BANK OF ENGLAND

August 2017

The Bank of England's proposed policy on valuation capabilities to support resolvability

A Consultation Paper

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This consultation paper sets out the Bank of England's proposed policy for the capabilities firms should have in place to ensure that an inability to produce timely and robust resolution valuations does not impede resolvability. The proposed policy applies to UK-based firms whose preferred resolution strategy involves the use of stabilisation powers, and to material UK subsidiaries of overseas-based banking groups.

The Bank of England welcomes views on its proposed policy. The Bank of England reserves the right to publish any information which it may receive as part of this consultation.

Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure, in accordance with access to information regimes under the Freedom of Information Act 2000 or the Data Protection Act 1998 or otherwise as required by law or in discharge of our statutory functions.

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Responses are requested by 17 November 2017.

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1 Overview

1.1 This consultation paper sets out the Bank of England's (the Bank's) preliminary views on a policy for the valuation capabilities firms should have in place to support resolvability.

1.2 For the purposes of this consultation paper, references to "firms" should in general be taken to include:

(i) Banks, building societies and certain investment firms that are authorised by the Prudential Regulation Authority (PRA) or Financial Conduct Authority (FCA) and are incorporated in, or formed under the law of any part of, the United Kingdom;

(ii) parent companies of such institutions that are financial holding companies or mixed financial holding companies and are established in, or formed under the law of any part of, the United Kingdom; and

(iii) subsidiaries of such institutions or such parent companies that are financial institutions authorised by the PRA or FCA, and are established in, or formed under the law of any part of, the United Kingdom.

1.3 The Bank is legally required[1] to obtain independent valuations when using resolution tools set out in Part 1 of the Banking Act 2009 (the Banking Act).[2] These valuations will be a key input into the Bank's decisions around the application of resolution tools. To ensure that resolution is credible and effective, it will be crucial for the necessary valuations to be timely and robust. However, given the inherent complexity of the valuation task, it is unreasonable to expect that resolution valuations will be sufficiently timely and robust unless firms themselves have suitable valuation capabilities in place prior to resolution. These capabilities include the data, systems, and processes that collectively support valuations of a firm's assets, liabilities, and shares.

1.4 The Bank considers that limitations to a firm's valuation capabilities constitute an impediment to resolvability where they would not reliably enable valuations that support that firm's intended resolution strategy. Insufficiently timely and robust valuations present a number of risks to effective resolution, including delays to resolution action, insufficient resolution action being taken, misallocation of equity across bailed-in creditors, and the associated costs and risks to financial stability, market confidence, and public funds.

1.5 The Bank is developing a policy for the minimum standard of valuations capabilities firms should have in place to support resolvability. The Bank is now seeking views on its proposed policy as set out in this consultation paper. The Bank will use feedback received on this consultation paper to ensure that any policy adopted in the future would be as effective as possible while seeking to avoid any unintended consequences and undue compliance costs.

1.6 This consultation paper is structured as follows:

[1] Under section 6E of the Banking Act.

[2] These tools include the five stabilisation options and the power to convert or write-down certain capital instruments at the point of non-viability through a mandatory reduction.

- Section 1: Overview sets out the purpose of this paper and provides a high level summary of the Bank's proposals;
- Section 2: Context explains the role of valuations in resolution and the potential for valuation capabilities to constitute a barrier to resolvability;
- Section 3: Proposed policy approach sets out the Bank's thinking around how requirements for valuation capabilities would be applied.
- Section 4: Application of the proposed policy sets out the Bank's views on the scope of firms and valuations to which the proposed policy would apply;
- Section 5: Proposed policy objectives sets out the Bank's proposed objectives for resolution valuation capabilities, and summarises the rationale behind these;
- Section 6: Proposed principles sets out the Bank's proposed principles for resolution valuation capabilities, and summarises the rationale behind these;
- Section 7: Preliminary impact assessment provides a preliminary qualitative assessment of the costs and benefits of the Bank's proposed valuations policy;
- Section 8: Next steps sets out discussion questions and details on how to respond to this consultation paper.

1.7 The Bank welcomes feedback on all aspects of this paper and the discussions questions listed in Section 8 by 17 November 2017.

Box 1: Overview of the proposed policy

The proposed policy sets out the Bank's principles-based expectations for firms' valuation capabilities. Firms are expected to develop, enhance, and maintain their capabilities to meet the required standard. Where they do not, the Bank would consider using its resolvability power of direction[3] to ensure that the necessary improvements were made.

We intend the proposed policy to apply to all firms where resolution-specific valuations are expected to be needed. This includes:

a) Firms whose preferred resolution strategy involves the use of statutory stabilisation tools in the UK, as determined by the Bank in accordance with the indicative thresholds set out in the Bank's "Statement of Policy on the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)"[4] and communicated to firms on an individual basis. In these cases, the firm will need capabilities to support the valuations required under the Banking Act, Bank Recovery and Resolution Directive (BRRD), and associated regulatory technical standards.

[3] The Bank's "resolvability power of directions" refers to Bank's power of direction to require firms to address barriers to resolvability under section 3A of the Banking Act.

[4] The Bank of England's approach to setting a Minimum Requirement for own funds and Eligible Liabilities (MREL) - responses to consultation and Statement of Policy, November 2016

b) Firms that are material UK subsidiaries of an overseas-based banking group, as reflected in a judgement by the Bank to hold internal MREL in addition to regulatory capital requirements.[5] In these cases, the firm will need capabilities to support valuations to adequately inform the Bank's decisions around the conversion of internal MREL. Firms should also look to the technical specifications of valuations required in their home jurisdiction (where these exist).

Under the proposed policy, these firms would be expected to have capabilities in place to support the objective that valuations are sufficiently timely and robust not to impede the effectiveness of their preferred resolution strategy.

Under the proposed policy, firms would be expected to establish, maintain, and demonstrate valuation capabilities that meet the following principles:

(i) **Data and information:** Firms should ensure that the underlying data and information are complete and accurate, and that relevant data and information would be readily available to a valuer.

(ii) **Valuation models:** As necessary to meet the timeliness objective, firms should have valuation models in place that are available to be tested and used by a valuer.

(iii) **Valuation methodologies:** Valuation models should use methodologies that are consistent with the methodologies a valuer could reasonably be expected to apply in producing valuations that met the robustness objective.

(iv) **Valuation assumptions:** Firms should have models and processes that use realistic valuation assumptions, and that enable a valuer to review, revise, and demonstrate sensitivity to these assumptions if necessary.

(v) **Governance:** Firms should apply sound governance arrangements and processes to ensure that valuation capabilities are maintained in business-as-usual and available prior to and during resolution.

(vi) **Transparency:** Firms should document, and be open with the Bank and the valuer about, their valuations capabilities and any associated limitations.

(vii) **Assurance:** Firms should periodically review and evaluate their valuations capabilities with regard to these principles, and should facilitate reviews undertaken by the Bank or a third party to test compliance.

[5] References to "regulatory capital requirements" mean the amount of capital required to meet the (i) overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 of the PRA Rulebook or IFPRU 2.2.1R of the FCA Rulebook (as applicable) and (ii) (if applicable) minimum leverage ratio in Leverage Ratio 3.1 of the PRA Rulebook. Unless otherwise specified, this refers to Pillar 1 requirements and Pillar 2A add-ons applicable to an institution, or any higher applicable leverage ratio or Basel I floor. Capital and leverage buffers are treated separately.

2 Context

2.1 This section provides background information on the valuations required for resolution and the potential for valuations capabilities to constitute a barrier to resolvability.

Valuations required for resolution

Resolutions involving the use of resolution tools in the UK

2.2 For the resolution of larger UK-incorporated firms, and the resolution of UK sub-groups of overseas based multiple-point-of-entry (MPE) groups, the Bank intends to use the stabilisation powers set out in the BRRD, as transposed into the Banking Act in the UK. Article 36 of the BRRD, and section 6E of the Banking Act, require the Bank to obtain valuations of the firm (at least provisionally)[6] before applying stabilisation powers or using mandatory reduction powers to write down or convert capital instruments outside resolution at the point of non-viability.

2.3 The purpose of these pre-resolution valuations is to ensure the full extent of expected losses are appreciated at the point that tools are applied, and to inform decisions as to:

- Whether the statutory conditions for using stabilisation powers or mandatory reduction powers have been met;
- Which stabilisation powers should be used;
- The extent of any cancellation, dilution, transfer, write-down or conversion of shares, capital instruments, or eligible liabilities;
- What assets, liabilities, or securities (e.g. shares), if any, are to be transferred under a transfer tool;[7] and
- The consideration paid in respect of any assets, liabilities, or securities transferred.

2.4 For the use of stabilisation power(s) (as well as the mandatory reduction power), the Bank must appoint an independent valuer to carry out the valuations required under the Banking Act. The independent valuer must possess sufficient skills and resources, and must meet criteria for independence, as set out in the European Banking Authority's (EBA's) regulatory technical standard (RTS) on independent valuers as adopted by the European Commission.[8]

2.5 Section 6E(6) of the Banking Act requires that pre-resolution valuations follow the methodologies set out in the EBA's RTS on pre-resolution valuations.[9] This RTS will be binding once it is adopted by the European Commission as a regulation. This consultation has been prepared on the basis of the EBA's final draft RTS published on 23 May 2017. The Bank will review its approach to valuations capabilities to ensure it is compatible with the RTS as finally adopted by the Commission. At a high level, the valuations required under this RTS will include:

[6] In cases of urgency, the Bank may carry out a provisional valuation itself, but must subsequently obtain a replacement valuation from an independent valuer to determine the final terms of the resolution.
[7] Transfer tools include the sale of business option, the bridge bank option, and the asset management vehicle option.
[8] Regulation (EU) 2016/1075
[9] EBA/RTS/2017/05

- An updated valuation of assets and liabilities in accordance with accounting and prudential rules – for the purpose of informing authorities' determination of whether an institution is failing or likely to fail;

- A valuation of the firm's assets and liabilities on a hold value and/or disposal value basis, reflecting the intended resolution strategy – for the purposes of determining the necessary write-down, conversion, or transfer, and (in a bail-in) of informing the firm's restructuring plan;

- Where applicable, an estimate of the market value of equity in the resolved firm – for the purposes of determining the allocation of shares to creditors in a bail-in, or informing what constitutes commercial terms for a transfer of shares; and

- An estimate of the likely compensation that each class of creditor would have received in insolvency – for the purposes of assessing the potential compensation to be paid under the no-creditor-worse-off (NCWO) safeguard.

