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EUROPÄISCHE VEREINIGUNG DER

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EUROPEAN ASSOCIATION OF PUBLIC BANKS -EUROPEAN ASSOCIATION OF PUBLIC BANKS AND FUNDING AGENCIES

> WW/MT N° 0455

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Letter of Comment No: 92
File Reference: 120/-100
Date Received: 7-70-05

Brussels, 20 July 2005

Comments from the European Banking Industry on the FASB Exposure Draft "Fair Value Measurements"

Dear Mr Chairman,

The four organisations signing this letter together represent the whole European banking industry.

We have been made aware of the existence of the FASB ED on "Fair Value Measurements" at the second meeting of the IASB Financial Instruments Working Group that was held in London on 21 and 22 March 2005. We understand that our comments (attached to this letter) on this document would be still useful notwithstanding that the official deadline for responding to it has expired.

The European banking industry welcomes FASB's initiative to provide guidance on the issue. However, we believe it to be of a paramount importance for such guidance to adopt a principles-based approach. Guidance that would be excessively prescriptive might fail to deliver accounting entries which match the numbers that are based on sound risk management practices which are used internally within entities to measure an instrument's performance.







As to the substance, our main critical comment is that any guidance which accounting standard setters would issue should recognise that there may be particular circumstances in which it may be justified to adjust the transaction price. We would, therefore, prefer the FASB to adhere to the solution provided for in IAS 39 which has precisely the merit of highlighting that the transaction price may be adjusted if the fair value of the instrument is evidenced by other observable market transactions or based on a valuation technique whose variables include only data from observable markets.

We trust our comments to be useful.

Yours faithfully,

Guido RAVOET Secretary General Chris DE NOOSE Chairman of the Management Committee

Hervé GUIDER Secretary General

Henning SCHOPPMANN Secretary General

Enclosure: 1

Copy to: Sir David TWEEDIE, Chairman IASB



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EUROPEAN ASSOCIATION OF PUBLIC BANKS -EUROPEAN ASSOCIATION OF PUBLIC BANKS AND FUNDING AGENCIES

W5114EEW 19.7.2005

### FASB EXPOSURE DRAFT "FAIR VALUE MEASUREMENTS"

### INTRODUCTORY REMARKS

 Given the ever-expanding use of fair value concepts in financial reporting standards, we welcome FASB's initiative to examine if there would be a need to prepare guidelines on how to measure fair value.

Within the framework of IAS 39, instruments which are available for sale, held for trading purposes, or – with the adoption of the new Fair Value Option (FVO) – whose performance is valued on a fair value basis must all be measured at fair value. This brings the accounting representation of items closer to the procedures used by management in evaluating the performance of a financial instrument or set of instruments for certain risk exposures. For those exposures a fair value may provide for a better, more truthful representation of the company's performance.

- We have noted with satisfaction that the IASB has agreed to work with the FASB on fair value measurement and related projects with the aim of achieving convergence. It is indeed essential for both standard setters to adopt a common view in this area and agree on a similar approach on the various issues set out in the FASB Exposure Draft.
- 3. The Exposure Draft should establish a principles-based framework on fair value measurement instead of adopting a rules-based approach. As we will demonstrate below, guidance that would be excessively prescriptive might fail to deliver accounting entries which match the numbers that are based on sound risk management practices which are used internally within entities to measure an instrument's performance. These sound risk management practices are normally subject to high-quality internal control procedures.

Sound principles should, moreover, be combined with:

- sound corporate governance requirements;
- a requirement to apply fair valuations in a consistent way within an entity from period to period;
- appropriate disclosures.

Such a mixture of measurement, internal control procedures and market discipline will result in the most relevant and meaningful information to users.







