d-fine

Prudent Valuation (AVAs) in COVID-19 crisis

Time to optimize your capital utilization!

analytical. quantitative. tech.

March 2020

COVID-19 related crisis: AVAs add to capital stress

Essential part of the prudent valuation (CRR, Art. 105) is the calculation of additional valuation adjustments (AVAs, cf. del. Regulation (EU) 2016/101). The AVAs in essence lower the available CET1-capital by lowering the value of fair valued books to the so-called prudent value aiming at a 90%-confident exit price (cf. figure 1)

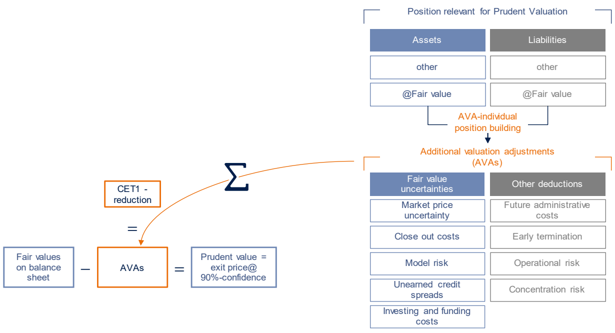

Figure 1: The mechanics of additional valuation adjustments (AVAs)

Since inception, the pro-cyclical nature of AVAs was pointed out by practitioners: In particular, in times of severe market stress, the 90%-quantile of exit prices is structurally different from the 90%-quantile as estimated under normal market conditions (cf. figure 2 for an illustrative sketch for a single valuation input). As a result, in times of market stress, the AVAs do not dampen capital effects due to fair valuation, but risk to propagate market exaggerations and distortions directly into CET1.

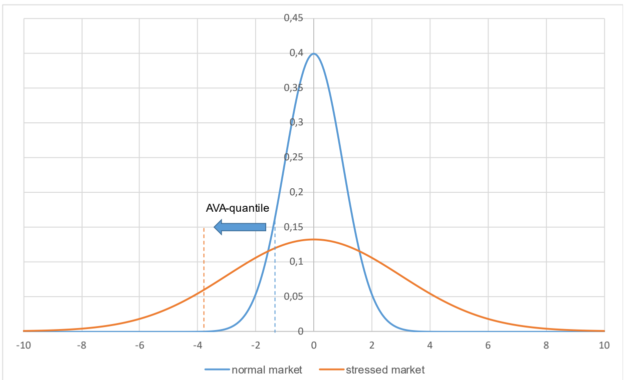

Figure 2: Illustrative distribution (density) of a valuation input with typical quantile movement due to stress

This will become apparent in the Q1 AVA-figures, which will show the full impact of COVID-19 related thin liquidity, high volatility and widened spread. The capital needed for supporting credit business in particular (and therefore being protected by current regulatory ad-hoc measures) will be hit.

Systematic cushions for capital stress: Optimizing AVA methods

Commonly, observed market data simply propagate through the AVA methodological frameworks, yielding figures, which are in this sense correct under the circumstances. Thus, in the absence of targeted measures, the CET1-capital will be hit automatically as described above.

There are two distinct strategies to dampen this effect on CET1-capital:

1 Ad-hoc measures: Essentially, the validity of currently observed market data may be questioned. This can be implemented by either grooming the resulting statistics or by directly moving to proxies by expert judgement reflecting more or less a through-the-cycle view. However, these measures need to be aligned with fair valuation practices in the stress period. Furthermore, they will lose their effect after going back to a normal market.

2 Sustainable measures: Regulation allows for various methodological refinements to systematically lower AVAs. This holds in particular for the usually most important AVAs concerning fair value uncertainties (cf. figure 1). This does not directly approach the pro-cyclicality, however, if figures e.g. double, they double on a considerably lower level. Furthermore, the lowering effect stays through the cycle.

It is time to take measures.

We support you!

We design, implement and optimize prudent valuation frameworks for 10+ years for all kind of bank's business models.

From this experience, we recommend considering both strategies above to be able to react swiftly to the crisis at hand and to take the opportunity to optimize your AVA methodologies. Given usual costs of capital, project cost will amortize in less than a year!

Please do not hesitate to get in touch.

Your contact at d-fine

DR. HANS PETER WÄCHTER, CFA, FRM
Senior Manager, d-fine GmbH, Frankfurt
hanspeter.waechter@d-fine.de

You can explore our services on www.d-fine.com, or contact us via phone +49 (0)69 90 737 0.

Berlin
d-fine GmbH
Friedrichstraße 68
10117 Berlin
Germany
berlin@d-fine.de

Dusseldorf
d-fine GmbH
Dreischeibenhaus 1
40211 Dusseldorf
Germany
duesseldorf@d-fine.de

Frankfurt
d-fine GmbH
An der Hauptwache 7
60313 Frankfurt
Germany
frankfurt@d-fine.de

London
d-fine Ltd
6-7 Queen Street
London, EC4N 1SP
United Kingdom
london@d-fine.co.uk

Munich
d-fine GmbH
Bavariafilmplatz 8
82031 Grünwald
Germany
muenchen@d-fine.de

Vienna
d-fine Austria GmbH
Riemergasse 14 Top 12
1010 Vienna
Austria
wien@d-fine.at

Zurich
d-fine AG
Brandschenkestrasse 150
8002 Zurich
Switzerland
zuerich@d-fine.ch

d-fine