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Dear IVSC Members

IVSC Exposure Draft: *"Credit and Debit Valuation Adjustments"*

Ernst & Young welcomes the International Valuation Standards Council (IVSC) issuing an Exposure Draft (ED) on credit and debit valuation adjustments.

Overall, we think the exposure draft (ED) provides some good explanations of the concepts of credit and debit valuation adjustments (CVA and DVA, respectively), as well as describing certain approaches, such as expected positive exposure (EPE) and expected negative exposure (ENE). However, many of the entities that would use such approaches (i.e., large financial institutions and dealers) already understand CVA and DVA and have systems in-place and/or have established a framework. As such, we would encourage the IVSB to focus on providing additional application guidance focused on entities that would apply less sophisticated methods.

From a general valuations perspective, we are supportive of the proposed technical information paper and have no further comments, apart from those highlighted in the previous paragraph. We outline below our comments in respect of ED as it relates to valuations prepared for financial reporting purposes.

Interaction with financial reporting requirements

The ED notes that credit and debit valuation adjustments (CVA and DVA, respectively) may be required in the valuation of derivatives for several purposes, including financial reporting, establishing the regulatory capital of financial institutions and for management and investor information.

We agree that this topic is the subject of greater focus and debate. We understand the ED is intended to respond to this debate, particularly as regards measurements of CVA and DVA for financial reporting and other purposes. However, there are some methodologies in the ED that would not necessarily be acceptable when derivatives are being measured at fair value for financial reporting purposes. We do not believe this is very clear in the ED, which may lead some to assume that compliance with the ED's proposals will ensure compliance with International Financial Reporting Standard 13 *Fair Value Measurement* (IFRS 13) or

Topic 820 *Fair Value Measurement* in the FASB Accounting Standards Codification (ASC 820) in respect of CVA and DVA.

While dual compliance with financial reporting requirements may be possible, it cannot not be assured. We also believe that while compliance with accounting and solvency regulations (Basel III) may be possible, it also cannot not be assured. For example, IFRS 13 and ASC 820 do not limit methodologies an entity might use when measuring fair value, except to require that an entity use techniques that are consistent with the market, income or cost approach and "are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs."[1] While we appreciate efforts made to identify methods that can be used to measure CVA and DVA, some may view the ED as specifying the only methods that are acceptable under IFRS 13 and ASC 820, which we do not believe is the intent.

Therefore, we believe it is important that the final technical information paper explicitly state that methodologies, other than those described, may exist and may be appropriate to use under different frameworks.

The ED includes summarised discussion of financial reporting requirements for measuring fair value, primarily those within IFRS 13. In some instances, summarised discussion of IFRS 13 requirements was not consistent with our understanding or could be misleading without further guidance.

As noted in our 3 September 2010 comment letter, "In our view, the inclusion of IFRS requirements within the body of the exposure draft creates a maintenance risk for the IVSB given the ongoing development of accounting standards. In addition, without adequate cross-referencing to IFRS, the summary guidance may be misleading. Therefore, we would:

- Discourage direct repetition of specific standards, including related guidance, in IFRS, interpretations, discussion papers, or exposure drafts issued by the IASB or the IFRS interpretations Committee.
- Encourage cross-referring to both standards and guidance provided by the IASB, preferably within bridging guidance or technical notes.
- Encourage the separation of any IFRS-related guidance from valuation standards generally…"

Furthermore, while we understand the use of different terminology (or similar terms with different meanings) between financial reporting standards and valuation standards, it may lead to misunderstandings and miscommunication between valuers and those they support

[1] Paragraph 61 of IFRS 13

in providing valuations for financial reporting purposes. As noted in our 3 September 2010 comment letter, we "... support the IVSB's attempts ... to cross reference IFRS terminology to the IVS equivalent... However, where the same terms are used in both IFRS and IVS but with different meanings (for example, fair value) it will inevitably lead to confusion. Therefore, we would encourage:

- Convergence of terminology between IVS and IFRS, particularly to ensure that common terms have common meanings
- Continued cross-referencing of terms used in IVS and their IFRS equivalent terms [outside the technical information paper].
- Clear explanations of any differences between terms used in IVS and the IFRS meaning of the same terms."

