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on Banking Supervision

Supervisory guidance on the use of the fair value option for financial instruments by banks

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Supervisory guidance on the use of the fair value option for financial instruments by banks

Principles underlying this supervisory guidance

This supervisory guidance is principles-based and is structured around seven principles that fall into the following two broad categories:

Supervisory expectations relevant to the use of the fair value option

1. Supervisors expect a bank's application of the fair value option to meet the criteria set forth in IAS 39 in form and in substance.
2. Supervisors expect banks to have in place appropriate risk management systems (including related risk management policies, procedures and controls) prior to initial application of the fair value option for a particular activity or purpose and on an ongoing basis.
3. Supervisors expect that banks will not apply the fair value option to instruments for which they are unable to reliably estimate fair values.
4. Supervisors may require banks to provide supplemental information to assist them in assessing the impact of banks' utilisation of the fair value option.

Supervisory evaluation of risk management, controls and capital adequacy

5. Supervisors should evaluate a bank's risk management and control practices as they pertain to the use of the fair value option.
6. Supervisors should consider risk management and control practices related to the use of the fair value option when assessing capital adequacy.
7. Regulatory capital should be adjusted for gains and losses from changes in own credit risk as a result of applying the fair value option to financial liabilities.

While this supervisory guidance refers specifically to the fair value option in IAS 39, the Committee believes that the principles set forth in this document should be generally applicable to similar fair value option approaches that exist or are being considered in other accounting regimes. National supervisors will need to make this determination based on the criteria and requirements of the fair value option in their jurisdiction.

The supervisory guidance is not intended to set forth additional accounting requirements beyond those established by the IASB. Instead, this supervisory guidance addresses such matters as bank risk management and capital assessment issues, and thus should not be in conflict with the IASB's accounting and disclosure guidance on the fair value option.

Background and summary

1. This document is intended to provide supervisors with guidance on the prudential supervision of banks' implementation of the fair value option for financial instruments, such as under IAS 39, *Financial Instruments: Recognition and Measurement,* as amended in June 2005. While this guidance refers specifically to the fair value option in IAS 39, the Basel Committee on Banking Supervision (Committee) recognises that similar fair value option approaches exist or are being considered in various other accounting regimes. The Committee believes the principles set forth in this supervisory guidance should be generally applicable in such other regimes, although national supervisors will need to make that determination based on the criteria and requirements of the fair value option in their jurisdiction. This guidance focuses on supervisors' expectations for key policy positions and sound practices for banks that the Committee believes will promote sound risk management and controls and maintain the integrity of regulatory capital measures.

2. The guidance presented here addresses: (a) sound risk management and control processes for banks that utilise the fair value option; and (b) the manner in which supervisors should consider the level and nature of banks' use of the fair value option when assessing the adequacy of bank risk management and regulatory capital. In addition, the guidance also discusses supplemental information through supervisory reporting that will assist supervisors in understanding how banks are using the fair value option and its impact on their financial condition. This document builds upon the Committee's 8 June 2004 press release on regulatory capital and own credit risk of liabilities, its 30 July 2004 *Comments on the IASB Exposure Draft of Proposed "Amendments to IAS 39, Financial Instruments: Recognition and Measurement – The Fair Value Option"*, and its 15 December 2004 press release *Capital Treatment of Certain Items Under IFRS*. In addition, the guidance draws from relevant portions of IAS 39 and the Group of 30's report *Enhancing Public Confidence in Public Reporting* (December 2003).

Introduction

3. In June 2005, the IASB amended the 2003 version of the fair value option under IAS 39, which allowed entities to designate irrevocably at initial recognition *any* financial instrument as at fair value through profit and loss. To address the concerns of prudential regulators, the June 2005 amendment added conditions stipulating that the fair value option be applied only in cases where (a) such designation eliminates or significantly reduces an accounting mismatch, (b) a group of financial assets, financial liabilities or both are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy, or (c) an instrument contains one or more significant embedded derivatives that meet particular conditions.

4. The purpose of the option was to simplify the application of IAS 39, which imposes a mixed-attribute measurement model on financial instruments. Under IAS 39, some financial assets and liabilities must be measured at fair value and others must be measured at amortised cost. For those measured at fair value, some gains and losses are recognised in profit or loss, while others are recognised initially as a component of equity. Where there is an economic relationship between particular financial assets and liabilities to which different measurement and recognition requirements apply or where such assets and liabilities are managed together on a fair value basis, the accounting results may differ from the underlying economics.

