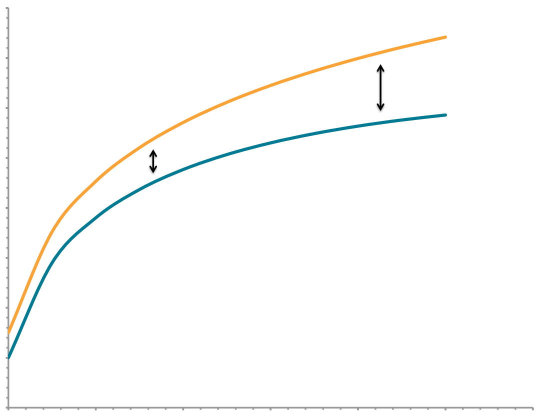
Calibrate Consulting
Own Credit Process Audit

Own Credit Adjustments on FVO Liabilities are frequently a source of unexpected but significant issues for banks, including the misreporting of quarterly earnings and over or understatement of regulatory capital

What is Own Credit, and who does it impact?

Own Credit arises on instruments that have been designated as being held at fair value through profit or loss under the Fair Value Option (FVO). It is defined as the change in the fair value of the liability that is attributable to changes in the own credit spreads of the issuing entity. Own Credit will be relevant for any bank that issues structured notes or has other liabilities risk managed in the trading book.



Why is Own Credit Important?

Own Credit is sometimes dismissed as being merely an accounting disclosure, whereas in reality it impacts the entity's results and capital position, usually materially.

Own Credit PnL is currently disclosed separately in profit and loss within the financial statements, and is usually adjusted out of the firm's underlying results by analysts when considering earnings. It is also typically removed from instrument valuations when a firm's regulatory capital position is calculated.

The adoption of IFRS 7 is likely to move own credit out of the quarterly results headlines, however it will not in any way reduce the impact that issues with the own credit figures would have on reported results and capital.

Under IFRS 7 own credit will be taken directly to OCI rather than reported in profit and loss. This will make the impact of any issues in stripping this element of PnL out of the overall change in the instrument's fair value a fully explicit bottom line concern. IFRS 7 also requires "no recycling", meaning that the own credit element of the total gain or loss which is crystalised on early redemption is permanently left in OCI, and is never reported through profit and loss.

Own Credit is and will remain a key figure, in practice a bottom line adjustment rather than simply being an additional PnL classification item.

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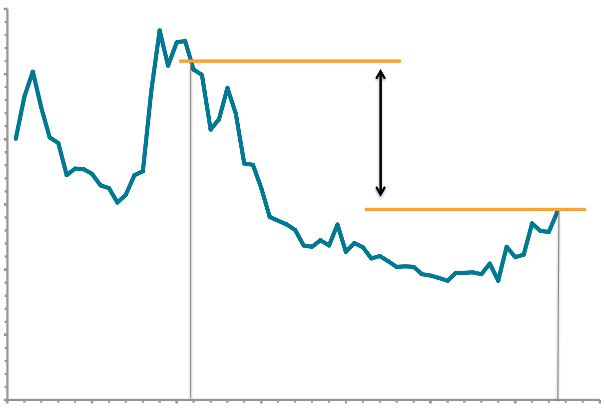
Why does own credit often go wrong?

Most of the risk management systems that banks use to calculate the valuations used in their results were designed before own credit became relevant during the financial crisis. Unlike DVA on derivatives, own credit on FVO liabilities is usually not managed by the firm's CVA desk. Additionally the common misperception that own credit is "just a disclosure item" means that there is typically low if any front office review and sign off on the figures.

All of this means that the own credit process is usually managed by finance in isolation, often as an after thought, and is frequently heavily reliant on manual excel based processes rather than fully automated solutions.

"Firms should understand their Own Credit process risk"

It is therefore not surprising that problems can emerge, often many years after first starting to build up. Given the nature of own credit, the figures involved are usually huge. Firms should therefore understand their own credit process risk.



A Calibrate Own Credit Process Audit can Help Reduce the Risk of Errors and Improve Accuracy and Efficiency

We have deep practitioner experience in this area, and can offer a full review of your current process. We will highlight any current issues, and suggest ways in which the process can be made more efficient and robust going forward.

Calibrate Consulting

At Calibrate Consulting we recognise that the people best placed to help other business are those with hands-on experience. We therefore use successful industry operators rather than career consultants to lead, manage and drive our client projects.

Established in 2008, Calibrate operates globally with bases in London and New York. Our team has deep industry practitioner experience in the area of own credit reporting and remediation.

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