Basel Committee on Banking Supervision

Consultative Document

Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards

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Principles underlying this consultative document

The draft supervisory guidance is principles-based and is structured around eight 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 banks to apply the fair value option only to instruments for which fair values can be reliably estimated.
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 assessment of risk management, controls and capital adequacy

5. Supervisors should assess whether a bank's internal financial analysis of counterparties evaluates the impact of the counterparties' use of the fair value option.
6. Supervisors should evaluate a bank's risk management and control practices as they pertain to the use of the fair value option.
7. Supervisors should consider risk management and control practices related to the use of the fair value option when assessing capital adequacy.
8. 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.

The draft 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 is not in conflict with the IASB's accounting and disclosure guidance on the fair value option.

Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards

Background and summary

This document is intended to provide supervisors with guidance on the prudential supervision of banks' implementation of the fair value option under IAS 39 as amended on 16 June 2005. This guidance focuses on supervisors' expectations for key policy positions and sound practices for banks that the Basel Committee on Banking Supervision believes will promote sound risk management and controls and maintain the integrity of regulatory capital measures.

The guidelines and recommended practices presented here address: (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 Basel 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).

Comments from the public on all aspects of the consultative paper are welcome by ***31 October 2005***. These should be addressed to the Basel Committee at the following address:

Basel Committee on Banking Supervision
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Alternatively, comments may be sent by e-mail to **baselcommittee@bis.org**.

Introduction

1. To address the concerns of prudential regulators, 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. The IASB's June 2005 amendment to the fair value option 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 an embedded derivative that meets particular conditions.

2. 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 shareholder funds. 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.

3. 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 "economic hedging" of risk positions could take place without having to satisfy the strict 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.

4. 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.

5. 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

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

dedication to working constructively with accounting standards setters, bankers and others to promote both sound practices and transparency.

6. This document is not intended to 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 accounting standards 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 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 where their national accounting standards are not exactly the same as those standards in IAS 39.

7. 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]

In the past, the Committee has recommended various adjustments that it believes should be made for prudential purposes to accounting information prepared under International Financial Reporting Standards (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.

8. 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 applicable accounting standards and that addresses prudential concerns. The primary prudential concern is that banks 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. An important related concern is that

[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.

unrealised gains or losses on items designated as at fair value should not alter regulatory capital in a way that would be unsound. The Committee recently addressed a similar concern by issuing guidance that prevents unrealised gains and losses for some available for sale assets from being reflected automatically in regulatory capital.[4]

9. Assuming that a bank has properly addressed the prudential issues and concerns set forth in this guidance for the use of the fair value option, the Committee is recommending that national supervisors recognise 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 (e.g., 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.

10. As part of assessing fair value option activities, national supervisors may wish periodically to obtain information about how the fair value option is being implemented by their banks. 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.

11. 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. Additionally, as discussed below, the national supervisor may take appropriate action, which could affect the assessment of risk and capital adequacy. 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.

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

[4] See the Committee's 15 December 2004 press release, "Capital Treatment of Certain Items Under IFRS."

[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.

Supervisory expectations relevant to the use of the fair value option

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.

13. 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 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.[6]

14. Although the fair value option presents an alternative to hedge accounting in many circumstances, the two may not be perfectly interchangeable in every circumstance. For example, in cases where the bank is seeking to hedge only a component risk of the hedged item and not all risks, and the bank is readily able to satisfy hedge effectiveness criteria for its transaction, bank management should consider whether hedge accounting is preferable to the use of the fair value option. When considering alternative treatments for categorising financial instruments available under IAS 39, including the fair value option, banks should strive for a treatment that results in the most faithful representation of economic substance.

15. When a bank utilises the fair value option under either paragraph 9 or 11A of IAS 39, supervisors reserve the right to consider the manner in which management has interpreted the criteria of the fair value option and/or the adequacy of its risk management and controls as they pertain to the fair value option. For example, a bank may have a substantial volume of hybrid contracts with embedded derivatives that significantly modify the cash flows of the host contracts. In this situation, the bank should understand the impact of embedded derivatives upon its financial condition and risk profile when it chooses not to account for the derivatives separately from the host contract and instead applies the fair value option to these hybrid contracts in their entirety under paragraph 11A. Even when a bank applies the fair value option in a manner compliant with paragraphs 9 or 11A, supervisors may take actions to respond to the bank's application of the fair value option in situations where risk management or controls are deficient.[7] These actions are discussed in Principles 6 and 7 below.

16. Banks following IFRS are expected to provide all required disclosures including those specifically related to the fair value option. Of particular importance in this context is

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[6] 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.

[7] 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.

that IAS 32[8] 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.

17. Banks should maintain documentation that supports their public disclosures about the use of the fair value option in a manner that is 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.