- 4. Making fair value measurements understandable and increasing their relevance implies re-examining the measurement methodologies and the manner in which these measurements are presented in the financial statements and/or the accompanying disclosures. There is, therefore, a clear link between the Fair Value Measurements issue and the Financial Performance Reporting Project which the IASB and the FASB have put on high on the agenda of the Convergence Program. When developing the forthcoming standard on Fair Value Measurement, care should therefore be taken to avoid any inconsistency with progress made in the area of Performance Reporting.
- 5. The Fair Value Measurement Exposure Draft does not deal with fair value measurement issues in an exhaustive way. This should, however, not prevent the Board to take a decision on some of the main uncertainties which currently exist in the area of fair value measurement.
- 6. Finally, the completion of a standard on how to measure fair value should not encourage the Board to rush forward its broader Full Fair Value Measurement Project regarding financial and non-financial instruments without proper consideration of the relevance of fair value measurements. It is known that many market participants, particularly in Europe, are sceptical about the relevance of fair value information for non-trading book items for those components of risk that are not managed internally on a fair value basis. Moreover, concerning these items the reliability of fair value information should not always be taken for granted, particularly in the absence of efficient and liquid secondary markets.

### **DEFINITION OF FAIR VALUE**

7. It is proposed to define fair value as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties". We understand this definition to be conformity with the definition used in IAS 39 ("the amount for which an asset could be exchanged, or a liability settled, between knowledgeable parties at arm's length transaction").

We support the basic concept underlying the proposed approach: the objective should be to rely on the transaction price in normal circumstances. However, the Exposure Draft should recognise that there may be particular circumstances in which it may be justified to adjust the transaction price. The forthcoming standard should, therefore, be brought in line with IAS 39 which has the merit of highlighting that the transaction price may be adjusted if the fair value of the instrument is evidenced by other observable market transactions or based on a valuation technique whose variables include only data from observable markets.

### HIERARCHICAL STRUCTURE OF VALUATION TECHNIQUES

- The Exposure Draft establishes a hierarchy of fair value measurements based on the 8. reliability of the inputs used in their determination. It distinguishes three levels.
  - Level 1 relies on quotes for identical assets or liabilities in an active market. Thus if an instrument is traded in an active market, the fair value is the price at which it is quoted in that market.





- Level 2 must be used when identical assets and liabilities are not quoted in an active market. It relies on quotes in an active market for similar assets or liabilities, adjusted as appropriate for differences where such information is available.
- Level 3 calls for multiple valuation techniques consistent with the market approach, the income approach and the cost approach. This level applies where the financial instruments are not quoted in an active market and the appropriate adjustment based on quotes of similar instruments cannot be objectively determined. The valuation techniques used must maximize market inputs and minimize inputs internal to the entity making the valuation.
- 9. We question whether it would be appropriate to impose a hierarchical structure over the valuation techniques as proposed in the Exposure Draft. Such an approach is overly prescriptive and imposes an artificial methodology. Its application would, moreover, require undue cost and effort.

Accounting standards should not interfere with the processes and methods which entities use to determine fair values but limit themselves to outlining a few basic principles that need to be observed, i.e.:

- (i) market prices should be used whenever they are truly representing a fair value;
- (ii) if not, models should be used that faithfully represent an item's fair value;
- (iii) such models need to be back-tested by the reporting entity against actual market transactions on a regular basis.

Entities should, therefore, be allowed to select a methodology in any level of the Fair Value Hierarchy, provided that the method produces a reasonably reliable estimate, that it is used in a consistent way and, finally, that it relies on an entity's governance structure and controls over the fair value process (validation and verification functions, risk oversight and governance controls) (see the Group of Thirty 2003 Report entitled 'Enhancing Public Confidence in Financial reporting").

- 10. The proposed classification is, moreover, not helpful in producing a reasonable estimate of fair value.
  - Concerning more particularly <u>Level 1</u>, the Exposure Draft should recognise that there may be circumstances in which it would be appropriate to adjust the transaction price (see above, under No. 7).
  - Concerning <u>Level 2</u>, the Exposure Draft provides that when active market quotes are not available fair value is to be determined with reference to the price quotes for similar assets or liabilities traded in active markets. These prices then have to be adjusted for the differences between the instrument being valued and the ones quotes as reference. For fair value to qualify as Level 2, in any event, the price effect of these adjustments must be objectively calculable; otherwise, the fair value is of Level 3.

These conditions are overly restrictive and therefore inappropriately limit the possibility of using a Level 2 fair value methodology to financial instruments. The reason for this is whenever an instrument is not quoted on an active market, estimating its fair value will generally require both inputs directly







observable in markets and inputs estimated internally by the entity based on the features of the instrument.

