

General Prudential sourcebook

Chapter 1

Application

1.3 Valuation

Application

- 1.3.1 **R** (1) [deleted]
(2) This section of the *Handbook* applies to a *BIPRU firm*.
(3) [deleted]

- 1.3.1A **R**

Purpose

- 1.3.2 **G** This section sets out, for the purposes of *GENPRU* and *BIPRU*, *rules* and *guidance* as to how a *firm* should recognise and value assets, liabilities, *exposures*, equity and income statement items.

- 1.3.3 **G** (1) In the case of a *BIPRU firm*, this section implements Articles 64(4) and 64(5) of the *Banking Consolidation Directive* (Own funds) and Article 33 and Part B of Annex VII of the *Capital Adequacy Directive*.
(2) [deleted]

General requirements: Accounting principles to be applied

- 1.3.4 **R** Subject to ■ GENPRU 1.3.9 R to ■ GENPRU 1.3.10 R and ■ GENPRU 1.3.36 R, except where a *rule* in *GENPRU*, *BIPRU* or *INSPRU* provides for a different method of recognition or valuation, whenever a *rule* in *GENPRU* or *BIPRU* refers to an asset, liability, *exposure*, equity or income statement item, a *firm* must, for the purpose of that *rule*, recognise the asset, liability, *exposure*, equity or income statement item and measure its value in accordance with whichever of the following are applicable:
 - (1) [deleted]
 - (2) Financial Reporting Standards issued by the Financial Reporting Council;
 - (3) Statements of Recommended Practice, issued by industry or sectoral bodies recognised for this purpose by the Financial Reporting Council;
 - (4) [deleted]

(5) *international accounting standards*;

(6) the Companies Act 1985; and

(7) the Companies Act 2006;

as applicable to the *firm* for the purpose of its external financial reporting (or as would be applicable if the *firm* was a company with its head office in the *United Kingdom*).

1.3.5

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Except where a *rule* in *GENPRU* or *BIPRU* makes a different provision, ■ GENPRU 1.3.4 R applies whenever a *rule* in *GENPRU* or *BIPRU* refers to the value or amount of an asset, liability, *exposure*, equity or income statement item, including:

- (1) whether, and when, to recognise or de-recognise an asset or liability;
- (2) the amount at which to value an asset, liability, *exposure*, equity or income statement item; and
- (3) which description to place on an asset, liability, *exposure*, equity or income statement item.

1.3.6

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In particular, unless an exception applies, ■ GENPRU 1.3.4 R should be applied for the purposes of *GENPRU* or *BIPRU* to determine how to account for:

- (1) netting of amounts due to or from the *firm*;
- (2) the securitisation of assets and liabilities (see also ■ GENPRU 1.3.7 G);
- (3) leased tangible assets;
- (4) assets transferred or received under a sale and repurchase or *stock lending* transaction; and
- (5) assets transferred or received by way of initial or variation margin under a *derivative* or similar transaction.

General requirements: Adjustments to accounting values

1.3.9

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For the purposes of *GENPRU* or *BIPRU*, except where a *rule* in *GENPRU* or *BIPRU* provides for a different method of recognition or valuation:

- (1) when a *firm*, upon initial recognition, designates its liabilities as at fair value through profit or loss, it must always adjust any value calculated in accordance with ■ GENPRU 1.3.4 R by subtracting any unrealised gains or adding back in any unrealised losses which are not attributable to changes in a benchmark interest rate;
- (2) in respect of a *defined benefit occupational pension scheme*:
 - (a) a *firm* must derecognise any *defined benefit asset*;
 - (b) a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*.

- 1.3.10 R An election made under ■ GENPRU 1.3.9R (2) must be applied consistently for the purposes of *GENPRU* or *BIPRU* in respect of any one financial year.
- 1.3.11 G A *firm* should keep a record of and be ready to explain to its supervisory contacts in the *appropriate regulator* the reasons for any difference between the *deficit reduction amount* and any commitment the *firm* has made in any public document to provide funding in respect of a *defined benefit occupational pension scheme*.
- 1.3.12 G The provisions of ■ GENPRU 1.3.9 R to ■ GENPRU 1.3.10 R and ■ GENPRU 1.3.36 R apply only to the extent that the items referred to in those paragraphs would otherwise be recognised under the accounting requirements applicable to the *firm*. Some of those requirements may only be relevant to a *firm* subject to *international accounting standards*.

