

Client Alert

Financial Markets Developments

Supervision of Bank Fair Value Practices: A Basel Committee on Banking Supervision Consultative Document

Director Concerns

On November 28, 2008, the Basel Committee on Banking Supervision issued a consultative document entitled "Supervisory guidance for assessing banks' financial instruments fair value practices."¹ The Committee is seeking comments on the document by February 6, 2009.

This supervisory guidance should be of interest to banking organizations, directors and those that advise them, as bank supervisors continue to impose responsibilities on directors. The Basel II regime has three parts, or "pillars." Pillar 1 is the capital adequacy guidelines. Pillar 2 is the bank supervisory and examinations process. Pillar 3 is banking organization disclosure. This consultative document is part of Pillar 2 and provides guidance to bank supervisors in their assessment (and examination) of banks' fair value accounting practices. The document focuses on asset valuations and is silent as regards valuation of liabilities.² In its April 12, 2008 report, the Financial Stability Forum (which is comprised of senior representatives of national financial authorities (e.g., central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts, and the European Central Bank) noted that the Basel Committee would undertake this work.³

The consultative document is a draft of the guidance that the Basel Committee may provide national supervisors to assist in their assessment of bank fair value accounting practices and

¹ <http://www.bis.org/publ/bcbs145.pdf?noframes=1>.

² International Accounting Standards do not now require reporting of liabilities at fair value.

³ Recommendation III. 3. of the April 12, 2008 Report of the Financial Stability Forum stated with respect to valuation:

Potential weaknesses in valuation practices and disclosures, and the difficulties associated with fair valuation in circumstances in which markets become unavailable, have become apparent from the turmoil. International standard setters should enhance accounting, disclosure and audit guidance for valuations. Firms' valuation processes and related supervisory guidance should be enhanced. To address these issues:

- The IASB will strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations.
- The IASB will enhance its guidance on valuing financial instruments when markets are no longer active. To this end, it will set up an expert advisory panel in 2008.
- Financial institutions should establish rigorous valuation processes and make robust valuation disclosures, including disclosure of valuation methodologies and the uncertainty associated with valuations.
- The Basel Committee will issue for consultation guidance to enhance the supervisory assessment of banks' valuation processes and reinforce sound practices in 2008.
- The International Auditing and Assurance Standards Board (IAASB), major national audit standard setters and relevant regulators should consider the lessons learned during the market turmoil and, where necessary, enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures (emphasis added).



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the impact those practices could have on capital adequacy. As with all Basel Committee documents, the final guidance is not a law or regulation but is the result of discussions among the central banks and bank supervisors from the Group of ten countries, plus Luxembourg and Spain, that compose the Committee and its invited guests. Much of the Committee's guidance is implemented by national supervisors. Generally speaking, supervisors can adopt more stringent guidelines or rules but are discouraged from implementing more liberal guidelines or rules.

Importance to Directors

We want to stress the importance to bank directors and those who provide them with legal guidance of their need to review this consultative document and any final guidance that may be issued with a view to assessing the obligations imposed on directors. An ever-increasing amount of bank supervisory "guidance" seeks to impose obligations on directors. Those new obligations can subsequently be converted into a remedial action against a director by a bank supervisor or a shareholder action seeking to impose liability on a director. Indeed, a guidance document can be a road map for those seeking to impose liability on directors.

Directors' Duties and Responsibilities

Among the directors' designated responsibilities are:

Supervisors expect a bank's board and senior management to ensure adequate governance structures and control processes with respect to the fair valuation of financial instruments for risk management and financial reporting purposes.

More specifically, the board's oversight responsibilities for the bank's use of fair value accounting should include:

- Reviewing and approving written policies related to fair valuations

- Ongoing review of valuation model performance issues escalated to senior management for resolution and all significant changes to valuation policies
- Ensuring adequate resources are devoted to the valuation process
- Articulating the bank's tolerance for exposures subject to valuation uncertainty and monitoring compliance with the board's overall policy settings at an aggregate firm wide level
- Ensuring independence in the valuation process between risk taking and control units
- Ensuring appropriate internal and external audit coverage of fair valuations and related processes and controls
- Ensuring accounting and disclosures are consistent with the applicable accounting framework
- Ensuring significant differences, if any, between accounting and risk management measurements are well documented and monitored.

Among other things the controls and procedures should:

- Include well documented policies for all significant valuation methodologies, which would be reviewed by management and approved by the board as frequently as necessary and at least annually.
- The use of a third-party pricing service for fair valuations for financial instruments does not relieve the board of its oversight responsibility or senior management of its responsibility to ensure appropriate fair valuations and provide appropriate supervision, monitoring and management of risks.
- Any significant differences in categorization for the measurement and management of risk and that necessary for the applicable accounting framework should be well documented and approved by senior management and appropriate board level committees.

- Supervisors acknowledge that a bank's strategy and therefore the management of financial instruments may change based on changes in economic conditions. In these circumstances, any subsequent reclassification of financial instruments should be made under the control of the bank's senior management and appropriate board level committees and strictly in accordance with accounting requirements.
- Furthermore, procedures for the resolution and escalation of valuation issues and exceptions to the board of directors or a committee thereof (such as the audit or risk committee) should be defined and documented.
- In addition, there should be a clear process to resolve significant disagreements about valuation adjustments and to escalate material valuation issues to the bank's board of directors or appropriate board committee. Reporting to senior management and to the board should be on a regular basis in an appropriately aggregated and understandable form.
- Fair values used for financial reporting purposes must be internally reconciled to valuations used for risk management and regulatory purposes. Any significant differences should be understood by senior management and reported to the board.
- Supervisors expect that a bank will have valuation and risk management processes that explicitly assess valuation uncertainty and include this as part of information communicated to the board and senior management.
- Assessments of valuation uncertainty are expected to be fully integrated in the internal decision-making process of the institution. Quantitative and qualitative assessments of uncertainty should accompany all internal reports of valuation information through the firm as well as the reports containing risk information across the institution. It is important that this information reaches all relevant bodies in the institution where investment and risk management decisions are made, including senior management and the board. It is also important that the information is communicated with the same frequency and timeliness that information about value of positions and associated risks are communicated to the same bodies.

- To assess the engagement of senior management in valuation issues, supervisors may request valuation reports provided to the board or information from assessments by external auditors or by a bank's internal auditors or independent risk management groups.

Should the bank supervisor not be satisfied with the bank's fair value practices, among the supervisory alternatives listed are:

Supervisory responses could include the following approaches and measures:

- Communicating supervisors' concerns routinely to the bank's senior management and supervisors' significant concerns to the bank's board and evaluating management's and the board's responses as to how they are addressing these concerns.
- Taking informal or formal supervisory actions (which can be of a nonpublic or public nature) requiring management and the board to remedy the deficiencies in a specified time frame and to provide the supervisor with periodic written progress reports.

Some Suggestions

The Basel Committee will likely make some changes in response to comments received from the public. Unlike a governmental agency, the Committee does not publish public comments or make them available. The Committee does, however, explain the reasons for changes from its draft.

Counsel to the board and/or audit committee of a banking organization might consider developing a check list from the Committee's final guidance to help ensure that directors are fulfilling the expectations of bank supervisors.

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