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Dear Mr Nelson

Discussion Paper - Fair Value Measurements

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the Discussion Paper Fair Value Measurements (DP) issued by the IASB.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

Measurement is a key aspect of accounting and CEBS welcomes the efforts of the IASB in this area which are reflected in two important projects that are currently being considered by the Board, namely the Conceptual Framework project and the present Fair Value Measurements project. CEBS moreover acknowledges that both projects manifest the Board's strong commitment to achieve convergence with US GAAP.

Before answering in appendix 2 the specific questions that are raised in the Discussion Paper, we would like to underline in appendix 1 some key remarks that are of particular importance from our perspective.

The comments hereafter have been prepared by one of CEBS' expert groups, the Expert Group on Financial Information (EGFI), chaired by Mr. Arnoud Vossen, in charge of monitoring any developments in that area and of preparing positions to be taken by CEBS. The development of our comments on this Discussion Paper was coordinated by a Subgroup of EGFI under the direction of Mr. Patrick Amis.

If you have any questions regarding our comments, please feel free to contact Mr. Arnoud Vossen (+31.20.524.3903) or Mr. Patrick Amis (+ 33.1.4292.6032).

Yours sincerely

Danièle Nouy
Chair, Committee of European Banking Supervisors

Appendix 1

General Comments

1. The Discussion Paper should be embedded in the wider context of ongoing conceptual discussions, notably on the Conceptual Framework and the replacement of IAS 39.

While in the context of the revision of the Conceptual Framework the Board is engaging in a discussion on the fundamental aspects of accounting and financial statements, we have concerns that the DP is dealing with such issues without consideration of the related discussions. Notably, the discussion paper could be perceived as pre-empting the work on milestones I and II that the IASB (jointly with the FASB) has determined as key steps for the conceptual framework discussions on measurement issues. We therefore would encourage the Board to consider the input it receives in this consultation in the wider context of the measurement discussions that are taking place with regard to the conceptual framework.

Moreover, we have difficulty in separating the issues raised in the discussion paper from the discussion on the objectives and qualitative characteristics of financial reporting (i.e. Phase A of the Conceptual Framework project) given that the choice of an appropriate definition of fair value is closely linked to the objectives and qualitative characteristics of financial reporting. In a similar way, we are concerned about the implications of the Fair Value Measurements discussion paper on the work that the IASB and the FASB currently carry out with regard to financial instruments, which aims to replace IAS 39. Indeed some of the views expressed in the DP seem to pre-empt this discussions.

2. The Board should consider the DP's consistency with other IFRS standards.

CEBS acknowledges and supports the Board's effort to develop a single definition for fair value applicable to all IAS/IFRS, as this approach would simplify the present situation where entities face slightly differing definitions in different standards.

We are concerned that the exit price definition that is currently under discussion is not necessarily developed for use in all situations where IFRSs currently foresee the use of a fair value measurement basis. The exit price definition, as developed in the FASB context, is applicable to a much narrower use (i.e FAS 133 –derivatives- and FAS 115 –securities) as would be the case under IFRS. As such, we are concerned that this might create consistency issues that are not sufficiently addressed in the discussion paper, for instance in the case of instruments that are recognized at fair value initially and are subsequently re-measured at amortised cost. We therefore encourage the Board to explore this issue further.

Finally, CEBS has a number of questions about the consistency between the exit price definition and the way the risks of some assets and liabilities are actually managed within credit institutions, notably when those assets and liabilities are not managed on a fair value basis. We would encourage the Board to further explore this issue with preparers and regulators.

3. The use of an exit price measurement basis should be articulated with the fundamental qualitative characteristics of IFRS

We noted that the assumptions that are underlying the proposed fair value definition presume that there are liquid markets for nearly all assets and liabilities, which is not always the case in practice.

In the case of non active markets, we believe that certain features of the exit price definition are not clear enough and might therefore require reporting entities to make additional assumptions. This would imply a wide variety of approaches in the practical implementation of the standard.

As a result, the application of an exit price definition might raise reliability and auditability issues in certain cases, in particular when dealing with level 3 measurements. We believe that these issues, such as the recognition of day-one profits or losses, require further examination.

Regarding the fair value hierarchy, we are not sure that the boundary between level 2 and level 3 measurements is clear enough. We would welcome a clarification in that respect, notably on the treatment of model assumptions. In our view, it should be clarified that measurement which depends on a model which is not generally accepted, for example because it is entity specific, is unlikely to qualify as Level 2, even if all inputs are deemed observable.

Appendix 2

Comments on the specific questions

Issue 1 SFAS 157 and fair value measurement

Q1 In your view, would a single source of guidance for all fair value measurements in IFRSs both reduce complexity and improve consistency in measuring fair value? Why or why not?