General requirements: Methods of valuation and systems and controls

- 1.3.13 R
 - (1) Except to the extent that *GENPRU* or *BIPRU* provide for another method of valuation, ■ GENPRU 1.3.14 R to ■ GENPRU 1.3.34 R (Marking to market, Marking to model, Independent price verification or Valuation adjustments) apply:
 - (a) for the purposes set out in ■ GENPRU 1.3.41 R;
 - (b) for the purposes set out in ■ GENPRU 1.3.39 R; and
 - (c) to any balance sheet position measured at market value or fair value.
 - (2) A *firm* must establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates.
 - (3) Systems and controls under (2) must include at least the following elements:
 - (a) documented policies and procedures for the process of valuation, including clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month-end and ad-hoc verification procedures, and, in the case of a *BIPRU firm*, guidelines for the use of unobservable inputs reflecting the *firm's* assumptions of what market participants would use in pricing the *position*; and
 - (b) reporting lines for the department accountable for the valuation process that are:
 - (i) clear and independent of the front office; and
 - (ii) ultimately to a main board executive director.

General requirements: Marking to market

- 1.3.14 R Wherever possible, a *firm* must use mark to market in order to measure the value of the investments and positions to which this *rule* applies under ■ GENPRU 1.3.13 R and ■ GENPRU 1.3.38 R to ■ GENPRU 1.3.41 R. Marking to

market is valuation (on at least a daily basis in the case of the *trading book* positions of a *BIPRU firm*) at readily available close out prices from independent sources.

1.3.15 **R** For the purposes of ■ GENPRU 1.3.14 R, examples of readily available close out prices include exchange prices, screen prices, or quotes from several independent reputable brokers.

1.3.16 **R**

- (1) When marking to market, a *firm* must use the more prudent side of bid/offer unless the *firm* is a significant market maker in a particular position type and it can close out at the mid-market price.
- (2) When calculating the current *exposure* value of a credit risk *exposure* for *counterparty credit risk* purposes:
 - (a) a *firm* must use the more prudent side of bid/offer or the mid-market price and the *firm* must be consistent in the basis it chooses; and
 - (b) where the difference between the more prudent side of bid/offer and the mid-market price is material, the *firm* must consider making adjustments.

General requirements: Marking to model

1.3.17 **R** Where marking to market is not possible, a *firm* must (in the case of a *BIPRU firm*, conservatively) use mark to model in order to measure the value of the investments and positions to which this *rule* applies under ■ GENPRU 1.3.13 R and ■ GENPRU 1.3.38 R to ■ GENPRU 1.3.41 R. Marking to model is any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input. ■ GENPRU 1.3.18 R to ■ GENPRU 1.3.25 R apply when marking to model.

1.3.18 **R** When the model used is developed by the *firm*, that model must be:

- (1) based on appropriate assumptions which have been assessed and challenged by suitably qualified parties independent of the development process;
- (2) independently tested, including validation of the mathematics, assumptions, and software implementation; and
- (3) (in the case of a *BIPRU firm*) developed or approved independently of the front office.

1.3.19 **R** A *firm* must ensure that its senior management are aware of the positions which are subject to mark to model and understand the materiality of the uncertainty this creates in the reporting of the performance of the business of the *firm* and the risks to which it is subject.

1.3.20 **R** A *firm* must source market inputs in line with market prices so far as possible and assess the appropriateness of the market inputs for the position being valued and the parameters of the model on a frequent basis.

- 1.3.21 **R** A *firm* must use generally accepted valuation methodologies for particular products where these are available.
- 1.3.22 **R** A *firm* must establish formal change control procedures, hold a secure copy of the model, and periodically use that model to check valuations.
- 1.3.23 **R** A *firm* must ensure that its risk management functions are aware of the weaknesses of the models used and how best to reflect those in the valuation output.
- 1.3.24 **R** A *firm* must periodically review the model to determine the accuracy of its performance.
- 1.3.25 **R** Examples of periodical review are assessing the continued appropriateness of the assumptions, analysis of profit and loss versus risk factors and comparison of actual close out values to model outputs.
- General requirements: Independent price verification**
- 1.3.26 **R** In addition to marking to market or marking to model, a *firm* must perform independent price verification. This is the process by which market prices or model inputs are regularly verified for accuracy and independence.
- 1.3.27 **G** For independent price verification, where independent pricing sources are not available or pricing sources are more subjective (for example, only one available broker quote), prudent measures such as valuation adjustments may be appropriate.
- 1.3.28 **R** In the case of the *trading book* positions of a *BIPRU firm*, while daily marking to market may be performed by dealers, verification of market prices and model inputs must be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/trading activity, more frequently).
- General requirements: Valuation adjustments**
- 1.3.29 **R** The recognition of any gains or losses arising from valuations subject to ■ GENPRU 1.3.13 R and ■ GENPRU 1.3.38 R to ■ GENPRU 1.3.41 R must be recognised for the purpose of calculating *capital resources* in accordance with ■ GENPRU 1.3.14 R to ■ GENPRU 1.3.34 R (Marking to market, Marking to model, Independent price verification or Valuation adjustments). However if *GENPRU* or *BIPRU* provide for another treatment of such gains or losses, that other treatment must be applied.
- 1.3.30 **R** A *firm* must establish and maintain procedures for considering valuation adjustments. These procedures must be compliant with the requirements set out in ■ GENPRU 1.3.33 R.

