February 28, 2014

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

Reference: IVSC Exposure Draft – *Credit and Debit Valuation Adjustments*

Dear Technical Director:

Duff & Phelps appreciates the opportunity to provide comments on the above referenced Exposure Draft.

Our valuation advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques.

We would be pleased to further discuss our comments with the IVSC. Please direct any questions to me via the contact information set forth below.

Sincerely,

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Duff & Phelps

International Valuation Standards Council

Comments on Exposure Draft: Credit and Debit Valuation Adjustments

February 28, 2014

Contents

General Observations

General Impressions

We would like to thank the Standards Board (the "Board") for their efforts in developing guidance on credit and debit valuation adjustments ("CVA/DVA").

In addition to our responses to certain of the questions posed in the proposed Technical Information Paper ("TIP"), we offer some general observations and specific comments on particular paragraphs. Our intent is to provide additional perspectives for the Board to consider before finalizing its CVA/DVA guidance.

Purpose of the Guidance

Paragraph 2 of the TIP suggests that the guidance would serve a variety of purposes, including financial reporting under IFRS, establishing the regulatory capital of financial institutions, and for management and investor information. This represents a vast array of purposes, each having its own intricacies, and as such we believe that a one-size-fits-all approach in addressing the issues is not sufficient typically in capturing and highlighting the nuances.

We suggest that the Board consider one of these purposes as the anchor in providing CVA/DVA guidance and highlight any differences in the analysis when it is performed for other purposes. We think that analyses performed for financial reporting may be best suited to serve as such an anchor since regulatory capital calculations use financial reporting analyses as a starting point, and since computing CVA/DVA adjustments for management purposes may involve certain proprietary information.

Target Audience for the CVA/DVA Guidance

While the Introduction to the TIP lists a number of parties whom the guidance is intended to benefit - valuation and risk professionals [who calculate CVA/DVA adjustments], senior management, auditors, analysts and users - it appears that the nature of the discussion in the TIP does not correlate to the potentially varying levels of expertise of these groups. We do acknowledge, however, that the TIP makes an effort to explain certain principles on a more accessible level, as is the case when the basic philosophy for assessing credit risk is discussed in the context of both loans and derivatives.

Depending on the level of sophistication of a more narrowly defined target audience, the guidance would need to discuss the issues with the appropriate depth.

Financial Reporting Applications

The TIP comes across as rather formulaic, with math that requires specialized knowledge, and does not seem to address how one should go about selecting or deriving market participant assumptions.[1] Further, except for a few references, the TIP should be re-written to discuss the priority of inputs or the relative merits of applying the various methods in particular circumstances, reflecting the views of market participants. We recommend that the guidance be enhanced to make it more suited to meeting or being more consistent with the IFRS valuation and reporting requirements which starts by anchoring the discussion to a market participant perspective.

Regulatory Capital Requirements Applications

In addition to mentioning that DVAs are to be reversed for regulatory capital purposes under Basel III, we think it would be helpful to set forth a discussion about whether and how the calculations for this purpose should follow any particular framework, i.e., requiring specific assumptions or an applying a specific perspective that differs from the one used for financial reporting or management purposes. To have practical value, the guidance should address such process issues to the extent they are not specific to a particular jurisdiction.

A Compilation of Approaches vs. Best Practices

In its Introduction, the TIP states as one of its objectives to identify principles of best practice. However, in a number of cases the TIP lays out a variety of methods without recommending one or another as best practices under particular circumstances. While we do find the discussion of the limitations of a number of methods and inputs insightful, it would be helpful if the guidance, at least to some extent, (i) acknowledged this is an evolving area, and (ii) also discussed the merits of the various approaches and inputs in light of arriving at various more specific recommendations for their application in particular circumstances.

Also, it would be helpful if there is further elaboration on the simpler alternatives available for corporate entities that may have a limited number of derivatives used to hedge interest rate or foreign exchange risk in their business. Similar to other TIPs, this guidance would not be prescriptive and would allow for the application of judgment in the particular valuation situation.