In addition to these general comments, we include, in the attached appendix, our responses to the specific questions raised in the exposure draft.

Should you wish to discuss the contents of this letter with us further information, please contact Sven Schieszl (sven.schieszl@de.ey.com) or Philipp Lindenmayer (philipp.lindenmayer@de.ey.com).

Yours faithfully

Ernst & Young

Appendix: Responses to the specific questions in the Exposure Draft

From a general valuations perspective, we are supportive of the proposed technical information paper and have no further comments, apart from those highlighted in the in the cover letter. Our comments below are generally in respect of ED as it relates to valuations prepared for financial reporting purposes.

Paras 4 - 7 set out the proposed scope of the paper. Q1: Do you agree that the proposed scope is appropriate? If you disagree, please indicate changes that you would recommend.

The ED includes discussion of approaches, inputs and concepts that would not necessarily be acceptable when derivatives are being measured at fair value for financial reporting purposes. For example, in our view, the unilateral CVA approach (described in paragraph 52 of the ED) would not be acceptable for financial reporting under IFRS 13. As another example, close-out notion (described in paragraph 10 of the ED) is not consistent with transfer or sale notion in IFRS 13 and ASC 820. While specific requirements are addressed at the end of the paper (specifically in paragraphs 113-119), we believe it would be helpful to clarify this further. One option would be to explicitly address this in the scope section.

Para 8 sets out a series of proposed definitions for terms used in this TIP. Q2: Do you agree with these definitions? If you consider an alternative or additional definition is appropriate then please provide this in your response.

While we understand the use of different terminology (or similar terms with different meanings) between financial reporting standards and valuation standards, it may lead to misunderstandings and miscommunication between valuers and those they support in providing valuations for financial reporting purposes. As noted in our 3 September 2010 comment letter, we "… support the IVSB's attempts … to cross reference IFRS terminology to the IVS equivalent… However, where the same terms are used in both IFRS and IVS but with different meanings (for example, fair value) it will inevitably lead to confusion. Therefore, we would encourage:

- Convergence of terminology between IVS and IFRS, particularly to ensure that common terms have common meanings
- Continued cross-referencing of terms used in IVS and their IFRS equivalent terms.
- Clear explanations of any differences between terms used in IVS and the IFRS meaning of the same terms."

Comments on specific definitions including within the ED:
We have concerns about the definition of 'basis risk' within the ED. This is only used twice in the ED, as such we question whether a definition is warranted. However, the following comments are included assuming the definition is retained.

The proposed definition is “The risk that the value of offsetting investments will not change in equal and opposite amounts.” We have a number of concerns regarding this definition.

- We recommend referring to ‘derivatives’ rather than ‘investments’ to ensure consistency with the scope of the ED and discussion within the ED.
- The proposed definition could be misunderstood. As currently drafted it would capture any valuation difference irrespective of its cause.
- The proposed definition could lead to confusion regarding how hedge accounting works in IFRS. In IFRS 9 *Financial Instruments* the IASB carefully avoided using the term ‘basis risk’, but instead used more precise descriptions of what is meant (different underlyings, different terms, effect of different credit risk). We recommend the IVSB takes a similar approach to avoid confusion.

Without revising the definition, we have concerns about the use of this term in paragraphs 38 and 78 of the ED.

- Paragraph 38 (3rd bullet): The ‘risk’ being to which this paragraph refers seems to be the uncertainty about how similar the implied input is or should be to the actual (which is not known because it unobservable). That is, a measurement uncertainty about whether your proxy spread reasonably represents the actual spread that is unknown. In common language, ‘basis risk’ has a connotation of an economic phenomenon (mismatch in underlyings or other terms). As such, use of the term ‘basis risk’ in this paragraph does not seem to adequately convey the measurement uncertainty. Similarly, the ‘risk’ that different valuers come up with different values for the same item in such situations (because of selecting different proxies) is not, in our view, consistent with ‘basis risk’, but rather a function of the degree of judgement involved that creates valuation or measurement uncertainty.
- Paragraph 78: As noted below, we are uncertain why the ED discusses hedging. However, if the IVSB retains this paragraph, we recommend replacing the reference to ‘basis risk’ with a clearer description of the risk to which the IVSB is referring.

