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International Accounting Standards Board
30 Cannon Street,
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Dear Madam, dear Sir,

Exposure Draft ED/2009/5 Fair Value Measurement

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 IASB's Exposure Draft ED/2009/5 Fair Value Measurement (ED).

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.

CEBS welcomes the IASB's efforts to address the issue of fair value measurement, which has attracted much comment over recent months.

In particular, reaching a common position on fair value measurement between IFRS and US GAAP is an important move towards achieving the objective of a single set of high quality accounting standards. CEBS regards this ED as a positive step towards removing some of the differences between the two frameworks.

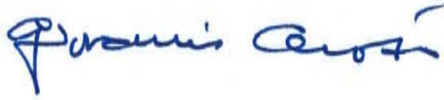
Nonetheless, CEBS believes that there are some aspects of the ED that could benefit from further clarification, including the identification of markets, applying the market participant view to illiquid assets and the application of fair value to liabilities. CEBS would welcome additional application guidance on these issues, which would benefit preparers and also encourage consistency of application.

CEBS also supports full transparency on the fair value measurement processes: this information is valuable for users and thus contributes to transparency and market confidence. Further disclosures, particularly on valuation techniques, would be helpful.

The comments put forward in this letter and in the related appendix have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Commission Bancaire) - in charge of monitoring any developments in the accounting area and of preparing related CEBS positions - and in particular by its Subgroup on Accounting under the direction of Mr. Ian Michael of the UK FSA. If you have any questions

regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) or Mr. Michael (+ 44.20.7066.7098).

Yours sincerely,



Giovanni Carosio
Chair, Committee of European Banking Supervisors

Appendix

General comments

In commenting on the ED, CEBS has focussed on fair value measurement of financial instruments, since these assets are of the greatest significance for the European banking industry.

We welcome the scoping out from this project of financial liabilities with a demand feature, as presented in paragraph 49 of IAS 39.

The application of fair value to liabilities is linked to the issue of own credit risk. Although CEBS acknowledges that the purpose of this ED is "*to define fair value, not to determine when to use fair value*", we think these issues are interlinked. In this context, we would like to reiterate the view that we have expressed in the comment letter on the DP Credit Risk in Liability Measurement (1 September) that our main concern is not with the principles for the application of fair value measurement to liabilities per se, but rather with the scope of liabilities that should be measured at fair value.

Moreover, in contrast to the proposed ED, CEBS is not convinced that the fair value of a liability, in all instances, is not affected by a restriction on an entity's ability to transfer the liability. We believe that the fair value of a liability should recognise any restriction on an entity's ability to transfer it. In addition, as stated in our response to Question 9, there seems to be an inconsistency with the reasoning of the Board with regard to paragraph 47 of the ED.

The definition of "active market" presented in Appendix A of the ED focuses on the availability of the information about prices. We would like to express our concern about liquidity issues on financial instruments, particularly when the normal volume of transactions in the market is insufficient to absorb sales (or purchases) without extremely sharp price movements. We suggest additional guidance on how to distinguish active from inactive markets.

We also urge IASB to give due consideration to the application of the concepts embedded in the fair value notion when the markets are not active, for instance with regard to the "market participant approach" for level 3 financial assets.

Overall, CEBS is of the view that adequate application guidance is of the utmost importance for an adequate implementation of the proposed draft IFRS. Particularly in view of this, we encourage the Board to consider again whether there is a need to incorporate a higher proportion of the report of the Expert Advisory Panel into the proposed IFRS.

We would also like to reiterate our long standing view that 'Day 1' gains (or losses) should not be recognised for transactions at level 3 of the fair value hierarchy. We note that the IFRS approach to this issue is dealt with in IAS 39, and strongly encourage the Board to retain the existing approach to 'Day 1' gains or losses at level 3 during the current revisions to IAS 39.

Finally, as set out in our detailed answer to Question 12, we would like to stress the importance we attach to high quality disclosures in the area of fair value measurement.

Detailed responses to questions

Question 1

The exposure draft proposes defining fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs.

Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

CEBS welcomes the IASB's efforts aimed at converging the definition of fair value with that applied by the FASB.

However, as stated in our comment letter dated 4 May 2007 on the DP Fair Value Measurement, CEBS considers that the notion of fair value as an exit price may not be appropriate for all assets and liabilities currently measured at fair value at initial recognition under IAS 39. This could be the case for example for some financial instruments recognised initially at fair value and measured subsequently at amortised cost. In particular, a question arises about how to determine the exit price of the majority of originated bank loans given the fact that they are held for the purpose of collecting cash flows. CEBS therefore encourages the two boards to liaise with constituents in order to deliberate further on this issue.