- 1.3.31** **R** A *firm* using third-party valuations, or marking to model, must consider whether valuation adjustments are necessary.
- 1.3.32** **R** A *firm* must consider the need for making adjustments for less liquid positions and, on an ongoing basis, review their continued appropriateness in accordance with the requirements set out in **■ GENPRU 1.3.33 R**. Less liquid positions could arise from both market events and institution-related situations e.g. concentration positions and/or stale positions.
- 1.3.33** **R**
- (1) This paragraph sets out the requirements referred to in **■ GENPRU 1.3.30 R** and **■ GENPRU 1.3.32 R**.
 - (2) A *firm* must consider the following adjustments: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where appropriate, model risk.
 - (3)
 - (a) In the case of a *BIPRU firm*, a *firm* must establish and maintain procedures for calculating adjustments to the current valuation of less liquid positions. Those adjustments must, where necessary, be in addition to any changes to the value of the position required for financial reporting purposes and must be designed to reflect the illiquidity of the position.
 - (b) A *firm* must consider several factors when determining whether a valuation adjustment is necessary for less liquid positions. These factors include the amount of time it would take to hedge out the position/risks within the position; the average and volatility of bid/offer spreads; the availability of market quotes (number and identity of market makers); the average and volatility of trading volumes; market concentrations; the ageing of positions; the extent to which valuation relies on marking to model and the impact of other model risks.
 - (4) With regard to complex products including, but not limited to, *securitisation exposures* and *nth-to-default credit derivatives*, a *BIPRU firm* must explicitly consider the need for valuation adjustments for model risk arising from using a valuation which may be incorrect or the risk from using unobservable calibration parameters in the valuation model.
- 1.3.34** **R** If the result of making adjustments under **■ GENPRU 1.3.29 R** to **■ GENPRU 1.3.33 R** is a valuation which differs from the fair value determined in accordance with **■ GENPRU 1.3.4 R**, a *firm* must reconcile the two valuations.
- 1.3.35** **G** Reconciliation differences under **■ GENPRU 1.3.34 R** should not be reflected in the valuations under **■ GENPRU 1.3** but should be disclosed to the *FCA* 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 *FCA* under **■ SUP 16.16.4 R**.
- 1.3.35A** **G**

Specific requirements: BIPRU firms

- 1.3.36** **R** Adjustments to accounting values
- (1) For the purposes of *GENPRU* and *BIPRU*, the adjustments in (2) and (3) apply to values calculated pursuant to **GENPRU 1.3.4 R** in addition to those required by **GENPRU 1.3.9 R** to **GENPRU 1.3.10 R**.
 - (2) A *BIPRU firm* must not recognise either:
 - (a) the fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortised cost; or
 - (b) any unrealised gains or losses on debt instruments held, or formerly held, in the available-for-sale category.
 - (3) A *BIPRU firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.
 - (4) The items referred to in (2) and (3) must be excluded from *capital resources*.

- 1.3.37** **G** Provisions for equity instruments held in the available-for-sale category can be found in **GENPRU 2.2.185 R**.

Trading book and other fair-valued positions, and revaluations

- 1.3.38** **R** to **GENPRU 1.3.40 R** apply only to a *BIPRU firm*.
- 1.3.39** **R** Both *trading book* positions and other fair-valued positions are subject to prudent valuation rules as specified in **GENPRU 1.3.14 R** to **GENPRU 1.3.34 R** (Marking to market, Marking to model, Independent price verification, Valuation adjustments or, in the case of an insurer or a UK ISPV, valuation adjustments or reserves). In accordance with those *rules*, a *firm* must ensure that the value applied to each of its *trading book* positions and other fair-valued positions appropriately reflects the current market value. This value must contain an appropriate degree of certainty having regard to the dynamic nature of *trading book* positions, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of *trading book* positions and other fair-valued positions.
- 1.3.40** **R** *Trading book* positions must be re-valued at least daily.