory dialogue will be more important, and four on the basis that they would require more guidance on what to include'.

Our response

IFRS 7 disclosures do not include all positions on the fair value B/S as is required for a full understanding of the level of valuation uncertainty on firms' books. Most firms that express a preference do indicate a preference for the opportunity to explain the reporting in the main table in more detail. Excessive or insufficient disclosure may need to be resolved through bilateral engagement with the firm.

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

3.17 11 of the 19 respondents gave responses related to the reporting timeline. Two agreed with the proposal, but the other nine disagreed for a variety of resource and systems reasons, in particular the reconciliation to the FS that would be difficult to complete in one month

given the timelines for finalisation of the annual accounts. Of those who expressed an exact figure for the additional time required, four preferred two months and three preferred six weeks. Five felt that a longer timeline should be given for early returns that could then be reduced over time.

Our response

Owing especially to the difficulties around the reconciliation to the FS, the timeline has been extended to six weeks.

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

3.18 Four of the 19 respondents gave responses related to additional narrative boxes. Two would like additional space to make further clarifications and the others felt that supervisory dialogue is sufficient or that they did not agree with narrative boxes in general.

Our response

The general lack of response to this question leads us to not change the current layout in this regard.

3.19 There were a number of other responses that made points or asked questions on subjects not directly related to one of the 11 questions posed in the CP. These responses have been grouped together in the following sections.

a) Does the CP improve transparency (one of the stated aims in the CP)?

3.20 Five of the 19 respondents felt that, if the return were ever published, it would create confusion around, and reduce trust in, the FS. Three were in agreement that the returns should not be published for the moment because the IFRS 7 covers this ground already. Two pointed out that the stated aim of improved transparency is not met without full publication (while agreeing that this would not be the correct course of action due to the reasons above).

3.21 Two would prefer extended IFRS disclosure or for regulatory bodies to work with accounting bodies to align fair and prudent value.

Our response

There is no current plan to publish this new return and the stated aim of improved transparency was intended to refer to the improved transparency the return will give the FSA into the firms' capital positions (which are not always clear from the accounting disclosures). We also do not agree that IFRS 7 already covers the uncertainty in the valuations as it does not cover all fair-valued positions.

The main aim of accounting standards is to capture a best estimate of valuation rather than to estimate valuation risk. Therefore, accounting standards are unlikely to be entirely sufficient for regulatory requirements in the short term.

b) Timing of the current proposals to create a new return.

3.22 Four of the respondents asked whether the new return puts the FSA in a position where it is requesting reports that may be superseded by FINREP/COREP or which create super-equivalence to EU regulations. They also asked how this return fits in with future EU and Basel policy.

Our response

It should be noted that this return aims to improve compliance with regulations on prudent valuation that have been in place in the EU since 2006. We do not agree that showing evidence of compliance with existing rules is super-equivalent. We are involved in the drafting of EBA Binding Technical Standards and as such will seek to incorporate lessons learned from this return.

c) Capital effect.

3.23 Two of the respondents asked if there could be a separate box for the offsetting reduction in tax liability that may result from reducing valuations to a more prudent level and therefore reducing the profit and loss balance. Another respondent also asked where they could put the offset if they were already reducing their capital in regulatory returns for prudent valuation reasons.

Our response

A separate box will be added that will be usable for any reductions in the total PVA for other offsets, including tax and any PVAs already taken to capital separately. This would include being allowed to reduce the PVA where a position has been fully capitalised for other risk requirement reasons.

d) Diversification benefit.

3.24 One respondent asked whether diversification benefit is taken inside each asset class category (and therefore is not disclosed anywhere separately in the return) and only cross-category in row 16. Another expressed a preference for discussing diversification benefit qualitatively rather than subjecting it to detailed calculations due to the complexity and subjectivity of the methods that would need to be used for a quantitative calculation.

Our response

The diversification benefit within an asset class category should be included within the uncertainty figures for that category. It will therefore not be disclosed separately in the return and there will be a supervisory focus on this calculation because of this. This will be made clearer in the text of the SUP.

We agree that there is difficulty in calculating the diversification benefit but the total PVA requires a number to be calculated to gain an estimate for the total effect of moving from fair values of all positions to a more prudent valuation. Without this, supervisory decisions based on the new return would be extremely subjective.

e) Production of returns for each legal entity and consolidated entity.

3.25 One respondent expressed a preference to produce a return for the consolidated group and not for each entity while another preferred producing a return for each entity but not for the consolidated group.

Our response

The return will be needed to be produced for each entity that is regulated by the FSA and for which available capital and capital requirements are calculated as the prudent valuations should be used for each of these entities. This will often include the consolidated entity and the individual entities that make up that consolidated entity.

f) Other.