CEBS acknowledges that there are currently several definitions of fair value in different standards and that a single source of guidance on fair value measurement is desirable.

However, notably because fair value measurement is applicable in IFRS to a wider range of instruments than in US GAAP, we recommend that the Board, before issuing an Exposure Draft, should further explore potential consistency and applicability issues with other IFRS standards as well as consider the need for further guidance regarding specific calculations of fair value.

Q2 Is there fair value measurement guidance in IFRSs that you believe is preferable to the provisions of SFAS 157? If so, please explain.

As banking supervisors, we favour fair value measurements that are both relevant and reliable. These concepts should be included in the Guidance on Fair Value Measurements and articulated with respect to specific circumstances (such as varying market liquidity and the use of different valuation techniques) or instruments. Also, since IFRSs allow the use of fair value measurements in many areas, it may be necessary for the IASB to continue providing specific guidance where SFAS 157 is limited.

Issue 2A. Exit price measurement objective

Q3 Do you agree that fair value should be defined as an exit price from the perspective of a market participant that holds the asset or owes the liability? Why or why not?

As mentioned in our general comments, we believe that this discussion is linked to and should therefore be considered in conjunction with Phase C of the Conceptual Framework project regarding the definition of appropriate measurement bases.

The definition provided in SFAS 157 might not be fully appropriate in all circumstances where fair value may be used, for instance for financial instruments recognised initially at fair value and measured subsequently at amortized cost.

We also believe that in a non active market, more examination and guidance would be needed (please refer in this context also to our answers to questions 7 and 17), notably as regards the recognition of day-one profits or losses.

Q4 Do you believe an entry price also reflects current market-based expectations of flows of economic benefit into or out of the entity? Why or why not? Additionally, do you agree with the view that, excluding transaction costs, entry and exit prices will differ only when they occur in different markets? Please provide a basis for your views.

In our opinion, an entry price would also reflect the entity’s current market based expectations of flows of economic benefits.

We believe that, excluding transaction costs, entry and exit prices for the same asset or liability might differ in a single market when the market is not liquid because:

- In a non liquid market, there is a possibility that the assumptions of different entities participating in that market regarding the perspective of a market participant will not be consistent.
- At initial recognition, the fair value of an instrument in a non liquid market, based on model calculations including non observable market data, might differ from the transaction price.

On the contrary, for liquid and efficient markets, with low transaction costs, it is probable in our opinion that entry and exit prices will be similar.

It should be observed also that the "in use valuation premise" may imply entity specific assumptions, which could be another reason for having entry prices different from exit prices.

Q5 Would it be advisable to eliminate the term 'fair value' and replace it with terms, such as 'current exit price' or 'current entry price', that more closely reflect the measurement objective for each situation? Please provide a basis for your views.

We believe that this question should be discussed in the context of the conceptual debate on appropriate measurement bases.

Q6 Does the exit price measurement objective in SFAS 157 differ from fair value measurements in IFRSs as applied in practice? If so, which fair value measurements in IFRSs differ from the measurement objective in SFAS 157? In those circumstances, is the measurement objective as applied in practice an entry price? If not, what is the measurement objective applied in practice? Please provide a basis for your views.

We are not convinced that, in general, the notion of fair value that exists currently in IAS 39 includes the assumption of the perspective of a market participant.

Moreover, there are cases where fair value measurement in IFRS differs from the exit price measurement objective in SFAS 157: for instance, for instruments traded in non active markets, where in IAS 39, AG 76 refers to the transaction price (i.e. the entry price).

Also in IAS 39, the fair value of a financial liability refers to the settlement of the liability.

Issue 2B. Market participant view

Q7 Do you agree with how the market participant view is articulated in SFAS 157? Why or why not?

The exact definition of a market participant is not clear to us. In a banking industry context, based on discussions with other constituents, we noted in particular that the notion could be read alternatively as the view of a counterparty of the reporting entity (a retail market customer for instance) or of a peer of the reporting entity (a banking entity). This could make a significant difference on the level of day one profit or loss that an entity would report consequently. Therefore, before expressing an opinion on this question, we believe that the Boards should provide more guidance on the definition.

However, from a general perspective, we believe that the determination of the market participant view, although theoretically acceptable, would require, in comparison with the current situation, additional assumptions from the reporting entity in the absence of liquid market, which might raise reliability concerns.

Q8 Do you agree that the market participant view in SFAS 157 is consistent with the concepts of 'knowledgeable, willing parties' and 'arm's length transaction' as defined in IFRSs? If not, how do you believe they differ?

We agree that from a theoretical point of view there would be no inconsistencies, although it would be advisable to have exactly the same wording in both frameworks. We noted however that the ability aspect (FAS 157.10 c) is absent from the IFRS-definition.