Further, one topic that might rise to the top is that of FVAs. The TIP acknowledges that there is debate on the inclusion of, and if so, the methods for deriving the FVA in financial reporting. We understand that recently certain banks have observed an "industry migration" to incorporating FVAs as part of valuations for financial reporting and that the adjustments can be significant. Clearly there is diversity in practice in this area and best practices guidance is by its nature intended to reduce such diversity without being mandatory. We are hopeful that the Board and working group can make an effort to build consensus on this topic when it is most needed.

[1] As we have learned in Fair Value Measurement language, it is both the specificity of the definitions and the context and quality of the assumptions used and their relevance to the facts and circumstances surrounding the subject matter being addressed.

Summary

In conclusion, we believe that the guidance should convey good valuation economic rigor with clarity and ease of communication and more focused relevance to the specific audiences. The tone and depth of discussion should be adjusted to the target audiences – with specific guidance for depth and breadth of issues between financial institutions, large global corporates with extensive exposure and the vast majority of reporting entities with limited application. The guidance should discuss the attributes of the analysis that make it suitable for the specific intended purpose(s), highlighting the differences in applications for various purposes. Finally, the guidance should arrive at a current recommendation for best practices as a function of the broad characteristics of particular situations.

Questions

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

Question 1:

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

Response: Generally, the scope is appropriate. However, since the proposed scope seems to identify all the major applications of a CVA/DVA analysis:

1) management information;
2) financial reporting; and
3) regulatory capital calculation,

we believe it would need to address the differences amongst the various frameworks/requirements.

We observe that paragraph 82 recognizes that the methodology used for CVA/DVA normally resides with the front office and that ideally the same methodology will also be used with minor *adjustments* for other purposes, including ongoing risk management and external reporting to regulators and shareholders. As stated in our General Observations, we suggest that the Board consider one of these purposes as the anchor in providing CVA/DVA guidance in the TIP and highlight any differences in the analysis when it is performed for other purposes. We think that analyses performed for financial reporting may be best suited to serve as such anchor since regulatory capital calculations use financial reporting analyses as a starting point, and since computing CVA/DVA adjustments for management or pricing purposes may involve certain proprietary information.

* * *

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

Question 2:

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

Response: The definition ‘Debt Valuation Adjustment’ is used here, which seems inconsistent with the majority of the text. Either one term only should be used, or it should be clarified that ‘Debt’ and ‘Debit’ can be used interchangeably.

Some of these definitions seem at odds with the Basel definitions, which is probably not helpful for the target audience. Subsequently, this has an impact on the equations defined throughout the document.

> <u>*For example:*</u>
>
> The IVSC TIP describes EPE (Expected Positive Exposure) as "the discounted receipts and unrealised gains an entity forecasts to receive from the counterparty." The Basel 2005 definitions[2] specify that EPE is the Average Expected Exposure (EE) over all time horizons, with EE, a strictly positive value equivalent to the IVSC's EPE.

The above may demonstrate yet again the need for a differential approach in discussing the CVA/DVA estimation for various purposes.

* * *

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

Question 3:

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

Response: For the purpose of calculating CVA/DVA, we believe that Monte Carlo should be used in all but the simplest cases. The use of other numerical methods (e.g., trees, finite difference, Fourier methods or quadrature) is only applicable in the valuation of the underlying derivatives, the results of which are 'plugged into' the Monte Carlo. Therefore, the TIP could mention other methods, but only in the context of their use as tools to evaluate a derivative contract's potential future value.

In addition, we think that the TIP should provide further clarification on paragraph 92 with regards to the methods, circumstances and types of derivatives where the proposed guidance might apply.

Further, we recognize that derivatives may not be a major asset for certain types of entities (having a limited number of derivatives used for hedging interest rate or foreign exchange risk), and that levels of sophistication in matters affecting CVA/DVA may vary. While the TIP makes a distinction in the case of various sizes of derivatives operations, we think that the TIP should address the needs of such entities by further discussing simpler, "practical expedient" approaches for estimating CVA/DVA, and their merits and limitations, including use of pseudo-analytical methods where appropriate.

