

29 August 2008

The Committee of European Securities Regulators
11-13 avenue de Friedland
75008 Paris
France

Submitted via the "Consultations" page at www.cesr.eu

Dear Sirs

Consultation Paper: Fair value measurement and related disclosures of financial instruments in illiquid markets.

I am writing on behalf of LIBA (the London Investment Banking Association) to comment on the Committee of European Securities Regulators (CESR) Consultation Paper: Fair value measurement and related disclosures of financial instruments in illiquid markets ("the CP") that was issued on 10 July 2008. LIBA is, as you know, the principal UK trade association for investment banks and securities houses; a list of our members is attached.

We welcome the opportunity to contribute to the debate on this issue, which addresses an area which is critical for our members, especially during the current market situation. Trading in, and originating, financial instruments are businesses which lie at the heart of modern investment banking, and getting the appropriate fair value measurement and disclosure for these activities is therefore an essential requirement for our members. It follows that the members of the LIBA Accounting Committee have wide experience of all aspects of accounting for financial instruments, under both US GAAP and IFRS, and we believe we are therefore particularly well qualified to comment on this CP.

We have one cautionary comment at the outset. Principle 20 of CESR's Standard No.1 on Financial Information: Enforcement of Standards on Financial Information in Europe" (dated 12 March 2003) states that "Material controversial accounting issues will be conveyed to the bodies responsible for standard setting or interpretation" and that "No general application guidance on IFRSs will be issued by the enforcers", and the explanatory notes below add that "Issuing general interpretations of the existing standards is part of the standard setting process conducted by the relevant bodies, such as IFRIC. Enforcers and regulators may contribute to this process by providing their experience to the interpretation debate rather than attempting to create a parallel body of interpretations".

We note that the CP “acknowledges that the competence of setting, formally interpreting standards and issuing general interpretation of existing standards lies with the IASB/IFRIC”, but we nonetheless believe the CESR Statement proposed in the CP (“the Statement”) comes (at the very least) close to breaching Principle 20 by issuing what could be seen as “general application guidance” and/or “general interpretations”. We are therefore concerned that the Statement will in practice be seen as CESR guidance on this topic, could lead to a distinct “European view” of fair value measurement under IFRS, and could also require European organisations to prepare disclosures over and above their non-European peers.

We therefore urge CESR to ensure that the final version of the Statement makes it clear that its contents do not amount either to “general application guidance” or to “general interpretations” of IFRS, and to work with the IASB on the issues of fair value measurement and disclosure rather than to create what could amount to de facto separate guidance. To the extent that the Statement may suggest a need for additional disclosures, it should be made clear that such disclosures are not required by IFRS and so do not form part of the financial statements.

Turning now to the content of the CP, we support the view that recent market events imply that relevant and comprehensive financial information is needed to strengthen market confidence. We understand that, as a consequence of the recent financial turmoil, there have been concerns about the potential for significant differences and inconsistencies between and within institutions as regards fair value measurement and disclosure of financial instruments. Our view, like that of the IASB’s Expert Advisory Panel, is that there is much consistency in the approach and thought processes which larger institutions use to arrive at fair value measures, although further guidance maybe helpful to smaller organisations. We acknowledge however that, even with broad consistency in approach, determining fair value for illiquid financial instruments requires careful judgment to be applied.

There is also a need for transparency and consistency in the valuation practices and methodologies to ensure better communication to users on the impacts of fair valuation, as well as any uncertainties which it implies. Whilst we broadly support the views for more clear disclosure with regards to valuation practices and methodologies, it is important to achieve the right balance between reflecting the complexity of transactions and the understandability of financial statements. We need to remember that financial statements cannot meet all the information needs of users and we therefore need to achieve a balance between the costs and benefits of any change to financial reporting, whilst still adhering to the qualitative objectives of financial statements. Given the diversity and complexity of stakeholders’ information needs, we believe consideration is required as to what is best disclosed in the financial statements and what is better provided by individual issuers outside the framework of the Statement.

Section 1 Measurement

Question 1

Do you agree with CESR’s views regarding the distinction between active and non active markets for fair value measurements?

We agree that the distinction between active and non-active within IAS 39 is important and that judgment will be required to determine when an active market becomes sufficiently less liquid to be considered non-active due to changed market conditions. However, given the relatively narrow scope of financial instruments generally considered active i.e. actively traded listed equities, listed derivatives and most US Government securities and G8 bonds, we believe these instruments are in most part not the financial instruments now considered illiquid and thus would remain as active market financial instruments. As a result, given the context of the CP, we do not consider this the primary issue.

In general the financial instruments that are most significantly impacted by recent market events are those that were considered non-active before the recent events. Therefore, the more relevant issues are those associated with when inputs are considered observable, how infrequent observable inputs should be used and how judgment should be applied in determining the most appropriate inputs.

