IVSC Project on Credit and Debit Valuation Adjustments

OVERVIEW

The International Valuation Standards Council (IVSC) is an independent, not-for-profit, private sector organisation that has a remit to serve the public interest. The IVSC's objective is to build confidence and public trust in the valuation process by creating a framework for the delivery of credible valuation opinions by suitably trained valuation professionals acting in an ethical manner.

The IVSC achieves this objective by:

(a) creating and maintaining the International Valuation Standards (IVS);

(b) issuing technical guidance for professional valuers; and

(c) promoting the development of the valuation profession and ethical practices globally.

In view of concerns expressed by governments, financial regulators and others over both how financial instruments were valued in the financial statements of banks and other financial institutions, the IVSC formed a Financial Instruments Expert Advisory Group (FIEAG) in 2009 to assist it in identifying valuation problems in the financial markets and projects that could be undertaken to help rebuild confidence in the valuations of financial products.

The FIEAG contributed to the production of a new high level International Valuation Standard for financial instruments (IVS 250) that following due process has now been published[1] as one of a completely revised suite of standards. The FIEAG identified further projects, two of which have been accepted by the IVSC for inclusion in its current Work Plan. One of these is to produce a Technical Information Paper examining methods for measuring adjustments for counterparty and own credit risk when valuing certain categories of financial instruments for either financial reporting or prudential regulatory purposes. These adjustments are generally known as credit valuation adjustments (CVA) and debit valuation adjustments (DVA).

This paper describes the background to the project and sets out matters that the Board believes need to be considered.

The IVSC wishes to form a **working group** to help progress the project. This will ideally include individuals with different perspectives on the valuation of financial instruments, for example:

- experience in the valuation of financial instruments that are subject to CVA or DVA adjustments;
- users of valuations (including preparers and auditors of financial statements that include valuations of financial instruments),

Because of the anticipated interest of regulators in the project the IVSC is also considering the formation of a **review panel** of experts from financial sector regulators. This panel would have input into the scope of the project and an opportunity to provide feedback on a draft proposals before they were made public. However, in order to allow the participants in the working group to explore ideas and discuss matters freely, members of the regulatory community would not take part in in the working group sessions.

Nominations for membership of the working group or review panel are invited no later than 30 September 2011. An application form and further details can be obtained from the IVSC Technical Director, Chris Thorne by email to cthorne@ivsc.org.

[1] IVS 2011 – available from www.ivsc.org

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Project Objective

The increasing adoption of International Financial Reporting Standards (IFRS) around the world over recent years has led to a requirement for financial institutions and other entities to measure certain financial assets at "fair value". These include most types of derivative contract, as well as fair value cash instruments.

IFRS 13 *Fair Value Measurements*, published in April 2011 and effective from January 2013, clarifies not only the definition of "fair value" as applied generally in IFRS but also certain conditions and assumptions that apply when the fair value of certain types of financial assets and liabilities are measured. IFRS 13 provides that when the fair value of a liability is being measured that non-performance risk has to be reflected in the value. In the case of a liability held by an entity this includes its own credit risk. In the case of an asset this includes the counterparty credit risk.

The Basel Committee on Banking Supervision has also introduced a requirement into "Basel III" that requires a capital charge to be made for losses caused by credit valuation adjustments.

The emergence of these requirements for banks and other financial institutions to make credit and debit valuation adjustments when valuing derivative instruments and cash instruments has brought to light inconsistencies of approach between different institutions. The objective of the IVSC project is to identify and promote best practice in making CVA and DVA adjustments in order to improve the understanding the strengths and weaknesses of different methods.

While the guidance produced by the project will hopefully be of value to valuation and risk professionals producing valuations, it should also assist senior management, auditors, analysts and regulators in understanding the principles behind CVA and DVA adjustments. While the guidance may include some illustrative examples, these will be mainly qualitative rather than quantitative. The objective is not to produce a comprehensive training manual or to otherwise teach people how to use complex mathematical formulae or models. The focus should be on practical issues rather than academic theory.

Project Scope

The IVSC Standards Board has identified the following issues that it considers should be addressed by the project, although the working group is encouraged to make recommendations to amend or extend this list.

- To identify those instruments, whether cash based, derivative or hybrids, that are sensitive to changes in either own or counterparty credit risk;
- Consideration of underlying netting and collateral arrangements.
- Consideration of when use of LIBOR or OIS rates is more appropriate;

- Examination of different techniques for making adjustments and endeavouring to identify best practice. Also to compare techniques used with the Basel III requirements on CVA.
- Potential for automation: Processes should be as consistent as possible to ensure per organisations report on a comparable basis. The project should consider the feasibility of identifying the key parameters for any model, eg interest rate and credit curves or weaknesses or assumption limits in any path adopted.
- Systemic Liquidity v Credit Risk: The project should consider the validity of trying to distinguish the effect of systemic risk from changes within the organisation itself on its credit risk.

Other matters that may be considered include the treatment of CVA/DVA with respect to consolidated and unconsolidated special purpose vehicles, and the interaction of CVA/DVA with Day 1 profit rules.

It is envisaged that the style of the guidance will be mainly narrative with a minimal number of mathematical examples.

The working group is requested to firstly review the scope outlined above and feedback any recommendations for a significant change to the IVSC Standards Board. If the scope is agreed the second stage will be to develop a skeleton paper to indicate the overall structure and contents that are proposed. This will be shown to the proposed review panel and the Board. Once agreed the working group will then be asked to develop a detailed document that, subject to Board approval will be released for public comment as an Exposure Draft.