Chatham Financial
ADVISORY | TECHNOLOGY | SOLUTIONS

February 28, 2014

International Valuation Standards Council
1 King Street
London EC2V 8AU
United Kingdom

Dear IVSC Standards Board (the "Board"):

Chatham Financial wishes to thank the Board for providing an opportunity to comment on the Credit and Debit Valuation Adjustments Technical Information Paper Exposure Draft (the "ED"). We recognize this is a challenging area for many companies to consider in their valuation practices and that many companies, particularly non-financial institutions, may not be aware that changes to their valuation practices may be necessary. We applaud the efforts of the Board to provide valuation professionals, practitioners, auditors, and regulators with guidance on incorporating credit risk into the fair value measurement of derivative financial instruments through the incorporation of credit and debit valuation adjustments.

Chatham Financial is a global financial risk management firm specializing in: 1) helping companies assess and manage their exposures to financial risks; 2) facilitating the execution of derivative transactions on behalf of our clients to manage those risks; and 3) providing ongoing derivative valuation and hedge accounting assistance to these companies. We work with more than a thousand companies globally and on a daily basis execute more than USD 2 billion of derivative notional on behalf of our clients in the global financial markets. Chatham assists companies that apply both IFRS and US GAAP and has extensive experience helping companies measure the fair value of their derivatives under these frameworks for financial reporting purposes.

The information contained in the ED impacts companies applying IFRS, specifically IFRS 13 Fair Value Measurement ("IFRS 13"), which is an accounting standard that is converged with ASC 820: Fair Value Measurement ("ASC 820") under US GAAP. Although IFRS 13 only became effective in January 2013 for many companies, ASC 820 has been in effect since January 2008. Chatham was a pioneer in developing fair value measurement solutions under ASC 820 that are both sophisticated and cost effective for companies to apply. We use robust valuation methodologies, similar to those used by leading global financial institutions, to incorporate credit risk into the fair value measurement of derivative instruments and we provide technical accounting advisory to our clients in this area. Since 2008, we have assisted more than 600 companies across a wide range of industries, including financial institutions, real estate, telecommunications, retail, healthcare, manufacturing, and leisure and entertainment, in successfully adopting the global fair value measurement standards. As a result of our experience, we are uniquely qualified and well positioned to provide commentary on the ED.

Our responses to the questions raised by the Board in the ED are included below. Chatham Financial wishes to thank the Board for providing an opportunity to comment on the ED and we would be happy to discuss any of our comments in more detail with the Board at its request.

Sincerely,

Dan Gentzel
Chatham Financial

Paras 4 - 7 set out the proposed scope of the paper.

1. **Do you agree that the proposed scope is appropriate? If you disagree, please indicate changes that you would recommend.**

We believe guidance related to incorporating FVA into the fair value measurement should be removed from the ED until a consensus develops on how FVA should be considered, at which time the guidance in the ED could be amended or additional guidance could be issued separately. There are currently numerous ongoing theoretical and practical debates about the appropriateness of incorporating a funding value adjustment ("FVA") into the fair value measurement of derivatives, including debates between global financial institutions and world renowned financial theorists. Further, from a financial reporting perspective, IFRS 13 provides guidance indicating that although a fair value measurement should be based on an exit price (which dealers may argue includes FVA), it should also be a market-based measurement and not an entity-specific measurement. The measurement should also maximise the use of observable inputs and minimise the use of unobservable inputs. With respect to calculating FVA from an end user (ie, a non-dealer bank) perspective, it would require the use of funding curve information which is both entity-specific (ie, specific to its counterparty dealer bank) and unobservable (ie, the funding curve is proprietary to the counterparty dealer bank and the end user would not have access to such information). As a result, end users presently would not be able to make such adjustments because they would not have access to the necessary funding curve information. See additional discussion in our response to Question 9.

Para 8 sets out a series of proposed definitions for terms used in this TIP.

2. **Do you agree with these definitions? If you consider an alternative or additional definition is appropriate then please provide this in your response.**

We believe that currently Debt Valuation Adjustment (DVA) is incorrectly named in the definitions section and should instead be labeled Debit Valuation Adjustment (DVA), as the remainder of the ED makes reference to Debit Valuation Adjustment rather than Debt Valuation Adjustment.

The "Principles, Methodology, and Practical Application" sections all reference the Monte Carlo method as the most accepted method of exposure simulation.

3. **Do you believe that other methods should be considered in addition to the Monte Carlo, such as binomial and trinomial trees?**

Unlike the semi-analytic methods outlined in Para 40(a), trinomial trees can fully capture netting and collateral arrangements, as well as the path dependencies of option and structured instruments. Trinomial trees thus enable a comprehensive depiction of potential future exposures, and often tend to be less computationally intensive to implement. As such, we recommend including trinomial trees in Para 40 and Para 62.

The "Principles, Methodology, and Practical Application" sections all reference netting sets.

4. **Do you believe that netting sets have been discussed to an appropriate level of detail?**

We believe the information provided on netting sets has been discussed at an appropriate level to aid in understanding and applying the concept in measuring CVA and DVA.