2.6 Further guidance on the Bank's interpretation of the EBA RTS on pre-resolution valuations is provided in Appendix 1. Firms whose intended resolution strategy involves the use of stabilisation powers in the UK should consult this Appendix when considering the practical implications of the Bank's proposed policy.

2.7 Under Article 74 of the BRRD, valuations must also be carried out after resolution for the purposes of assessing what compensation, if any, is to be paid under the NCWO safeguard. These valuations are distinct from, and further to, those described above, and are carried out by an independent valuer appointed by HM Treasury. However, pre-resolution valuations will need to include an estimate of the outcome of these post-resolution NCWO valuations.

Recapitalisation through write-down or conversion of internal MREL

2.8 For material UK sub-groups of overseas-based single-point-of-entry (SPE) banking groups, the stabilisation of the sub-group is expected to involve the use of intra-group loss-absorbing capacity held for the purposes of meeting minimum requirements for own funds and eligible liabilities (i.e. internal MREL)[10]. In these cases, the Bank will need valuations to understand the full extent of expected losses in the subgroup, and to assess whether, following any recapitalisation, the sub-group will meet, and continue to meet, its UK regulatory capital requirements set by the PRA. In the event of the parent entity also entering resolution, group-wide valuations would be required by the firm's home authority to inform resolution action, including the extent of recapitalisation necessary for the group as a whole. In the first instance, the Bank would look to use home-led valuations to assess the need for, and adequacy of, recapitalisation via internal MREL. In some instances, the Bank may need to obtain its own valuations of the sub-group.

Modified insolvency procedures

2.9 When using a modified insolvency procedure (such as the Bank Insolvency Procedure), there is no statutory requirement for the Bank to obtain an independent valuation. An updated regulatory balance sheet may be required to inform the determination of whether a firm is failing or likely to fail, and the Bank may still want to engage an independent valuer to carry out or review valuations in certain circumstances. However, it is unlikely that additional valuations would be required in these cases.

[10] The Bank will be releasing a consultation paper on its proposed approach to setting internal MREL in due course.

Overview of the valuations process

2.10 A valuer external to the firm will be responsible for producing the valuations required in a resolution scenario. When the Bank uses stabilisation powers or mandatory reduction powers, this valuer would be an independent valuer appointed by the Bank. For overseas-based resolutions, valuations may be carried out by either an independent valuer appointed by the home authority, or by a home authority itself. In certain circumstances the Bank may also carry out valuations itself.[11]

2.11 The process for valuation carried out prior to resolution is expected to involve several stages:

- Firms will need to provide the valuer access to their data, information, models, and relevant personnel;
- The valuer will review this data, information and models, and may specify overlays or adjustments to inputs and assumptions as seen necessary given the situation at hand;
- Firms will then need to provide valuations for their assets and liabilities on an individual or portfolio basis, using in-house models or other sources of reliable information;
- The valuer may also carry out their own valuations for certain assets and liabilities where suitable valuations are not available from the firm;
- The valuer will then collect, aggregate, and process these valuations taking into account other relevant information to produce the necessary valuations for the firm as a whole; and
- Finally, the valuer will present the outcomes of the valuation exercise to the Bank in the form of a valuation report.

2.12 In a UK-led bail-in resolution, the Bank's bail-in mechanic provides additional time for final valuations to be carried out. On entry into resolution, bailed-in creditors will receive certificates of entitlement to the equity in the firm in resolution. Before the firm exits resolution, valuations will be needed to inform the development of the firm's reorganisation plan[12] and the allocation of equity across holders of these certificates.[13] Firms will also be required to assist an independent valuer in carrying out valuations throughout a bail-in resolution by providing access to information, models, and key personnel.

2.13 Further detail on the valuations required for resolutions under the Banking Act's *Special Resolution Regime* is provided in Appendix 1.

Valuation capabilities as a barrier to resolvability

2.14 The Bank considers that a firm's valuation capabilities constitute an impediment to resolvability where they cannot reliably enable valuations that are sufficiently timely and robust to support the effective resolution of the firm. In considering barriers to resolvability we are focused on avoidable limitations to the valuation process itself that would contribute to valuation uncertainty. It is recognised that there will be inherent uncertainties when assessing a firm's financial position in a time of distress.

[11] This could occur if the Bank was not using its powers in Part 1 of the Banking Act, or if the Bank was carrying out a provisional valuation itself due to the urgency of the situation.
[12] In a bail-in, a business reorganisation plan must be produced under s48H of the Banking Act.
[13] For more detail on the Bank's bail-in mechanic see The Bank of England's Approach to Resolution, October 2014.

2.15 Timely and robust valuations support the Bank’s statutory resolution objectives in a number of ways, including by limiting risks to public confidence and financial stability, and by protecting public funds from a number of risks in resolution. Not having sufficiently timely and robust valuations present a number of risks to the Bank’s resolution objectives, including:

- The risk of delays in taking resolution action, including on entry into, and exit from, resolution;
- The risk that resolution action does not stabilise the firm sufficiently to restore it to viability, as could occur if there was an inadequate recapitalisation, or if the firm’s customers, creditors, and counterparties did not see the recapitalisation as credible;
- The risk that the Bank will need to impose losses on liabilities to a greater extent than it would otherwise have done had more timely and robust valuations been available; and
- The risk that NCWO compensation will be required due to a misallocation of equity (or other compensation) to creditors in a bail-in, or a misallocation of assets, liabilities or securities in a transfer.

2.16 We consider that there is a significant risk that valuations capabilities would constitute a barrier to resolvability for material firms where we would envisage applying stabilisation powers or converting internal MREL. For these firms, the valuations required for resolution or recapitalisation through conversion of internal MREL differ in several ways from the valuations that firms typically produce in business-as-usual. Engagement with firms to date[14] has suggested that, in many cases, systems are not in place for producing the specific valuations that will be required in resolution. There are also limitations in firms’ abilities to provide rapid access to complete, accurate, and granular data and information to support these valuations. We therefore consider it unlikely that the necessary valuations could be produced on a suitably timely and robust basis to ensure the effectiveness of resolution in these cases.

2.17 For smaller firms whose preferred resolution strategy is modified insolvency, it is less clear that valuation capabilities constitute a barrier to resolvability. First, in these cases, we do not anticipate that resolution-specific valuations would be needed in addition to the accounting valuations (i.e. balance sheets) those firms already provide for regulatory reporting purposes. Secondly, the consequences of not having timely and robust valuations are less severe where the firm will no longer be a going concern. Thirdly, even if additional valuations are needed, such as if the Bank were to consider applying stabilisation powers or a mandatory reduction, carrying out these valuations in contingency planning is likely to be less complex and less time-consuming than for larger firms.

[14] The Bank surveyed a sample of firms in 2015 on their capabilities to support valuations set out in the EBA’s draft RTS on valuations for resolution.

3 Proposed policy approach

3.1 This section sets out the Bank's proposed policy approach to ensuring valuation capabilities do not constitute a barrier to resolvability.

Proposed policy wording

3.2 Section 3A of the Banking Act gives the Bank the power to direct firms to take measures which, in the Bank's opinion, are required to address impediments to the effective[15] exercise of statutory stabilisation powers or winding-up of that firm. This power of direction applies to:

(i) Banks, building societies and certain investment firms[16] that are authorised by the Prudential Regulation Authority (PRA) or Financial Conduct Authority (FCA) and are incorporated in, or formed under the law of any part of, the United Kingdom;

(ii) Parent companies of such institutions that are financial holding companies or mixed financial holding companies and are established in, or formed under the law of any part of, the United Kingdom; and

(iii) Subsidiaries of such institutions or such parent companies that are financial institutions[17] authorised by the PRA or FCA, and are established in, or formed under the law of any part of, the United Kingdom.

3.3 The Bank has published a Statement of Policy setting out its intended process around the use of its power to direct firms to address impediments to resolvability following a resolvability assessment.[18] In summary, this process would involve the Bank:

(i) **Determining** whether specific aspects of a firm's business constitute a substantive impediment to resolvability;

(ii) Where a substantive impediment is identified, and following consultation with the PRA, FCA and the Bank's Financial Policy Committee, **notifying** the firm of the impediment and giving the firm four months to take remediating action; and

(iii) If the Bank remained dissatisfied with the actions taken by the firm, **directing** the firm to take specific action to remediate the impediment within a specified time period.

3.4 The Bank is establishing a policy for valuation capabilities in the context of its resolvability power of direction. This policy sets out principles that firms' valuation capabilities would need to meet in order to not be considered an impediment to resolvability. Compliance with these principles would therefore be expected to avoid the need for use of such directions.

