Chapter 3

Own funds

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Prudent valuation and additional valuation adjustments

Application and purpose			
8.1	R	(1)	This annex applies for the purposes of calculating additional valuation adjustments under article 34 of the *UK CRR* (as applied by MIFIDPRU 3.3.1AR).
		(2)	Any reference to the *UK CRR* in this annex is to the *UK CRR* as applied and modified by MIFIDPRU 3.3.1R.
8.2	G	(1)	Under article 34 of the *UK CRR*, a *firm* must apply the requirements of article 105 of the *UK CRR* to the *firm's* assets measured at fair value when calculating the amount of its *own funds*.
		(2)	Under MIFIDPRU 3.3.1AR, a *firm* is only required to apply article 34 of the *UK CRR* to positions held within its *trading book*.
Sources of market data			
8.3	R	(1)	Where a *firm* calculates an *AVA* based on market data, it must consider the same range of market data as the data used in the independent price verification process referred to in article 105(8) of the *UK CRR*, subject to the adjustments in this *rule*.
		(2)	A *firm* must consider the full range of available and reliable market data sources to determine a prudent value, including each of the following to the extent relevant: (a) exchange prices in a liquid market; (b) trades in the *financial instrument* or a very similar instrument, either from the *firm's* own records or, where available, trades from across the market; (c) tradable quotes from brokers and other market participants; (d) consensus service data; (e) indicative broker quotes; and (f) counterparty collateral valuations.
		[**Note**: article 3 of BTS 2016/101.]	
Determination of AVAs			
8.4	R	(1)	A *firm* must calculate the value of assets for which the *firm* must determine *AVAs* in accordance with this *rule*.

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		(2)	The value in (1) is the sum of the absolute value of fair-valued assets and liabilities, as stated in the *firm's* financial statements in accordance with the applicable accounting framework, modified as follows:			
			(a)	exactly matching offsetting fair-valued and liabilities must be excluded; and		
			(b)	where a change in the accounting valuation of fair-valued assets and liabilities would:		
				(i)	only be partially reflected in *common equity tier 1 capital*, the value of those assets or liabilities must only be included in proportion to the impact of the relevant valuation change on *common equity tier 1 capital*; or	
				(ii)	have no impact on *common equity tier 1 capital*, the value of those assets or liabilities must be excluded.	
		[**Note**: article 4 of BTS 2016/101.]				
8.5	R	A *firm's* total *AVAs* are 0.1% of the sum of the assets calculated under MIFIDPRU 3 Annex 8.4R(1).				
		[**Note**: articles 5 and 6 of BTS 2016/101.]				
Documentation, systems and controls						
8.6	R	A *firm* must appropriately document its prudent valuation methodology and its policies on the following:				
		(1)	the range of methodologies for quantifying *AVAs* for each valuation position;			
		(2)	the hierarchy of methodologies for each asset class, product, or *valuation position*;			
		(3)	the hierarchy of market data sources used in the *AVA* methodology;			
		(4)	the required characteristics of market data to justify a zero *AVA* for each asset class, product, or *valuation position*; and			
		(5)	the fair-valued assets and liabilities for which a change in accounting valuation has a partial or no impact on *common equity tier 1 capital* according to MIFIDPRU 3 Annex 8.4R(2)(b).			

		[**Note**: article 18(1) of BTS 2016/101.]		
8.7	R	The *firm* must ensure that the documentation and policies in MIFIDPRU 3 Annex 8.6R are:		
		(1)	reviewed at least annually; and	
		(2)	approved by the firm's senior management following each review. [Note: article 18(3) of BTS 2016/101.]	
8.8	R	A *firm* must:		
		(1)	maintain records to allow the calculation of *AVAs* at *valuation exposure* level to be analysed; and	
		(2)	ensure that the senior management of the *firm* are provided with information from the *AVA* calculation process to permit them to understand the level of valuation uncertainty on the *firm's* portfolio of fair-valued positions.	
		[**Note**: article 18(3) of BTS 2016/101.]		
Systems and controls requirements				
8.9	R	A *firm* must ensure that *AVAs* are authorised and subsequently monitored by an independent control function.		
		[**Note**: article 19(1) of BTS 2016/101.]		
8.10	R	(1)	A *firm* must have:	
			(a)	effective controls related to the governance of all fair-valued positions; and
			(b)	adequate resources to implement the controls in (a) and ensure robust valuation processes even during a stressed period.
		(2)	The controls and processes in (1) must include the following:	
			(a)	a review of the performance of the *firm's* valuation model at least annually;
			(b)	approval by senior management of all significant changes to valuation policies;
			(c)	a clear statement of the *firm's* risk appetite for exposure to positions subject to valuation uncertainty, which must be monitored at an aggregate *firm*-wide level;
			(d)	independence in the valuation process between risk-taking and internal control functions; and
			(e)	a comprehensive internal audit process relating to valuation processes and controls.
		[**Note**:article 19(2) of BTS 2016/101.]		
8.11	R	(1)	A *firm* must:	

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(a) have effective and consistently applied controls relating to the valuation process for all fair-valued positions; and

(b) ensure that the controls in (a) are subject to regular internal audit review.

(2) The controls in (1) must include the following:

(a) a precisely defined *firm*-wide product inventory, ensuring that every *valuation position* is uniquely mapped to a product definition;

(b) valuation methodologies for each product in the inventory covering:

(i) the choice and calibration of model;

(ii) fair value adjustments;

(iii) independent price verification;

(iv) *AVAs*;

(v) the methodologies applicable to the product; and

(vi) the measurement of valuation uncertainty.

(c) a validation process ensuring that, for each product, both the risk-taking and relevant control functions approve the product-level methodologies described in point (b) and certify that they reflect the actual practice for every *valuation position* mapped to the product;

(d) defined thresholds based on observed market data for determining when valuation models are no longer sufficiently robust;

(e) a formal independent price verification process based on prices independent from the relevant trading desk;

(f) a new product approval process referencing the product inventory and involving all internal stakeholders relevant to risk

		measurement, risk control, financial reporting and the assignment and verification of valuations of *financial instruments*; and
	(g)	a new deal review process to ensure that pricing data from new trades are used to assess whether valuations of similar valuation exposures remain appropriately prudent.

[**Note**: article 19(3) of BTS 2016/101.]