Issue 2C. Transfer versus settlement of a liability

Q9 Do you agree that the fair value of a liability should be based on the price that would be paid to transfer the liability to a market participant? Why or why not?

We believe that any transfer notion needs to explicitly recognise the settlement obligations of the transferee, especially where liabilities are not traded on an active market or where there are contractual or legal barriers to, or prohibitions on, transferring liabilities to a third party. Otherwise, the accounting would in those cases not reflect the actual risk run by the reporting entity. We believe that this complex issue should be discussed further.

Q10 Does the transfer measurement objective for liabilities in SFAS 157 differ from fair value measurements required by IFRSs as applied in practice? If so, in practice which fair value measurements under IFRSs differ from the transfer measurement objective in SFAS 157 and how do they differ?

We think that IAS 39 currently refers to a settlement measurement objective. Therefore, at initial recognition, the fair value of a liability is usually the transaction price. With a transfer measurement objective, the fair value at initial recognition might not necessarily be the transaction price.

Issue 3. Transaction price and fair value at initial recognition

Q 11 – In your view is it appropriate to use a measurement that includes inputs that are not observable in a market as fair value at initial recognition, even if its measurement differs from the transaction price? Alternatively, in your view, in the absence of a fair value measurement based solely on observable market inputs, should the transaction price be presumed to be fair value at initial recognition, thereby potentially resulting in the deferral of day-one gains and losses? Please give reasons for your views.

We note that SFAS 157 assumes that in many cases the transaction price at initial recognition equals the exit price. We are not convinced that this necessarily is the case, in particular for non liquid markets.

The consequence of a distinction between a transaction price - which we believe is in a large majority of cases the best evidence of a fair value -, and an exit price notion at initial recognition is the recognition of day-one profits or losses. For instruments fair valued under Level 3 assumptions, the recognition of day-one profits or losses at initial recognition could give rise to reliability issues and we believe that these issues require further examination.

In particular strong risk management and valuation controls are necessary to ensure rigorous fair values, especially when there are not established valuation techniques or where one or more important inputs to the valuation process are not observable.

Q 12 – Do you believe that the provisions of SFAS 157, considered in conjunction with the unit of account guidance in IAS 39, would result in a portfolio-based valuation of identifiable risks of instruments considered in aggregate, or an in-exchange exit price for the individual instruments? Please give reasons for your views.

As noted by the IASB in its Discussion Paper, SFAS 157 does not explicitly define the unit of account for assets or liabilities measured at fair value except in Level 1. As such, even in conjunction with existing requirements in IAS 39, it is difficult to give a precise answer to this question. We noted however that there are different interpretations among the IASB constituents on this crucial issue. We would advise clarification.

Issue 4. Principal (or most advantageous) market

Q13 Do you agree that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability? Why or why not?

We agree that a fair value measurement should be based on the principal market for the asset or liability or, in absence of a principal market, the most advantageous market. Indeed, we believe that in most instances, excluding transaction costs, the principal market for an asset or liability would also be the most advantageous and this would prevent entities from monitoring continuously multiple markets in order to determine which market is the most advantageous at the measurement date. Furthermore, we agree that the market on which an asset or liability is principally traded provides a more liquid and therefore more representative input for a fair value measurement.

Issue 5. Attributes specific to the asset or liability

Q14 Do you agree that a fair value measurement should consider attributes specific to the asset or liability that market participants would consider in pricing the asset or liability? If not, why?

We agree with the consideration of attributes specific to the asset or liability in pricing the asset or liability.

Notably, some attributes are very specific to non financial assets and may, under certain circumstances, directly determine the market on which such assets could be dealt or sold. For example, the determination of the principal or most advantageous market for assets like electricity or gas closely depends on restrictions on their transport.

Q15 Do you agree that transaction costs that would be incurred in a transaction to sell an asset or transfer a liability are an attribute of the transaction and not of the asset or liability? If not, why?

We agree that transaction costs are an attribute of the transaction and not of the asset or liability. We noted that transaction costs are excluded from the current definition of fair value in IAS 39.

However, we believe that the systematic inclusion in P&L at initial recognition of transaction costs incurred at the origination of an asset or a liability, as it seems to be the case in SFAS 157, would entail a significant consistency issue with items not remeasured at fair value in IAS 39, where those transaction costs are currently included in the calculation of the effective interest rate. We would be in favour of keeping the current definition of the effective interest rate.

Issue 6. Valuation of liabilities

Q16 Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value of a liability? If not, why?

We think that own credit spread variations should not be incorporated in the fair value of liabilities. Doing so would imply the recognition of gains when a reporting entity's credit quality deteriorates, which does not result in information which is useful for users of financial statements.

