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The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

May 9, 2000

Dear Mr. Talisman and Commissioner Rossotti:

I am writing on behalf of the International Swaps and Derivatives Association ("ISDA") to provide information regarding procedures used by securities dealers in valuing derivatives for financial reporting purposes. This information supports ISDA's request that the Internal Revenue Service (the "Service") issue guidance permitting securities dealers to value derivatives in applying the mark-to-market rules of section 475 the same way they do for financial reporting purposes. ISDA's position, and the legal and policy considerations underlying it, were presented in detail in a letter to you dated September 21, 1999 (copy attached).

Based on informal discussions with representatives of the Treasury Department and Service, there seems to be no disagreement that use of financial reporting values would simplify compliance, and thus would have practical advantages for both taxpayers and the Service; indeed, it is not clear what, if any, realistic alternatives exist. There also seems to be agreement that use of book values would tend to conform US practice to that of other major industrial countries, minimizing the chance that less (or more) than 100% of the income from a global dealing operation will be taxed.

Most importantly, we believe there is general agreement on the legal principle that section 475 requires only answering a question of fact: what is the fair market value of derivatives and other securities positions a dealer holds? The legal principles governing other accounting methods—particularly the rule that accrual method taxpayers cannot take into account expected future expenses and losses—are simply not relevant in applying section 475. The mark-to-market rules of section 475 are as applicable to private bilateral contracts as they are to financial instruments that are widely traded on established markets.

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Because certain future expenses and losses are implicitly reflected in the prices of publicly traded stocks and bonds, it is necessary to take these costs into account when determining the fair market value of financial instruments for which no active secondary market exists.

The remaining question—and the question we address in this letter—is whether, as a factual matter, the procedures used by dealers for book purposes accurately measure the value of their derivatives positions. As discussed in detail in our letter of September 21, we believe that book methods for valuing derivatives accurately measure value and, in any event, certainly do not *understate* it. This letter will show that dealers face substantial competitive pressure to use methods for book purposes that measure as accurately as possible the value of the derivatives they hold.

Based on informal discussions, we recognize that the Service and Treasury would be more able to accept the view that book valuations accurately measure fair value if they better understood the various procedures and adjustments that go into book valuations. They could then confirm that the kinds of procedures and adjustments used by dealers in fact are designed accurately to determine value—which is the section 475 standard.

I. Competitive Pressures Ensure That Book Adjustments Estimate Fair Value Accurately

Although different dealers use a variety of names and categories for adjustments, all have the same purpose: adjustments are designed accurately to measure fair value. In the following discussion of the kinds of adjustments commonly used, we will note why each is appropriate in measuring value. We do not believe that any of the adjustments merely reflect general costs of being in the securities business that would not be taken into account by buyers and sellers of particular positions in the market. All the kinds of adjustments discussed below, including not only adjustments for credit losses, but also adjustments for expected costs of hedging and servicing, reflect factors that participants in derivatives markets must and do take into account in determining price.

A dealer's traders generally use book valuations, net of all the adjustments discussed in this letter, to decide what positions to take on (or hold) and which to pass up (or terminate). If a particular adjustment used by a dealer tended to produce a book valuation below true fair market value, its traders would forgo contracts that would make money for the firm. A dealer making such an adjustment would repeatedly lose deals—and profits—to competitors with more accurate valuation methods. Thus, we reject the idea that derivatives could generally be worth more (or less) in the market than the value shown on the dealer's books net of *all* adjustments.

In addition, if a dealer's book valuations were below true market value, its traders could easily create book profits by disposing of positions at prices in excess of book, but perhaps still below market value. Thus, dealers will make every effort to ensure that their book values are not below market, so that their traders are not encouraged to create profits by

selling positions too cheaply. If, despite the dealer's efforts, some positions are undervalued on its books, the problem will rapidly correct itself as traders cull its portfolio and unwind undervalued positions in order to produce profits. On the other hand, traders have no similar incentive to eliminate any overvalued positions. Thus, although dealers strive to value positions accurately—neither undervaluing nor overvaluing them—if there is any bias, it will be towards overvaluation.

It has been suggested that some firms may deliberately value certain kinds of positions at less than market in order to discourage traders from entering into them and thereby enforce compliance with decisions to avoid those positions. Even if this were true, the result would be that the firm would *not* hold positions that its book method would undervalue. Since section 475 applies only to positions that a firm holds, the Service would have no reason to be concerned. It is only if the values of positions that a dealer actually holds, not of positions that it passed up, are understated, that the Service should be reluctant to accept the dealer's valuation methods. If the dealer successfully discourages its traders from taking on positions by undervaluing them, the dealer may have lost profits, but it will not have understated the value of positions it actually does hold, and thus will not have underpaid its taxes.