3.26 Several other points were made by one respondent each.

- The definition of downside valuation uncertainty includes the words '…the amount by which the correct fair value might be lower than the 'Net B/S' supplied…'. The respondent disagreed with this definition as they believe there is no 'correct' value, rather a reasonable range in which it may fall.

- The expectation was expressed that there would be opportunities to discuss the direction and progress of the uncertainty initiative. In addition, it was pointed out that the FSA would be the only party with all of the data and also the only party with detailed knowledge of methodologies used. This information would be of use to the industry so it was requested that regular quantitative and qualitative feedback is provided.
- One respondent pointed out that the new return applies only to fair value positions and not to the amortised cost positions mainly held on the banking book. It was argued that it is not fair for firms that mostly use fair value accounting to be forced to use full prudent valuation when firms that mostly use amortised cost might value a similar position at a considerably higher level.

Our response

- From the definition of fair value, which essentially looks for the exit value of a position, there is a 'correct' value, which is the actual realisable exit value. This actual realisable exit value is often not known precisely but this does not prevent it from being possible to refer to it as the 'correct' fair value. However, due to the fact that it is not known precisely, it is only possible to define a range in which it might fall.
- We will continue to give opportunities to all firms to discuss the direction and progress of the uncertainty initiative along with providing feedback generally to the industry on best practice and individually to firms on their specific approach.
- The response implies that the regulatory attention given to the valuation of positions held at amortised cost and in the banking book in general is insufficient. This may be an area around which there is greater future regulatory scrutiny.

Appendix 1

Made rules
(legal instrument)

SUPERVISION MANUAL (PRUDENT VALUATION REPORTING) 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 30 June 2012.

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) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Supervision Manual (Prudent Valuation Reporting) Instrument 2012.

By order of the Board
26 April 2012

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, in the case of an insurer or a UK ISPV, 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. *Firms* which are subject to the reporting requirement under *SUP* 16.16 should disclose those reconciliation differences in the Prudent Valuation Return which they are required to submit to the *FSA* under *SUP* 16.16.4R.

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, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

After SUP 16.15 insert the following new section. The text is not underlined.

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 six weeks 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 CVA								
14 DVA								
15 Other Portfolios	1							
	…							
	n							
16 **Aggregate Portfolios Included**								
17 Less Diversification Benefit								
18 **Total**								
						Proposed Capital Add-On		
Portfolios Excluded due to Extreme Valuation Subjectivity								
19 Portfolios Excluded	1							
	…							
	n							
20 **Total Portfolios Excluded**								
21 **Total Value of Fair-Valued Portfolios**								
22 **Total Downside Valuation Uncertainty**								
23 Less Regulatory Capital Offsets	1							
	…							
	n							
24 **Prudent Valuation Adjustment**								
25 Portfolios of Particular Interest	1							
	…							
	n							

Reconciliation to Financial Statements

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

Detailed Explanations

29	Definitions of Portfolio Type	
30	Portfolios Subject to Valuation Uncertainty Assessment	
31	Portfolios Excluded due to Extreme Valuation Subjectivity	
32	Portfolios of Particular Interest	
33	Reporting Currency	

16 Annex 31BG 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. However, at the balance sheet (B/S) date it is likely that there will be a range of plausible estimates of the valuation of many financial instruments. The choice of a point estimate is influenced by a range of factors including different market data points and valuation methodologies. This range will change over time and will tend to widen for markets that are less liquid or lack transparency.

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 are 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.

The gross B/S figures give a sense of the overall size of the positions, as large uncertainty and/or VaR figures may otherwise appear inconsistent if the net B/S is small.

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.

In certain cases, e.g. non-Trading Book positions for which no VaR is currently produced, it may be allowable for a firm to use an alternative metric to VaR while still estimating the 1 day loss which is expected to occur on no more than 1% of days. If a *firm* wishes to use an alternative metric, it must be requested and agreed with the *FSA*.

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.

The uncertainty estimates at asset class level may include a diversification benefit rather than simply summing the uncertainty for each position. There is currently no formal policy on the aggregation of prudent valuation by asset class; hence *firms* should determine an approach to be assessed by the *FSA* for reasonableness.

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 25.

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' or between two asset classes, where a portfolio includes significant positions of a type that would normally be reported in an alternative classification and are not present to hedge other products in the portfolio, these positions should be included within that other classification.

Row 13-14 CVA and DVA

CVA and DVA 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 15 Other Portfolios

There may be other cross-portfolio fair-value reserves or other portfolios not represented in rows 1-14. 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 1-14 and a short description of the portfolio included in column G.