We believe that the existence of a "practical expedient" that could be applied when certain criteria are met (perhaps there is little material variance with short duration derivatives and a practical expedient might be more cost effective) would not detract from the understanding that the Monte Carlo approach might be the preferred method for CVA/DVA calculations. We also think the TIP should give

[2] According to Gregory, *Counterparty Credit Risk and Credit Value Adjustment*, 2012

consideration to when such "practical expedient" approaches might be available to entities not just based on the size of the derivatives operation, but possibly based on other criteria as well.

* * *

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.

Question 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?

Response: We do not believe this should be the topic of a TIP at this time. Furthermore, to the extent the issue pertains to valuers, this would be the remit of professional standards, rather than the IVS and its related best practices guidance.

* * *

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.

Question 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?

Response: We agree. Also, please see our response to Question 3.

* * *

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

Question 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?

Response: Yes, we believe so.

* * *

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.

Question 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?

Response: As recommended earlier, the guidance should address the financial reporting aspects as well. Specifically, on this issue, we believe the working group should conduct an outreach as part of this project to try and build consensus around the FVA issue, or present alternatives with supporting reasoning. This would be consistent with one of the TIP's objectives, as stated in the Introduction, which is "to assist valuation and risk professionals by identifying principles of best practice."

We understand that recently certain banks have observed an "industry migration" to incorporating FVAs as part of valuations for financial reporting and that these adjustments can be significant. Clearly there is diversity in practice and best practices guidance is by its nature intended to reduce such diversity without being mandatory.

Miscellaneous Comments by Paragraph Number

The following are some suggested wording or semantic changes that the Board may want to consider before publishing the final TIP on CVA/DVA.

Paragraph 8 (Definitions):

- DVAs are described as “debt” rather than “debit” valuation adjustments, unlike elsewhere in the document.

Paragraph 13

- The equation is missing a closing ‘dt’ term.

Paragraph 25

- Is the discussion of Master Netting Agreements in this section consistent with their treatment in financial reporting, or is it limited to a more general business perspective?
- We think that the discussion (in this paragraph or elsewhere) should also give consideration to CVA pricing between desks within an entity (internal counterparties), in addition to addressing external counterparties. Items relating to unit of account (netting agreements and collateral) should also be addressed in an internal context as well.

Paragraph 33

- This point does not seem to belong under the heading of ‘Hedging CVA.’ It may be more appropriate to make it a component of paragraph 38.

Paragraph 39

- There seem to be several concerns with this paragraph: stating that historical default rates are lower than market implied-levels is a generalization that may not necessarily always hold, and is dependent on the economic cycle. One has to be careful in discussing this point, revolving around market-implied vs. historical measures, the former being applicable to valuation (and thus hedging), the latter for risk management purposes. Whether one hedges CVA or not is moot, what is important is that CVA is a tradable rather than a risk measure.

Paragraph 41

- It is unnecessary to make statements about the number of simulations required.

Paragraph 45

- The acronym OIS should be defined.

Paragraph 64-65

- These statements are not very clearly written and as a result may convey an incorrect impression to a reader who is not closely familiar with the topic.

Paragraph 68

- This links to paragraph 39 – the description given assumes using historical volatility as the appropriate input, rather than implied volatility. This may not be the case.

Paragraph 71

- Heath-Jarrow-Morten should be corrected to reflect the proper spelling.
- “Libor” should be replaced with “LIBOR Market Model”.

Paragraphs 113-119

- As stated earlier, the discussion of CVA/DVA in financial reporting should espouse a market participant perspective when it comes to sources of inputs (in accordance with the fair value hierarchy) and choices of methods.

  Further, there may be differences in practice in trading between institutions as counterparties and the reporting of these transactions for financial statement purposes. While paragraphs 113 and 119 seem to acknowledge this fact, we believe that the guidance should discuss these issues in greater depth, to be helpful in practice.