Paras 79 - 83 discuss the importance of appropriate governance and controls around the process of calculating credit and debit valuation adjustments. They highlight this as a particular issue for financial entities which create and trade instruments but also for non-financial entities where there is also a need for systems to ensure that the data used is objective and reliable. Although the IVS Framework indicates that it is a fundamental expectation that adequate controls and procedures are in place to ensure objectivity in the valuation process, the standards do not otherwise expand on this.

The IVSC publishes a Code of Ethical Principles for Professional Valuers that can be applied to a wide range of valuation activity.

5. **Do you consider that there is a need for the IVSC to augment this with more specific guidance on governance and controls in the financial sector?**

6. **Do you consider that there is a particular issue or issues that arise when considering a suitable governance and control protocol for calculating CVA or DVA that does not otherwise give rise to concern?**

We do not have comments on these questions.

Paras 84 - 94 of the paper dealing with the Practical Application of the principles discussed previously proposes that entities adopt more complex methodology as the size or materiality of their derivative transactions increases.

7. **Do you agree that it is appropriate to suggest that entities with less complex or smaller derivative holdings in relation to their overall business should adopt less complex methodology, or instead should all entities be expected to implement equally rigorous methodology?**

Appropriately incorporating credit risk in accordance with the guidance contained in the ED as well as IFRS 13 and ASC 820 is a complex task for entities of all sizes. Despite this, we do not agree with the recommendation of the Board that entities with "less complex or smaller derivative holdings in relation to their overall business should adopt less complex methodology". We believe the suggestion does not provide sufficient context around what qualifies as less complex or smaller derivative holdings and also does not appropriately consider that even less complex or smaller derivatives can have a significant impact on both financial position and results of operations.

Although perhaps a nuanced change, we believe it would be more appropriate to recommend that companies base the selection of valuation modelling techniques on the *materiality* of the fair value of the derivatives to their financial position and results of operations. Under this approach, we believe the likely outcome would be that if a company determined that the impact of the fair value measurement had a material impact on financial position or results of operations, then more robust methodologies akin to those used by sophisticated financial institutions would be appropriate. Similarly, in situations where a company determined that the impact of the fair value measurement did not have a material impact on financial position or results of operations, then less robust methodologies similar to those described in paragraphs 93-96 of the ED could be viewed as appropriate.

The "Cost of Funding" section discusses Funding Valuation Adjustments (FVAs) and their relationship to CVA and DVA.

8. **Does the discussion about the cost of funding contribute to the objectives of the TIP outlined in the "Scope and Purpose" section on p3?**

As we mentioned in our response to Question 1, we believe that discussions around cost of funding and FVA should be removed from the ED. We do not believe the discussion about the cost of funding provides sufficient information for all entities (financial and non-financial) to assess the impact to them and the extent it should be incorporated into their valuation practices related to derivative instruments. Rather than present guidance on this issue, which is described as being currently debated, we recommend the Board remove the guidance and conduct further research aimed at reaching a conclusion on the extent to which such information should be made a part of the guidance.

The "Cost of Funding" section indicates that there is still an on-going discussion about how best to apply FVA, or whether it is even relevant to the calculation of market value, or fair value as defined in IFRS 13.

9. **Given the current debate in this area, do you believe it is appropriate for this TIP to outline the main issues, or should this be removed altogether until there is greater consensus?**

There are currently very different opinions in practice on whether it is or is not appropriate to incorporate FVA into the fair value measurement of derivatives. While there are a number of financial institutions that appear to have determined that incorporating such adjustments is appropriate, there are also well-respected members of the academic finance community that are currently publishing papers and abstracts that disclaim the use of FVA as a violation of the risk-neutral valuation principle. Given the widely opposing views on this topic, we believe it would be more appropriate for the Board to solicit more feedback and conduct more extensive research before publishing guidance on FVA. As a result, we recommend the Board remove discussion on this topic altogether until a consensus on the appropriate treatment of FVA is reached. Alternatively, perhaps the ED should simply note that FVA represents an emerging valuation concept that is subject to ongoing discussion and debate, and that currently there is no industry consensus on whether or how it should be calculated.

Going forward, however, we are very interested in the ongoing discussion around FVA and believe it should be reconsidered by the Board. From our perspective, as noted in our response to Question 1, we believe there are a number of theoretical and practical obstacles with the application of FVA. Conceptually, we struggle with the apparent inconsistency with the requirement in IFRS 13 that "fair value is a market-based measurement, not an entity-specific measurement" if proprietary and internal funds transfer pricing curves are used in the calculation. This also creates an obvious practical hurdle for end users (ie, entities that are not dealers or market-makers), as we currently are not aware of any "market average funding curve" or FVA pricing consensus service. Accordingly, it is unclear how end users would comply with a potential requirement to incorporate FVA, given the lack of observable market inputs to calculate it.

The TIP is not intended to be used as an educational resource; however one objective is to aid professionals who are not specialists in understanding the principles that underline credit and debit valuation adjustments.

10. **With this in mind, are there any key principles that have been omitted or not fully explained?**

We believe the TIP provides sufficient discussion to aid in the understanding of the key principles utilized in developing credit and debit valuation adjustments.

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