As noted above, we support consistent definitions of commonly used terms, where possible. As written, the proposed definitions of CVA and DVA could be misread to mean an adjustment of fair value or market value, rather than a component of that measurement. This would be inconsistent with the definition of fair value in IFRS and US GAAP and, we understand, with the definition of market value in IVS. As such, we recommend, revising the definitions to state ‘a component in the measurement of a derivative…’ or similar.

It is not clear why you’ve taken a wider view on default probability (i.e., ‘not honouring obligations vs. the probability of defaulting. In our view, this definition should be narrower to refer to particular obligations (such as payment [maybe including collateral] or financial obligations), rather than any obligation even if that is not relevant for default in this ED (such as, failing to timely update the counterparty on a change in mailing address or sending information by email instead of the required facsimile…).

The “Principles, Methodology, and Practical Application” sections all reference the Monte Carlo process as the most accepted method of exposure simulation.
Q3: Do you believe that other methods should be considered in addition to the Monte Carlo, such as binomial and trinomial trees?

As noted above, we believe other methods should be considered, for the reasons stated earlier.

The “Principles, Methodology, and Practical Application” sections all reference netting sets.
Q4: Do you believe that netting sets have been discussed to an appropriate level of detail?

The following comments are included in respect of the discussion regarding netting:

- Discussion of netting agreements and collateral could be confusing when the measurement of derivatives is for financial reporting purposes. For example:
    - Measurement is dependent on the unit of account as defined for financial reporting purposes, which may or may not include consideration of side agreements or collateral.
    - Reference to portfolios (explicit or implied), could be confused with application of the measurement exception in IFRS 13. In situations where an entity is able to utilize its master netting agreements and passes the measurement exception criteria detailed in IFRS 13, it will still need to assess whether it has the practical ability to implement a credit valuation method which reflects the net counterparty exposure.   This can be challenging, particularly for those which do not have systems in place to capture the relevant net positions by debtor/counterparty. Also, an allocation of the portfolio level adjustments is required which can be complex, what is the proposed approach to determine expected exposure at the portfolio level (i.e., on a net basis)?
- The inclusion of hedging in the ED. In our view, this is beyond the scope of the document. We are particularly concerned about the statement in paragraph 39 of the ED, which states: “This has implications on the calculation of CVA because hedging of CVA requires an implied view of the risks present, whereas if an entity does not plan to hedge CVA, a

historical estimation approach may be feasible.” In our view, this is inconsistent with a fair value measurement notion, which takes a market participant perspective. An entity’s own intent to hedge is, therefore, irrelevant to what market participants would consider in measuring the fair value of a single derivative. In addition if paragraphs 75-78 are intended to address monetisation of DVA and the IVSB believes a hedge instrument is not the best way to monetise DVA that fact should be made clear.

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.

Q5: 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?

Q6: 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 have no specific comments.

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.

Q7: 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?

The discussion regarding ‘Practical Application’ in paragraph 84-96 is, in our view, very important. The ED acknowledges that expectations regarding the sophistication of the approach used will vary based on the type of entity and the extent to which they use derivatives. Therefore, while more simplistic approaches may be appropriate in some circumstances for some corporates, large financial institutions and dealers should be using more theoretically sound techniques.

However, we are concerned about the ED’s discussion of less complex approaches in paragraphs 93 and 94-96, which seem too prescriptive. At a minimum, we believe this final technical information paper (when issued) should acknowledge that other approaches may also be acceptable.

> The “Cost of Funding” section discusses Funding Valuation Adjustments (FVAs) and their relationship to CVA and DVA.
> Q8: Does the discussion about the cost of funding contribute to the objectives of the TIP outlined in the “Scope and Purpose” section on p3?

We appreciate that the IVSB has identified FVA as a topical issue. However, we have concerns about its inclusion in the ED, which are outlined in our response to question 9.

> 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.
> Q9: 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?

