Finance and Treasury Association

ABN 70 006 509 655

Friday 28th February 2014

International Valuation Standards Council ("IVSC")
1 King Street
LONDON EC2V 8AU
United Kingdom
Email: CommentLetters@ivsc.org

Dear Sir/Madam

Exposure Draft: Credit and Debit Valuation Adjustments
- Consultation paper from Finance and Treasury Association

The Finance and Treasury Association ("FTA") welcomes the opportunity to make comment on the IVSC's *Exposure Draft: Credit and Debit Valuation Adjustments*.

The FTA is the peak professional body in Australia for corporate treasurers and senior financial risk managers with over 850 members primarily from Australia's top 300 listed corporations. The FTA has been operating for over 30 years in different forms and has established its reputation as a premier provider of continuing professional development (CPD) for finance and treasury forums in Australia.

Since the onset of the GFC, counterparty credit risk in financial instruments, particular OTC derivatives has been a focus area for regulators, banks, non-financial corporations and other financial institutions. The areas impacted have been primarily risk, capital and pricing, however with the introduction of FAS 157 and more recently IFRS 13, this has become a financial reporting issue with the requirement to consider counterparty and own credit risk in the valuation and reporting of their derivatives, and one that non-financial corporations are dealing with for the first time.

We understand that this is a highly complex and specialised area, which is particularly important to sellers of derivatives (mostly banks), as this directly affects pricing and

PO Box 6137 St Kilda Rd Central 8008, **Phone:** +61 3 8534 5060 **Fax:** +61 3 9530 8911 www.finance-treasury.com

profitability. However for other financial institutions and non-financial corporations, in most cases this is purely a financial reporting issue, and has proved extremely challenging to implement. The key reasons are the lack of expertise and capability within non-financial corporations to calculate the adjustments, which is further compounded by the fact that there is no single source of clear guidance on precisely how to calculate these adjustments.

The FTA is pleased that the IVSC has taken on the task of producing this guidance paper, as we hope it will provide much needed clarity and guidance to preparers of financial reports.

The FTA would welcome the opportunity to discuss the information contained in this submission and our CEO David Michell can be contacted for further explanation on +61 3 8534 5011 or david.michell@fta.asn.au.

Background and context

To provide context, we would like to highlight some of the issues that the introduction of CVA/DVA has brought about, and also some of the practical concerns we have with the introduction of these valuation adjustments:

The effect on hedge accounting for perfectly good hedges

The introduction of CVA/DVA potentially causes ineffectiveness in accounting hedge relationships, which in the vast majority of cases creates accounting "noise" for what is typically a perfectly good hedge and which by maturity of the instrument disappears completely. At worst, under IAS 39 CVA/DVA can sometimes cause a breach of the 80-125% effectiveness test and frustrate the ability to apply hedge accounting for sensible economic hedges.

Fair value under AASB 13 vs close out values quoted by bank counterparties

Users of OTC derivatives have difficulty conceptually understanding the decision usefulness of reporting derivatives at fair value under IFRS 13, if these values could never actually be realised in a transaction. In practice, we understand that banks do not necessarily accept the CVA or DVA adjusted amount in settlement of outstanding derivatives, and in addition an end-user to end-user OTC derivatives transfer market typically does not exist that establishes a fair value that takes into account CVA/DVA.

PO Box 6137 St Kilda Rd Central 8008, **Phone:** +61 3 8534 5060 **Fax:** +61 3 9530 8911 www.finance-treasury.com

Whilst we do not expect the IVSC to solve the above concerns as they are financial reporting and market related matters, we would like to highlight the issues so that the IVSC can appreciate the practical implications of any final guidance paper issued by the IVSC.

Response to questions in the exposure draft

The FTA represents mostly non-financial corporations on the buy-side of OTC derivatives. Therefore our comment letter focuses on question 7 below in relation to entities with less complex or smaller derivative holdings.

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?

We agree that it would be very useful for the IVSC to provide guidance that illustrates how simplified methods could be used to achieve a valuation adjustment which approximates more complex methods, and yet is robust enough in order to facilitate compliance with IFRS 13. In addition it would also be helpful to produce high level guidance explaining the conceptual theory behind CVA and DVA, in order to assist management in non-financial corporations to explain in layman's terms what the adjustments represent to audit committees and board of directors.

Conclusion

FTA is pleased that the IVSC has taken on the task of producing this guidance paper to provide clarity and guidance to preparers of financial reports.

However, we note there are transitional issues until companies adopt new IFRS 9 i.e. treasurers are being required to do a hypothetical valuation different to current practice and not be able to include credit in the underlying hedge item as CVA is not allowed to be included in the underlying hedge item.

Australian corporate experience from December 2013 reporters is that CVA can cause previously robust hedge relationships to fail. The dollar offset method is no longer working reliably.

Some companies are trying to create their own curve – which is difficult as, even with true arms-length transactions, highly rated corporations are not being charged a full market rate as other services are built into a wider relationship.

PO Box 6137 St Kilda Rd Central 8008, **Phone:** +61 3 8534 5060 **Fax:** +61 3 9530 8911 www.finance-treasury.com

FTA members recognise the imperative to incorporate a measure of both counterparty's credit risk but are concerned that the calculation method misses the point i.e. that the credit charge being valued is not representative of what is being charged in the market.

The practical significance of this variation from market practice is that at the end of the day a treasurer is not going to close out a swap and realise at this rate. Hence there may be significant variability in accounting outcomes, and between interim financial reporting of imputed valuations versus final reporting of realised outcomes.

FTA recommends as a simplified approach the common market practice of adding a credit spread to an appropriate benchmark curve.

We look forward to working with the International Valuation Standards Council on future consultations.

Yours faithfully,

Paul Travers FFTP

President

Finance and Treasury Association

David Michell CFTP (Snr)

CEO

Finance and Treasury Association

About FTA

The Finance & Treasury Association (FTA) is Australia's pre-eminent professional association for executives in non-financial corporations working across all aspects of treasury and financial risk management. The FTA provides training and skills development and access to current information, facilitates networking and builds a community in this specialised area of business. It seeks to increase recognition of the skills of members and to convey the views of members on key technical issues facing the profession to government, other associations and the wider community.

PO Box 6137 St Kilda Rd Central 8008, **Phone:** +61 3 8534 5060 **Fax:** +61 3 9530 8911 www.finance-treasury.com