5. Furthermore, IAS 39's mixed-attribute model requires derivatives to be recognised on the balance sheet as either assets or liabilities at their fair value. This treatment is required regardless of whether a hedged item is held at fair value. In general, changes in the fair value of derivatives are recorded directly in profit and loss. However, gains and losses arising from the fair value of derivatives qualifying as "cash flow" hedges, to the extent the hedges are effective, can instead be deferred and recorded initially in equity as opposed to through profit or loss. When certain other criteria are met, IAS 39 permits hedge accounting treatment for "fair value" hedges, which results in the gains or losses associated with a derivative and the losses or gains attributable to the risk being hedged on the hedged item being recognised in profit or loss in the same period. However, in order to qualify for cash flow or fair value hedge accounting treatment, the derivative and the hedged item must satisfy, at the inception of the hedge and on an ongoing basis, strict and often complex hedge effectiveness tests. In contrast, when certain criteria are met, under the fair value option both sides of such a transaction would be measured at fair value and the accounting mismatch of "economic hedging" of risk positions could be addressed without applying complex hedge effectiveness tests otherwise required by the standard. If they meet the criteria for the fair value option, banks may be able to convey more relevant financial information by immediately recognising gains and losses in current profit and loss on the financial assets and liabilities to which the option is applied. In other circumstances, banks may use the fair value option to avoid the costs and other potential problems associated with separately accounting for embedded derivatives that significantly modify the cash flows of their host contracts as required by other aspects of IAS 39.

6. Over the last decade the Basel Committee on Banking Supervision (the Committee) has issued guidance on sound practices for managing risks such as credit, market, operational, and compliance risks. Those efforts have involved consultation with bankers and other interested parties throughout the world to promote sound risk management practices. Furthermore, the Committee has long held that the transparency of banks—facilitated by sound accounting and disclosure—is an important objective.[1] As such, it has been the topic of a number of the Committee's policy papers and supervisory guidance documents. Since 1998, the Committee has been involved in projects with the IASB and its predecessor to enhance financial instruments accounting and disclosure.

7. The Committee has had constructive dialogues with both the IASB and the banking industry on the fair value option, including the technical and risk management issues arising from its use. The Committee is issuing this guidance to describe supervisors' expectations for, and to promote sound risk management, control, valuation and capital practices by banks with regard to their use of the fair value option. This effort reflects the Committee's continuing dedication to working constructively with accounting standards setters, bankers and others to promote both sound practices and transparency.

8. While emphasising expectations for sound risk management policies at banks, this guidance does not indicate a preference for either the use of hedge accounting approaches or the fair value option. Moreover, this document does not set forth additional accounting requirements beyond those established by the IASB. Instead, it provides guidance to supervisors on the implications for prudential supervision of the fair value option now incorporated in International Financial Reporting Standards (IFRS) and some national accounting regimes. The Committee recognises that responsibility for compliance with accounting standards rests with a bank's senior management, and in most cases is subject

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[1] See Principle 21 of the Basel Committee's Core Principles for Effective Banking Supervision (September 1997).

to verification through formal external audit.[2] Moreover, a variety of public bodies oversees this process, such as securities regulators and regulators of auditors. The Committee also recognises that this guidance may need to be modified by national supervisors based on the criteria and specific requirements of the fair value option in their jurisdictions

9. Nonetheless, prudential supervisors need to consider whether financial statement information is suitable for their purposes and, when it is not, to make suitable adjustments to such information. Indeed, the IASB acknowledged the role of supervisors in its basis for conclusions accompanying IAS 39:

> The Board noted that the primary objective of prudential supervisors is to maintain the financial soundness of individual financial institutions and the stability of the financial system as a whole. Prudential supervisors achieve this objective partly by assessing the risk profile of each regulated institution and imposing a risk-based capital requirement.
>
> The Board noted that these objectives of prudential supervision differ from the objectives of general purpose financial reporting…[T]he Board acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution's fair value measurement practices and the robustness of its underlying risk management strategies, policies and practices.[3]

10. In the past, the Committee has recommended various adjustments that it believes should be made for prudential purposes to accounting information prepared under IFRS. This paper sets forth the conditions under which data prepared under the fair value option are suitable for use by prudential supervisors without adjustment and suggests responses if the relevant criteria are not met.

