



**MCFS**  
**Robust Valuations in today's  
environment**



**Blaik Wilson**  
**Solutions Consultant**  
**APAC**

# About Reval

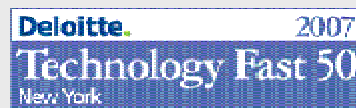
- ü Web-based derivative risk management solution delivered under the Software-as-a-Service (SaaS) model
- ü Founded in 1999
- ü Specialists in derivatives valuation and hedge accounting under US GAAP and IFRS
- ü 120 employees - Offices in NYC, London, Sydney, & India
- ü 200 clients using single version of HedgeRx®

*New York, New York*  
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BEST PRACTICES SUMMIT

2008 Alexander Hamilton Award for FAS 157 Solution



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Top 10 Tech

# Our clients include



STAGECOACH



Standard Chartered



Morgan Stanley

Deloitte.



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# Credit impact on derivatives

## The Theory (AASB 139):

### **“AG69 Fair value measurement considerations**

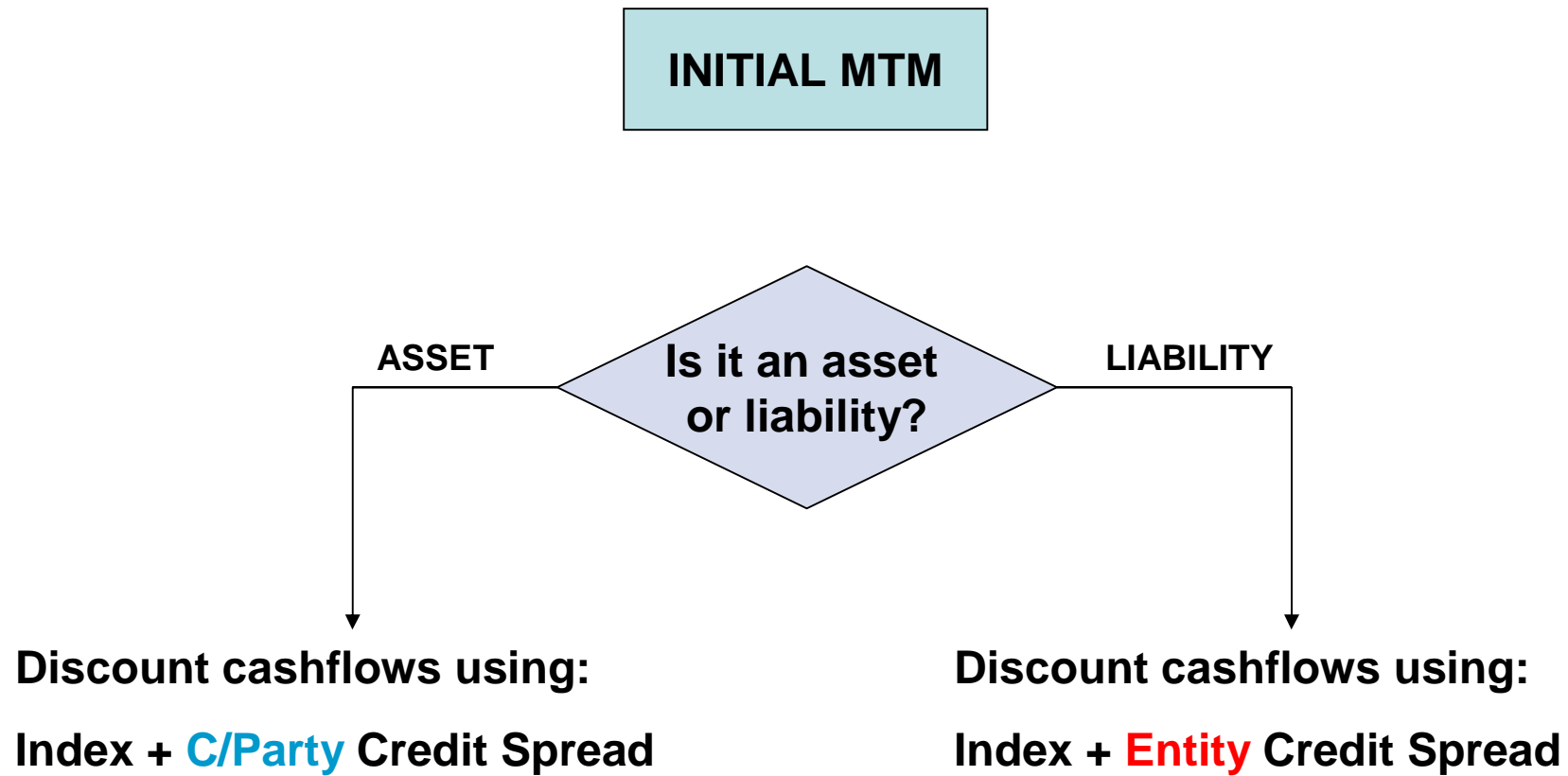
Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. **However, fair value reflects the credit quality of the instrument.”**