In sum, dealers face intense competitive pressure to use only valuation adjustments that result in accurate estimates of the actual prices at which particular derivative positions would change hands in the market. Common sense shows that a dealer would continually lose profits to its competitors if its book methods systematically undervalued positions by making adjustments for costs not reflected in actual prices.

In reading what follows, it is crucial to keep a basic point in mind. Dealers make adjustments for one reason, which is to estimate fair value as accurately as possible. In fact, dealers hope to gain a market advantage by using procedures that are better—that measure fair value more accurately—than those used by their competitors. If one dealer uses a lower value than another for a given position, it is doing so because it believes that the latter dealer is overpaying. Competitive forces will soon show which of the two was correct. If the dealer with the lower valuation was correct, the other dealer will lose money by overpaying; if the dealer with the lower valuation was incorrect, it will lose profits to its competitor.

Dealers are in competition with each other to do exactly what section 475 requires that they do. Section 475 presents the Service with an unusual opportunity to minimize administrative costs by relying on the market. Even if it were possible for the Service to develop its own methodology for valuing derivatives—which we question—it is unlikely that any such methodology would be as accurate as the methods that the market compels dealers to use. In any event it would be far more expensive for both the Service and taxpayers to develop, and continually update, "shadow" valuation methods solely for tax purposes. Not only would it be expensive, it would be quite wasteful, because valuations already exist whose accuracy is ensured, and continually refined, by competitive pressures.

Allowing dealers to use book valuations will avoid substantial costs for the Service as well as for taxpayers. We acknowledge that it may sometimes be necessary to develop alternative valuations for dealers who are not entitled to rely on rules generally permitting dealers to follow books; such dealers might include those who do not apply book valuations consistently for nontax purposes. However, the costs to the Service of developing its own valuation methodologies for all dealers would be far greater than the costs of dealing with the few exceptions to general rules allowing dealers to follow their books.

Not only is it inefficient to require use of special valuation methods by all dealers for purposes of section 475, it is also, we submit, contrary to the wishes of Congress. As we pointed out in our September letter, the Conference Report accompanying the 1993 legislation enacting section 475 stated that "the conferees expect that the Treasury Department will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for Federal income tax purposes."¹

II. Dealers Use a Variety of Names and Categories for Adjustments That All Are Designed To Achieve the Same Basic Purposes

We recognize that dealers use a great variety of names for the adjustments they employ, and that some dealers slice the adjustments they make more finely into subcategories than other dealers. Different approaches to the basic task of estimating value, as well as different circumstances, lead to a wide range of names for, and variations on, procedures and adjustments. Such variety can create the misleading impression that dealers are using fundamentally different methodologies. Thus, the Service might infer that allowing dealers to follow books would result in inconsistent approaches to measuring income for tax purposes. An important purpose of this letter is to demonstrate that this would not be the case.

In fact, each dealer applies the same basic theory and approach, but implements it slightly differently to suit to its own business and circumstances. The basic theory and approach used by all dealers is set out in a 1993 report by the Group of Thirty ("G-30"), an independent nonprofit body comprising prominent private sector representatives and co-chaired at that time by former Federal Reserve Chairman Paul Volcker.² The G-30 report specifically provides that the valuation adjustments discussed below are necessary components of any system attempting to determine the fair market value of an instrument for which no active secondary market exists.

¹ H.R. Rep. No. 213, 103rd Cong. 1st Sess. 616 (1993).

² Group of Thirty, *Derivatives: Practices and Principles* 9-10 (1993) (setting forth basic theory of market valuation, and general approach); Group of Thirty, *Derivatives: Practices and Principles, Appendix I: Working Papers* 3-11 (1993) (more detailed discussion of kinds of adjustments).

Valuing derivatives—like trading derivatives—is not an exact science to which a single set of mechanical rules or procedures can be applied. Dealers use a variety of valuation adjustments and procedures, each striving to do better than the others at determining fair value. Thus, what follows below can only be a discussion of the general kinds and categories of adjustments and procedures commonly in use.

III. Midmarket Method

Securities dealers value their derivatives positions using the "midmarket" method. The midmarket method values derivatives at the middle of the current market and takes into account specific kinds of adjustments (including those referred to in the aggregate as "portfolio adjustments") discussed below. The midmarket method replaced an earlier method where derivatives were valued at bid or ask price, *i.e.*, at a value that did not reflect any portion of the bid/ask spread and thus produced lower valuations than the midmarket method currently in general use.