11. Supervisors expect banks to conduct their fair value option activities for portfolios of financial assets and liabilities and individual financial assets and liabilities in a manner that is consistent with both applicable accounting standards and supervisory expectations for risk management and controls. As such, supervisors expect banks to implement strong risk management and controls to ensure that the effect of the use of the fair value option is understood and that its use is managed, monitored and reported in a sound manner.[4] An important related supervisory objective is that unrealised gains or losses on items designated as at fair value through profit and loss should not be included in regulatory capital when this treatment gives rise to safety and soundness concerns.

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[2] The Committee acknowledges that the responsibility for financial reporting also may rest with the board of directors and that the responsibility may vary by jurisdiction. Accordingly, "senior management" here refers to the parties that are responsible for financial reporting in any given jurisdiction.

[3] See BC79 and BC79A in the Basis for Conclusions of the IASB's June 2005 amendment to IAS 39 on the fair value option. References in this paper to specific paragraphs in IAS 39 are to the paragraphs in IAS 39 as amended in June 2005.

[4] Supervisors will generally look for the integration of the approaches discussed in this guidance into a bank's overall system of risk management and controls as applied to the bank's fair value option activities and not expect a bank to have a separate risk management and control system solely for its fair value option activities. Moreover, consistent with objectives to reduce unnecessary burdens, the discussion in this guidance of banks' internal documentation should be understood to mean that supervisors will expect reasonable levels of documentation to be maintained.

12. The Committee expects banks to implement the fair value option in a sound manner that properly addresses the prudential issues and concerns set forth in this guidance. Based on this expectation, the Committee at this time would encourage national supervisors to consider recognising gains and losses from the application of the fair value option in Tier 1 capital, with the exception of gains and losses arising from changes in own credit risk of liabilities.[5] The Committee is recommending this treatment because there are likely to be corresponding losses and gains from other financial instruments that have also been reflected in Tier 1 capital (eg when the fair value option is used for economic hedging purposes). Moreover, this approach combined with strong risk management and valuation controls will allow economic hedging strategies and other risk management activities to be reflected in financial statements. However, under this approach, supervisors want to ensure that weaknesses in a bank's risk management and control systems do not result in the inclusion in regulatory capital of overstated unrealised gains and understated unrealised losses resulting from unreliable fair values, including those that could be created by applying internal models to illiquid financial instruments. This supervisory guidance is intended to address these prudential concerns.

13. In connection with assessing fair value option activities, the Committee notes that banks are to disclose information on the use of the fair value option required by their relevant accounting framework (eg information disclosed in accordance with IFRS 7, *Financial Instruments: Disclosures*). In addition to this publicly available information, supervisors may wish to periodically obtain supplemental information about how the fair value option is being implemented by their banks. Normally, this will be information that a bank should have developed for internal purposes. For example, information about credit risk and related changes in fair values will be particularly useful since, for financial reporting purposes, loss provisions will not be maintained for financial assets in the fair value option category. In addition, it would be helpful to obtain information that assists in understanding the impact of the use of the fair value option on net interest margins. Relevant information about other significant financial statement components affected by banks' use of the option could assist supervisors in assessing the option's impact on the measurement of overall risk and on earnings and capital adequacy.

14. The supervisory expectations set forth in this guidance are applicable to all banks. The manner in which sound risk management and controls are implemented by an individual bank will depend on factors such as the bank's size and the nature, complexity and geographical extent of its business, and the significance of its use of the fair value option. In smaller banks, for example, it may not be practicable to implement some of the specific practices recommended in this paper to the detailed extent that larger banks would (eg certain aspects of the G30 Best Practices) but smaller banks should still be able to implement practices that will achieve the objectives set forth in this supervisory guidance. Keeping the above in mind, for banks that do not apply the fair value option in ways consistent with this guidance, the national supervisor should reserve the right to inquire further of the bank regarding its use of the fair value option and its documented risk management policy.

15. Additionally, the national supervisor may take appropriate action, which could affect the assessment of risk and capital adequacy. For example, a supervisor may take action to respond to the bank's application of the fair value option in situations where risk management or controls are deficient, even if a bank applies the fair value option in a

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5 See the Committee's 8 June 2004 Basel Committee press release on the capital treatment of gains and losses on financial liabilities due to changes in own credit risk.

manner consistent with the relevant accounting standards. These actions are discussed in Principles 5 and 6 below. The Committee fully recognises that supervisors may utilise various approaches to assess banks' use of the fair value option and that supervisors will exercise their discretion in determining appropriate action when necessary.

