

# ZENTRALER KREDITAUSSCHUSS

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## **Consultative document: Supervisory guidance for assessing banks' financial instrument fair value practices“**

Dear Madam, dear Sir,

On 28 November 2008 the Basel Committee on Banking Supervision published consultative document no. 145. The document examines supervisory expectations concerning the valuation practices used to measure financial instruments at fair value and sets out principles dealing, among other things, with the governance and control of the valuation process, the internal and external communication of valuation uncertainty and appropriate valuation adjustments for risk management and reporting purposes.

Comments have been invited by 6 February 2009. We appreciate the opportunity to respond to the document and send you herewith the views of the German banking industry as represented by the Zentraler Kreditausschuss.

## General remarks

Before commenting on the principles in detail, we would like to make a few general remarks.

The German banking industry supports the ten principles, which aim at enhancing the governance and control of the valuation process for financial instruments measured at fair value. We nevertheless take the view that a more principles-based approach needs to be applied. General observations on the valuation process, details, examples and overlaps with other prudential and accounting requirements should be avoided.

Accounting issues associated with valuation disclosure and disclosure in the notes are covered by the relevant IFRS, particularly IAS 39 and IFRS 7. Additional guidance on determining fair values in inactive markets is provided in a document published by the IASB Expert Advisory Panel in October 2008 entitled *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. The consultative document should therefore be taken at its word when it states that the principles will not set additional accounting requirements, such as separate rules on valuation methods.

Responsibility for ensuring a globally consistent application and interpretation of the IFRS regime rests with the International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRIC). We therefore welcome the assertion in the introduction to the consultative document that the guidance *does not set forth additional accounting requirements beyond those established by accounting standard setters*.

In our view, however, the principles do not always translate this undertaking into practice and thus risk establishing additional rules which go beyond IFRS. We would therefore urge the Basel Committee to revise the principles so that they neither increase the number of accounting requirements for German banks nor impose further restrictions on account preparers.

There are, for example, overlaps between the consultative document's envisaged guidance and existing accounting requirements and guidelines in IAS 39, IFRS 7 and the above-mentioned document *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. The general consensus of opinion is that IFRS (especially IAS 39 and IFRS 7), together with the guidance on fair value measurement in inactive markets issued by the IASB Expert Advisory Panel, contain all the relevant and appropriate information needed to clarify accounting issues concerning the fair value measurement of illiquid financial

instruments. To avoid overlaps, or even inconsistencies, with determining fair values under IAS 39, we recommend deleting passages such as those in Principle 5 which deal with matters already covered by IFRS or IASB fair value guidance. Parallel rules issued by different bodies risk imposing additional requirements on preparers or restricting their ability to exercise existing options or discretion. This would fly in the face of the objective of establishing global accounting standards and uniform framework conditions for banks.

We also assume that the principles set out in the consultative document are intended to apply only to listed banks which are required to prepare IFRS-based consolidated accounts. We would appreciate clarification by the Basel Committee of the document's scope.

Although regulatory and financial reporting are equally important, in our view, they each have different objectives and are normally concerned with different processes and procedures in the banks. Much as we support the convergence of the two in the interests of cost-effectiveness, among other things, we nevertheless assume that certain differences will be the norm rather than the exception. It is sometimes banking supervisors themselves who are responsible for these differences, e.g. by setting requirements for regulatory valuations which differ from financial reporting rules. Requirements of this kind are to be found, for instance, in the January 2009 BCBS consultation paper *Revisions to the Basel II market risk framework*, in the section on prudent valuation guidance, paras 718(xcx) to 718(vcxxii), especially para. 718(xcxx). Another example is the Basel rules on measuring exposures to determine counterparty credit risk under the internal model method (IMM). The principles should not state or imply that one type of reporting should be based on the other.

We warmly welcome the fact that application of the principles should depend on the significance, complexity and risk content of the bank's fair valued exposures. We would recommend explicitly mentioning the principle of double proportionality in this context.

## Specific comments

### **A. Valuation governance and controls**

#### **Principle 1 – Adequate governance structures for the valuation process**

The proposed responsibilities of the Board with regard to overseeing the use of fair value accounting are extremely far-reaching in our view (e.g. *ongoing review of valuation model performance*). The requirements outlined in Principle 1 seem to be based essentially on the typical responsibilities of a board of directors in a company organised along Anglo-American lines. These responsibilities do not correspond to those typically exercised by the supervisory or administrative board in a German company and, indeed, significantly exceed them since they relate to a firm's operational management. We would ask this point to be taken into account when the principles are to be applied in the European Economic Area.

We assume that the Basel Committee considers a periodic and robust independent price verification (IPV) process to be appropriate and sufficient. Periodic IPV does not necessarily require a daily independent valuation of all financial instruments. Longer intervals may be sufficient depending on the nature of the group of financial instruments involved. The exact length of the intervals could be specified in the bank's internal IPV guidelines. We would appreciate clarification of this point.

