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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel Switzerland
Email: baselcommittee@bis.org

Ref.: Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices

Dear Sirs,

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the above referenced Consultation Document issued by the Basel Committee on Banking Supervision ('the Basel Committee').

ISDA has over 840 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, 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. As such, we believe that ISDA brings a unique and broad perspective to the work of the Basel Committee.

In this letter we first outline our key messages in response to the Consultative Document and subsequently we also provide detailed comments to some of the specific principles contained in the paper in Appendix 1.

Key Messages:

- ISDA's members are committed to maintain robust risk management and control processes around the fair value measurement of financial instruments. As such we support the efforts of the Basel Committee to strengthen Supervisor's guidance and ensure that there is a global consistency in valuation practices.

- We share the views of the Basel Committee and broadly agree with the majority of the statements made in the Consultation Document.

We hope you find ISDA's comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

Charlotte Jones
Deutsche Bank AG
Chair, European Accounting Policy Committee

Antonio Corbi
International Swap and Derivatives Association
Risk and Reporting

Appendix 1 – Detailed comments to the Consultation Document

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Principle 4

Supervisors expect a bank to have sound processes for design and validation of valuation methodologies used to produced valuations.

Under the sub-heading entitled, 'Rigorous Validation', the Consultative Document states that, model validation processes should be systematically applied for both internally generated and vendor provided models. Validation should incorporate a number of factors, including, among other things, the model 'theoretical soundness and mathematical integrity'.

We believe that the assessment of any model should consider whether the model appropriately reflects the underlying risks inherent in the instrument (the risk position). In evaluating models, it is also common practice for the output of the model to be assessed in terms of its price integrity, that is, to confirm that the price generated by the model reflects the price at which an orderly transaction would take place between market participants on the measurement date (an exit price). As presently drafted the words 'theoretical soundness and mathematical integrity' could be further clarified in the Paper. We would therefore recommend that this section include a specific reference to the validation of models to incorporate the following:

- An evaluation of the risk position inherent in the instrument
- An evaluation that the model's price output reflects that at which an orderly transaction would take place between market participants at the measurement date.

Principle 5

Supervisors expect that a bank will maximize the use of relevant and reliable inputs and incorporate all other important information so that fair value estimates are as reliable as possible.

The Consultative Document states that when assessing the reliability and relevance of data sources, banks should take into consideration 'the maturity of the market, and in particular whether quotes will continue to be available for the foreseeable future' (top of page 7, third bullet).

The objective of a fair value measurement is to arrive at an exit price as of the measurement date. Therefore the continued availability (or unavailability) of a price or quote in the foreseeable future is not relevant in assessing the fair value as of the measurement date. In other words, if an appropriate input or price is available at the reporting date then that observation would not be adjusted for the possibility that the valuation may not be observable in the future. If the price or input required adjustment then, appropriate adjustments such as non performance risk, liquidity risk, etc. would have to be included based on the assumptions that market participants would make at the reporting date.

Principle 6

Supervisors expect a bank to have a rigorous and consistent process to determine valuation adjustments for risk management, regulatory and financial reporting purposes, where appropriate.

ISDA supports the principle that a rigorous and consistent process to determine valuation adjustments should exist for risk management, regulatory and financial reporting purposes. Our view is that there is a high interdependency between fair value in the context of financial reporting, risk management and regulatory reporting. Therefore we encourage the Basel Committee to work together with the IASB to minimise any differences in the fair value framework across these areas. One area that ISDA believes could be considered in such discussions is the prohibition of block discounts in a fair value measurement under IFRS.

Principle 7

Supervisors expect that a bank will have valuation and risk management processes that explicitly assess valuation uncertainly and include this as part of information communicated to the board and senior management.

The paper envisions that banks provide a number of quantitative reports and sensitivity analysis using alternative models and modeling assumptions for key input and for different parameters that are presumed to be available for all counterparties (referred to as sensitivity reports). Furthermore, the Paper states that the sensitivity reports should be reviewed by management, including senior management and the Board, regularly.

We agree that in the face of uncertainty in valuations sensitivity analysis may provide meaningful information. However, banks may not currently have ongoing processes in place to generate all the quantitative information described in the Consultative Document. Therefore our recommendation is to pursue further dialogue with stakeholders to define the scope and contents of the quantitative information for this specific requirement.