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[15] When determining what constitutes effective exercise of the stabilisation powers for these purposes, the Bank will have regard to the stabilisation powers it would expect to use in the preferred resolution strategy and the extent to which the impediment identified would prevent or reduce its ability to achieve the special resolution objectives.

[16] For the purposes of the UK special resolution regime, the term "investment firm" means those firms that are required to hold initial capital of €730,000, in particular those that deal as principal. The majority of such firms are prudentially regulated by the FCA; the nine largest, more complex investment firms are prudentially regulated by the PRA.

[17] The term "financial institution" has the meaning given by article 4 (1) (21) of Regulation 575/2013/EU.

[18] The Bank of England's power to direct institutions to address impediments to resolvability, December 2015

Discussion

3.5 A principles-based approach helps to ensure that the proposed policy is proportionate and outcomes-focussed, helping to minimise the cost of removing valuation capabilities as a barrier to resolvability. In meeting the principles, firms may, and are encouraged to, leverage existing valuation capabilities, such as those in place as part of their accounting, management information, regulatory reporting, and stress testing functions, as well as those developed as part of the PRA's solvent wind-down exercises where relevant. Where these capabilities did not meet the principles, firms would be expected to make the improvements needed to comply.

3.6 Once a Statement of Policy is in place, the Bank will engage with firms on the specific aspects of their valuation capabilities to ensure ongoing compliance with the principles and to support the firm's overall resolvability. Engagement could occur directly with the Resolution Directorate of the Bank, or, where relevant, be integrated into the PRA's solvent wind-down exercises. In cases where firms did not adequately address areas of non-compliance, the Bank would consider using its resolvability power of direction.

4 Application of the proposed policy

4.1 This section sets out our proposed scope of firms and entities covered by the proposed policy, and the relevant valuations for each firm.

Scope of firms covered by this policy

Proposed policy wording

4.2 This policy applies to all firms where the Bank expects to require resolution-specific valuations as a home or host resolution authority. This includes:

(i) Firms whose preferred resolution strategy involves the use of statutory stabilisation powers in the UK, as determined by the Bank in accordance with the indicative thresholds set out in the Bank's "Statement of Policy on the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)"[19] and communicated to firms on an individual basis; or

(ii) Firms that are a material UK subsidiary of an overseas-based banking group, as reflected in a judgement by the Bank that the firm must hold internal MREL in addition to regulatory capital requirements.

4.3 Firms whose preferred resolution strategy is designated as modified insolvency would not be within scope of the proposed policy. Hereafter, references to "firms" should only be taken to include those firms that meet the criteria set out in this section.

Discussion

4.4 This approach aims to align the policy to where we consider valuations could constitute a barrier to resolvability (as discussed in the previous section). The first criterion aligns with that established under the Bank's MREL policy. The second criterion will align with the threshold that will be applied under the Bank's forthcoming policy on internal MREL. Whilst the Bank's policy on thresholds for internal MREL is still being considered, it is likely to reflect the thresholds set out in the Financial Stability Board's term sheet for total loss-absorbing capacity (TLAC)[20], as well as whether the Bank considers that the sub-group provides critical economic functions in the UK.

Subsidiaries of firms covered by this policy

Proposed policy wording

4.5 All firms that meet the criteria described above should have capabilities in place in respect of itself and all of its material subsidiaries, including subsidiaries in other jurisdictions. For the purposes of this policy, material subsidiaries include all subsidiaries where limitations to valuation capabilities for that subsidiary could compromise the timeliness and robustness of valuations of the firm as a whole. This could include where timely and robust valuations of subsidiaries would be needed to adequately assess group-wide losses and the value of the firm following post-resolution

[19] The Bank of England's approach to setting a Minimum Requirement for own funds and Eligible Liabilities (MREL) - responses to consultation and Statement of Policy, November 2016

[20] Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet, November 2015. The four thresholds set out in the term sheet are where hosted sub-groups (i) have more than 5% of the consolidated risk-weighted assets of the G-SIB group; (ii) generate more than 5% of the total operating income of the G-SIB group; (iii) have a total leverage exposure measure larger than 5% of the G-SIB group's consolidated leverage exposure measure; or (iv) have been identified by the firm's CMG as material to the exercise of the firm's critical.

restructuring. At a minimum, this would include subsidiaries subject to internal MREL requirements. The Bank may identify to firms other subsidiaries that would be considered material for the purposes of this policy.

Discussion

4.6 Resolution valuations will be consolidated at the level of the UK resolution group and will need to capture all material subsidiaries of that group in order to be considered robust. We do not consider it proportionate to require valuation capabilities for all entities, given that many entities will be too small to meaningfully affect the firm-wide valuation. That being said, data and information will still be needed on an entity-by-entity basis to carry out certain valuations (discussed further in Section 6).

Valuations to which the policy applies

Proposed policy wording

4.7 The technical specifications of the valuations that a firm should have capabilities to support will depend on a firm's home jurisdiction and resolution strategy:

(i) Where a firm's preferred resolution strategy is based on the application of stabilisation powers by the Bank as resolution authority, the firm should have capabilities to support the valuations required under the Banking Act, BRRD, and regulatory technical standards set out in the associated EBA RTS[21] as finally adopted by the European Commission.

(ii) Where a firm's preferred resolution strategy involves the use of resolution tools by an overseas resolution authority, the firm should have capabilities to support group-wide valuations led by the home authority, including cash-flow based valuations that estimate the extent of losses and recapitalisation needed in accordance with the firm's preferred resolution strategy. Such capabilities should be consistent with the technical specifications of valuations required in the home jurisdiction, to the extent these exist.

Discussion

4.8 Valuations requirements for UK-led resolutions are set out in legislation. Further detail on the technical specifications of these valuations, and the capabilities needed to support these, is provided in Appendix 1.

4.9 For material UK sub-groups of overseas-based SPE resolution groups, the Bank's preference is to recapitalise the firm through the conversion of internal MREL. Should the parent entity also be entering resolution, the Bank would look to use valuations led by home authorities in order to mitigate the risk of conflicting valuations. These valuations would be based on technical specifications in the home-jurisdiction, where applicable. Where the necessary valuations could not be or were not carried out by the home jurisdiction, the Bank may obtain its own valuations, which would leverage capabilities in place to support home-led valuations. In either case, it will be important that the valuations necessary to ensure an effective recapitalisation and stabilisation of the UK sub-group can be carried out on a sufficiently timely and robust basis.

4.10 Additional valuations or information requests may be needed prior to resolution for other purposes, for example, to assess funding needs and collateral availability throughout the resolution. Capabilities to produce these additional valuations or information requests may be leveraged to

[21] EBA/RTS/2017/05

comply with this policy. However, these additional valuations are not themselves wholly within scope of the proposed policy.

Summary

4.11 The table below summarises the application of this policy across different categories of firms. Categories of firms that are within the scope of the proposed policy are shaded.

Table 1: Application of valuation requirements across categories of firms

<table>
<tr><th></th><th>Category of firm</th><th>Purpose of valuations</th><th>Requirements for valuation capabilities</th><th>Technical specification of valuations</th></tr>
<tr><td rowspan="3">UK as <u>home</u> resolution authority</td><td>Firms belonging to UK-based SPE resolution groups including material domestic and foreign subsidiaries thereof</td><td rowspan="2">- Inform failing or likely to fail assessment
- Establish the extent and terms of resolution action (including statutory write-down or conversion)</td><td rowspan="2">- UK requirements for resolution valuation capabilities</td><td rowspan="2">- BRRD Article 36,
- Section 6E of the Banking Act
- EBA/RTS/2017/05 as adopted by the European Commission</td></tr>
<tr><td>Material UK subsidiaries of overseas based MPE resolution groups and material subsidiaries thereof</td></tr>
<tr><td>Other UK-authorised firms where resolution strategy has been designated as modified insolvency</td><td>- Inform failing or likely to fail assessment (if needed)</td><td>- N/A</td><td>- N/A</td></tr>
<tr><td rowspan="2">UK as <u>host</u> resolution authority</td><td>Material UK subsidiaries of overseas-based SPE banking groups including material subsidiaries thereof</td><td>- Inform failing or likely to fail assessment
- Support group-wide valuations
- Assess the adequacy of intra-group recapitalisation</td><td>- Requirements of home authorities (where applicable)
- UK principles for resolution valuation capabilities</td><td>- Technical specification of home jurisdiction (where applicable)
- Additional specifications as may be necessary to inform conversion of internal MREL</td></tr>
<tr><td>Other UK-authorised subsidiaries of overseas-based banking groups where the Bank's preferred resolution strategy is modified insolvency</td><td>- Inform failing or likely to fail assessment (if needed)</td><td>- N/A (home jurisdiction requirements may be applicable)</td><td>- Technical specification of home jurisdiction (where applicable)</td></tr>
</table>

5 Proposed policy objectives

5.1 This section sets out the Bank's objectives for its proposed policy on resolution valuation capabilities and the rationale underlying these objectives.

Proposed policy wording

5.2 The overarching objective of this policy is to ensure that a valuer could carry out the necessary resolution valuations on a sufficiently timely and robust basis not to impede the effectiveness of resolution. To achieve this overarching objective, a firm's valuation capabilities should, in the opinion of the Bank, meet the following objectives for timeliness and robustness as relevant to that firm's preferred resolution strategy.

5.3 The **timeliness objective** is that

(i) Valuations needed to inform decisions around the initial application of resolution tools could be carried out within two months during contingency planning for resolution (assuming that this amount of time was in fact available). This includes those valuations needed to inform:

- whether the statutory conditions for using stabilisation powers or mandatory reduction powers have been met;
- which stabilisation powers should be used;
- the extent of application of stabilisation powers;[22] and
- the conversion of internal MREL held by material subsidiaries and the adequacy of the resulting recapitalisation.

