

International Valuation Standard Council
1 King Street
London EC2V 8AU

By email: CommentLetter@ivsc.org

28 February 2014

Dear Sir,

Ref.: Exposure draft – Credit and Debit Valuation Adjustments

We are writing to you to comment on the International Valuation Standard Council ('IVSC') above referenced Exposure Draft (ED). ISDA¹ welcomes the opportunity to comment on this important project. In this letter we outline our overall comments in response to the ED and in the Appendix we provide our more detailed responses to the specific questions.

Overall comments:

Generally, we are supportive of the IVSC's initiative to provide information and guidance around a complex and current topic. We believe that the IVSC has drafted an excellent paper and that with some amendment it can be improved further. We outline our suggestions below.

We believe that some sections of the ED are too detailed, in particular the sections describing the different methodologies or approaches to calculate the CVA/DVA or FVA components. We believe that rather than to provide detailed guidance, the ED could give greater emphasis to identifying the principles expected to be applied by the valuation practice, and less emphasis on detailed application guidance and preferred methods, which could perhaps be included as an appendix if necessary.

The objective of the ED is to assist valuation and risk professionals by identifying principles of best practice. However in its current drafting the ED does not present a single "standardised" practice. We support this drafting as an educational document which presents an overview of the current market practice on CVA / DVA; it provides useful insight on this complex topic and also contributes to enhanced transparency regarding valuations practices. In the current environment valuation practice is still evolving and to identify best practice approaches might be premature.

¹ Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 62 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The audience of the document is unclear i.e. who is the document addressed to. While paragraphs 85 to 96 address practical applications for larger to smaller entities, the general drafting of the paper seems to be geared towards large entities in the financial services industry. This seems to be contradictory with one of the objectives of the paper as stated as “aid professionals who are not specialists in understanding the principles”.

However, the ED specifically references many Basel III terms which might be confusing for non-financial services entities. While we appreciate the references and the consideration of the regulatory environment that banks operate in, these considerations might be dealt with better in a separate chapter or an appendix.

The ED is highly technical and some of the expected models and applications are very complex. A comment to the effect that the application would need to be scaled to the sophistication of the entity and the financial instruments it holds might be a helpful caveat. Additionally, examples on how to calculate CVA / DVA under the guidance in paragraphs 93 to 96 for medium and smaller entities could be included in an appendix to the paper to provide further guidance.

A large section of the ED is referring only to CVA and not to DVA. Further elaboration on DVA as well would be helpful.

Finally, we believe that the ED is somewhat repetitive and sometimes inconsistent between sections. For example the use of Monte Carlo simulations is discussed in paragraphs 23 and 24 and again in paragraph 61. The CVA formula is presented multiple times and the clarity of some paragraphs could be improved.

We hope you find ISDA’s comments 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,

David Bradbery
Barclays Bank plc
Chair, European Accounting Committee

Antonio Corbi
ISDA, Inc.
Risk and Capital

Appendix – Detailed responses to the specific questions raised in the ED

Appendix: specific comments on the questions raised in the ED

Question 1: Do you agree that the proposed scope is appropriate? If you disagree, please indicate changes that you would recommend.

We would like to highlight that the current drafting of the document appears to be focussed on IFRS users. In the purpose of the document section (paragraph 4) the ED makes reference to US GAAP, however never clearly refers to it again. It would be good to balance the document so that it is clearer that it relates to both IFRS and US GAAP users. Alternatively, if it is intended to be specifically tailored to IFRS users, this should be made clear in the scoping section.

Question 2: Do you agree with the definitions? If you consider an alternative or additional definition is appropriate then please provide this in your response.

The ED provides a definition of market value as well as a definition of fair value in paragraph 8 which are not consistent with each other. It might be worth providing an explanation of what the differences are and how to align the two concepts for. The clarification could draw on the explanations arising from the IVSC ED, Illustrative Examples, Chapter 1 – Bases of Value, once the document is finalised. Furthermore the market value definition refers to “parties acting knowledgeably, prudently and without compulsion”. The term prudently or prudence has a very specific meaning in accounting as well as in regulatory and might be confusing to readers in this context.