Obviously the definition has to be considered in light of the accompanying application guidance. In that context there may be a need for clarifying the definition's notion of "at measurement date", if, at that specific date, a market is not active. This is also true for "orderly transactions", where in non-active markets, the most recent orderly transaction could take place days, weeks, or even months before, or after the measurement date. the standard and more specifically the fair value hierarchy should include clear guidance on how to address such situations.

Question 2

In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts:

(a) In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 Share-based Payment and reacquired rights in IFRS 3 Business Combinations) (see paragraph BC29 of the Basis for Conclusions).

(b) The third context is the requirement in paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

CEBS believes that the requirement in paragraph 49 of IAS 39 should remain out of the scope of the Fair Value Measurement IFRS and thus welcomes this proposal. As noted by the Board in its basis for conclusions, recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit which is inappropriate. Still, for the purposes of clarity, we believe that using a term other than "fair value" in this context would be appropriate.

CEBS also believes that the proposals for replacing the term 'fair value' in IFRS 2 and IFRS 3 are appropriate.

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?

CEBS recognises that the proposed pragmatic approach - which in accordance with paragraph 10 presumes that the most advantageous market is the market in which an entity would normally enter into a transaction for the asset or liability - avoids the need for an entity to conduct extensive research of all possible markets to identify the most advantageous one.

The ED also states that, in the absence of evidence to the contrary, an entity may assume that the principal market for the asset or liability is the most advantageous market, provided that the entity can access the principal market. CEBS considers that there is a need for further guidance clarifying the relationship between the two pre-mentioned presumptions.

SFAS 157 assumes that a transaction takes place in the principal market (or, in the absence of a principal market, the most advantageous market). Thus, there will be a difference between the US GAAP treatment and the proposed new IFRS treatment. We encourage the IASB and FASB to work together to eliminate further differences in this field where possible.

Question 4

The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions).

Is the description of market participants adequately described in the context of the definition? Why or why not?

In general, we think that the market participant view is consistent with very liquid and efficient markets, in which the relevant information about an asset or a liability is widely distributed and readily available to any interested market participant.

In an inactive market there is always a possibility that the assumptions of different entities participating in that market are different or even inconsistent. Since this makes it harder for entities to evaluate a market participant view, we believe that the standard should contain adequate application guidance. Incorporating parts of the Expert Advisory Panel guidance is likely to be helpful in this regard.

We note that, in practice, it seems difficult to assume that an external party (market participant) would have the same information and knowledge about the asset or liability as the entity that holds it. We agree with the IASB that an entity willing to enter into a transaction would undertake due diligence to become knowledgeable about the asset and liability. Despite this, an information asymmetry is likely to remain, and therefore we believe that it could be sufficient for market participants to be reasonably and objectively knowledgeable to enable them to understand the transaction, without referring back to the knowledge of the entity holding the instrument.

This issue is very much amplified in case of level 3 financial assets when it seems difficult to refer, in practical terms, to a market participant view about an asset or a liability whose features may be very specific and complex, with actually no information available in the market. In this case, the only knowledgeable party, or at least the best informed, seems to be the reporting entity.

Nonetheless, we recognise that in practice it is likely to be difficult for entities to distinguish between the information that a market participant would or would not have, in comparison to the entity holding the instrument. Therefore, there are practical advantages (and reduced opportunity for arbitrage) to requiring the entity to take into account the full breadth of its knowledge of the instrument when measuring its fair value.

Again, CEBS encourage the IASB and FASB to work together to eliminate further differences in this field where possible.

Question 5

The exposure draft proposes that:

(a) the fair value of an asset should consider a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).

(b) the highest and best use of an asset establishes the valuation premise, which may be either 'in use' or 'in exchange' (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).

(c) the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

CEBS considers the proposals to be appropriate. Non-financial assets may be used for different purposes depending on the entity that holds them. The highest and best use-value refers to that market participant 'use' which would maximise the value of the asset. The value of financial assets is not dependent in same way on the in-use premise; in principle financial assets do not have alternative use purposes.

We also believe that the value of liabilities cannot be valued on the basis of the in-use valuation premise, although the entity can decide/influence on the payment methods depending on its financial situation and other factors. These are entity-specific factors and so they do not represent the markets' view.

Question 7

The exposure draft proposes that:

(a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).

(b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).

(c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

Regarding the general principles for the application of fair value measurement to liabilities, we would like to emphasize that our main concern is not with the principles themselves but rather with the range of liabilities measured at fair value to which they apply (please also see our comment letter on "Credit Risk in Liability Measurement").