The requirement to establish from the outset *the information feeds and thresholds for determining when there is a presumptive case for challenging the valuation model* would be very difficult to implement in practice with a purely quantitative threshold. This passage should be dropped.

#### **Principle 2 – Adequate capacity in the bank for the valuation process**

It is emphasised in both the introduction and in Principle 2 that the guidance applies both to normal market conditions and periods of stress. Nowhere in the document, however, is a clear distinction made between which requirements are to be met under normal conditions and which additional requirements would be triggered by a stress situation. In the interests of greater clarity, we would ask the Basel Committee to differentiate between the two sets of circumstances. We believe that staff capacity planning, for example, does not need to be geared solely to the extreme demands of a crisis.

### **Principle 3 – Consistency between the categorisation and management of financial instruments**

This principle calls for largely consistent treatment of financial instruments for accounting, regulatory and risk management purposes. Differences should be documented and approved by senior management. As understandable as this requirement may be, the differences between the above three functions are far greater in practice than the consultative document suggests. Held-for-trading instruments measured at fair value under IAS 39.9, for example, are not necessarily identical to all positions allocated to the trading book on the basis of regulatory criteria. Under national regulatory rules, for instance, financial instruments whose maturity exceeds a bank's own definition of short-term (normally six months) may only remain in the regulatory trading book in justified exceptional circumstances (e.g. in the event of their upcoming sale or if the risk is transferred to another party). Under IAS 39.9 in conjunction with IAS 29.AG15 and IAS 39.IGB11, on the other hand, financial instruments may be classified as held for trading if they are part of a portfolio whose overall content is intended for short-term trading.

The differences to be documented cannot, therefore, be seen as exceptions, but rather as the rule. The guidance itself recognises their existence: Principle 6, for instance, states that *fair values used for financial reporting purposes must be internally reconciled to valuations used for risk management and regulatory purposes*. As explained in our general remarks, we consider it essential for the principles to avoid imposing additional requirements or restrictions and would therefore urge the Basel Committee to ensure that there are no overlaps between its guidance and IFRS. Nor do the rules on the content of the regulatory trading book need expanding on; this issue is already adequately regulated at national and European level.

### **B. Risk management and reporting for valuation**

#### **Principle 4 – Sound processes for the design and validation of valuation methodologies**

When evaluating a valuation model, account should be taken of the extent to which it considers the specific (risk) characteristics of the instrument or position in question. It is also standard practice to examine whether the valuation result is consistent with the market price at the time of valuation. The call for an evaluation of *the model's theoretical soundness and mathematical integrity* should be expanded on accordingly. We suggest adding the following points to the explanation of what a model validation process should involve:

- an analysis of the specific (risk) characteristics of the instrument in question and
- a comparison of the valuation result with the observed market price at the time of valuation.

The consultative document states that integrated control processes should include a constant link between explicit thresholds in the valuation model and in risk management. The nature of this link should be explained and clarified.

### **Principle 5 – Reliable data sources for the valuation process**

This principle is based on IFRS (particularly IAS 39 and IFRS 7) and on the IASB Expert Advisory Panel guidance *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. All duplication of existing requirements should be deleted because, as explained in our general remarks, we believe such overlaps risk giving rise to diverging regimes.

We would, by contrast, welcome it if explicit reference were made to the relevant passages in the above documents.

The consultative document states that the assessment of the reliability and relevance of a data source should consider the *maturity of the market, and in particular whether quotes will continue to be available for the foreseeable future*. If a price is observable at the time of reporting, it should not be adjusted to reflect the fact that it may no longer be observable at some point in the future.

The document should point out that assessing data sources and input factors is a highly subjective and judgemental process in which all facts and circumstances have to be taken into account. With this in mind, the supervisory review should focus on the procedures and guidelines documented by the bank rather than on rechecking individual calculations. If, however, there is evidence of shortcomings in a bank's procedures and processes, it is naturally appropriate for supervisors to take further action.

We have serious reservations about the final paragraph on the distinction between active and inactive markets and on the requirements concerning the appropriateness of the valuation process together with the associated documentation needs. IAS 39.48A states that quoted prices in an active market are the best basis on which to determine fair value. If the market for a financial instrument is not active, fair value has to be determined using a valuation

procedure. This procedure has to be applied in accordance with IAS 39.AG69-AG82. Valuation procedures and the documentation of these procedures are therefore already covered adequately and appropriately by IAS 39.

It is also unclear whether the requirements set out in Principle 5 are to apply in both normal and stress situations. We would appreciate clarification of this point.

### **Principle 6 – Appropriate processes for determining valuation adjustments**

In our view, the paragraph beginning *Fair value measurements may involve a significant amount of judgement, including judgements about whether a market is active or inactive ...* does not constitute a principle for the assessment of the governance and control of the valuation process but is an integral part of fair value practices (see guidance on fair value issued by the IASB Expert Advisory Panel). We suggest its deletion.