(ii) Where a firm's intended resolution strategy is a UK-led bail-in, the need for valuations during resolution should not inhibit exit from resolution within three to six months of entry into resolution. This includes valuations to inform the restructuring plan, and valuations to inform the final allocation of equity (or other compensation) to bailed-in creditors. A greater degree of robustness will be needed for these decisions than for the decisions on entry into resolution.

(iii) Where the nature of a firm's business is such that the firm was particularly exposed to rapid changes to solvency, valuations could be carried out in quicker timeframes to the extent the Bank considered this necessary and proportionate.

5.4 The **robustness objective** is that valuations support decisions by the Bank that achieve the Bank's resolution objectives in the given circumstances. This includes ensuring that the decisions taken would not have been meaningfully different had more time been available to carry out the necessary resolution valuations.

Discussion

5.5 The first aspect of the timeliness objective reflects the Bank's view that contingency planning for resolution should be possible within three months, acknowledging that this amount of time may not

[22] This includes: (i) the extent of any cancellation, dilution, transfer, write-down or conversion of shares, capital instruments or eligible liabilities; (ii) what assets, liabilities, or securities are to be transferred under a transfer tool; and (iii) the value of any consideration to be paid for assets, liabilities, or securities so transferred.

always be available. The proposal that valuations could be carried out within two months reflects that additional time is needed to appoint an independent valuer, scope the valuation work, and factor the outcomes of the valuation exercise into authorities' resolution decisions. Therefore, the entire valuation process for pre-resolution valuations (described in section 2 above) should be possible within at least two months. This means that valuations of individual assets and liabilities should be possible within shorter timeframes.

5.6 The Bank recognises the possibility that valuations may need to be carried out in shorter timeframes, but does not consider it proportionate to require *ex-ante* capabilities to support a higher degree of timeliness for all firms and all valuations. For example, the Bank may require capabilities to support a greater degree of timeliness for valuations undertaken for other purposes, such as assessing the value of collateral available for funding.

5.7 The second aspect of the timeliness objective reflects the Bank's view that the bail-in period (the period between entry into resolution and return to private sector control) should not last more than three to six months. In a UK-led bail-in, the Bank will need updated valuations after entry into resolution but before allocating equity (or other compensation) to bailed-in creditors and shareholders.[23] Valuations will need to inform and reflect the firm's reorganisation plan. The Bank is mindful that delays to a firm exiting resolution may risk erosion of the firm's franchise value and a potential loss of confidence in the resolution. Delay may also increase uncertainty and contagion risk in a market-wide stress event. As such, it is important that exit from resolution would not be unduly held up by the need to produce robust valuations.

5.8 The third aspect of the timeliness objective reflects the heightened risk that the Bank would require more rapid valuations for certain firms. For example, firms with large trading books may be exposed to sudden swings in market prices, in which case valuations may need to be carried out in less than two months. When requiring a greater degree of timeliness for certain firms, the Bank would take into account the incremental costs to firms of meeting such a requirement.

5.9 The robustness objective reflects the importance that limitations to the valuations process do not lead to the Bank taking decisions in resolution that give rise to risks to the Bank's resolution objectives, including risks to public funds, being exposed to NCWO compensation claims, and failing to maintain public confidence in stabilisation.

[23] For more detail on the Bank's bail-in mechanic see The Bank of England's Approach to Resolution, October 2014.

6 Proposed principles

6.1 This section sets out the Bank's proposed principles firms that would be expected to meet, and summarises the rationale underlying each principle.

Principle 1: data and information

Proposed policy wording

6.2 **Firms should ensure that their underlying data and information is complete and accurate, and that relevant data and information would be readily available to a valuer.**

6.3 Firms should collect and hold all relevant data and information that would be reasonably considered necessary to enable timely and robust resolution valuations. This would include, but is not limited to:

- Unconsolidated balance sheets for all active entities within the UK resolution group (including overseas entities within this group);
- Loan-by-loan data tapes for the firms' loan portfolios;
- Supporting information for material assumptions that will need to be made for the valuation analysis of loan portfolios, including historical payment data (with a comparison to contractual/scheduled cash flows), forbearance information, and management information supporting previous such as internal credit reviews (notably for more heterogeneous loan exposures);
- Granular data on the firms' trading positions and liquidity management, including investment securities, repo transactions, and derivatives;
- Information on netting and set-off arrangements applicable to the firm's exposures;
- Legal and financial information on the collateral available to the firm in respect of its individual exposures - this would include documentation to support the value of any underlying collateral that loans and other financial products are secured against;
- Information on intragroup assets, liabilities, and guarantees;
- Supporting information on the carrying value of the firms' non-financial assets and liabilities;
- Information on contingent liabilities and assets, such as information on material guarantees, litigation proceedings, and other off-balance-sheet exposures;
- Information on creditor hierarchies and asset encumbrance for each entity within the UK resolution group;
- Financial and legal information on special purpose vehicles (SPVs);
- Forecasted financial information, including profit and loss, balance sheets, and management information supporting the strategic plan; and

- Further information to enable a valuer to forecast operating income and costs under the firm's resolution strategy, such as management budgets and forecasts, as well as information on leases, service contracts, and staff costs.

6.4 Firms should have arrangements in place to ensure the data and information they hold is complete, accurate, and reliable. Robust processes and controls should be in place to ensure data is high quality including (but not limited to) integrity checking, consistency checking, and access control. Data should be subject to regular verification, including reconciliation and testing, to ensure accuracy and completeness.

6.5 Data and information should be cross-referenced in order to enable a valuer to understand the relationship between various sources of information. This should include clear linkages between the various exposures to a counterparty, the collateral available against these exposures, and any applicable netting or set-off arrangements.

6.6 Firms should have capabilities in place to ensure that all relevant data and information could rapidly and reliably be made available to an independent valuer for the purpose of carrying out resolution valuations. Capabilities should include systems and processes to aggregate and warehouse data and information, and to provide secure access to this data and information through a virtual data room[24] (or similar mechanism) as and when it is needed for resolution.

Discussion

6.7 Robust valuations will require underlying data that accurately reflects all material aspects of the firm's business and balance sheet. The valuer's confidence in the accuracy of the data will be a key determinant of the uncertainty around valuations provided. The accuracy and completeness of the data will also affect the timeliness of the valuation. Past experience suggests that the first few weeks of a valuation exercise is typically spent collating, validating and reconciling the required data. In order to minimise this time period, firms should have an understanding on the information needed for valuations and be able to deliver that information when required.

6.8 In contingency planning, the Bank is likely to require a firm to establish a virtual data room (VDR) to provide the independent valuer with access to necessary data. The Bank has considered requiring firms to establish VDRs in business-as-usual, given the difficulties and potential delays in setting up and populating a VDR prior to resolution. A standing VDR may also provide benefits outside of resolution, such as by speeding up due diligence processes for asset disposals, including in recovery. It may also help facilitate offsite testing of a firm's data as part of resolvability assessment. However, the Bank acknowledges that establishing and maintaining a VDR does involves costs, and we would be willing to consider alternative mechanisms should firms demonstrate that timely and reliable access to relevant information could be provided and tested without establishing a VDR in business-as-usual.

6.9 The Bank welcomes views on the data needed for resolution and the approach to ensuring this data could be rapidly made available when required.

Principle 2: valuation models

Proposed policy wording

6.10 **As necessary to meet the timeliness objective, firms should have valuation models in place that are able to be tested and used by a valuer.**

[24] A virtual data room is a secure online repository of information typically used to facilitate due diligence during a capital transaction.

6.11 Valuation models should be in place for all material aspects of the firm's business where robust valuation models could not reasonably be developed and deployed on a timely basis during contingency planning for resolution. At a minimum, models should be available for loan assets and financial instruments that do not have observable market prices in liquid markets.[25]

6.12 Where relevant, firms should have capabilities to forecast operating income and cash-flows on a timely basis for the purpose of assessing the market value of equity in the firm or divestible business units. These capabilities should ensure that forecasts may take into account planned resolution action and, in the case of a bail-in strategy, the firm's reorganisation plan.

6.13 Firms should ensure that a valuer would have the necessary access to the relevant valuation models, and to the staff responsible for operating these models, such that model outputs could be used by the valuer in producing timely and robust valuations of the firm as a whole.

6.14 Valuation models should be sufficiently flexible to enable a valuer to evaluate the impact of alternative resolution strategies, and reflect the facts and circumstances of the resolution.

Discussion

6.15 Building, testing, and operating the valuation models necessary to produce robust resolution valuations is likely to be a difficult and time-consuming process, especially for more complex firms. Our view is that, rather than developing models in a resolution scenario, a valuer should be able to rely on models firms have in place *ex ante* to provide valuations of the material aspects of firms' banking books and trading books. The independent valuer will still need to consolidate firm-led valuations and apply adjustments to meet the applicable legal requirements and to reflect the resolution options being considered. There may also be certain assets and liabilities where a valuer could reasonably base valuations on carrying values or other available information (applying adjustments as considered necessary) without the need for firms to develop models in business-as-usual. This could include where observable market values are available or where the assets are not sufficiently material to impact the robustness of the valuation.

6.16 The Bank recognises that there are costs involved with building valuations models, but considers that firms should be able to leverage other capabilities to deliver resolution valuations, such as management information systems, and capabilities in place for IFRS 9, solvent wind-down exercises, and stress testing.