16. The Committee believes that it would be worthwhile to see how banks use the fair value option in practice and whether their use of the option gives rise to widespread supervisory concerns. The Committee supports national supervisors reviewing the use of the fair value option by banks and exchanging information about its usage.

Supervisory expectations relevant to the use of the fair value option[6]

Principle 1

Supervisors expect a bank's application of the fair value option to meet the criteria set forth in IAS 39 in form and in substance.

17. When certain criteria are met, the fair value option under IAS 39 allows firms to make an irrevocable decision at the time of acquisition to designate any financial asset or liability to be measured as at fair value through profit or loss. Items are eligible to be designated as at fair value under the fair value option when they meet the criteria in paragraph 9 or 11A of IAS 39. Paragraph 9 allows the fair value option to be utilised when doing so results in more relevant financial information because (1) it eliminates or significantly reduces an "accounting mismatch" or (2) a group of financial assets or liabilities or both is managed and its performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy. Paragraph 11A allows an entire contract to be designated as at fair value when it has one or more embedded derivatives that significantly modify the cash flows of the host contract and the embedded derivatives are not otherwise prohibited from being accounted for separately from the host contract.[7]

18. When considering alternative treatments for categorising financial instruments available under IAS 39, including the fair value option, banks should be fully cognisant of the implications their choice may have on economic hedging strategies. For example, the requirements that the fair value option designation be made at initial recognition and that it is irrevocable may significantly constrain dynamic hedging strategies. Conversely, hedge accounting treatment brings with it the requirement to demonstrate sustained compliance with complex and strict accounting rules. While this guidance does not express a preference for the choice of one accounting treatment over another, supervisors will expect banks to make such choices in a fully informed and disciplined manner.

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[6] As noted above, while this guidance refers specifically to the fair value option in IAS 39, the Committee recognises that similar fair value option approaches exist or are being considered in various other accounting regimes. The Committee believes the principles set forth in this supervisory guidance should be generally applicable in such other regimes, although national supervisors will need to make that determination based on the criteria and requirements of the fair value option in their jurisdiction

[7] For example, IAS 39 specifies that a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost does not meet the paragraph 11A criteria to apply the fair value option

19. When a bank utilises the fair value option under either paragraph 9 or 11A of IAS 39, supervisors may wish to consider the adequacy of risk management and controls as they pertain to the fair value option.[8]

20. Banks following IFRS are required to provide specific disclosures related to the fair value option. Of particular importance in this context is that IFRS 7 requires summary disclosures about the credit risk and changes in the credit risk for loans and receivables designated as at fair value through profit or loss, and the impact of credit derivatives or similar risk mitigants on such loans and receivables.

21. Banks should maintain documentation that supports their public disclosures about the use of the fair value option in a manner that is reasonably sufficient for supervisory review purposes. After review of a bank's policies and practices for using the fair value option, the supervisor should discuss with bank management and the bank's external auditor any concerns about the disclosures on its use of the fair value option.

Principle 2

Supervisors expect banks to have in place appropriate risk management systems (including related risk management policies, procedures and controls) prior to initial application of the fair value option for a particular activity or purpose and on an ongoing basis.

22. The Committee consistently has expected banks to conduct economic hedging and other risk management activities in accordance with sound risk management policies.[9] This expectation extends to the use of the fair value option, as in many cases its use will interact with economic hedging strategies and practices and other risk management activities. When the option is used to eliminate or significantly reduce an accounting mismatch and therefore should reduce earnings volatility, basis risk or any unhedged risk factors within the hedged risk position may still result in some residual earnings volatility. Increased earnings volatility can arise from applying the option to unhedged risk positions (ie when the fair value option is applied in accordance with a documented risk management or investment strategy). As such, the Committee expects banks to fully address these issues in their risk management policies and to deal with the potential for any residual or increased earnings volatility associated with issues such as those noted above.

23. Therefore, supervisors expect banks to ensure that sound documented risk management and valuation policies are applied to individual (and portfolios of) financial assets and liabilities designated as at fair value through profit and loss. This section summarises key aspects of sound risk management policies that should be in place to underpin banks' use of the fair value option for these purposes. As noted in Principle 6, the failure to apply sound risk management and control practices with respect to the fair value option may significantly affect the supervisory assessment of capital adequacy.

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8 Consistent with paragraph 15, this supervisory prerogative also exists in situations where a bank: (a) separates an embedded derivative from the host contract according to paragraph 11 of IAS 39; and (b) is unable to measure an embedded derivative separately and therefore is required by paragraph 12 of IAS 39 to designate the entire combined contract as at fair value through profit or loss.