We appreciate that the IVSB has identified FVA as a topical issue. However, we have concerns about its inclusion in the ED and recommend removing the discussion from the final technical information paper, when issued.

- Overall, the section is somewhat confusing, adds complexity and, as there is no definitive view in the marketplace, the discussion does not assist users of the final technical information paper.
- It seems strange to include this in final guidance when the concept of FVA is not yet accepted widely and views regarding FVA continue to evolve. If retained in the final technical information paper, we are concerned that the discussion could soon be out-of-date.
- In our view, interpretation of financial reporting requirements goes beyond the IVSB’s remit. We believe this section could be misread, leading to views that the IVSB is assessing whether the inclusion of FVA in the valuation of derivatives would comply with financial reporting requirements in IFRS 13.

> 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.
> Q10: With this in mind, are there any key principles that have been omitted or not fully explained?

Please see the comments listed below.

Paragraph of ED	Comment
Second paragraph of the Introduction	This paragraph refers to IFRS 13 explicitly stating that fair value of a liability must reflect non-performance risk and then continues to state that in the case of an asset this would include counterparty credit risk. IFRS 13's reference to non-performance risk refers to liabilities only and the standard is less explicit regarding counterparty credit risk for derivative asset positions. From a financial reporting perspective, fair value should take into consideration assumptions that market participants would consider; which would include counterparty credit risk in derivative asset valuations.
Fourth paragraph of the Introduction	Paragraph 4 refers to the 'emergence of the requirement to reflect these credit risks in the valuation of assets and liabilities'. We do not believe this should be characterised as an 'emerging' issue'. It could be argued that the requirement was always required in fair value measurements under IFRS and other accounting standards. In addition many regulators may have already had similar requirements.
Sixth paragraph of the Introduction	As noted in our general comments, it is implied from paragraph 1 that this ED will provide compliance with IFRS 13 although this isn't clear in the objective and certainly not within the content of the ED. There are a number of principles within IFRS 13 that would have a significant impact on the approach to determining the fair value of derivative instruments which do not seem to be covered. In addition, it is not clear what is meant by the 'principles of best practice'. For example, what is the context for determining best practice and how does that link to a user's accounting and regulatory requirements? We believe, consideration of accounting and regulatory requirements would be critical, when valuations are prepared for those purposes, to ensure valuation transparency and consistency.
1	This paragraph states 'In this paper the adjustment required to the value of a derivative to reflect counter party credit risk is termed a Credit Valuation Adjustment (CVA) and the adjustment to reflect own credit risk is termed a Debit Valuation Adjustment (DVA)' The wording in this paragraph implies credit adjustments are separate to fair value rather than an integral part of determining fair value. This also implies the ED provides guidance with the requirements of IFRS 13.
3	It is not clear whether this ED is intended to only address over-the-counter (OTC) derivatives.
7	This paragraph states that 'other financial instruments held at fair value follow a similar process, but are not specifically referenced here.' It is not clear what is meant by 'a similar process'.
19	In respect of the second bullet in this paragraph, to avoid confusion, it may be helpful to clarify whether the IVSB believes the non-adjustment for CVA is appropriate or inappropriate.
30-35	These paragraphs seem to go beyond the scope of this document. Paragraph 33 then switches back to calculating CVA and some of the inputs