Principle 3: valuation methodologies

Proposed policy wording

6.17 **Valuation models should use methodologies that are consistent with the methodologies a valuer could reasonably be expected to apply in producing valuations that met the robustness objective.**

6.18 Firms' valuation models should use methodologies that:

- produce valuations of assets, liabilities, instruments, or business units based on expected realisable cash-flows reflecting their nature and intended treatment or uses in resolution (such as hold and disposal);

[25] In practice, this includes financial instruments that would fall into level two (mark-to-model based on observable inputs) and level three (mark to model based on unobservable inputs) of the fair value hierarchy, regardless of whether they are actually held at fair value in the firm's accounts.

- produce valuations at a level of granularity that ensures the valuations meet the robustness objective; and

- produce valuations that comply with relevant requirements under the applicable resolution regime considering the home jurisdiction and resolution strategy of the firm in question (further guidance on the technical specifications of valuations required for UK resolutions is provided in Appendix 1).

6.19 Firms’ valuation models should be able to apply different valuation methodologies to the same asset or instrument where a valuer would need to assess different potential treatments in resolution or cross-check and triangulate across multiple valuation methodologies.

6.20 Firms should ensure that their valuation models use consistent methodologies across jurisdictions and subsidiaries wherever this is reasonable and practical.

Discussion

6.21 The appropriate valuation methodology used in producing resolution valuations will ultimately be determined by the valuer. For a firm’s valuation models to be effective, they should be compatible with the methodologies that a valuer would reasonably choose to apply if time constraints were not an issue. Concerns over the appropriateness of a firm’s valuation methodologies may arise in a number of scenarios, including where:

- Valuations were applied at a portfolio level, but more granular (e.g. loan-by-loan) valuation of that asset class was necessary for the valuation to be regarded as robust;

- An asset is valued only on an accounting basis (e.g. amortised cost), when the relevant resolution regime requires valuation on a different basis;

- An asset is valued on a basis that is inconsistent with the intended treatment or use of the asset given the resolution strategy; and

- Different methodologies or inputs have been used across different parts of the business, including different geographies, making valuations difficult to reconcile.

6.22 In these and other cases, the valuer may find it necessary to revise or enhance the firm’s existing methodologies, or develop additional methodologies or proxies as a cross-check, which could be very time-consuming. Alternatively, the valuer may need to rely on the existing methodologies to produce valuations in the necessary timeframe, which may lead to valuations that fail to meet the robustness objective.

Principle 4: valuation assumptions

Proposed policy wording

6.23 **Firms should have processes that support the use of realistic valuation assumptions, and should enable a valuer to review and revise, and demonstrate sensitivity to these assumptions if necessary.**

6.24 Firms should have processes in place for ensuring that the assumptions they use are realistic and up-to-date. This includes protocols for periodic and ad-hoc reviews, and clear escalation procedures and sign-off responsibilities for material assumptions.

6.25 The assumptions used in resolution valuations will ultimately be determined by a valuer external to the firm, and firms should ensure that a valuer will be able to update or revise the assumptions used. Consistent with Principle 1, firms should be able to provide a valuer with relevant data and information for the purpose of validating assumptions made by the firm, such as historical data, market data, economic data, loan documentation, and documentation of the rationale underlying previous management judgements.

6.26 Firms should facilitate a valuer's access to relevant experts in order to review the firm's assumptions. Such parties could include, but are not limited to, management, counterparties, stakeholders, trustees, and local experts. The valuer should be able to consult with these experts without undue delay.

6.27 Where relevant, firms should apply consistent underlying assumptions, such as macroeconomic conditions, across the various valuations undertaken, including across different assets and instruments, different jurisdictions and legal entities, and different resolution valuations (e.g. asset and liability valuation, equity valuation).

6.28 Firms should ensure that it would be possible to demonstrate, on a timely basis, the sensitivity of valuation outcomes to alternative assumptions in order to evaluate the extent of valuation uncertainty. Firms should evaluate the extent of valuation uncertainty as part of model validation in business-as-usual.

Discussion

6.29 Resolution valuations will involve a number of assumptions around uncertain input variables. For valuations to be robust, these assumptions must fairly reflect the circumstances at hand, including relevant market conditions and the expected actions of customers, creditors, counterparties and other stakeholders.

6.30 In the first instance, firms should aim to use realistic assumptions in their existing valuations, supported by data and analysis as appropriate. The reliability of a firm's existing assumptions will affect the amount of time a valuer will need to produce valuations that are suitably realistic and robust. Firms should therefore have processes in place for validating assumptions, and should aim to keep assumptions up-to-date through regular reviews as appropriate.

6.31 In carrying out resolution valuations, a valuer will need to review and potentially revise a firm's existing assumptions. This is likely to be the case as the facts and circumstances of resolution are not foreseeable in advance, and the valuer must apply their independent expert judgement in determining the appropriate assumptions, which may differ from judgements made by management. Access to relevant information and internal experts will be critical for the valuer to understand assumptions adopted by management and inform updated assumptions.

6.32 To inform resolution decisions, it will be important for authorities to understand how valuations outcomes are affected by the valuer's determination of key assumptions, and to understand the extent and impact of valuation uncertainty. The valuer will therefore need to present sensitivity analyses. Firms' models and systems should be able to produce these analyses on a timely basis.

Principle 5: Governance

Proposed policy wording

6.33 **Firms should apply sound governance arrangements and processes to ensure that valuation capabilities compliant with these principles are maintained in business-as-usual and available prior to and during resolution.**

6.34 Firms should have clear and documented procedures in place to ensure that valuation capabilities are compliant with the principles set out in this policy. This includes clear decision-making protocols, oversight arrangements, and internal review functions. To the extent possible, these governance arrangements should be incorporated into existing governance arrangements for other aspects of firms' data and modelling capabilities. Resolution valuation capabilities should be treated as consistently possible as business-as-usual valuation capabilities, having regard to the contingent nature of their use.

6.35 Firms should identify a relevant individual to be responsible for reviewing and monitoring compliance with these principles and ensuring steps are taken to remedy any shortcomings. This individual, or another individual identified by the firm, should be responsible for overseeing the firm's engagement with a valuer appointed for the purpose of carrying out resolution valuations.

6.36 Firms should ensure that governance of valuation capabilities would remain intact throughout resolution.

Discussion

6.37 Under business-as-usual, governance arrangements are important to ensure that the necessary work is undertaken to build, update, review, and maintain the systems and processes needed to avoid impediments to resolvability. During, and in the lead-up to, a resolution, clearly defined and documented roles and responsibilities will be important to ensuring the valuer has the necessary support in carrying out the required valuations.

Principle 6: Transparency

Proposed policy wording

6.38 **Firms should document, and be open with the Bank and the valuer about, their valuations capabilities and any associated limitations.**

6.39 Firms should document their methodologies, processes, and responsibilities that support resolution valuations. This should include:

- Processes and responsibilities for verifying data and dealing with data errors;
- Process and responsibilities for the development, maintenance, and operations of relevant valuation models
- Escalation procedures and sign-off responsibilities for internal policies, model design, and key assumptions relevant to resolution valuation models; and
- The underlying assumptions used by the firm and the basis for these assumptions.

6.40 These documents should be readily available to the Bank for the purposes of assessing valuations capabilities. They should also be readily available to a valuer for the purposes of assessing the reliability of the firm's data, assumptions, and methodologies when preparing to carry out resolution valuations.

6.41 Firms should be up-front and open with the Bank and a valuer about any limitations to their data, methodologies, and assumptions that may compromise the feasibility of timely and robust resolution valuations.

6.42 Firms should provide information as required to support to the Bank's resolvability assessments and ongoing resolution planning. This could include, but is not limited to:

- The firm's assessment of their compliance with the principles set out in this policy, and a description of the testing and assurance procedures performed to support this assessment;

- An overview and status update on projects underway that will improve or amend the firm's resolution valuation capabilities; and

- Estimates of amount of time it would take to carry out various aspects of the valuation process in a potential resolution scenario (e.g. populating an up-to-date data room, running valuation models for specific portfolios).

Discussion

6.43 For valuations to be considered robust, a valuer will need to take into account all relevant information, and take measures to address gaps, inconsistencies, inaccuracies, and other limitations in the firm's existing data, models, methodologies and assumptions. Firms will most likely have better insight than a newly-appointed valuer of the business and the operation (including any limitations) of valuation models, and should be open in supporting a timely and robust valuation process.

6.44 Similarly, firms are most likely to have a better understanding than the Bank about their valuation capabilities. It follows that firms should be responsible for demonstrating their level of compliance with these principles, as well as any areas of non-compliance, and the measures being adopted to ensure ongoing compliance.

Principle 7: Assurance

Proposed policy wording

6.45 **Firms should periodically review and evaluate their valuations capabilities with regard to these principles, and should facilitate reviews undertaken by the Bank or a third party to test compliance.**

6.46 Valuation capabilities should be subject to validation to support resolvability and verify compliance with these principles. Firms should incorporate reviews of their valuation capabilities into processes for regular review and testing in place for other data and modelling capabilities. This includes review by internal experts independent of the individual responsible for the capability being reviewed. It also includes review by the firm's internal audit functions or experts who are independent from the firm.

6.47 Firms should facilitate tests and independent reviews initiated by the Bank to assess compliance with these principles as part of its ongoing assessments of resolvability or contingency planning for resolution.

6.48 Where deficiencies in capabilities are identified, firms should take the necessary steps to ensure that they are compliant with this policy, such that valuation capabilities are not an impediment to resolvability.