The ED refers in several sections to larger financial entities without defining what such entities are. In paragraph 40 for example, it states that the historical method of calculating exposures would be considered insufficiently sophisticated for larger financial entities. We believe a definition of a larger financial entity should be provided or alternatively a different wording could be used, such as the description in the heading of paragraph 85.

We also believe that some definitions in the ED could be improved, including those for ‘basis risk’ and ‘wrong-way-risk’ and we have suggested some changes and additional comments in the Annex to this letter.

Question 3: Do you believe that other methods should be considered in addition to the Monte Carlo such as binomial and trinomial trees?

We believe that this document should present a statement of principles valid for all models. As mentioned in the general comments, the ED expects a high degree of sophistication from the entities applying the guidance. The Monte Carlo method is complex and costly to apply, it might therefore be worth further expanding in the practical section appropriate methods for entities with less sophisticated systems and volumes in derivative holdings. Therefore, we believe that the ED should identify a ‘principle-based’ approach which is valid for all types of entities independently of the sophistication of their implementation approach.

We believe that ‘tree models’ have very limited application.

Question 4: Do you believe that netting sets have been discussed to an appropriate level?

Yes, we believe they have been addressed at an appropriate level.

Question 5: Do you consider that there is a need for the IVSC to augment the Code of Ethical Principles for Professional Valuers with more specific guidance on governance and controls in the financial sector?

Please see our response to question 6 below.

Question 6: Do you consider that there is a particular issue or issues that arise when considering a suitable governance and control protocol for calculating CVA or DVA that does not otherwise give rise to concern?

Addressing both questions 5 and 6, we believe that discussions around the governance and control principles in relation to CVA and DVA in the IVSC framework, are outside the scope of this ED. Any enhancements or changes to that framework should be addressed in a consultation paper and put through the required due process.

In general, we believe that the control framework needs to be appropriate for the risk of the entity and the derivative holding.

Question 7: Do you agree that it is appropriate to suggest that entities with less complex or smaller derivative holdings in relation to their overall business should adopt less complex methodology, or instead should all entities be expected to implement equally rigorous methodology?

As outlined in the general comments, there needs to be a clear statement that entities which have less complex or smaller derivative holdings should be able to tailor their solution to their needs.

Especially small companies would struggle to implement highly complex solutions and the cost benefit analysis of such a solution is unlikely to be positive.

We would therefore suggest that in paragraphs 85 to 95, further consideration should be given to what distinguishes an entity between the three approaches and more guidance could be provided on the simpler approaches, either in an appendix, or in the body of the document to allow entities to understand their situation.

Examples on how to calculate CVA / DVA under the guidance in paragraphs 93 to 96 for medium and smaller entities could be included in an appendix to the paper to provide further guidance. In order to obtain this information, it may be helpful for the IVSC to acquire specific detailed input and feedback from corporates and smaller banks, since the majority of the content as currently drafted, whilst relevant and useful for larger banks, may provide less useful information to other smaller less complex entities.

Question 8: Does the discussion about the cost of funding contribute to the objectives of the TIP outlined in the “Scope and Purpose” section on p3?

See response to question 9 below.

Question 9: Given the current debate in this area do you believe it is appropriate for this TIP to outline the main issue around FVA or should this be removed altogether until there is greater consensus?

We agree that the discussion about the cost of funding contributes to the objectives of the TIP. However we would like to highlight that practice around the inclusion and calculation of FVA is continuing to evolve and there is currently no industry consensus on exactly how it should be calculated. We therefore believe that the ED should be careful not to pre-empt industry decisions and be mindful of the developing nature of this topic.

We believe that this section lacks clarity and should be improved.

Question 10: Are there any key principles that have been omitted or not fully explained?

No additional points to note.