18. 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. Volatility in earnings can arise from applying the option to unhedged risk positions. Even where the use of the option involves economic hedging strategies, basis risk or any unhedged risk factors within the hedged risk position may still lead to volatility in earnings. Therefore, the Committee expects banks to fully address these issues in their risk management policies and to deal with the risk of increased earnings volatility that may result from basis risk and/or unhedged risk factors in connection with the use of the fair value option.

19. Therefore, supervisors expect banks to have sound documented risk management policies and sound valuation policies associated with their use of the fair value option for portfolios of financial assets and liabilities and for individual financial assets and liabilities. 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 7, the failure to maintain sound risk management and control practices with respect to the fair value option may significantly affect the supervisory assessment of capital adequacy.

20. 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;

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8 Note that the IASB may soon issue a new financial risk disclosure standard that will incorporate the disclosure requirements now located in IAS 32. The proper reference will be cited here after the IASB releases its new guidance.

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).

(b) appropriate valuation methods are being used;

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

(d) policies related to the use of the fair value option and related valuation methodologies are being consistently applied and are being complied with throughout the bank; 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.

21. 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.

22. 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.

23. 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.

24. 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.

25. Banks should ensure that staff independent of those responsible for originating transactions monitor that utilisation of the fair value option is consistent with IFRS accounting and disclosure requirements. Such monitoring typically should be managed by individuals outside the risk taking functions (e.g., 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.

26. 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 strategy. In conducting such assessments, the financial control unit should ensure that sufficient documentation exists to support the use of the fair value option.

27. 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.

Principle 3

Supervisors expect banks to apply the fair value option only to instruments for which fair values can be reliably estimated.

28. 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.

29. 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. Nevertheless, serious reliability concerns arise where 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.

30. 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.

31. If fair values cannot be reliably estimated for the financial instruments concerned, the Committee strongly discourages use of the fair value option. The Committee encourages banks to apply the fair value option only to instruments for which they can ensure that the variability in the range of reasonable fair value estimates is low. Moreover, the Committee also strongly encourages backtesting of the valuations 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.

32. Finally, in cases where the fair value option is applied, and particularly with respect to illiquid instruments, supervisors expect banks to fully incorporate 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.

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.

33. While supervisors should rely on publicly available information whenever possible, they may require banks to provide supplemental information (e.g., in supervisory reports) regarding their use of the fair value option. This information would assist supervisors in assessing the impact of banks' use of the fair value option on risk, earnings and capital adequacy. Such information could include the following:

- To fully understand the credit risk implications of the fair value option, supervisors should utilise all relevant IFRS disclosures (especially those related to the fair value option). Of particular importance in this context is that IAS 32 requires summary disclosures about the credit risk for loans and receivables (e.g., 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.
- When the use of the fair value option has a large impact upon significant disclosed earnings components or risk measures in a given period, information that explains the impact of utilising the option on earnings or risk components, including information on the related economic hedging strategies.
- The cumulative impact of using the fair value option on shareholders' funds (i.e., information that 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 shareholder funds and regulatory capital. Such information should be adjusted for transactions that have matured or have been terminated.
- Information that assists in understanding the impact of the use of the fair value option on net interest margins.
- Information that 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 assessment of risk management, controls and capital adequacy

Principle 5

Supervisors should assess whether a bank's internal financial analysis of counterparties evaluates the impact of the counterparties' use of the fair value option.

34. Bank borrowers and other bank counterparties may utilise the fair value option, and this may affect their reported measures of equity and profit or loss. Therefore, banks should ascertain whether their counterparties have used the fair value option. If so, as part of the financial data received from borrowers and other counterparties, banks should obtain summary information pertaining to the fair value option (by using, for example, the types of information disclosed under IAS 32) and determine its impact on the counterparties' reported earnings, capital and analytical ratios. This information, if material, should be factored into a bank's assessment of whether a counterparty meets the bank's established underwriting guidelines or other criteria. Banks should ensure that their use of the fair value option (e.g., with regard to deteriorations of own credit risk of the borrower or other counterparty) is not distorting the earnings, capital and analytical ratios it relies upon to determine, for example, whether to extend credit or assume counterparty exposure to a particular counterparty. This would not preclude a bank from financial relationships with sound companies.

Principle 6

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

35. 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 IAS 32, as well as the type of information highlighted in Principle 4, can provide useful information to supervisors.

36. 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.

37. 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 (e.g., factoring this into prudential risk management or capital adequacy ratings).
- Communicating significant concerns to the bank's 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.

These possible approaches also could apply to any supervisory concerns arising with respect to capital adequacy issues as discussed below in Principles 7 and 8.

Principle 7

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

38. 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 6 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 (e.g., under Pillar 2).

- 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 (with the exception of impairment losses, which are always deducted from Tier 1 Capital).

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

Principle 8

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.

39. 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 IAS 32 provide information that may be useful to supervisors in determining the amount of such gains and losses to be excluded from regulatory capital.

Annex

Summary of recommended 17 best practices regarding governance, control, price verification and audit practices from the G30 Report "Enhancing public confidence in public 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 (e.g., 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.