

# Prudent valuation versus confidence accounting

As the financial crisis showed, the market sometimes does not know what something is worth. David Rowe argues explicit estimates of value uncertainty would be a better way of addressing this than so-called prudent valuations

**W**e often try to simplify complex concepts by reducing their dimensionality. For example, we talk about the stock market rising or falling by a certain percentage amount when we are really talking about the change in an index that is a weighted average of the prices of many different shares.

Such simplifications are necessary and usually fairly harmless. The more complex underlying reality is usually quite close to the surface and will occasionally exhibit sufficiently unusual characteristics to be worthy of note. An example would be when a small market drop was the result of a modest rise in the price of most shares offset by a large drop in one given sector.

Sometimes, however, insisting on representing a complex reality with a single number creates a spurious impression of precision and confidence. One example of this is the presentation of financial statements as a set of precise single numbers. Two proposals seek to address this issue in very different ways. The first is the final draft of the European Banking Authority's (EBA) 50-page standards on prudent valuation.<sup>1</sup> The paper accurately notes that asset valuation may rely on a wide variety of available data. These categories include:

- Exchange prices in a liquid market;
- The price of actual transactions in the same or very similar instruments from an institution's own records or from independent trade reporting services;
- Tradable quotes from brokers and other market-makers;
- Consensus pricing service data<sup>2</sup>;
- Indicative (ie, not binding) broker quotes, and
- Counterparty collateral calculations.

The EBA publication contains detailed procedures for deriving a variety of additional valuation adjustments (AVAs) relative to expected values for various positions. These are to reflect the possible impact of market price uncertainty, close-out costs, model risk, unearned credit spreads, investing and funding costs, concentrated positions, future administrative costs, potential early termination and operational risk. It also specifies simplistic and generally 'conservative' procedures for aggregating these AVAs.

The stated goal is to assure that "the prudent value of a position is linked to a range of plausible values and a specified level of certainty (90%)". A puzzling gap in the document is a clear statement of how this level of confidence is to be tested after the fact.

The closest the EBA comes to an answer is in the discussion of close-out costs. Here, it is stated that "institutions shall estimate a point within the range [of plausible bid-offer spreads] where they are 90% confident that the spread they could achieve in exiting the valuation exposure would be at that price or better". This appears to imply a liquidation rather than a going-concern perspective. If applied broadly, it could have dramatic ramifications for institutions' post-AVA net worth.

Clearly, this cannot be the EBA's intent. The simplified approach involves an across-the-board AVA equal to 0.1% of the sum of the absolute value of fair-valued assets and liabilities. A 'best efforts' quantitative impact study estimated the effect of the more complex core approach to be an even smaller 0.07%.

To an external observer, it appears the EBA has laboured mightily and delivered a mouse, albeit one that will add considerable compliance costs and raise yet another barrier to entry in an industry where enhanced competition would be socially desirable.

Perhaps most disturbing is that the EBA proposal is slavishly bound to the traditional point-estimate approach to accounting. A more constructive approach would be to introduce explicit estimates of uncertainty around reported fair-value figures. This idea is advanced in detail in

a paper published in July 2012,<sup>3</sup> which describes a way of providing supplementary information to traditional financial statements that illuminates the degree of uncertainty around valuation estimates. It deals with several sticky issues, including how to partition uncertainty surrounding current valuation from the more familiar concept of risk from uncertain future events, and the messy issue of how to aggregate valuation uncertainty for specific positions into the implied uncertainty of net worth.

Confidence accounting would enhance awareness of the varying degrees of uncertainty in financial reports. For that reason alone, it is worth serious consideration. **R**



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<sup>1</sup> European Banking Authority, March 31, 2014 (<https://www.eba.europa.eu/documents/10180/642449/EBA-RTS-2014-06+RTS+on+Prudent+Valuation.pdf>)

<sup>2</sup> This could include matrix pricing of rarely traded bonds based on triangulation to observable trades of similar bonds – a common practice in the US municipal bond market, where many small issues may not trade for weeks or months at a time.

<sup>3</sup> Harris, Ian; Mainelli, Michael and Onstwedder, Jan-Peter; Confidence accounting: a proposal, ACCA, CISI and Long Finance; London, July 2012 (<http://www.longfinance.net/images/PDF/Confidence%20Accounting1.pdf>)