Annex: proposed changes to the definitions in the Exposure Draft

Page	Current language	Proposed language / comment
4	Basis Risk: The risk that the value of offsetting investments will not change in equal and opposite amounts	The risk that offsetting investments in a hedging strategy will not experience price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy, thus adding risk to the position.
4	<i>Default Probability (DP): The likelihood of a counterparty not honoring its obligations.</i>	Default Probability (DP): The likelihood of either counterparty not honoring its obligations.
5	<i>Funding Valuation Adjustment: An adjustment to the measurement of derivatives to reflect an entity's funding cost.</i>	Funding Valuation Adjustment (FVA): An adjustment to the measurement of derivatives to reflect an entity's funding cost or benefit .
5	<i>Wrong-way-risk: Occurs when exposure to a counterparty or collateral associated with a transaction is adversely correlated with the credit quality of that counterparty.</i>	This type of risk occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty. There are two types of wrong-way risk. <i>Specific</i> wrong way risk arises through poorly structured transactions, for example, those collateralized by own or related party shares. <i>General or conjectural</i> wrong way risk arises where the credit quality of the counterparty may for non-specific reasons be held to be correlated with a macroeconomic factor which also affects the value of derivatives transactions. An example of conjectural wrong way risk is that fluctuations in the interest rate causes changes in the value of the derivative transactions but could also impact the credit worthiness of the counterparty. Another example might occur with an emerging-market counterparty, where there is country and possibly currency risk associated with the counterparty (however creditworthy it might otherwise be).
6	<i>As a result the credit risk at the inception of a derivative contract will often be very small, particularly compared with that on a loan.</i>	As a result the exposure at the inception of a derivative contract will often be very small, particularly compared with that on a loan.

7	<i>The increase in the significance of CVA charges, accounting requirements and higher capital requirements proposed by Basel III for uncollateralised trades have all led to market participants incorporating counterparty credit risk into trade pricing. These all act to incentivize trading desks to choose stronger counterparties and for profit to be measured considering credit risk.</i>	The increase in the significance of CVA charges, accounting requirements and higher capital requirements proposed by Basel III for uncollateralised trades have all led to market participants incorporating counterparty credit risk into trade pricing. These all act to incentivize trading desks to charge appropriately for credit risk.
8	<i>CVA charges are based on many assumptions and unobservable parameters and as a result may not correctly capture the full credit risk of a counterparty. Also CVA is based only on expected loss; sound credit risk management should also consider scenarios where unexpected losses may occur.</i>	CVA charges are based on assumptions and modeling choices which may not correctly capture the full credit risk of a counterparty without due consideration. Also CVA is based only on expected loss; sound credit risk management should also consider scenarios where unexpected losses may occur (e.g., jump to default and other stress tests).
11	<i>... situations can arise where the CDS spread is, for example, well above the spread at which loans are traded with counterparties. This is because the CDS spread can contain a speculative element unrelated to the credit exposure of a derivative portfolio. It is therefore important to consider these factors when choosing the most appropriate method.</i>	... situations can arise where the CDS spread is, for example, well above the spread at which loans are traded with counterparties. This is because the CDS spread can contain a speculative element unrelated to the credit exposure of a derivative portfolio. It is therefore important to consider these factors when choosing the most appropriate method.
8, 9	<i>EPE and ENE</i>	The definitions do not include the fact that this is an expectation not merely discounting – “forecast” does not really capture what is needed.
20	<i>An entity can attempt to hedge its credit risk by selling self-referencing CDS, but this is not generally considered practical. ... Practically, CDS can be sold on a set of correlated entities, either individually or via Credit Indices. Considerable basis risk may exist between these proxies and the entity’s own credit spread, leading to reduced hedge effectiveness and significant profit and loss moves.</i>	The danger of JTD risk from liability side proxy hedges should be mentioned in this paragraph.
22	<i>In respect to collateral, CVA algorithms should account for specific details in the CSA agreements including thresholds, unilateral versus bilateral collateral posting, collateral call frequency or gap risk, and rating triggers.</i>	In respect to collateral, CVA algorithms should consider material impacts of CSA agreements including thresholds, unilateral versus bilateral collateral posting, collateral call frequency or gap risk, and rating triggers.
23	<i>Cost of Funding...</i>	The paper discusses but does not conclude on the FVA. See our response to question 9 of the ED.