Paragraph of ED	Comment
	that could be used. For valuations prepared in accordance with IFRS, entities are required to maximise the use of market-observable credit information, which does not appear to be mentioned. The advantages and disadvantages of each input should be examined by entities. The use of historical default rates would seem to be inconsistent with the “exit price” notion in IFRS 13, particularly when credit spread levels in the current environment differ significantly from historical averages. Therefore, in our view, when current observable information is unavailable, management should adjust historical data to arrive at its best estimate of the assumptions market participants would use to price the instrument in an orderly transaction in the current market.
36-50	*Key inputs* We would encourage the IVSB to provide guidance regarding the challenges in determining which inputs are appropriate to use with the selected valuation method. For example, a hierarchy for the use of inputs may be appropriate. The need for such guidance is highlighted, for example, in the following areas: • Paragraph 36 – 39 – Observable inputs such as CDS curves, current debit/credit spread or sector specific or competitor curves all have advantages and disadvantages of use such as market-observability. Information is normally current (for counterparties with adequate CDS trading volume) and data should be easy to source from third-party data providers. However, these may not be available for many entities; may require adjustment; may have liquidity issues, etc. Non-observable data such as historical default information and internal credit risk analysis will likely be based on unobservable info, may be outdated or have questionable calculated creditworthiness. • Paragraph 40 – 50 –Regardless of methodology used, PD, LGD or credit spread assumptions are important inputs. While the sources of information may vary, the objective remains unchanged, that is, to incorporate inputs that reflect the assumptions of market participants in the current market. In addition, we note that this section seems to be confused between discussing inputs and discussing valuation methods.
38	It’s not clear why this paragraph refers to ‘offsetting investments’, as we understand this is in reference to one derivative, rather than two investments.
39	This paragraph seems to imply that if reporting entity does not plan to hedge CVA then the use of historical approach would be appropriate. We do not agree with this view. In our view, fair value for financial reporting purposes is the same whether the reporting entity plans to hedge or not, and should consider implied default probability to the extent possible.
51-57	In our view, it would be helpful if the IVSB clarified what bilateral and unilateral approaches exist and the advantages and disadvantages of using

Paragraph of ED	Comment
	each.
56	This paragraph states that the effect of break clauses, such as those listed in the paragraph, may be used in the CVA calculation. Some have read this to mean that a valuer may, but need not, include the effect of break clauses. In our view, if such clauses are relevant to the CVA calculation they should be integrated. We recommend the IVSB reconsider the drafting of this paragraph to ensure their view is clearly expressed.
60	This paragraph indicates that, in certain situation, an entity would use its own estimated parameters. This may be inconsistent with the requirements in IFRS 13 which requires to maximise external observable inputs.
75-78	As noted earlier, we have concerns about including discussion of hedging. If these paragraphs are meant to address monetisation of DVA and the IVSB believes a hedge instrument is not the best way to monetise DVA that fact should be made clear.
77	We are not sure of the purpose of the last part of paragraph 77, where the IVSB comments on the accounting convention that should be used in measuring liabilities. This seems to be beyond the scope of this document.
104	Regarding the third bullet point in this paragraph and subject to our earlier comments regarding the inclusion of FVA in the ED, if an FVA is calculated, in our view, it should ignore any expected holding periods otherwise there is a pre-fixed intention (documentation) to close the position before the legal maturity.
113-119	In the chapter "CVA and DVA in Financial Reporting", the requirements of IFRS 13 are mentioned briefly. If the IVSB elects to retain this discussion without additional cross-references, we recommend including, at a minimum, a discussion regarding the exit price concept that underpins the definition of fair value in IFRS 13.
113	Throughout the document there reference is made to the concepts of IFRS 13, including the requirement to maximise observable inputs. If the intention is to detail how compliance with IFRS 13 would be met, subject to our earlier comments, we would encourage discussion in relation to how inputs and methods of credit adjustment calculation relate to the principles of IFRS 13.
114	The ED mentions that IFRS 9 requires fair value measurement of financial instruments. As IFRS 9 is not yet effective, this paragraph should also refer to IAS 39 *Financial Instruments: Recognition and Measurement* .
115	This paragraph states "IFRS 13 states that the fair value of a liability reflects the effect of non-performing risk". Instead of "reflects" we would encourage adding further emphasis, such as "must reflect" to make it clear that this is a requirement in IFRS 13 (see IFRS 13.42-44).
117	We would encourage further clarification of the discussion in this paragraph. If this paragraph is intended to refer to the transfer notion of IFRS 13, the liability is assumed to be the same before and after the transfer. This is not intended to reflect what would be observed in an actual transaction.

Paragraph of ED	Comment
119	This paragraph states "While fair value as defined in IFRS 13 is based on the assumption of a market transaction and therefore is generally consistent with the definition of market value in the IVSs,..." The definition of market value in the paper (page 5) is not the same as IFRS 13.9.