  An entity may view a transaction a certain way from an economic perspective but may have to report it differently. Below is a short list of representative examples:

  - An entity may price transactions involving groups of financial instruments taking into account the size of the block. However, for financial statement purposes, blockage discounts/premiums are not permitted, and the instruments are measured on a standalone basis, and not as a block.
  - Restrictions on assets may be priced into deals from an economic perspective, however, whether the restriction is taken into account in the valuation of the asset for financial reporting depends on whether it is an attribute of the asset or the holder.
  - In certain situations, financial instruments may need to be valued separately from their related credit enhancements thus breaking

the valuation into two components (two different units of account), even if the instrument may be priced in the market with the enhancement in place. For example, a collateralized bond may be priced as by investors as a single instrument, but from the obligor's perspective, there may be a need to account for the liability separately from the credit enhancement.

- To conclude, as in the above examples, the entity's analysis of CVA/DVA in the ordinary course of business, or from an economic standpoint, may not coincide with the assumptions that need to be made for financial reporting. Therefore, an additional level of analysis in the CVA/DVA discussion is needed in the TIP to close the gap.

Paragraph 116

- This paragraph (or the Financial Reporting section of the TIP in general) should address in more detail the situations in which the unit of account should be the individual instrument (such that the analysis is be confined to that level) vs. an entire portfolio.
- Also, there should be a discussion of what constitutes an appropriate netting set for financial reporting purposes in light of the IFRS criteria, and whether a legal opinion may be needed as part of that as well.
- Reference is being made to the credit standing of the reporting entity. We recommend that the discussion be expanded to address when the credit standing of the instrument(s) – and, therefore, the assumptions used in the analysis - may be different from that of the reporting entity.
- The latter point also gets into whether the financial instrument should be analyzed separate and apart from any related collateral, which depends on what the requirements and practices are for IFRS, regulatory capital calculations, or management information, respectively.
- The term "transfer price" is commonly used in transfer pricing arrangements for the purpose of allocating a multinational corporation's profit to the different tax jurisdictions that it operates in. Thus, "transfer price" is an established tax term. To avoid confusion, we suggest that the following sentence:

  > *"…the credit risk incorporated in the valuation of a liability should reflect a hypothetical transfer price involving a market participant…"*

  be edited as follows:

  > *"…the credit risk incorporated in the valuation of a liability should reflect the hypothetical price at which the liability would be transferred to a market participant…"*

Paragraphs 120-123

- Please see our comments in the General Observations Section of this letter on the need for a separate and deeper discussion of CVA and DVA in regulatory capital calculations, where we suggested using CVA/DVA analysis for financial reporting as an anchor in the TIP.
- Further in this regard, due to their objective, regulatory capital analyses might be more focused on the tails of the distribution of possible outcomes, which might pose a systemic risk, whereas financial reporting is more focused on expected values from a market participant perspective. The latter, in addition to the removal of DVA adjustments may be but a few of the general differences that are worth highlighting in the guidance.

Various paragraphs

- When discussing the credit risk of the counterparty, we believe that special consideration should be given to those scenarios in which money would change hands, and the impact of such scenarios on the creditworthiness of the obligor.

  In particular, in a downside scenario, the credit perception of the obligor may be dramatically different from that in other scenarios, especially when there is correlation with other material obligations of the obligor. As part of this, one would have to obtain an understanding of the events that change credit risk, including micro/macro events and their effect in downside scenarios.

Various paragraphs

- It should be explained more clearly what the unit of account should be for computing a CVA adjustment: for example, should the analysis be conducted independent of the existence of collateral, and if so when, or should the analysis be conducted while taking any collateral into account.

  This represents yet another dimension of what is known as the “gross/net issue”, which pertains to unit of account, or the level of aggregation in the analysis carried out for a particular purpose. In general, discussing, performing and presenting an analysis on a “gross basis” has greater informational value than presenting it on a “net basis.” An analysis showing more componentization contributes to greater transparency.

The Glossary of Acronyms should contain the following:

- OIS Overnight Index Swap