9 See, for example, the Basel Committee's Risk Management Guidelines for Derivatives (July 1994), Principles for the Management of Interest Rate Risk (September 1997), Sound Practices for Managing Liquidity Risk in Banking Organisations (February 2000), Principles for the Management of Credit Risk (September 2000) and Principles for the Management and Supervision of Interest Rate Risk (July 2004).

24. Before availing itself of the fair value option, a bank must have risk management systems and related risk management policies and procedures to ensure that:

(a) sound risk management objectives consistent with the risk management framework and overall risk appetite approved by the board of directors (or a committee of the board) are being met when the fair value option is used;

(b) appropriate valuation methods are being used;

(c) fair values are indeed reliable for instruments in the fair value option category;

(d) risk management and control policies pertaining to the use of the fair value option and related valuation methodologies are being consistently applied and complied with; and

(e) appropriate information is provided periodically to senior management and the board of directors (or committees of the board) about the use of the fair value option and its impact on the bank's financial condition and performance.

25. Assets and liabilities designated as at fair value under the fair value option should be captured in the firm's risk measurement systems. The resulting exposure amounts should be included in internal reports that compare actual overall exposure to approved overall risk management limits.

26. The policies for measurement and management of risk and reliable valuation should be well documented and these policies should be approved by senior management. Assets and liabilities designated as at fair value under the fair value option should be subject to the same rigorous valuation policies and practices applicable to other financial assets and liabilities measured at fair value. For example, the fair values of assets and liabilities designated as at fair value under the fair value option should be independently verified by an appropriately qualified unit independent of the business unit with the same frequency that the fair values of any related assets or liabilities are independently verified.

27. As with any valuation model, models used to value items designated as at fair value under the fair value option should be independently verified by an appropriately qualified unit as part of a regular cycle of model validation. The validation process should include monitoring of model stability and backtesting that occurs at regular intervals with regular reporting to senior management. This would require banks to retain at least enough data to verify model performance over a variety of conditions and to maintain supporting documentation on their models, model validation process and verification of model performance.

28. Banks should establish procedures for approving the use of the fair value option for new items, products or transactions, as well as the related controls. When determining whether to apply the fair value option to a particular new instrument or class of instruments, the bank should ascertain whether reliable fair values can be determined for those instruments. This critical element of the control framework is addressed in part by Principle 3 of this guidance. Existing risk management policies, procedures, and controls (including those related to valuation) may need to be revised or expanded to address the characteristics and risks of the new items, products or transactions to which the fair value option will be applied. The procedures must ensure that new approvals are consistent with the established policies for using the fair value option.

29. Banks should ensure that staff independent of those responsible for originating transactions monitor the application of the fair value option for conformity with IFRS accounting and disclosure requirements. Such monitoring typically should be managed by individuals outside the risk taking functions (eg by financial/accounting control staff). In

addition, the appropriateness of a bank's use of the fair value option should be subject to periodic review by internal audit, based on its risk assessment.

30. The independent monitoring of a bank's use of the fair value option should encompass the review of accounting policies for consistency with IAS 39 requirements ***and*** testing of individual transactions to verify that policies are being adhered to in practice. For example, in cases where management utilises the fair value option in accordance with paragraph 9(b)(ii) of IAS 39, the bank's financial control unit (or persons with similar responsibilities) should assess whether the fair value option is being used in accordance with a documented risk management or investment strategy. In conducting such assessments, the financial control unit should ensure that sufficient documentation exists to support the use of the fair value option.

31. As part of their risk management and controls, the Committee strongly encourages banks that utilise the fair value option to adopt the 17 best practices outlined in the December 2003 Group of 30's report "Enhancing Public Confidence in Financial Reporting" ("G30 Report"). These best practices address (a) governance, (b) control, (c) price verification, and (d) internal and external audit practices that can help assure more reliable fair value estimates by banks and other major market participants. The G30 Report's best practices are summarised in the Annex of this report. A summary of the report is available at www.group30.org/docs/G30=Overview.pdf.

32. While this guidance addresses banks' own use of the fair value option, the Committee notes that the use of the fair value option by bank borrowers and other counterparties may affect their reported measures of profit or loss and equity that banks may rely upon when considering whether to extend credit or enter into other financial transactions with counterparties. As such, banks should consider the extent to which their due diligence on counterparties, including the review of significant accounting policies, addresses the impact of counterparties' significant use of the fair value option on reported earnings, capital and associated analytical ratios (eg to take into account that a deterioration of a company's own credit risk may inflate reported profits and equity). This would not preclude a bank from financial relationships with sound counterparties.

