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International Accounting Standards Board
1st Floor
30 Cannon Street
London
EC4M 6XH

Ref.: ED/2010/7: Measurement of Uncertainty Analysis Disclosure for Fair Value Measurement

Dear Sirs,

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee¹ appreciates the opportunity to provide comments and observations with respect to the above mentioned Exposure Draft ("ED") issued by the International Accounting Standards Board ("IASB"). We note that the IASB and the FASB will jointly consider the responses to the ED referenced above and also to the FASB's ED on Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (File Reference No. 1830-100). ISDA is submitting two comment letters in response to these two consultations, given that the impact of the proposals is different for US GAAP and IFRS filers. However, the comments and the solutions proposed by our members to the two exposure drafts are almost identical.

Within the remainder of this letter we have outlined our key messages in response to the IASB's Exposure Draft and in the Appendix, attached, we have provided more detailed observations and responses to the questions included in the Exposure Draft.

Key Messages:


- ISDA recognises that some fair value measurements use unobservable inputs which inherently lead to some degree of uncertainty. Therefore, we recognise the need for financial institutions to provide users of financial statements with an adequate understanding of the measurement of uncertainties inherent in those instruments categorised as Level 3 in the fair value hierarchy.

¹ ISDA's Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

- We believe that the existing disclosure requirements achieve the right balance between providing the users of financial statements with information about uncertainty on Level 3 instruments without requiring disclosing a high volume of complex data, which in many cases is not observable and could lead to more subjectivity. Moreover, ISDA is concerned that the proposed ‘quantitative’ disclosure of the effect of correlation would be extremely difficult to implement and highly judgmental, leading to a lack of comparability between institutions. Therefore, ISDA members believe that a ‘qualitative’ disclosure approach would better achieve the Board’s objectives.
- ISDA is concerned with the term “correlation” as it is used in the ED, since it is not appropriate for this type of data and recommends the Board to change it for a more suitable one, such as ‘interdependency’ or ‘interconnections’ between unobservable variables in the measurement analysis of level 3 inputs.

We hope you find ISDA’s comments in this letter and the responses to the IASB’s questions for respondents included in the appendix attached hereto informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.

Yours faithfully,



Tom Wise
HSBC Bank plc
Chair of Accounting Policy Committee



Antonio Corbi
International Swaps and Derivatives Association
Risk and Reporting

Attachments:

Appendix – Responses to specific questions raised by the IASB

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Question 1: Are there circumstances in which taking into account the effect of the correlation between unobservable inputs (a) would not be operational (eg for cost-benefit reasons) or (b) would not be appropriate? If so, please describe those circumstances.

ISDA is concerned with the term “correlation” as it is used in the ED, since it is not appropriate for this type of data and recommends the Board to change it for a more suitable one, such as ‘interdependency’ or ‘interconnections’ between unobservable variables in the measurement analysis of level 3 inputs.

While ISDA supports the IASB’s efforts to enhance the existing fair value measurement disclosures for instruments whose measurements rely heavily on unobservable inputs, we question whether the proposed measurement uncertainty disclosure requirements will provide meaningful information for many financial instruments that are based on single best estimates.

More significantly, the requirement to disclose the effect of correlation amongst level 3 inputs used to measure fair value will not be practical in most cases, as we will explain. The measurement of many financial instruments which are categorized in level 3 of the fair value hierarchy reflects inputs for which management is often unable to assess or measure the level of interdependency. Therefore, the proposed measurement uncertainty disclosure would require entities to make highly subjective assumptions about the correlation of inputs used in recurring level 3 fair value measurements. Also, the requirement to revise the assumptions each quarter would prove operationally burdensome and likely would require a separate set of records to maintain and update management’s assumptions about each class of financial instrument. Further, there are many situations where “buy side” market participants’ access to inputs is limited. While certain large financial institutions with in-house valuation departments may have access to the inputs underlying the fair values, many institutions rely on third-party pricing services for fair values. Further requiring these entities to access the information necessary to assess the relationship amongst different inputs will create a largely impossible task.

More importantly, the inclusion of significant subjective assumptions about an entity’s financial instruments—which may differ by entity depending on access to data, views about correlation risk, and the level of sophistication—will erode comparability in the reporting of the same financial instruments by different entities. ISDA, therefore, believes that interdependency risk is best addressed through qualitative disclosures that describe the various factors that drive correlation and their potential impact on a fair value measurement.

Accordingly, ISDA recommends that the IASB remove the requirement to disclose quantitatively the effect of correlation risk amongst the interdependent inputs to level 3 fair value measurements and instead require entities to disclose qualitatively how changes in the various interdependent unobservable inputs affect the fair value measurement. A requirement for only qualitative disclosure of correlation risk would reduce the concerns about including additional significant, subjective estimates in the financial statement footnotes, but would provide users the information needed to understand better the potential risk of estimation error inherent in the fair value measurements.

Question 2: If the effect of correlation between unobservable inputs were not required, would the measurement uncertainty analysis provide meaningful information? Why or why not?

Our members' view is that the requirements set out in the IASB's May 2009 ED, provide sufficient information for users to assess uncertainty and that therefore it is not necessary to require the correlation (interdependency) between unobservable inputs to be disclosed too.

Where the interdependency of inputs is important to the valuation it is likely that this will already been included as an input to the model and the potential variability included in the existing measurement uncertainty analysis disclosures. However in the majority of cases the interdependency will not have a significant impact and therefore making subjective amendments to these unobservable relationships will only lead to confusion and potential misinterpretation. This will be even more pronounced if there is any attempt to extrapolate these interdependencies across the valuations of different asset and liability classes and positions held in different jurisdictions.

Question 3: Are there alternative disclosures that you believe might provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy that the Board should consider instead? If so, please provide a description of those disclosures and the reasons why you think that information would be more useful and more cost-beneficial.

As discussed in our response to question 1 and 2 above, ISDA recommends that the IASB remove the proposed requirement to disclose quantitatively the effect of correlation risk amongst the interdependent inputs to level 3 fair value measurements and instead require entities to disclose qualitatively how changes in the various interdependent unobservable inputs affect the entity's fair value measurement.

Qualitative disclosure of correlation risk would reduce the concerns about including additional significant, subjective estimates in the financial statement footnotes but would provide users the information needed to understand the potential risk of estimation error inherent in the fair value measurements.