Theoretically, we tend to agree with the general principle presented in paragraph 25 of the Exposure Draft (ED). In particular, we are of the view that, as explained in the paragraph BC68, the relative efficiency of an entity in settling the liability using its own internal resources appears in profit or loss over the course of its settlement, and not before.

Where there are no observable market prices, paragraph 26 of the ED states that the entity shall measure the fair value of a liability using the same methodology that the counterparty would measure the fair value of the corresponding asset. This kind of solution reinforces the need to pay particular attention to the use of fair value as it applies to liabilities.

Question 8

The exposure draft proposes that:

(a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfil the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).

(b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

a) As stated in previous comment letters to the IASB, CEBS accepts that own credit risk should be taken into consideration at initial recognition because this is a factor in determining the transaction price at inception. However we believe that changes in own credit risk in subsequent measurement of a liability can, in many circumstances, be misleading and unhelpful to users of accounts, including depositors and investors, and can lead to a perception of improved performance (and improved financial condition) precisely when, in fact, an entity's credit worthiness is deteriorating.

b) We believe that the fair value of a liability should recognise any restriction on an entity's ability to transfer the liability (ref §31 of the ED). CEBS is uncertain that the fair value of a liability, in all instances, is not affected by a restriction on an entity's ability to transfer the liability. We believe that further guidance is still required on this complex issue. Also, considering "hypothetical transfers" raises significant practical problems due to the impossibility to test the assumptions made against facts.

In addition it appears inconsistent with paragraph 47 of the ED which states that if a market participant would consider a restriction on the sale of an asset, when determining the price for the asset, an entity shall adjust the quoted price to reflect the effect of that restriction.

Question 9

The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs

36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions).

Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

In our comment letter to the Discussion Paper – Fair Value Measurement (dated 4 May 2007), we remarked that "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 no established valuation techniques or where one or more important inputs to the valuation process are not observable". We want to reiterate this statement, especially given that the ED specifies (in paragraph 37) that the recognition of possible profits or losses on Day 1 is the rule, and the contrary is an exception.

Regarding the four cases listed in paragraph 36, we believe that the articulation of point (d) needs further refinement. As financial instruments could be easily sliced and repackaged, a financial instrument traded in an inter-dealer market is frequently subject to modifications in order to be transacted in a retail market (retail markets requires contracts of smaller amounts and more standardized features). This modification could result in, for example, a change in the credit risk profile of the instruments.

Question 10

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples).

Is this proposed guidance appropriate and sufficient? Why or why not?

CEBS supports the IASB's inclusion of guidance on valuation techniques. In particular, CEBS believes it is important that entities use appropriate valuation techniques based on sufficient data, and that such valuation techniques are consistently applied.

As noted in our May 2007 comment letter on "Discussion Paper – Fair Value Measurement", CEBS supports a single fair value hierarchy which maximises the use of relevant observable inputs. We believe that the definitions and guidance given on the different levels of the hierarchy are generally clear and, when accompanied by robust disclosures, will provide decision-useful information for market participants.

CEBS also agrees that fair value measurements should be determined using the price within the bid-ask spread that is most representative in the circumstances, and supports the guidance given on mid-market pricing or other market pricing conventions.

However, CEBS believes that the IASB could provide further application guidance on valuation techniques. In particular, CEBS recalls its comment letter on "Proposed Amendments to IFRS 7" of October 2008, which encouraged the IASB to consider more fully how the Expert Advisory Panel's guidance on measuring and disclosing the fair value of financial instruments in markets that are no longer active can be incorporated into IFRS. Although the Expert Advisory Panel guidance is restricted to financial instruments, we believe that integrating the guidance would be useful for preparers in applying valuation techniques, and for users by encouraging greater consistency in market practice. Alternatively, specific application guidance could be provided for financial instruments when drawing on parts of the guidance that are more limited in scope (for example, credit protection).

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

On the whole, we agree with the proposed disclosure requirements, which would also apply to interim financial reports. We believe that disclosures on fair value measurements (methods and inputs used, including qualitative data on inputs and sensitivity analysis) are an important contributing factor to ensuring that users of financial statements can make well-informed decisions.