Consider for example an unlisted credit asset with a counterparty whose bonds are quoted in active markets. In such a situation, the fair value - though determined using the quoted price of the bonds - requires an estimation of elements (such as the collateral provided, the degree of subordination) proper to the instrument itself and which are impossible to observe in the market. Similar considerations apply to OTC options whose underlying assets are equity, baskets or indices. The fair value of these instruments is always based on entity-specific inputs, because the volatility parameter is not available beyond maturities of 12-18 months.

Over-the-counter interest rate swaps are another example. Their fair value is generally determined by valuation techniques that refer to directly observable, objective market data (interbank or government rates). The dependability of this fair value is thus essentially comparable to that of an instrument quoted in an active market. However, as its fair value is determined by a valuation technique, the Exposure Draft would refer it to Level 3 along with instruments whose fair value is more subjectively determinable.

 As for <u>Level 3</u>, the Exposure Draft requires the entity to use "multiple evaluation techniques consistent with the market, income and cost approaches". However, such a solution is not consistent with current practices.

Furthermore, it is not clear why the Exposure Draft focuses so much on the Present Value technique, which - while important - is merely one of a whole range of techniques used to value financial instruments.

Finally, classifying all fair values which are determined on the basis of multiple valuation techniques under Level 3 implies that this level will embrace instruments whose fair values differ in degree of reliability and comparability. As a result, we do not believe the proposed fair value hierarchy to represent an improvement to the guidance which IAS 39 provides.

11. If the IASB and FASB should nevertheless jointly decide to introduce a fair value hierarchy, it should focus primarily on the degree of reliability and comparability of the inputs. It should, moreover, not be excessively prescriptive in setting rules on the various valuation techniques and, instead, allow the use of the most commonly used techniques. What matters the most is (i) that prices are used which are determinable on an objective basis and (ii) that the chosen methodologies are used consistently.

An effect of such choice of methodology is that such parameters that are subjective should not be altered from first time recognition when fair valuing illiquid assets and liabilities. Models for valuing illiquid financial assets and liabilities should therefore only use market parameters leaving other parameters unchanged.







### **USE OF BID-ASKED PRICES**

The ED proposes that the fair value of instruments quoted in active markets be their market price (para. 15). Specifically, if the instrument is quoted in a dealer market, fair value is the bid price for long positions and the ask price for short positions. For offsetting positions, the mid-market price must be used for the off-set provision and the bid/ask price for the net positions after the offset. However, the FASB has decided in the meantime to make the use of bid-ask prices optional. We welcome this decision which overcomes complex operational problems which would otherwise have been costly to solve.

We recommend the IASB to bring the guidance which it has provided for in IAS 39 in line with the decision taken by the FASB by making the use of the bid-ask price optional instead of compulsory.

# **BLOCKAGE FACTORS AND CONTROL PREMIUMS**

13. The Exposure Draft authorises "broker-dealers" as well as "certain investment companies" to adjust prices with a view to catering for the possibility that the fair value of "blocks" of securities may differ from the simple product of volume and current quote. Under IAS 39, in contrast, the fair value is always assumed to be equal to the product of number of shares and per-share price.

We recommend the IASB to adopt a similar approach. However, it would be appropriate to extend the approach taken by the FASB to all entities whenever there is evidence that the price of a hypothetical "block" trade would different from the product of price and volume.

The need to take a blockage factor into account perfectly illustrates that the need to adjust the transaction price in particular circumstances.

## IMPACT OF AN ENTITY'S CREDIT STANDING

14. Many companies do not consider their own credit standing in the estimate of fair value for their liabilities.

The Exposure Draft proposes to measure liabilities through incorporating the entity's credit standing to the discount rate. Such an approach results in an unrealised gain being recognised if the credit standing of the entity deteriorates. Such measurement approach does not accurately present the entity's financial position. If the credit standing of the entity has decreased, it is highly unlikely that it will be able to realise that gain. Thus, if the entity terminates the existing liabilities and "realises" this gain, this gain will be offset in future periods by higher interest expenses incurred upon refinancing at higher rates. Alternatively, if the entity has no plan to refinance these liabilities, then this income will never be realised, and thus should not be recognised at the outset.

The same applies when an entity's credit standing has been improved. If the purpose of the liabilities is to finance assets being held in the banking book, repurchased debt will need to be refinanced. The loss that the repurchase causes will then be offset by future positive interest margins due to lower finance cost.