Discussion

6.49 Valuation capabilities will need to be reviewed and evaluated to ensure that they comply with the proposed policy and do not pose an impediment to resolvability. This could involve periodic reviews undertaken as part of resolution planning, or *ad-hoc* reviews in cases where there is a reasonable chance that a firm will enter resolution in the near future.

6.50 In the first instance, firms will be responsible for ensuring they are compliant with the policy. Firms should undertake review and testing themselves, for example, at operational level and through their internal audit functions. Firms should also consider having their capabilities externally reviewed by relevant experts.

6.51 To provide further assurance, the Bank may require test runs of valuations models or data provision capabilities for selected parts of the firm’s business. The Bank may also require independent review of a firm’s valuations capabilities if deemed necessary to provide assurance that suitable capability were in place. If firms did not address deficiencies that were identified through these processes, the Bank would consider using its resolvability power of direction.

7 Preliminary impact assessment

7.1 This section sets out the Bank’s preliminary qualitative assessment of the costs and benefits of its proposed policy on valuation capabilities to support resolvability. The Bank intends to undertake a more detailed impact assessment before finalising a Statement of Policy and welcomes views from firms on the scale of the potential impacts of the proposed policy.

Expected benefits

7.2 The key benefit of the proposed policy will be to reduce the costs and risks of resolving failed institutions by ensuring that valuations capabilities do not constitute a barrier to resolvability. This benefit arises through several related channels:

- Enabling the Bank to make timely and well-informed decisions that achieve the Bank’s resolution objectives;
- Improving public confidence in the resolution process and the post-resolution viability of the resolved entity, increasing the likelihood that customer, creditors, and other stakeholders engage with the firm on an ongoing basis;
- Reducing the risks of firms being insufficiently recapitalised from the resolution, potentially resulting in subsequent resolution actions;
- Informing the decisions undertaken by the Bank, the firm’s management and applicable resolution administrators or insolvency practitioners throughout the resolution process;
- Reducing the risk that compensation will be necessary under the NCWO safeguard (the costs of which are ultimately passed onto industry under BRRD requirements); and
- Reducing the cost of producing valuations in the lead up resolution, including the costs of an independent valuer (which would most likely be borne by firms).

7.3 Benefits may also arise to the extent that more timely and robust valuations help facilitate and evaluate the credibility of recovery options, such as asset disposals, capital raisings, sale of business units, or liability management exercises. This helps to reduce the likelihood that statutory resolution options will be applicable.

7.4 Furthermore, enhanced valuation capabilities provide benefits in business-as-usual. For example, they may increase the quality and availability of management information, improving firms’ abilities to monitor and manage risks, consider and execute changes to their business structure, or allocate capital resources across business areas. Capabilities may also reduce the time and effort firms require to produce information necessary for supervisory purposes, or for the purposes of due diligence on assets used in securitisations or as collateral.

Expected costs

7.5 It is expected that the costs associated with meeting the proposed principles will be mostly on a one-off operational basis, rather than on an ongoing basis. Firms may need to undertake a number of changes at the outset, prior to the policy coming into force, following which firms will need to ensure and demonstrate ongoing compliance. The Bank expects that the costs to firms of removing valuation capabilities as a barrier to resolvability will be smaller than for other barriers such as MREL and operational continuity in resolution.

7.6 Compliance costs are likely to vary between firms depending on the scale and complexity of the valuation task. The timeliness and robustness objectives have been formulated such that complying with the proposed policy is expected to be less onerous for smaller or less complex firms where producing timely and robust valuations in contingency planning for resolution is likely to be less challenging. This approach helps avoid compliance costs that are not necessary to remove valuation capabilities as a barrier to resolvability.

7.7 Compliance costs are also likely to vary between firms depending on the quality of current information and systems. We expect firms to leverage existing capabilities to comply with the proposed policy. In 2015, the Bank surveyed selected firms to enhance its understanding of firms' valuation capabilities. The feedback and results of the survey suggested that firms were unable, at that time, to estimate costs and timeframes precisely to meet any additional data and system requirements. Now that a proposed policy has been developed, the Bank will be surveying firms again to better understand firms' current capabilities and the expected incremental costs of complying with the policy.

7.8 There will be some resourcing requirements for the Bank in applying and reviewing compliance with the proposed policy.

Assessment of net benefit

7.9 The benefits of improved resolution valuation capabilities are difficult to quantify, and the Bank has not endeavoured to produce a quantitative estimate of the net benefits of its proposed policy at this stage. Our preliminary view is that firms should already have a number of the above capabilities in place, and that where further work is required, this is likely to have material commercial benefits in business-as-usual. As such, incremental costs to firms, net of these commercial benefits, are likely to be small relative to the wider long-run benefits associated with improved resolvability.

7.10 By adopting a principles-based approach, the Bank retains a degree of flexibility around the application of this policy. The Bank will seek to ensure proportionality in applying these principles to avoid imposing unduly burdensome compliance costs. This should ensure that the proposed policy will deliver a positive net benefit.

7.11 The Bank welcomes views on the possible scale of any of the expected costs and benefits outlined above, as well as any other costs and benefits that have not been identified here.

8 Next steps

8.1 The Bank intends to develop a Statement of Policy on resolution valuation capabilities based on the proposed policy set out in this consultation paper. It is envisaged that, once a Statement of Policy has been released, firms would be given around 18 months to implement the changes necessary to comply with the policy.

8.2 In developing this Statement of Policy, the Bank is particularly interested in views from industry on the following discussion questions:

(i) Do you agree with the proposed criteria for determining which firms are captured by the proposed policy?

(ii) Do you agree with the objectives and principles set out in the proposed policy?

(iii) Do you consider that the proposed policy and appendix provide sufficient clarity on what is expected of firms?

(iv) What do you consider to be the barriers to carrying out valuations within two months prior to resolution, or within shorter timeframes should less time be available?

(v) To what extent do you consider that current capabilities comply with the proposed policy, and where are the key gaps?

(vi) What assurance mechanisms do you consider would be necessary and appropriate to ensure compliance with this policy?

(vii) What costs would you anticipate being incurred to comply with the proposed policy? Please provide quantitative estimates where possible.

(viii) What commercial benefits do you consider might arise from improvements to valuations capabilities made in order to comply with the proposed policy?

(ix) Please provide any views on the proposed timeframe for implementation (18 months).

8.3 The Bank intends to survey those firms that are expected to be within scope of the proposed policy. The survey aims to give the Bank a better understanding of firms' current capabilities and the costs of complying with the proposed policy. The survey is contained in Appendix 2.

8.4 The Bank invites feedback on these discussion questions above, and on the views set out in this paper more broadly, by 17 November 2017. Please provide those comments by email to the address below:

RDvaluationspolicy@bankofengland.co.uk

Alternatively you may provide comments by post to:

Daniel Snethlage
Resolution Directorate
Bank of England
Threadneedle Street
London
EC2R 8AH

Appendix 1: Resolution valuations under the Special Resolution Regime

1.1 This appendix describes the valuations that the Bank is legally required[26] to obtain, when using one or more of the five stabilisation options[27] or the statutory power to write-down or convert capital instruments at the point of non-viability (PONV). As such, this appendix is most relevant to firms whose preferred resolution strategy involves the use of these tools in the UK. For hosted firms, the valuation analysis is most comparable to valuation two (asset and liability valuation) since the purpose of valuations to inform the conversion of internal MREL is focussed on estimating losses and the adequacy of recapitalisation.

1.2 The legal requirements for valuations in these cases are as follows:

- **Pre-resolution valuations:** valuations are required prior to resolution to inform the assessment of whether a firm is failing or likely to fail, and to inform the application of stabilisation powers. These valuations must be undertaken in accordance with Article 36 of the BRRD, and follow the methodology specified in the associated EBA RTS[28] once adopted by the European Commission.

- **Post-resolution valuations:** valuations will be performed to determine whether affected creditors have been made worse-off as a result of the resolution action, and if so, the extent of additional compensation due (in accordance with the NCWO safeguard). These valuations must be undertaken in accordance with Article 74 of the BRRD, and follow the methodology specified in in the associated EBA RTS[29] once adopted by the European Commission.

1.3 The Bank's planned approach to the valuations required in resolution is outlined below.

Figure 1: Valuations required for the use of BRRD resolution tools

	Stage 1 *Pre resolution*	**Stage 2** *During resolution*	**Stage 3** *Post resolution*
1) Failing or likely to fail valuation *Updated regulatory balance sheet (on an accounting basis)*	Informs assessment of conditions for use of resolution tools		
2) Asset and Liability Valuation *Fair, prudent and realistic basis – hold or disposal basis*	Assesses the extent of losses that need to be addressed in resolution	Informs restructuring plan through scenario analysis	
3) Equity valuation *Estimated market value of equity reflecting resolution and restructuring*	Provides an indication of the post-resolution value of the firm	Informs the allocation of equity to bailed-in creditors	Determines NCWO compensation
4) Estimated insolvency *Estimated recoveries to creditors in a hypothetical insolvency counterfactual*	Provides a preliminary indication of potential NCWO risks	Provides an updated indication of potential NCWO risks	Determines NCWO compensation
	BRRD Article 36	*Additional steps for bail-in*	*BRRD Article 74*

[26] Under Articles 36 and 74 of the BRRD, and sections 6E and 48X of the Banking Act.