However in several areas, CEBS believes that the proposals are not far reaching enough and hence reiterates the views stated in the comment letter dated 15 December 2008 to the exposure draft – Improving disclosures about financial instruments, proposed amendments to IFRS 7:

- We would welcome disclosures regarding the control environment and governance over valuation processes;
- CEBS encourages the IASB to strengthen disclosure requirements on valuation techniques to encourage entities to disclose information on valuation processes as well as adjustments applied to reflect model risk and other valuation uncertainties;
- Some of the requirements of paragraph 57 (e) and (f) could usefully be extended (at least to items measured using the level 2 of the fair value hierarchy); and
- Information about levels of fair value for financial instruments should be provided not only for classes of financial instruments but also for accounting categories. (We note the ongoing work of the IASB to revise its classification model, but believe that this point will be relevant were a standard on fair value measurement to be adopted prior to mandatory adoption of any new classification model.) In this regard, the example

provided by the IASB in IE40 could be required by the IASB as a minimum of disclosures.

Moreover, CEBS welcomes the proposed amendment to IFRS 7 regarding information on day one profit (in new paragraph 28A). More generally, the issue of the recognition of the day one profit was addressed in the CEBS June 2009 Transparency report where banks are encouraged to enhance their disclosures on methodologies used to account for day one differences (including explanations on how the current market situation, i.e. unobservable parameters due to the lack of liquidity, impacts the recognition of day one differences information on the policies and the controls that are in place and on how practices change when input becomes observable). CEBS encourages the IASB to consider more fully how these issues could be incorporated to IFRS7.

We also believe that disclosure of quantitative (as well as qualitative) information on the inputs for level 3 valuations would provide decision-useful information for users, in light of concerns about the reliability of measurement for these instruments.

Lastly, we understand that, once the ED has become a standard, some of the disclosures requirements regarding the fair value of financial instruments will be placed in IFRS 7 and others in the fair value standard. We question the appropriateness of such an approach for financial instruments within the scope of IFRS 7.

Question 12

The exposure draft differs from Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157.

Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

In principle CEBS is of the opinion that convergence with the accounting standards under US GAAP is of high importance. That is because of the importance of ensuring an international level playing field for firms on the one hand and, on the other, the long lasting target of achieving a single set of high-quality accounting standards applicable worldwide. As such the IASB should be careful whenever it differs to some extent from newly published accounting rules under US GAAP and should carefully analyse whether differences really improve the appropriateness of IFRS, although this is not to say that IFRS should always move towards or adopt US GAAP.

CEBS believes that the differences of the ED in comparison to SFAS 157 identified by the Board are not of a major relevance conceptually but might be of practical relevance to a certain extent. With this in mind, CEBS notes the following:

- As regards the reference market CEBS notes that the assumptions proposed by the IASB as regards the principal market are likely to

provide practical help in this area. It would be desirable if the IFRS-US GAAP difference in this area were eliminated.

- Concerning blockage factors, we believe that relevant valuation, including necessary adjustments, are critical to ensure that assets are reliably measured. SFAS 157 explicitly defines that the unit of account for financial instruments within Level 1 valuations is the single financial instrument, which might give room for an assumption that within Level 2 or 3 valuations the unit of account could be a portfolio of financial instruments and adjustments are possible to a certain extent. In contrast the ED is silent on that point but according to the paragraph BC110 d) it means that IAS 39 specifies the unit of account as the single financial instrument for all levels of the fair value hierarchy. Thus there would be no room in IFRS for any adjustment, which might be critical.
- Regarding day 1 gains or losses, as noted in answer to question 9 above, we have some doubts as to whether it is always reliable to recognize day 1 gains and losses resulting from a difference between transaction price and fair value especially when the fair value is not evidenced by an observable market price or, when using a valuation technique, solely by observable market data. As SFAS 157 implicitly requires the recognition of day 1 gains and losses even if the fair value measurement uses unobservable inputs it seems to be preferable to defer to the relevant standard, which is currently IAS 39 for financial instruments, and to follow the relevant standard when considering the recognition of day 1 gains and losses. It will also be necessary to bear this in mind when assessing the currently discussed new standard on financial instruments, replacing IAS 39.
- Regarding the exclusion of financial instruments from the in-use valuation premise, in contrast to SFAS 157, we believe that the in-exchange premise reflects the way banks use financial instruments.
- On measurement of liabilities we believe that some guidance on the measurement of liabilities is welcome especially if there is no observable market price. It seems to be appropriate that in such situations an entity should measure the fair value of a liability using the same methodology that the counterpart would use to measure the fair value of a corresponding asset. However, as noted above, this approach reinforces the need to pay particular attention to the use of fair value as it applies to liabilities.

Lastly we encourage the IASB to assess whether the guidance included in the ED on measuring fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying circumstances that indicate a transaction is not orderly (ED/2009/5.B5 – B15) is identical, in practice, to the respective guidance issued by the FASB in FSP FAS 157-4 as the wording of the guidance is slightly different.

Question 13

Do you have any other comments on the proposals in the exposure draft?

No.