IV. Midmarket and Model Adjustments

Dealers generally begin by using an estimate of midmarket value produced by a model. Before making the specific portfolio adjustments described below, a dealer makes adjustments ("midmarket adjustments") to ensure that the values produced by the model are as accurate as possible. These adjustments may be positive or negative. They may be necessary until a dealer's model can be revised to take into account a particular factor or economic condition. These adjustments may be based on internal research, on comparison of results produced by two different models or on observed prices of trades in the market. Where the estimate produced by one model is adjusted because a comparison to another model yields a different valuation, the adjustment may be referred to as a "model adjustment" or a "model fair value adjustment".

A particular dealer may use a variety of model adjustments to account for a variety of different imperfections in its model. For example, one ISDA member makes an adjustment called a "quanto adjustment" for certain commodity derivatives in which the two legs are payable in different currencies. The value of such a transaction depends in part on the correlation between the floating index and the relevant exchange rate. There are at least two schools of thought as to the most accurate way to reflect this correlation. A dealer using a standard model that takes the correlation into account in one way may believe that the alternate approach is more accurate and thus make a quanto adjustment to reflect the difference. Another dealer starting with the same standard model may make the same adjustment, but use a different name for it.

V. Portfolio Adjustments

Adjustments grouped together as "portfolio adjustments" fall into three general categories. The first includes adjustments for the effects on value of risks of changes in market factors; they are discussed below under "Market Risk Adjustments". The second includes adjustments for potential losses from counterparty default; they are discussed below under "Credit Adjustments". The remaining category includes adjustments for the effect on value of expected costs of maintaining a position in derivatives, including but not limited to servicing.

A. Market Risk Adjustments

Market risk adjustments are often broken down by dealers into subcategories based on the kind of market risk that each adjustment reflects. Market risks include both risks that are potentially hedgeable (bid/offer adjustments), risks that may be hedgeable only with difficulty because the dealer has a particularly large position in the risk (concentration adjustments) and risks for which no direct hedge exists (unhedgeable risk adjustments). Bid/offer adjustments and unhedgeable risk adjustments are generally much more significant than concentration adjustments.

1. Bid/Offer Adjustments

Bid/offer adjustments reflect a portion of the bid/ask spread for positions creating risks that are potentially hedgeable, but that have not yet been hedged. Thus, some dealers describe these adjustments as "hedging fair value adjustments". These adjustments reflect uncertainty that the dealer will be able to close out an unhedged position at the midmarket price, and instead would have to accept another dealer's offer price.

Bid/offer adjustments effectively adjust value by some or all of the difference between the mid-market value and the bid or offer price, and effectively reduce the reported value by up to one half the bid/ask spread, but only to the extent that the position has not been hedged. Once a position—or a particular risk created by a position—has been hedged, this adjustment is reversed and the value of the position is increased accordingly. Thus, as soon as the hedge is in place, a portion of the bid/ask spread is brought into income.

Bid/offer adjustments are sometimes broken out into a number of different components, each reflecting a different kind of risk that might be hedged separately. It is very important to note that these components never, in the aggregate, exceed the bid/ask spread, because a dealer could always enter into an offsetting position, rather than hedging separately each individual kind of risk.

The extent to which bid/offer adjustments are broken into different components, and the names used for those components, vary widely from dealer to dealer. The largest and

most sophisticated dealers tend to break down their bid/offer adjustments more finely than others.

Although conceptually the distinctions between the different components are not particularly relevant to ISDA's position—all components are alike in that they measure the effect of hedgeable risks on value—we will briefly explain below the factors into which the bid/offer adjustment might be divided. By doing so, we hope to reduce confusion that may result from the number of categories and names for them.

We believe that each of the components of bid/offer adjustments set forth below must be taken into account to measure accurately the prices at which derivatives held by dealers would change hands in the relevant market.

The most important and widely used component of the bid/offer adjustment is for "delta", which relates to risk of changes in the prices of the underlying instruments. In the case of interest-rate derivatives, for example, delta adjustments represent risk of change in interest rates.

Other commonly used adjustments include "gamma" and "vega". The gamma adjustment, which is sometimes referred to as an adjustment for convexity risk, relates to risk of changes in the risk of changes in prices of underlying instruments (*i.e.*, change in delta). The adjustment for "vega", which is an adjustment for volatility risk, reflects the risk of changes in value from changes in implied volatility of the underlying instruments. Many dealers do not include the gamma adjustment in their bid/offer adjustment, but instead treat it as a model adjustment; the rationale for including it in the model adjustment is that there is no separate market for it. Other components that are sometimes used include "theta" (time decay risk) and "rho" (discount rate risk).

2. Unhedgeable Risk Adjustments

Adjustments for unhedgeable risk reflect the costs that would be incurred in closing out a particular contract because there is no direct hedge against the risk the contract creates, leaving the dealer at least partly exposed. These adjustments are particularly likely to be necessary for "exotic" contracts that entail unusual risks. Accordingly, these adjustments are particularly important for larger dealers with a wide range of sophisticated products. Unhedgeable risk adjustments are quite distinct from, and do not duplicate, the bid/offer adjustments referred to above.