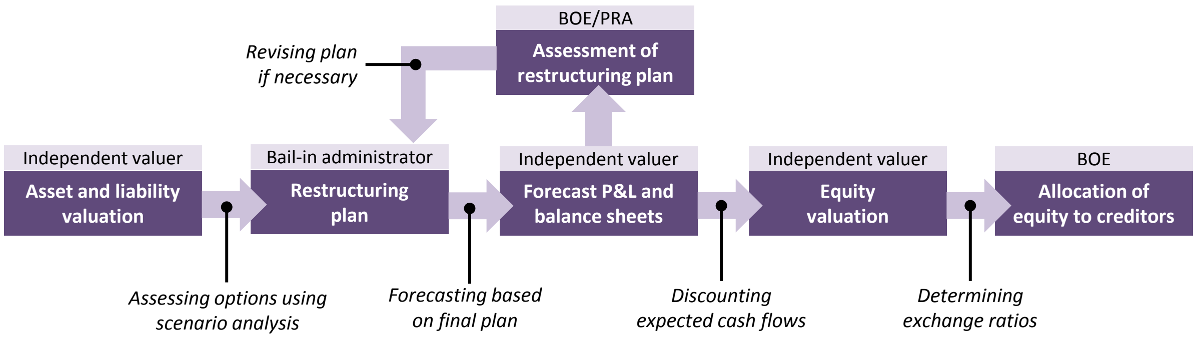
[27] The five stabilisation options are: sale to a private sector purchaser, transfer to a bridge bank, transfer to an asset management vehicle, bail-in, and temporary public ownership.

[28] EBA/RTS/2017/05

[29] EBA/RTS/2017/06

1.4 In the case of a UK-led bail-in, the Bank would require updated valuations following entry into resolution, but prior to the final terms of the bail-in being set. Updated valuations would reflect the date of resolution, inform the development of the firm's restructuring plan, and determine the subsequent allocation of equity to holders of the certificates of entitlement that would be distributed to bailed-in creditors on entry into resolution.[30] An overview of this process is set out in Figure 2 below. We expect that a forecast balance sheet would also be used to assess the adequacy of the recapitalisation. Further work may also be required to provide a more robust assessment of expected outcomes under an insolvency counterfactual.

Figure 2: Overview of valuations process during a bail-in resolution



Valuation 1: Failing or likely to fail valuation

1.5 The purpose of this valuation is to help inform the determination of whether the first condition for resolution is met, that being whether the firm is failing or likely to fail.[31] This determination would be made by the PRA in consultation with the Bank.

1.6 The final draft EBA RTS 2017/05 for pre-resolution valuations requires that the valuation for the purposes of assessing whether the firm is failing or likely to fail must be on a "fair and realistic" basis. The valuation will be on the basis of the applicable accounting and regulatory framework, and therefore will be based on an updated balance sheet as submitted through regulatory submissions.

1.7 The valuer may challenge the firm's assumptions, data, methodologies and judgements underpinning accounting values, although the role of the independent valuer is not to perform an audit function. In practice the extent of the independent valuer's review of accounting balances may vary depending on the degree of judgement involved and level of uncertainty in any given area.

1.8 Under the EBA's financial reporting (FINREP) requirements, firms are required to provide consolidated balance sheets to the PRA on a quarterly basis. This information must generally be provided within 40 calendar days of the last day of each quarter.[32] In most cases we would expect that regular FINREP reports should be sufficiently timely for the purposes of Valuation 1. In urgent situations, off-cycle reporting may be required, though we do not anticipate a need for capabilities to support intra-month reporting to be developed in business-as-usual.

[30] For further detail on the Bank's bail-in mechanic, see The Bank of England's Approach to Resolution, October 2014.
[31] Note that a firm may also meet Condition 1 as a result of non-financial considerations.
[32] Under certain circumstances this deadlines may be slightly longer.

Valuation 2: Asset and liability valuation

1.9 The asset and liability valuation serves the purpose of estimating the extent of resolution action necessary (i.e. the extent of incurred and expected losses that need to be addressed) and informing the choice and use of resolution tools. This valuation involves a granular assessment of the balance sheet to value assets and liabilities to "economic value", and must balance the objectives of being fair, prudent and realistic. Economic value is a realisable value concept, meaning that the expected use of the asset should be taken into account in the valuation. Accordingly, assets and liabilities will be measured on a **hold value** or a **disposal value** basis.

1.10 Assets and liabilities should be valued at **hold value** where a firm is expected to continue (at least in the near term) operating a business, holding assets, or maintaining positions in financial instruments. The RTS defines hold value as "the present value, discounted at an appropriate rate, of cash flows that the entity can reasonably expect under fair, prudent and realistic assumptions from retaining particular assets and liabilities, considering factors affecting customer or counterparty behaviour or other valuation parameters in the context of resolution". Hold value may, to the extent considered fair, prudent and realistic, anticipate a normalisation of market conditions, but must take into account all expected impairments to an asset over its lifetime, regardless of whether the asset is currently impaired. When using hold value, the overall valuations of the firm (or relevant parts thereof) should also take into account costs necessary to realise the value of an asset over time, including the costs of associated staff and premises.

1.11 Where a firm is expected to sell assets or business lines, or exit its positions in financial instruments, the firm's assets and liabilities should be valued at **disposal value**, which is defined by the RTS as reflecting "cash flows, net of disposal costs and net of the expected value of any guarantees given, that the entity can reasonably expect in the currently prevailing market conditions through an orderly sale or transfer of assets or liabilities". The disposal value should reflect the expected price attainable from selling an asset (or cost payable to transfer a liability) over a given time horizon based on currently prevailing market conditions. This should consider specific factors including advantages or disadvantages of a transaction to the parties involved. Disposal value should take into account estimated disposal costs and discounts for market illiquidity or accelerated sale taking account of market capacity, where applicable. So while the concept of disposal value is similar to that of fair value, different assumptions and overlays may need to be applied.

1.12 Firms' valuation capabilities will need to enable both hold value and disposal value where needed to support analysis of alternate scenarios (as set out in Principle 3). The asset and liability valuation is likely to involve scenario analysis to understand options and the impact of using alternative resolution tools, and may be iterative in nature. The analysis is likely to inform the basis of the firm's restructuring plan. In turn, the final valuation (potentially updated following entry into resolution) should reflect the expected use of assets and liabilities under the restructuring plan. When carrying out this valuation in practice, an independent valuer would therefore need to consult with the Bank to understand the resolution tools and potential restructuring options being considered, and firms' capabilities should have sufficient flexibility to support this.

1.13 As set out in the RTS, both hold value and disposal value should be based on expected cash-flows, which could include expected cash flows from holding an asset or cash-flows from exiting a position in a transaction with the market. Some key differentiating features between hold value and disposal value include (but are not limited to):

- **Market conditions:** disposal value should be based on currently prevailing market conditions, whereas hold value may incorporate a normalisation of market conditions to the extent that this is consistent with the objectives of the valuation being fair, prudent, and realistic;

- **Cost of capital:** disposal value may be based on the cost of capital of an expected acquirer, whereas hold value should be based on the firm's anticipated cost of capital considering the impact of resolution and restructuring;

- **Operational costs:** when using disposal value, valuations should incorporate the quantum of expected operational costs associated with disposal over the relevant disposal horizon. When using hold value, valuations may incorporate associated operational costs over the lifetime of the asset (though it may be preferable to apply this adjustment at the level of the portfolio or business unit rather than the individual asset);

- **Adjustments for market illiquidity:** where appropriate, disposal value should reflect discounts for market illiquidity or accelerated sale taking account of market capacity, to the extent not incorporated in the discount rate.

1.14 The appropriate application of the concepts of hold value and disposal value to different asset classes will require consideration. For financial instruments[33] with observable market prices in liquid markets, market data held by firms is expected to suffice for the purposes of resolution valuations. Calculating hold value and disposal value for financial instruments without liquid markets and observable market prices will require the use of firms' fair value modelling capabilities.

1.15 We expect that hold values for financial instruments may be equivalent to fair value including "XVA" valuation adjustments (these should reflect the firm's funding cost rather than a market average). When using hold value, broader valuations will also need to incorporate operational costs of holding assets in order to realise value. We expect that disposal values could be estimated based on fair values with adjustments for relevant factors that may lead to a gap between fair value and "exit value". These factors may include including market concentration, operational costs, required return on capital, intra-group hedge replacement, and loss of market maker flow. This would be similar to the definition of exit value currently being applied in PRA solvent wind-down exercises. In line with Principle 4, firms' models should allow for (such as discount rates, disposal horizon, and discounts for market liquidity) to be adjusted to reflect the views of an independent valuer.

1.16 For loan assets, hold value will need to incorporate expected lifetime credit losses. Valuation models being developed for IFRS 9 purposes may support these valuations. However, hold value will need to account for full lifetime expected credit losses even where assets are not currently credit-impaired, or have not experienced a significant increase in credit risk. Hold value should also incorporate other adjustments to interest rates and exposure at default over the life of the loan, suggesting a need for cash-flow based models. Where it is expected that the resolution may involve the disposal of assets (including in the case of a transfer resolution strategy) it would be necessary to estimate disposal value. It may also be important to understand fair value to in order to evaluate the value at which an acquirer would pay for the assets and assume the liabilities. As above, firms' capabilities should enable key input assumptions to be adjusted to reflect the views of an independent valuer. An independent valuer should also be able to apply overlays where necessary to bridge between fair value and disposal value.

[33] For the purposes of this discussion, the term "financial instruments" should not be taken as including loans.

1.17 The asset and liability valuation may also need to include additional liabilities that do not meet accounting recognition criteria but must be considered in resolution. This could include contingent liabilities and off-balance-sheet items. It could also include provisions for restructuring costs, including for the continued operation of unprofitable business lines to maintain critical functions throughout the restructuring period. Under Principle 2, firms may also need valuations models for these items where it is unreasonable to expect that an independent valuer could value these items within the timeframes necessary for resolution.