Row 16 Aggregate Portfolios Included

The sum of the B/S and valuation uncertainty figures in columns A-C and E-F from rows 1-15.

Row 17 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 18 Total

The ‘Aggregate Portfolios Included’ from row 16 less the ‘Diversification Benefit’ from row 17.

Row 19 Portfolios Excluded due to Extreme Valuation Subjectivity

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 subjectivity. 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 20 Total Portfolios Excluded

The sum of all excluded portfolios from row 19.

Row 21 Total Value of Fair-Valued Portfolios

The sum of the gross B/S and net B/S figures in columns A-C from row 18 and row 20.

Row 22 Total Downside Valuation Uncertainty

The sum of the downside valuation uncertainty in column E from row 18 and row 20.

Row 23 Less Regulatory Capital Offsets

The ‘Total Downside Valuation Uncertainty’ from row 22 shows the total difference between using the accounting fair value and the regulatory prudent value for valuations of all fair-valued financial instruments positions on the B/S. In order to arrive at the net adjustment to regulatory capital that would occur from using fair value instead of prudent value, there may be several offsets that need to be taken into account. These may include, for example, the reduction in the tax liability that would occur on adjusting the valuations in the B/S and therefore reducing P&L, regulatory capital adjustments that are already taken for elements of valuation uncertainty or situations where the capital requirement for a position is already at a level such that a prudent valuation adjustment would imply a capitalisation of more than 100%.

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

Row 24 Prudent Valuation Adjustment

The 'Total Downside Valuation Uncertainty' from row 22 less the 'Regulatory Capital Offsets' from row 23.

Row 25 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.

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 1-14 and a short description of the portfolio included in column G.

Reconciliation to Financial Statements

Row 26 Total Value of Fair-Valued Portfolios

The 'Total Value of Fair-Valued Portfolios' is copied directly from row 21 for columns A-C.

Row 27 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 28 Fair-Valued Portfolios per Financial Statements

The sum of the 'Total Value of Fair-Valued Portfolios' in row 26 and the differences to the financial statements shown in row 27. 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 in the *firm's* financial statements.

Row 29 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 15.

Row 30 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 31 Portfolios Excluded due to Extreme Valuation Subjectivity

This is a narrative box which allows the *firm* to provide details of each 'Portfolio Excluded due to Extreme Valuation Subjectivity' the *firm* has chosen to disclose in row 19. 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 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 32 Portfolios of Particular Interest

This is a narrative box which allows the *firm* to provide details of each 'Portfolio of Particular Interest' the *firm* has chosen to disclose in row 25. 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 33 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	15C	=	15A-15B
16	16A	=	1A+2A+3A+4A+5A+6A+7A+8A+9A+10A+11A+12A+13A+14A+Sum(15A)
17	16B	=	1B+2B+3B+4B+5B+6B+7B+8B+9B+10B+11B+12B+13B+14B+Sum(15B)
18	16C	=	16A-16B
19	16E	=	1E+2E+3E+4E+5E+6E+7E+8E+9E+10E+11E+12E+13E+14E+Sum(15E)
20	16F	=	1F+2F+3F+4F+5F+6F+7F+8F+9F+10F+11F+12F+13F+14F+Sum(15F)
21	18A	=	16A
22	18B	=	16B
23	18C	=	18A-18B
24	18E	=	16E-17E
25	18F	=	16F-17F
26	19C	=	19A-19B
27	20A	=	Sum(19A)
28	20B	=	Sum(19B)
29	20C	=	20A-20B
30	20E	=	Sum(19E)
31	21A	=	18A+20A
32	21B	=	18B+20B
33	21C	=	21A-21B
34	22E	=	18E+20E
35	24E	=	22E-Sum(23E)
36	25C	=	25A-25B
37	26A	=	21A
38	26B	=	21B
39	26C	=	26A-26B
40	27C	=	27A-27B
41	28A	=	26A+Sum(27A)
42	28B	=	26B+Sum(27B)
43	28C	=	28A-28B

External Validations

There are no external validations for this data item.

Amend the following as shown.

Schedule 2 Notification requirements

…

Sch 2.2G

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
…				
SUP 16.14.5G	…			
SUP 16.16.4R	Reporting - Prudent Valuation Return - *UK banks* and *BIPRU 730k firms* which meet the condition in *SUP* 16.16.2R.	The items listed in the form contained in *SUP* 16 Annex 31AR.	Quarterly (the quarter ends are 31 March, 30 June, 30 September and 31 December).	Six weeks
…				

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