Principle 3

Supervisors expect that banks will not apply the fair value option to instruments for which they are unable to reliably estimate fair values.

33. Paragraph 48A and other portions of IAS 39 provide guidance on the estimation of fair values, including a hierarchy that is useful in determining fair values. Indeed, IAS 39 sets forth requirements for determining reliable fair values that apply to all items held at fair value, including those designated as at fair value under the fair value option.

34. In cases where the fair value option is applied, and particularly with respect to illiquid instruments, supervisors expect banks to implement the relevant best practices in the G30 Report, such as those pertaining to model development and validation, price verification and both internal and external audit review.

35. A key issue underlying fair values in general is whether they can be obtained directly from observable market prices or through a robust valuation technique. Even with observable prices, care needs to be taken to ensure that the market in question is reasonably liquid and that the observable prices are representative of actual trades. The issues surrounding valuation models warrant further consideration. Some cases do not raise significant issues of reliability – for example, the derivation of interest rate yield curves for major currencies with deep markets for which there are well established valuation techniques. Other cases could raise reliability concerns, such as when there are not established valuation techniques with a

clear and rigorous basis or where one or more important inputs to valuation are not observable, even indirectly, from liquid markets. The concerns that pertain to the valuation of illiquid instruments are especially relevant to the fair value option.

36. When applying the fair value option to illiquid instruments, banks should employ a more rigorous valuation process than is used for liquid instruments. For some illiquid instruments, values can be reliably inferred. Examples include where there exists a very similar financial instrument that trades in a liquid market, or where an illiquid financial instrument can be rigorously decomposed into components for which prices can be obtained from liquid markets or from appropriate valuation approaches. Regardless, the process for estimating fair value should document the reliability of the valuation.

37. The Committee encourages backtesting of valuations, particularly those pertaining to illiquid instruments, and recommends that banks refrain from expanding the use of the fair value option for instruments for which the valuation methodology has proven in practice to be unreliable.

Principle 4

Supervisors may require banks to provide supplemental information to assist them in assessing the impact of banks' utilisation of the fair value option.

38. In connection with assessing fair value option activities, the Committee notes that banks are to disclose information on the use of the fair value option required by their relevant accounting framework (eg IFRS 7 disclosures). In addition to this publicly available information, supervisors may wish to periodically obtain supplemental information about how the fair value option is being implemented by their banks. Normally, this will be information that a bank should have developed for internal purposes. Such information, which would assist supervisors in assessing the impact of banks' use of the fair value option on risk, earnings and capital adequacy, could include information that:

- assists in fully understanding the credit risk implications of the fair value option. Of particular importance in this context is the IFRS 7 requirement for summary disclosures about the credit risk for loans and receivables (eg past due amounts, maximum exposure to credit risk and the amount of change in loan fair values due to changes in credit risk) designated as at fair value through profit or loss, and the impact of credit derivatives or similar risk mitigants on such loans and receivables. Also, supervisors may wish to request additional information, for supervisory purposes, about credit risk as it relates to use of the fair value option. This information in the disclosures and supervisory reports will be particularly useful since loss provisions will not be maintained for financial assets in the fair value option category.
- explains the impact of utilising the fair value option on earnings or risk components, including information on the related economic hedging strategies, when the use of the option has a large impact upon significant disclosed earnings components or risk measures in a given period.
- allows the supervisor to assess the amount of unrealised gains or losses attributable to items held at fair value under the fair value option. In particular, supervisors may wish to have cumulative unrealised gains reported by category of financial instrument and monitor the cumulative unrealised gains of items designated as at fair value under the option in relation to equity and regulatory capital. Such information should be adjusted for transactions that have matured or have been terminated.

- assists in understanding the impact of the use of the fair value option on net interest margins.
- assists in understanding the extent to which the fair value option is being used for financial instruments with embedded derivatives under IAS 39 paragraphs 11A and 12.

Supervisory evaluation of risk management, controls and capital adequacy

Principle 5

Supervisors should evaluate a bank's risk management and control practices as they pertain to the use of the fair value option.

