Funding Valuation Adjustments
Project Brief

Introduction

In recent years the practice has evolved within banks of making a specific adjustment to reflect the cost of funding their positions when valuing uncollateralised derivatives. This has become known as a “funding valuation adjustment” (FVA).

Prior to the 2008 credit crisis, most market participants used London Interbank Offered Rate (LIBOR) curves to discount cash flows, as LIBOR was seen both as a good proxy for the “risk free” rate and market participants’ cost of funding. However, since 2008 Overnight Index Swap (OIS) curves have increasingly been used for discounting. Prior to 2008 LIBOR and OIS rates were broadly similar but since the crisis the spread between the two has widened and at times been significant.

The uncoupling of these two rates has caused some controversy amongst practitioners and academics. Traditional finance theory assumes that market participants can borrow and lend freely at close to the risk free rate. Given the separation between the OIS and LIBOR rates that represents bank credit risk many banks have perceived the need to make an adjustment to reflect the cost of funding.

The situation has become confused with some banks making explicit FVA adjustments to fair valued positions in their financial reports whilst others do not. Questions have been raised with the IASB and FASB as to whether FVA is compatible with fair value under IFRS 13 (or its equivalent under US GAAP). There is debate as to whether this is an accounting or a valuation issue, ie if this is a cost being incurred, should it be separately accounted for or should it be captured in the fair value measurement.

While it is argued by some that an entity’s own funding cost is a factor that falls outside the definition of fair value in IFRS 13 and US GAAP, these standards do require the credit standing of the entity to be reflected in the fair value of a liability, and the credit standing of an entity does affect its cost of funding. In the IVSs and the market generally, adjustments to a valuation to reflect the credit standing of an entity are known as debit valuation adjustments (DVA). As already identified in the IVSs emerging guidance on CVA and DVA, there is interaction and potential for overlap between DVA and FVA.

IASB and IVSC staff have discussed the issue; it appears that the IASB’s current position is that there is no need to amend IFRS 13 as if the cost of funding is something that would be taken into account by a market participant it is reflected in fair value, and if not it is excluded.

Project Objective

The Standards Board considers that it has a role to play in bringing some clarity to the situation. It has approved a project to examine the issues around FVA and to determine the nature and scope of any future pronouncement that it needs to make on the topic. To assist the project it will form an expert working group with representation from banks, regulators, auditors, buy-side firms independent valuation firms and academia.

It is proposed that the project address the following:

- The conceptual rationale for FVA.
- Can the concept be captured in a single definition?
- Is FVA only a sell-side consideration or does it have implications for buy-side entities?
- When is the adjustment appropriate?
- Interaction and risk of double counting with DVA and other adjustments made during the valuation process.
- Is FVA more applicable to some types of instruments than others?
- Appropriate approaches to reflect FVA in a valuation.

It is proposed that this project does not attempt to address whether it is appropriate to reflect FVA in IFRS13 fair value or its use in valuations to support regulatory capital. These are matters for the appropriate accounting standard setters and regulators. However, it is proposed that engagement with these bodies is sought during the project as our findings and eventual pronouncements could be helpful to their consideration of the issue of FVA.

It is anticipated that the intended audience for any future pronouncement will include banks, buy-side firms, auditors and investors. The intention will be to assist by providing guidance on the concept of FVA, including circumstances when it is appropriate and circumstances when it is not. Guidance may also be included on acceptable methods for calculating FVA, It is recognised that most of the larger international banks will have systems in place and little need for guidance on calculation methods. However, in line with the emerging guidance on CVA/DVA, any IVSC guidance on methodology will not be prescriptive and will be aimed at smaller banks, buy-side firms and any other parties who may rely on valuations to increase their understanding of the topic. It can also help auditors if the industry has accepted benchmarks as to when FVA adjustments are appropriate and how they can be calculated.

The working group will be requested to firstly review the scope outlined above and feedback any recommendations for a significant change to the IVSC Standards Board. Subject to this, the first stage will be to develop a Discussion Paper that sets out the issues identified and possible alternative solutions on which views need to be sought in a public consultation, and refer this to the Board for approval.