We feel that the final paragraph needs clarification. It is not, for example, clear to us what is to be inferred from the statement *Fair values used for financial reporting purposes must be internally reconciled to valuations used for risk management and regulatory purposes*. We agree, in principle, that significant differences should be understood and reported to senior management. In view of the rules which already exist in this area, however, we see no necessity for additional requirements.

National supervisors, for example, already expect companies to apply the fair value option to illiquid financial instruments only if they have appropriate risk management practices in place.<sup>1</sup> The consultative document itself points out that the use of a prudential filter may be necessary for regulatory purposes, but may not always be suitable for financial reporting. When implementing CEBS's 2004 *Guidelines on prudential filters for regulatory capital*, national supervisors assume that the volatility of IFRS equity – caused by the more extensive use of fair value measurement – is significantly reduced for regulatory purposes with the help of prudential filters. The adjustment of the relevant positions using prudential filters serves the sole purpose of calculating regulatory capital and is based on the corresponding IFRS balance sheet items (e.g. revaluation reserve). Prudential filters therefore use accounting data as their starting point and correct unrealised profit and loss on assets measured at fair value.

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<sup>1</sup> Cf. *Supervisory guidance on the use of the fair value option for financial instruments by banks* (2006), principles 2 and 3.

For us, this raises the question of the relationship between

- this consultative document,
- the 2006 consultation paper *Supervisory guidance on the use of the fair value option for financial instruments by banks* and
- the 2004 *Guidelines on prudential filters for regulatory capital* and the associated possibility of using filters when exercising certain IFRS measurement options.

There is consequently a need to clarify the objective pursued in the final paragraph, giving due consideration to existing prudential requirements and bearing in mind that banks already prepare reconciliation accounts.

### **Principle 7 – Explicit assessment of valuation uncertainty**

We do not understand why so much importance is accorded to valuation uncertainty. We assume that uncertainties in the valuation process are already taken into account in a bank's model assumptions. Not every uncertainty needs to be countered by means of a haircut or cushion. Valuation approaches should remain appropriate for internal risk management purposes. We would point out that the fair value guidance of the IASB Expert Advisory Panel calls not for conservative valuation but for appropriate risk premiums, which market participants should set with the nature of the financial instrument and the relevant market conditions in mind.

The consideration of valuation uncertainty in the reporting and entire risk management process is especially relevant to financial instruments with significant unobservable inputs, e.g. level 3 instruments. It would make far less sense, in our view, to consider possibly still existing valuation uncertainty when dealing with instruments with observable prices or inputs, such as level 1 or level 2 instruments. We therefore suggest adjusting the reporting requirement along the lines of para. 27c of IFRS 7 and limiting a quantitative analysis of valuation uncertainty to level 3 instruments.

### **Principle 8 – External reporting on the valuation process**

It should be ensured that the requirements in Principle 8 do not exceed the principles set out in IFRS 7, which we consider both adequate and appropriate. One example of such a requirement is the following: *In addition, appropriate disclosure about the sensitivity of fair value measurements to reasonably possible alternatives is also of particular interest to users.* The financial reporting requirements in IFRS 7 are sound and sufficient for disclosure purposes. To avoid redundancies and inconsistencies, passages of this kind should be deleted.

### **Supervisory assessment of valuation practices**

#### **Principle 9 – Regular supplemental information for supervisors**

We recognise that supervisors are entitled to request information over and above that which is made available to third parties. It should also be borne in mind that auditors' reports already provide banking supervisors with a broad basis of information. It is therefore possible that such requests for information will go beyond IFRS requirements, e.g. *In addition to this publicly available information, supervisors may wish to periodically obtain supplementary information about fair values and related internal processes from the banks.*

Principle 9 also talks of periodic, supplemental information, however. It should be remembered that the considerable time and effort required to supply such information should be in reasonable proportion to the anticipated added value for supervisors. The disclosures frequently proposed are a response to the financial market crisis. Their scale should be limited to essential, sustainable information and, in particular, be reassessed after the crisis has passed.

#### **Principle 10 – Supervisory assessment of the valuation process under Pillar 2**

This principle requires any deficiencies identified by internal and external auditors with respect to their valuations and related corporate governance, controls, risk management and disclosure policies and practices to be reported to supervisors. This would mean, first, that internal auditors would have to communicate every shortcoming externally, which would be a highly questionable practice, in our view. Second, the tasks of external auditors would become considerably more onerous. In addition to being mentioned in the risk management report, among other things, deficiencies only have to be reported in the financial statements if the

company fails to eliminate them. All in all, we consider this proposal impracticable and the existing rules and regulations adequate and appropriate.

The capital add-ons mentioned in the final paragraph should be considered the very last means of dealing with deficiencies identified in a bank's risk management practices and should be used only if all other measures taken by supervisors have proved unsuccessful.

Yours sincerely  
on behalf of the Zentraler Kreditausschuss,



Dirk Jäger



Uwe Gaumert