39. Supervisors should periodically obtain information from banks on their use of the fair value option and related risk management and valuation policies and practices (including economic hedging strategies and new applications of the fair value option). Such information forms the basis for reviewing banks' use of the fair value option. This information should identify, at a minimum, whether the bank maintains policies and practices that are consistent with IAS 39 and this supervisory guidance and what impact the use of the fair value option is having on the bank's financial condition, financial performance and capital adequacy. In this respect, information required to be disclosed under IFRS 7, as well as the type of information highlighted in Principle 4, can provide useful information to supervisors.

40. If a bank makes extensive use of the fair value option, supervisors should assess the quality of its risk management and control policies and practices (including valuation policies and practices) with respect to the fair value option. Extra supervisory attention may be warranted during a bank's initial implementation of the fair value option. Supervisors may utilise various approaches to assess a bank's risk management and control policies and practices with respect to the fair value option, including receiving reports from internal and external auditors on these matters.

41. At a minimum, supervisors expect banks to maintain risk management and control policies and practices consistent with this supervisory guidance, and to comply with the accounting and disclosure treatments specified in IFRS. Supervisors also expect banks to promptly address any deficiencies identified in their use of the fair value option by internal and external auditors. When supervisors bring any risk management and/or control deficiencies regarding the use of the fair value option to the attention of management, they should consider the full range of supervisory measures at their disposal to ensure that deficiencies receive appropriate attention from management and are corrected in a timely manner. The supervisory response should be commensurate with the extent of the use of the fair value option by the bank, the severity of the deficiencies and bank management's responsiveness in addressing supervisory concerns. For example, supervisory responses could include the following approaches and measures:

- Communicating concerns routinely to the bank's senior management and evaluating management's response as to how it is addressing these concerns.
- Factoring into supervisory ratings any concerns with respect to a bank's fair value option practices (eg factoring this into prudential risk management or capital adequacy ratings).
- Communicating significant concerns to the bank's senior management and board of directors.

- Taking informal or formal supervisory actions (which can be of a non-public or public nature) requiring management and the board of directors to remedy the deficiencies in a specified timeframe and to provide the supervisor with periodic written progress reports.

42. These possible approaches also could apply to any supervisory concerns arising with respect to capital adequacy issues as discussed below in Principles 6 and 7.

Principle 6

Supervisors should consider risk management and control practices related to the use of the fair value option when assessing capital adequacy.

43. Supervisors expect banks to have sound documented risk management and controls associated with their use of the fair value option, including sound valuation controls (Principles 2 and 3). To the extent that supervisors have significant concerns about risk management, controls or reliability regarding a bank's use of the fair value option, they should consider several issues and a range of supervisory responses, including:

- When assessing capital adequacy at a bank that makes extensive use of the fair value option, supervisors should evaluate the bank's use of the fair value option with respect to its impact on the quality of earnings and, therefore, on the bank's capital position. For example, supervisors should consider the level of cumulative unrealised gains attributable to items designated as at fair value under the option in relation to shareholder funds and regulatory capital when assessing capital adequacy.
- In connection with the types of supervisory actions discussed under Principle 5 with respect to deficiencies in risk management or control policies and practices (including economic hedging strategies), supervisors should consider whether it is appropriate (for prudential capital purposes) to exclude from regulatory capital gains and losses resulting from applying the fair value option to newly acquired financial instruments and/or new classes of instruments until such time that the supervisor determines that the deficiencies have been satisfactorily corrected.
- If a bank using the fair value option in a manner that has a significant impact on earnings and capital exhibits weaknesses in its risk management policies, systems and controls (including valuation controls and practices), the supervisor should consider these deficiencies when assessing whether the bank's capital position is adequate in relation to its overall risk exposure. This may result in a supervisory determination that the bank needs to hold more capital in relation to its overall risk exposure (eg under Pillar 2 of the Revised Framework[10]).
- In situations where a bank's risk management and control practices pertaining to the use of the fair value option fall short of supervisory expectations and result in unreliable fair values, it is appropriate for a supervisor to exclude from Tier 1 capital the associated unrealised gains and losses.[11]

44. The above examples illustrate a range of potential supervisory responses. They are not intended to preclude supervisors from exercising discretion.

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[10] International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004).

[11] However, consistent with the Committee's longstanding guidance, impairment losses always should be deducted from Tier 1 Capital.

