TNP

HARNESS THE UNPREDICTABLE

POSITION PAPER

PRUDENT VALUE

NAVIGATING REGULATORY CHANGES AND DATA INTEGRITY CHALLENGES

The Prudent Valuation Framework, established through the Capital Requirements Regulation (CRR) in the **aftermath of the Global Financial Crisis of 2007/2008**, was designed to ensure the conservative valuation of assets and liabilities by financial institutions. Rooted in Article 105(14) of the CRR, this framework was further refined through Regulatory Technical Standards (RTS) on prudent valuation. On January 16, 2024, the European Banking Authority (EBA) released a consultation paper proposing amendments to these RTS, reflecting ongoing efforts to adapt to new market realities and enhance regulatory oversight.

Prudent Valuation Framework

Prudent Valuation Adjustments (PVA) play a crucial role in ensuring that fair-valued assets and liabilities are assessed at their exit prices, under prevailing market conditions, with a 90% confidence level. These Additional Valuation Adjustments (AVAs) are directly deducted from Capital Equity Tier 1, affecting both trading and non-trading books. The framework offers two main approaches:

Simplified Approach: Targeted at institutions with less than EUR 15 billion in fair-valued assets and liabilities, this approach uses a straightforward formula—0.1% of the absolute value of these assets and liabilities—to determine the AVA.

Core Approach: More complex and applicable to larger institutions, this approach, described in the previous RTS, is both point-in-time (PiT) and forward-looking. It involves a detailed breakdown of AVAs into various drivers and risks, including Market Price Uncertainty (MPU), Close-out Costs (CoC), and Model Risk AVAs. Individual AVAs are calculated and aggregated using an alpha factor—originally set at 50%—which modulates the total AVA based on risk exposure.

The EBA's proposed amendments in the consultation paper aim to **promote best practices while imposing additional constraints**, especially for prudential purposes and extraordinary circumstances. Indeed, regarding best practices, some reduction in AVAs have been considered as benefits from arbitrage opportunities and not mitigation. Thus, back-to-back trades and securities financing transactions have been included in the simplified approach and the threshold calculation for triggering it. Furthermore, regarding reporting frequency, institutions must be aware of its valuation risks so that they may calculate every month provisions, even though reporting requirement is quarterly, as the competent authority may request reporting on a monthly basis.

Emphasis on Data Quality and Reliability

The amendments emphasize the quality, accuracy, and reliability of the data used in valuation processes. **The revised data sources hierarchy** imposes stricter qualitative requirements, underscoring the necessity for high-quality data that can withstand regulatory scrutiny.

This change limits the use of expert-based approaches, which had previously allowed institutions some flexibility in their valuations. Instead, the framework now favors more stringent, data-driven methods over range-based approaches, requiring banks to enhance their data management systems and validation processes.

These amendments place a significant burden on institutions to ensure that their data sources are not only accurate but also reliable and consistent. The shift from expert judgment to data-driven methods demands significant investments in technology and human resources to uphold the required data integrity standards.

Increased Constraints on the Core Approach

The amendments also introduce more restrictive measures for institutions using the core approach. One significant change is the removal of Method 2, which had previously been allowed for some flexibility in AVA calculations but was criticized for enabling potential cherry-picking practices. By eliminating this method, the EBA seeks to enforce a more consistent application of the core approach, although this will increase operational complexity and heighten reliance on precise data inputs.

Moreover, **the reduction of the alpha factor to 0%** represents a substantial tightening of the prudential context, leading to higher AVAs and necessitating advanced data techniques such as dimensionality reduction. This is particularly relevant in scenarii involving concentrated portfolios and counterparty risks, also in case of absence of fair value adjustments (MPU and CoC AVAs) or independent price verification (IPV) adjustments, when the latter can be calculated. Otherwise, the most restrictive fall-back approach, whose definition have been revised too, shall be applied, such as for unlisted equities. These changes underscore the importance of accurate and reliable data in managing the increased AVA burden.

Another critical aspect of the amendments is the clarification of the conditions under which Future Administration Cost AVA must be calculated. Previously, many institutions failed to include these costs due to misunderstandings about their scope. The new guidelines provide clearer instructions, but they also add complexity to the valuation process. Institutions must now ensure that the data used to calculate these costs are accurate and appropriately sourced, further increasing the demand for high-quality data management.

Consequences with CRR3 entry in force

The importance of accurate and reliable data was starkly highlighted during the COVID-19 pandemic when volatility and bid-ask spreads surged, leading to a significant increase in AVAs. The procyclicality of the Prudent Valuation Framework, being point-in-time and forward looking, exacerbated the market stress. Recognizing this issue, the EBA proposed revisions to the CRR to grant authorities powers under extraordinary circumstances similar to those outlined in Article 325az(5). With the introduction of CRR3, Article 34 now provides guidance on **identifying extraordinary circumstances** and applying prudent valuation rules, including the ability to raise the alpha factor to 66% to mitigate procyclicality. However, implementing these adjustments requires precise, high-quality data to determine the appropriate triggers and responses.

CRR3 also introduces changes related to concentration positions and liquidity horizons, along with a new, simplified formula for Operational Risk AVA following the removal of the Advanced Measurement Approach (AMA) from the operational risk framework. While this simplification may reduce some of the complexity, it also removes the flexibility that AMA provided, making it even more crucial for institutions to rely on accurate and reliable data in assessing operational risks.

A robust valuation framework requires not only strict regulatory compliance but also unwavering data accuracy and quality

To better understand the impact of these amendments, **the EBA has launched a Quantitative Impact Study** (QIS). This study is gathering responses from institutions to capture their concerns, viewpoints, and the potential implications of the proposed changes on their operations. The feedback from this study will be instrumental in refining the RTS and ensuring that the new requirements strike a balance between prudential objectives and the practical challenges faced by institutions.

The amendments to the regulatory technical standards on prudent valuation reflect the **EBA's ongoing efforts to enhance the robustness of the valuation framework**. However, these changes also introduce significant challenges for financial institutions, particularly in terms of data quality, accuracy, and reliability. As banks strive to comply with these new requirements, they must invest in strengthening their data management capabilities and refining their valuation processes. The ongoing Quantitative Impact Study will play a crucial role in shaping the final standards, potentially leading to a more balanced approach that considers both regulatory objectives and the operational realities of implementation.

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