1.18 In general, firms should consider the extent to which existing capabilities – including those being developed for IFRS 9 and solvent wind down exercises – can be leveraged to provide the capabilities required for the asset and liability valuation.

Valuation 3: equity valuation

1.19 The Bank is obliged to ensure that creditors are treated fairly in resolution, including by avoiding taking actions that would result in creditors being made worse-off in resolution than they would have been under normal insolvency proceedings. It will therefore be important for the Bank to understand what recoveries different classes of creditor would receive in resolution, in order to compare with expected recoveries in a hypothetical insolvency (discussed below).

1.20 In the context of a bail-in, the purpose of this analysis is to estimate the value of equity available to compensate bailed-in creditors. The valuation must be based on the market value of the equity in the firm, or its successor entity, taking account of planned restructuring. In a bail-in, the market value of equity will also form the basis of the actual treatment valuation for the purposes of evaluating the need for NCWO compensation.[34] As such, it is necessary to understand the market value of equity before determining the final allocation of shares (or other compensation) across different classes of creditor.

1.21 In the context of a transfer to a private sector purchaser, bridge bank, or asset management vehicle, it would be necessary for the Bank to understand the expected actual treatment of creditors under the proposed resolution action. This will involve assessing the recoveries to different classes of creditors that are not transferred, based on the expected disposal values of any assets not transferred. In the case of a share transfer, it may also be desirable to understand the market value of equity to assist with evaluation of bids in the interests of ensuring commercial terms are obtained for the transfer.

1.22 The market value of equity is likely to differ from the book value of equity derived from the asset and liability valuations for several reasons. The market value of equity should reflect the execution risk associated with the delivery of the restructuring plan. The equity valuation will also need to consider the costs of issuing and rebuilding MREL and the potential lack of dividends in the near term. Franchise value (i.e. expected future profits arising from the firm's ability to write new business) may also be reflected in the equity valuation to the extent considered appropriate by an independent valuer.

1.23 In order to support the equity valuation, firms should have in place capabilities to produce forecasts on a timely basis reflecting planned restructuring. Given the need to understand expected cash flows, forecasts should comprise balance sheet, income statement and cash flow statement. Firms should consider the extent to which other capabilities can be leveraged to support this.

[34] The no-creditor-worse-off (NCWO) safeguard is established under Article 75 of the BRRD and section 60B of the Banking Act. It seeks to ensure that pre-resolution shareholders and creditors of a firm do not receive less favourable treatment than they would have received had the firm entered insolvency immediately before it was put into resolution.

Valuation 4: Estimated insolvency outcome

1.24 For the purposes of evaluating the NCWO safeguard, it is also necessary to estimate the treatment that creditors would have received had the firm entered into insolvency instead of stabilisation powers being exercised. The estimated insolvency outcome analysis is performed by estimating realisations from assets, the costs that would be incurred through the insolvency, and the consequent allocation of net proceeds to creditors in accordance with the hierarchy of claims under applicable national insolvency legislation. We expect that it may be necessary to conduct this analysis on an unconsolidated basis, reflecting the way in which insolvency is applied in practice. As such firms should be able to provide, for each entity in the UK resolution group, summary balance sheets and a clear articulation of the hierarchy of claims for that entity based on contractual arrangements and the national insolvency law applicable in relevant jurisdictions (see Principle 1).

1.25 The methodologies used to estimate the value of assets for the purposes of this analysis may be equivalent to those used for the purposes of assessing disposal value under the asset and liability valuations described above, although an independent valuer may choose to apply different assumptions across these two valuation analyses to reflect a hypothetical liquidation strategy. As discussed above, firms should ensure that valuations models would enable assumptions to be adjusted to reflect an independent valuer’s views on disposal.

Appendix 2: Survey on valuations capabilities to support resolvability

The Bank is surveying selected firms to better understand current capabilities, and the incremental costs and benefits of the proposed policy. Feedback from the survey will be used to ensure the policy is as effective as possible while seeking to avoid any undue compliance costs.

When providing assessments of costs, firms should focus on the costs that would be additional to costs that are already planned, or have already been incurred, for other systems improvements. Please also highlight where costs will be on a one-off or ongoing basis.

UK-based firms should consult Appendix 1 for further guidance on the practical application of the Bank's proposed policy.

1 Data and information

1.1 To what extent does your firm hold complete and accurate data and information as required under the proposed policy? This includes:

(i) Unconsolidated balance sheets for all active entities within the UK resolution group (including overseas entities within this group);

(ii) Loan-by-loan data tapes for the firms' loan portfolios;

(iii) Supporting information for material assumptions that will need to be made for the valuation analysis of loan portfolios, including historical payment data (with a comparison to contractual/scheduled cash flows), forbearance information, and management information supporting judgements such as internal credit reviews (notably for more heterogeneous loan exposures);

(iv) Granular data on the firms' trading positions and liquidity management, including investment securities, repo transactions, and derivatives;

(v) Information on netting and set-off arrangements applicable to the firm's exposures;

(vi) Legal and financial information on the collateral available to the firm in respect of its individual exposures - this would include documentation to support the value of any underlying collateral that loans and other financial products are secured against;

(vii) Information on intragroup assets, liabilities, and guarantees;

(viii) Supporting information on the carrying value of the firms' non-financial assets and liabilities;

(ix) Information on contingent liabilities and assets, such as information on material guarantees, litigation proceedings, and other off-balance-sheet exposures;

(x) Information on creditor hierarchies and asset encumbrance for each entity within the UK resolution group;

(xi) Financial and legal information on SPVs;

(xii) Forecasted financial information, including profit and loss, balance sheets, and management information supporting the strategic plan; and

(xiii) Further information to enable a valuer to forecast operating income and costs under the firm's resolution strategy, such as management budgets and forecasts, as well as information on leases, service contracts, and staff costs.

1.2 What costs would you anticipate incurring to remediate material gaps regarding the completeness, accuracy, and availability of this data and information in order to comply with the Bank's proposed policy?

1.3 How long do you expect it would take to collect and make available the data and information listed above through a virtual data room or similar mechanism?

1.4 What costs would you anticipate incurring to ensure that the data and information listed above could be rapidly made available in compliance with the Bank's proposed policy?

1.5 What commercial benefits, both in terms of recovery and resolution but also in business-as-usual, could be gained from improvements to data capabilities undertaken to comply with the proposed policy? How material might these benefits be?

2 Valuation models

2.1 To what extent do you consider that the expected credit loss' (ECL) modelling capabilities you are developing for IFRS 9 implementation could be leveraged to produce valuations required for resolution (e.g. hold and disposal value)? Specifically:

(i) To what extent will your ECL processes be automated as opposed to relying on manual processes?

(ii) Are you developing cash-flow based models for estimating lifetime credit losses? What significant adjustments would need to be made in order to use ECL cash-flow estimates for resolution purposes?

(iii) How easily will you be able to estimate lifetime losses for loans that are not impaired and have not experienced a significant increase in credit risk?

(iv) How quickly could the key input assumptions to your models (e.g. discount rates) be adjusted to reflect the views of a resolution valuer, or to carry out sensitivity analysis?

2.2 How long do you expect it will take to produce month-end IFRS 9-compliant valuations for loan portfolios? What lags would you expect for intra-period month-end valuations where certain data is refreshed quarterly or semi-annually?

2.3 What costs would you anticipate incurring to ensure that modelling capabilities for loan assets complied with the Bank's proposed policy?

2.4 To what extent do you consider that valuation processes in place for your financial instruments (e.g. trading positions) could be used to produce valuations required for resolution (e.g. hold and disposal value)? Specifically:

(i) Do your fair value models for financial instruments use prudent valuation adjustments?

(ii) How quickly could key input assumptions to your models (e.g. discount rates) be adjusted to reflect the views of a resolution valuer, or carry out sensitivity analysis?

(iii) How long would it take you to estimate hold value and disposal value (i.e. exit value) for trading positions in a potential resolution scenario, taking into account any planned systems improvements?

2.5 What costs would you anticipate incurring to ensure that modelling capabilities for financial instruments complied with the Bank's proposed policy?

2.6 What capabilities do you have in place to estimate hold and disposal values of other assets and liabilities, including non-financial assets and off-balance sheet liabilities?

2.7 How would it take to produce business forecasts, including balance sheets, income statements and cash flow statements based on a given restructuring plan to support equity valuation? What costs would you envisage from ensuring that these could be provided on a sufficiently timely basis?

2.8 What commercial benefits, both in terms of recovery and resolution but also in business-as-usual, could be gained from improvements to modelling capabilities undertaken to comply with the proposed policy? How material might these benefits be?

3 Governance, transparency, and assurance

3.1 To what extent do you consider that current governance and review process are compliant with the proposed policy? Specifically:

(i) What internal processes do you have in place to validate data that would be needed for resolution valuations, such as loan data tapes?

(ii) What internal processes do you have in place to test and validate valuation models?

(iii) What internal processes do you have in place to ensure the use of realistic valuation assumptions?

(iv) Have you designated responsibility to a senior staff member or members for overseeing your existing data and modelling capabilities?

(v) To what extent have you documented the governance arrangements around the data and models you use? To what extent are judgements around key valuation assumptions documented?

(vi) To what extent are existing data and modelling capabilities subject to external review? Are reviews one-off or periodic?

3.2 What costs would you anticipate incurring to ensure that internal review and documentation processes complied with the Bank's proposed policy?

3.3 What commercial benefits, both in terms of recovery and resolution but also in business-as-usual, could be gained from improvements to governance arrangements undertaken to comply with the proposed policy? How material might these benefits be?