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ISDA – IASB Meeting 28th May 2003

Dear Sandra

The International Swaps and Derivatives Association (ISDA) would like to thank you for arranging the follow up meeting on fair value measurement on May 28th 2003. We continue to appreciate the time that the IASB staff and Board members have taken in order to listen to our views and consider our concerns.

In support of your work in preparing papers for the Board in advance of the June Board meeting we write to summarise some of the key discussion points from the meeting on the 28th May and to provide the follow up material as agreed.

Market Risk Valuation Adjustment

As discussed at the meeting, ISDA believes that there is one 'mid-market' price at which transactions would be executed in a perfect market. However, transactions are rarely executed at this mid-market price. The difference between the execution price and the mid-market price represents the bid or offer spread.

Although OTC derivative instruments can be cancelled or novated, the most common practice to close out a derivative is by entering into transactions that offset the net open risk. As a result, transactions, or groups of transactions, are generally valued at mid-market with specific valuation adjustments made for net open risks. The specific adjustments for market risk are calculated by applying an appropriate, market spread to the net open risk positions.

The current language in the draft is open to differing interpretations and one possible interpretation is fundamentally at odds with the way the market determines fair value by attaching importance to individual transactions rather than risk.

As we discussed at the meeting, we are concerned that the presence of the sentence "The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price", combined with the requirement that appropriate "bid" or "offer" prices are applied unless an entity has matching assets and liability positions, could be interpreted as precluding the market practice of valuations based on net risk positions.

The BIS global OTC derivatives market statistics relating to December 2002, (published in May 2003) show the notional value of OTC interest rate and foreign exchange derivative contracts from the dealers' perspective are estimated to be in excess of USD 170 trillion. Applying "bid" or "offer" prices to these contracts on an individual basis without any regard for the actual open risk position would result in valuation adjustments that would far exceed the amount calculated on a net risk basis. This would not achieve fair value.

To illustrate, for a large derivative dealer with a portfolio of say 100,000 swaps with notional value of perhaps USD 10,000 billion and an average duration of 3 years, applying the bid offer adjustment of 1 basis point for market risk on an individual transaction basis could be in the region of USD 3 billion. This would be required irrespective of whether the dealer had significant open market risk or not and, for a dealer with a reasonably balanced portfolio, bear no relation to the current valuation adjustment for market risk calculated on a net risk basis.

Negative consequences of the approach

As we discussed at the meeting, we are concerned that the IASB's fair value objective is not met by this potential interpretation of the proposals in the Exposure Draft. Additionally, we believe that there are key differences when compared to US GAAP. Paragraph 7.14 and 7.42 of chapter 7 of the Broker Dealer Guide make specific reference to the fact that best practice for dealers is to mark derivative portfolios at mid market levels less specific adjustments. As illustrated above, the application of spreads for market risk to individual transactions, rather than on a net risk basis would result in significantly different values carried on the balance sheet. This approach would, therefore, create a significant difference between IFRS and US GAAP.

As we illustrated with the examples during the course of the meeting, market pricing is based on underlying risks. Therefore, achieving a different fair value for the same underlying risks simply because the trade has been structured as an individual transaction or as a collection of transactions cannot be a desirable outcome. ISDA is concerned that such an outcome could provide opportunities to transact in a manner that would distort earnings. For example, for a portfolio of derivatives that have zero market risk, applying the bid-offer price on a deal by deal basis, the fair values of derivative assets would initially be understated in the balance sheet and the fair values of derivative liabilities would initially be overstated. This would subsequently reverse over time as an increase to earnings. Further, any active restructuring of the number of trades by repackaging without changing the actual market risk exposure would also result in changes in the balance sheet value and a distortion in earnings.

Drafting proposals

Attached as appendix 1 to this letter are suggested amendments to the drafting of the Exposure Draft, paragraphs 95-101. In developing these suggestions we have been cognisant of not wishing to introduce wholesale changes that would necessitate re-exposure. The effects of the key changes suggested are as follows:

- Remove the distinction between active and inactive markets;
- Deconstruct the hierarchy;
- Move away from valuation on a transaction by transaction basis; and
- Move away from cash consideration being the key driver of fair value.

Longer term objectives

Through the course of our meetings with you, and within this letter, we have sought to demonstrate the impact of some of the changes introduced by the Exposure Draft. Within the short time frame available to finalise the revised standard, we urge the Board to consider the implications carefully and to defer issues which introduce significant areas of divergence that will need to be addressed in the longer term project.

We hope this information is of assistance; please do not hesitate to contact us if you require further information or clarification.

Yours sincerely,

Edward A. Duncan

Assistant Director of European Policy

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