45. Supervisors also should ensure that, in accordance with the Committee's July 2005 guidance on capital charges related to the trading book/banking book boundary[12], banks apply the appropriate risk-based capital treatment to financial instruments designated as at fair value through profit and loss. The guidance emphasises that the Revised Framework defines the trading book for regulatory capital purposes as consisting only of positions in financial instruments and commodities held either with trading intent[13] or to hedge other elements of the trading book. Moreover, the guidance states that the definition of the trading book may be more restrictive than the definition used for accounting (ie financial reporting) purposes. As such, the mere fact that a financial instrument, which otherwise would receive banking book treatment for regulatory capital purposes, is designated for accounting purposes as at fair value through profit and loss does not change its regulatory capital treatment.

Principle 7

Regulatory capital should be adjusted for gains and losses from changes in own credit risk as a result of applying the fair value option to financial liabilities.

46. Designation of a financial liability as at fair value under the fair value option could result in gains and losses from changes in an entity's own credit risk. Of particular concern is that if a bank applies the option to its own debt, it will recognise a gain and a resulting increase in its capital when its own creditworthiness deteriorates. Such an outcome would undermine the quality of capital measures and performance ratios. Therefore, as the Committee stated in its press release on 8 June 2004, it is appropriate for national supervisors to exclude these gains and losses from regulatory capital. Disclosures about the fair value option required by IFRS 7 provide information that may be useful to supervisors in determining the amount of such gains and losses to be excluded from regulatory capital.

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[12] The application of Basel II to trading activities and the treatment of double default effects (July 2005). See paragraphs 269-271.

[13] Paragraph 687 of the Revised Framework defines positions held with trading intent as those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits.

Annex

Summary of recommended 17 best practices regarding governance, control, price verification and audit practices from the G30 Report "Enhancing public confidence in financial reporting" (Processes and controls for estimating more reliable fair values)

Governance

1. A clear and delineated governance structure should exist including provision for appropriate segregation of duties as well as documented procedures for the escalation of issues and exceptions to the board of directors or the audit committee.

2. A senior management grouping should have responsibility for the management and oversight of control and valuation policies and procedures. This group should report the results of its work directly to the board of directors or the audit committee.

3. Initial responsibility for the determination of fair value should reside with the risk taking business. Ultimate responsibility for determining the fair values incorporated into financial statements must be outside the risk taking functions.

4. Senior management should ensure that there are adequate resources, with the appropriate experience, training and reward to ensure that control, risk management and independent price verification functions are performed to the highest standards.

Control

5. Risk limits (for both market and credit) should be established, approved and monitored within a framework and overall risk appetite approved by the board of directors or the audit committee.

6. For financial assets and liabilities measured at fair value, organisations should disclose information in their financial statements that is consistent with the way they measure and manage risk. Any significant differences between the day-to-day measurement and management of risk and GAAP should be well documented and approved by senior management and appropriate board-level committees. The same practice should be sought for other financial assets and liabilities to the extent that risk oversight and management reporting is not based on GAAP principles. This recommendation is not intended to limit the use of risk management information based on non-GAAP principles (eg value-at-risk, etc).

7. There should be a procedure for the approval of new transaction types and markets (New Product Approval) and related controls and risk management approaches. This is a critical element of the control framework.

8. An appropriately qualified and experienced independent price verification (IPV) unit should be responsible for the fair values used in the financial statements.

9. There should be a group dedicated to model verification, independent of risk taking activities, employing highly experienced and qualified quantitative professionals.

10. Valuation models or changes to a valuation model must be reviewed and approved by the Model Verification Group. Details of model approvals and changes thereto should be recorded in an inventory.

11. There should be procedures for the timely review of highly structured, complex trades independent of the persons responsible for their design and execution.

12. For institutions using hedge accounting, the documentation, valuation and control requirements should be managed by financial control.

Price verification procedures

13. Institutions should undertake a rigorous process, at least monthly, to verify fair values. The results should be reported to senior management. Where fair value is a critical component of reported results, senior management should report the price verification results to the board of directors or the audit committee.

14. An independent group should be responsible for approving and monitoring valuation adjustments for consistency and appropriateness. The group's findings and any changes to the method of determining such adjustments should be reported to senior management. A report of price verification differences and valuation adjustments should be distributed throughout senior management and, where fair value is a critical component of reported results, to the board of directors or the audit committee.

15. In addition to a rigorous monthly independent price verification process there should be a process for the review and explanation of daily profit and loss (and for non-traded financial assets/liabilities the relevant periodic profit and loss), which should be reported to senior management on a daily basis.

Audit

16. Internal audit departments should review at least annually the independent price verification procedures and control processes.

17. External audit should devote considerable resources to reviewing the control environment, including the price verification processes, and performing valuations of transactions, especially in those institutions where fair value is a critical component of reported results.