

AASB 13 PRACTICAL IMPLEMENTATION ISSUES FOR DERIVATIVE VALUATIONS

AASB 13 FAIR VALUE MEASUREMENT REQUIRES ENTITIES TO TAKE INTO ACCOUNT THE EFFECTS OF CREDIT RISK WHEN MEASURING THE FAIR VALUE OF A LIABILITY (AASB 13.42 AND 43).

This new requirement, effective for annual periods beginning on or after 1 January 2013, has practical implications when determining the fair value of derivative liabilities.

Entities cannot simply rely upon derivative valuations provided by the bank as AASB 13 compliant fair values without further consideration. This is because bank valuations of derivative liabilities are usually based on a risk free rate, without adjustments for your own credit risk.

Determining credit adjustments for derivatives is particularly challenging and often more complex than for basic loans. This is because the exposure amount can change over time, depending on market movements of the underlying interest rates for interest rate swaps, commodity prices for commodity derivatives or exchange rates for foreign exchange derivatives.

There are two common methods used in practice:

- Constant exposure methodology
- Potential future exposure methodology.

Constant exposure methodology, the simpler methodology, assumes that the amount of exposure at default is the derivative's present marked-to-market value. It relies upon the forward rates at that point in time (e.g. reporting date) and assumes that those forward rates do not change over time.

Potential future exposure methodology, the more complex methodology, involves future projections, often using Monte Carlo simulations, to calculate the future expected exposure amounts.

Other inputs for calculating credit valuation adjustments include recovery rates (i.e. the amount that can be recovered if there is a default) and the probability of default. These other inputs are entity-specific, often not observable from the market, and therefore highly subjective with significant judgement involved.

What types of derivatives are more likely to be impacted by 'own credit' adjustments?

Generally, we expect that derivatives with the following characteristics are likely to have greater 'own credit' adjustments in practice:

- Longer maturity dates
- Large notional amounts
- Large marked-to-market valuations.

Cross currency interest rate swaps, long dated interest rate swaps and commodity derivatives typically have the above characteristics. If your derivatives have some or all the above characteristics, we recommend that credit valuation adjustments be determined.

For shorter term derivatives such as foreign currency derivatives with maturities of less than 12 months, we expect that credit valuation adjustments are less likely to be material.