## The Practice:

- Financial institutions made some adjustment for credit
- Corporates assumed AA rated counterparties equated fairly well with benchmark index
- Including credit will introduce P&L volatility

# Credit impact on derivatives

## Valuation Methodology:



# The US Experience

## The Theory:

### **FAS 157 Fair Value Measurements**

- Mandatory
- Single definition of fair value i.e. exit price
- Incorporates credit risk
- Introduces 3 levels of hierarchy i.e. reliability of valuation

## The Practice:

- Straw that broke the camel's back for manual processes
- Very prescriptive – credit must be included in fair value
- Level 3 valuations highly scrutinised
- Still lacks clarity around effectiveness testing

# The US Experience

Fair value hierarchies

- Assignment of levels 1,2,3
- Inputs to valuation technique
- Getting values from the bank could be deemed Level 3
- Additional disclosures for level 3

Level 1: As is quoted liquid market prices

Level 2: Objective market data inputs to calc price

Level 3: Subjective assumptions used to model price

# Market Data Issues

## The Theory:

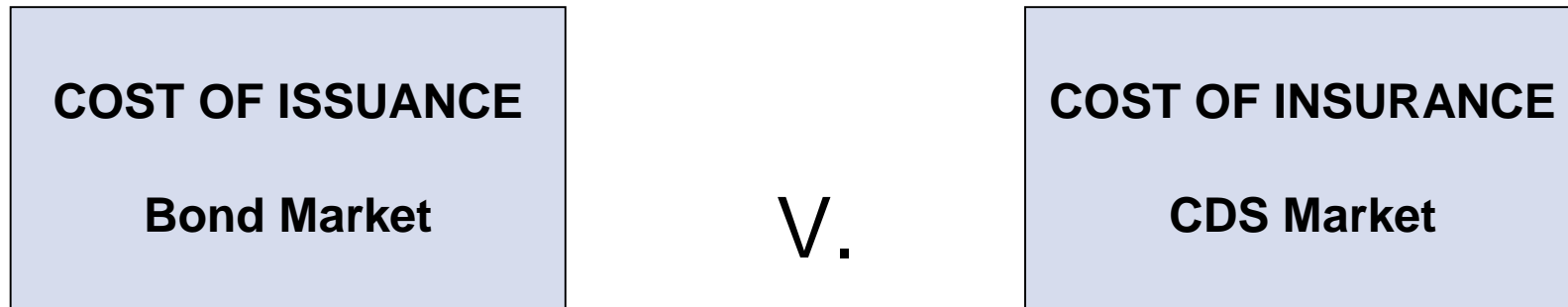
### **AG82 Inputs to valuation techniques**

An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others)...

**(b) Credit risk. The effect on fair value of credit risk (ie the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.**

# Market Data Issues

The Practice:



- Reval use credit data specialists for credit spreads
- No definitive approach

# Mark to Market v. Mark to Model

## The Theory:

### **AG73 No active market: valuation technique**

If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. **If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.**

## The Practice:

- Comes back to how do you estimate credit?
- IFRS 7 Exposure Draft may incline more to move to mark to market given additional Level 3 disclosures.

# Netting / Collateralisation

## Netting:

- How should netting agreements be reflected?
- CASE: Large US car company:
  - a) Net by ISDA agreement
  - b) Determine if net asset/liability
  - c) Apply counterparty or entity curve as reqd.

## Collateralisation:

- Zero threshold or some other threshold?
- How do you incorporate potential collateral calls?
- How do you track other securities you are not fair valuing?

# Effectiveness testing

## The Theory:

### **“AG109 Assessing Hedge Effectiveness**

A hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.”

## The Practice:

- Derivative should definitely include credit
- Exposure (or hypothetical derivative) should include credit (unless documented as such to be excluded)
- May lead to change in hedge accounting documentation

# Conclusions

Need flexibility:

- Calculate credit impact and hopeful ignore due to immateriality?
- Best methodology/source for credit data?
- Lack of clarity around effectiveness testing impacts
- Netting/collateralisation impacts need careful consideration

# Reval contacts

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