Some institutions refer to unhedgeable risk adjustments as "liquidity adjustments" or "liquidity fair value adjustments". Others use those terms more broadly to refer to all market risk adjustments.

3. Concentration Adjustments

Concentration adjustments reflect additional costs that would be incurred in closing out a particular contract because the dealer holds an especially large position in the risk or risks it creates. Conceptually, concentration adjustments can be viewed as similar to, but distinguishable from, both bid/offer adjustments and liquidity adjustments. Like bid/offer adjustments, concentration adjustments relate to a risk that is hedgeable, but only with difficulty because of the size of the dealer's position in the risk.

We recognize that legislative history indicates that blockage discounts are not to be considered in applying section 475.³ Concentration adjustments are, however, different from blockage discounts. Blockage discounts reflect the depressing effect on price of simultaneous availability of a large number of similar items. Concentration adjustments relate to the total amount of a particular kind of risk a dealer is subject to, without regard to the number of different items it holds that create that risk.

B. Credit Adjustments

Adjustments for default risk are of two general kinds. The first includes allowances for anticipated credit losses, and the second includes the cost of capital held to cover unanticipated credit losses.

1. Adjustments for Anticipated Defaults

These adjustments (sometimes called "unearned credit spread adjustments") are made to reflect the risk that the dealer will not receive payments because of anticipated defaults by the counterparty. These adjustments generally take into account netting arrangements and collateral. Thus, adjustments that dealers actually make for credit risk tend to be lower than adjustments that would be made if netting arrangements and collateral were ignored.

2. Capital Charge for Unanticipated Credit Losses

In addition to the cost of anticipated credit losses, some dealers may make adjustments for a capital charge for bearing the risk of unanticipated losses. Such a charge would be reflected in the prices at which market participants are willing to enter into derivatives transactions. These adjustments reflect the cost of the return that must be paid to capital held to absorb the risk that credit losses will exceed the highest anticipated level. Adjustments for the cost of unanticipated losses are appropriate since the risk of such losses is inherent in a portfolio as of any valuation date.

³ H.R. Rep. No. 213, 103rd Cong. 1st Sess. 613 (1993).

C. Administrative and Other Portfolio Adjustments

Other portfolio adjustments include, but are not limited to, the following:

1. Servicing Adjustments

These adjustments are also known as "maintenance adjustments" or "administration adjustments" or "administrative fair value adjustments" or "future operational costs adjustments". They reflect the anticipated costs of servicing (*e.g.*, monitoring compliance and processing payments) particular contracts, and include systems costs and operational costs. They also may include documentation costs (*i.e.*, legal and other costs of preparing and revising documentation for particular contracts).

It is important to note that a different—and more expensive—kind of servicing is required for derivatives than for debt and equity securities. Derivatives generally are bilateral contracts in which a potential two-way payment flow must be administered.

2. "Pending Due Diligence" Adjustments

These adjustments are also known as "market risk valuation due diligence" adjustments. They reflect uncertainties about the value of contracts until due diligence can be completed. They may be necessary where, for example, an unusually high volume of contracts is entered into at the same time, so that due diligence cannot be completed quickly. Such adjustments may also be necessary when a small number of contracts are so complex that due diligence is delayed.

Derivatives for which due diligence has not been completed are appropriately valued taking this factor into account. A seller would be willing to accept less, and a buyer would be willing to pay less, for a position for which this work has not been performed.

3. Investing and Funding Cost Adjustments

Another cost of maintaining a position in a derivative is the cost of borrowing or investing funds required or produced because of cash flow mismatches over its life. Adjustments for these costs are sometimes called "cash management" adjustments. Some dealers do not separately adjust for these costs.

Dealers do not estimate expected funding costs on a position-by-position basis to compute these adjustments. Instead they net expected cash flows to compute borrowing or investment needs, resulting in smaller adjustments. It might be argued that each position should be valued based only on expected funding costs for that position. We note that, as in the case of expected credit losses, netting produces lower adjustments, and thus *higher* taxable income, assuming book methods are used for tax purposes.

VI. Consistent Use of Book Methods for Nontax Purposes

ISDA recognizes the Service's concern that book values—if they are used for tax purposes—must be used consistently. Accordingly, as noted in our letter of September 21, we accept the need for consistency rules as a condition for use of book values for tax purposes. Such rules are beyond the scope of this letter, however. ISDA would be happy to work with the Service and Treasury in developing rules to ensure that dealers are permitted to follow books for section 475 purposes only where books are consistently followed for nontax purposes.

Very truly yours,



Mark Perwien

Chair, North American Tax Committee

cc: Treasury Department
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