In general, we think that fair value variations due to changes in own credit risk should not be recognised in financial statements exactly as it is the case for changes in the fair value of own equity instruments.

Issue 7. 'In-use valuation premise' versus 'value in use'

Q17 Is it clear that the 'in-use valuation premise' used to measure the fair value of an asset in SFAS 157 is different from 'value in use' in IAS 36? Why or why not?

Although the difference between the two notions appears to be conceptually clear, it seems that in practice there is a variety of understandings about the 'in use valuation premise', notably regarding the possibility to apply it to financial instruments. We believe that this point should be clarified.

It would also be useful for the Board to explore the merits of having the two concepts of in-use valuation and value in exchange in the definition of fair value. In all cases, the exit price approach requires determination of a "standard" transfer (exchange) price, not withstanding the final use of the asset by the market participant. Furthermore, identifying an in-use valuation would require additional assumptions about possible uses of an asset by standard market participants. This goes very far in terms of sophistication and raises the issue of information relevance for users of financial statements.

Issue 8. Fair value hierarchy

Q18 Do you agree with the hierarchy in SFAS 157? If not, why?

We are in favour of a single fair value hierarchy and acknowledge the attempt to clarify definitions and give a more detailed guidance on the principles on measuring fair values.

We are also in favour of emphasizing that the highest priority should be given to quoted prices in active markets and that lowest priority should be given to unobservable inputs.

Q19 Are the differences between the levels of the hierarchy clear? If not, what additional information would be helpful in clarifying the differences between the levels?

We are concerned that the difference between level 2 and level 3 might not be very clear in practice. Notably, it is not clear how an entity will determine whether a measurement is level 2 or level 3 when combining observable inputs and model assumptions. Consequently, we were not able to determine whether the boundary between level 2 and level 3 was similar or not to the existing boundary in IAS 39, in the case of non active markets, between observable and non observable inputs.

We believe that more guidance should be given in that respect, in order to achieve a more consistent application.

Issue 9. Large positions of a single financial instrument (blocks)

Q 20 – Do you agree with the provision of SFAS 157 that blockage adjustments should be prohibited for financial instruments when there is a price for the financial instrument in an active market (Level 1)? In addition, do you agree that this provision should apply as a principle to all levels of the hierarchy? Please provide a basis for your views.

CEBS believes that relevant valuation, including necessary adjustments, are critical to ensure that assets are reliably measured. As such, we support SFAS 157's general assumption that a measurement that would not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

On this basis we tend to believe that the prohibition of such adjustments for level 1 measurements should not be automatically extended to level 2 and level 3 measurements, but we think that this important issue merits further examination and guidance from the IASB.

Issue 10. Measuring fair value within the bid-ask spread

Q21 Do you agree that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances, as prescribed by paragraph 31 of SFAS 157? Alternatively, do you believe that the guidance contained in IFRSs, which generally requires assets to be valued at the bid price and liabilities at the ask price, is more appropriate? Please explain the basis for your view.

Q22 Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed even when another price within the bid-ask spread might be more representative of fair value? Why or why not?

Q23 Should bid-ask pricing guidance apply to all levels of the hierarchy, including when the fair value measurement includes unobservable inputs? Why or why not?

We agree that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances.

We also believe that the use of mid-market pricing or other pricing conventions as practical expedients for fair value measurements within the bid-ask spread would be acceptable, provided that the pricing is consistently determined over time. We would be in favour of using the mid-market pricing, unless the reporting entity can demonstrate that another pricing convention is indeed more appropriate and of course is used and disclosed consistently.

Issue 11. Disclosures

Q24 Do the disclosure requirements of SFAS 157 provide sufficient information? If not, what additional disclosures do you believe would be helpful to users and why? Alternatively, are there disclosures required by SFAS 157 that you believe are excessive or not beneficial when considered in conjunction with other disclosures required by IFRSs? Please provide a basis for your view.

Considering the potential lack of clarity in the practical implementation of the boundary between level 2 and level 3 measurements, we would be in favour of extending to level 2 measurements the existing disclosures on level 3 measurements.

We also believe that the IASB should clarify, standard by standard, how those disclosures would be combined with the existing ones, as this is currently difficult to assess. Finally, it would be appropriate to achieve the same level of disclosure in IFRS and in US GAAP.

Nevertheless, we would like to stress that disclosures -especially from a banking supervision point of view- cannot replace relevant and reliable measurement bases.

Issue 12. Application guidance

Q25 Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply under IFRSs? If not, please specify what additional guidance you believe is needed and why.

We noted that there seems to be a large variety of understanding regarding the application guidance and, more generally, the way key concepts in the standard will be applied in practice (see our above answers). We believe that this issue should be discussed further with the constituents of the IASB and the exposure draft should provide adequate guidance on this crucial issue.