

Banking & Securities Spotlight

Complying With the OCC's Supplemental Examination Procedures for Evaluating Derivative Risk Management Practices

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The Bottom Line

Complying with the new examination procedures may present policy and operational challenges associated with valuation processes, valuation models, independent price verification, and internal controls.

- On March 24, 2014, the Office of the Comptroller of the Currency (OCC) issued a [bulletin](#)¹ containing an [attachment](#) that outlines supplemental examination procedures for bank examiners to use in evaluating the derivative risk management practices of entities supervised by the OCC.
- The procedures note that the OCC expects entities under its supervision to do the following (which are permitted, although not required, under U.S. GAAP):
 - Measure end-user derivative positions on the basis of exit prices, which are bid prices for long positions and ask (i.e., offered) prices for short positions.
 - Elect, if qualified to do so, the measurement exception in ASC 820-10-35-18D² for derivative portfolios that are managed on a net risk exposure basis.
- Complying with the new examination procedures may present policy and operational challenges associated with valuation processes, valuation models, independent price verification, and internal controls.

¹ OCC 2014-8, "End-User Derivatives and Trading Activities: Comptroller's Handbook Supplemental Examination Procedures."

² For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Beyond the Bottom Line

The examination procedures outlined in the bulletin supplement those in the OCC's *Comptroller's Handbook: Risk Management of Financial Derivatives*. Regarding an OCC-supervised entity's derivative valuation policies and processes, the supplemental procedures state:

Generally, the OCC expects dealing positions to be marked to the middle of the bid/offer spread (before adjustments) and end-user positions to be marked to the less advantageous side of the bid/offer spread (that is, "bid" prices for long positions and "offered" prices for short positions). The OCC also generally expects entities to elect the portfolio exception of ASC 820-10-35-18D for all eligible portfolios and make appropriate fair value adjustments, such as concentration and liquidity adjustments, per [Section 3(b)(2) of the market risk capital rule] and ASC 820-10-35-36B.

Although the OCC expects an entity to use midmarket pricing to measure the fair value of "dealing" derivative positions, an entity would not be precluded from measuring a dealing derivative position on the basis of exit price.

Additional highlights of the supplemental procedures as well as implications for OCC-supervised entities are discussed below.

Scope of the OCC's Supplemental Examination Procedures

As the bulletin explains, bank examiners use the OCC's supplemental examination procedures to evaluate the derivative risk management practices of OCC-supervised entities, which include national banks, federal savings associations, and federal branches and agencies of foreign banks that "are active end-users of derivatives or that have significant trading activity." A community bank is not subject to the OCC's supplemental examination procedures unless it "is a significant end-user of derivatives." Since the procedures do not define "significant end-user" or "significant trading activity," banking entities may need to exercise judgment in assessing whether their derivative activity subjects them to OCC supervision.

Bid-Ask Pricing

ASC 820 allows reporting entities to elect midmarket pricing or other pricing conventions as a practical expedient for measuring fair value in the bid-ask spread. ASC 820-10-35-36C and 35-36D state the following:

If an asset or a liability measured at fair value has a bid price and an ask price . . . the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value The use of bid prices for asset positions and ask prices for liability positions is permitted but is not required.

[ASC 820] does not preclude the use of mid-market pricing or other pricing conventions that are used by market participants as a practical expedient for fair value measurements within a bid-ask spread.

In accordance with ASC 820, some banking entities may have made policy choices to use bid prices for measuring long positions, and to use ask prices for measuring short positions. Other entities may have used midmarket pricing to measure their end-user positions. With the release of the bulletin, OCC-supervised entities may need to reevaluate their bid-ask fair value measurement policies and align them with the OCC's expectations.

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The OCC expects entities under its supervision to elect the measurement exception in ASC 820-10-35-18D for derivative portfolios that are managed on a net risk exposure basis.

Portfolio Exception

Under ASC 820-10-35-18D and 35-18E, a reporting entity that meets certain criteria³ can elect to measure a group of financial assets and liabilities on the basis of the price it would receive for selling its net long position, or the price it would pay to transfer its net short position, for a particular risk exposure in an orderly transaction between market participants. An entity that makes this election must allocate any portfolio-level valuation adjustments to the appropriate unit of account.

Notably, while entities that qualify for the measurement exception in ASC 820-10-35-18D are not required under U.S. GAAP to elect it, the OCC expects entities under its supervision to elect the measurement exception for derivative portfolios that are managed on a net risk exposure basis. Adjustments related to credit risk and bid-ask pricing are commonly made on a portfolio (i.e., net risk exposure) basis.

Considerations for OCC-Supervised Entities

OCC-supervised entities need to evaluate whether their existing valuation processes and policies require modification and what impact the updated procedures have on valuation models and controls. Complying with the new examination procedures may present policy and operational challenges for certain OCC-supervised entities, including challenges related to:

- *Valuation processes* — Some banking entities may need to change their existing fair value measurement policies in light of potential challenges resulting from compliance with the bulletin. For example:
 - Entities with both end-user and dealing portfolios (e.g., entities that use midmarket pricing for both end-user and dealing positions) may have difficulty determining how to distinguish between derivative positions held in those portfolios.
 - Entities with end-user portfolios may have difficulty determining bid-ask and credit valuation adjustments for end-user portfolios.
 - Entities with derivative positions managed on a portfolio basis and that generally determine valuation adjustments on that basis may have difficulty determining how to allocate portfolio adjustments.
- *Internal controls* — Banking entities may need to adjust their controls in connection with derivative valuation processes, valuation models, and independent price verification as well as their reviews of such controls.

³ Under ASC 820-10-35-18E, a reporting entity is eligible to make the accounting policy election outlined in ASC 820-10-35-18D if it does all of the following:

- “Manages the group of financial assets and financial liabilities on the basis of the reporting entity’s net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the reporting entity’s documented risk management or investment strategy.”
- “Provides information on that basis about the group of financial assets and financial liabilities to the reporting entity’s management.”
- Measures “those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.”

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