The concepts discussed in paragraphs 28-29 are relevant in the context of when the use of current market inputs become inconsistent with the definition of FV i.e. when the market price in a transaction does not reflect “exchange ... between knowledgeable, willing parties in an arm’s length transaction” [IAS 39.9] and can therefore not necessarily be seen as reflective of the instrument’s fair value. However, this issue would apply equally to valuation of all instruments in the valuation hierarchy.

Additional observations on this section:

- We do not agree with CESR’s view in paragraph 24 that IAS 39.AG 72 refers to a valuation hierarchy within active markets. IAS 39.AG 71 is clear that within active markets, where market prices are used to value instruments, there should not be any adjustments other than in the limited circumstances in IAS 39.AG72.
- The CESR Statement follows the IAS 39 approach of active and inactive markets, yet the IASB have recently reconfirmed their preliminary view of replacing the IAS 39 two tier hierarchy with a 3 tier hierarchy based on SFAS 157. Therefore, we would encourage CESR to work with the IASB in making useful contributions on the issues that are common to both IAS 39 and IFRS 7 irrespective of which hierarchy is used instead of issuing guidance that may quickly become out of date.

Question 2

Do you agree with CESR’s view regarding inputs to valuation techniques for financial instruments in illiquid markets?

We support the CESR view that the list of inputs in valuation techniques detailed in IAS39.1G82 is not exhaustive, and we support the inclusion of other inputs such as liquidity and correlation risks in the valuation techniques for financial instruments, including those in illiquid markets. We also support the view that it is necessary to exercise judgment when valuing financial instruments in illiquid markets and that, when using inputs that are observable in the market, due consideration must be given to the particular facts and circumstances in which they are observed. Such considerations would include how relevant the input is to the financial instrument being valued and/or the similarity of the financial instrument traded in the market is to the position being valued.

We do consider that for integrity and comparability of financial statements it is essential that, despite the judgment involved, there is consistency in the approaches to choosing the appropriate valuation methodology and inputs. However, given different data sources and different markets, this would not necessarily always result in the same fair value. We consider that the work being conducted by the IASB's Expert Advisory Panel will help address these concerns and we would, as already noted, encourage CESR to work with the IASB on these matters.

Since there will continue to be a need to exercise judgment, given the difficulties (amongst others) of precisely measuring liquidity and correlation risks, the sensitivity and range of fair value estimates has provided more useful information to investors, especially for the most illiquid instruments. It is therefore essential that any valuation of illiquid instruments includes disclosures regarding valuation assumptions and potential volatilities.

We also have the following more general observations on this section:

- Paragraph 31 of the CP states that, where no active market exists, valuation techniques will require a significant amount of judgement. Whilst we broadly agree with this statement in certain circumstances, such as illiquid markets, we believe that the level of judgment required will in practice vary with the type of financial instrument. We consider the valuation hierarchy to be a continuum: valuation techniques at the top end of the inactive markets level will not necessarily be judgmental, for example when issuers apply well proven valuation techniques and reliable observable inputs. Thus not all valuation techniques are significantly judgmental, although those in illiquid markets generally are more judgmental.

Section 2 Disclosures

Question 3

Do you agree with CESR's view regarding disclosures of financial instruments in illiquid markets?
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The IASB are currently working on a project to enhance disclosure within IFRS 7 and we would again strongly encourage CESR to work alongside the IASB in this effort, rather than to introduce additional disclosures that would only apply to a subset of IFRS preparers and would therefore not enhance consistency.

When considering any additional disclosure, however, we need to consider the qualitative characteristics of relevance and understandability to ensure that financial information is relevant for decision making. To ensure universal applicability, accounting standards need to be principle-based, as rules-based standards cannot cover all areas. Guidance should be based around appropriate principles. Applying these principles requires judgement and IFRS 7 and SFAS 157 provide a good basis for disclosure, albeit not exactly the same, but the reality is that in the current extreme market conditions organisations need to provide additional disclosures.

Any such additional disclosures must reflect the illiquidity and increased market sensitivity to provide investors the confidence in those areas of greatest sensitivity and volatility. The more illiquid the markets, the greater the value of supporting disclosures. This information cannot be captured in a prescriptive approach for disclosures. Engagement via industry

groups would provide an effective way of establishing consistent approaches to this transitory disclosure. In addition, not all information is appropriate to the public domain and we recognise that certain stakeholders, such as regulators, may wish to ask for additional disclosure: we see this approach as a highly preferable to mandating further disclosures for all users of financial statements.

It is apparent that bank financial statements are already complex, and difficult to read and understand. It is crucial to avoid an indiscriminate increase in disclosures as this will not improve clarity of understanding. Hence, the compilation of appropriate disclosures is an area where there is the greatest demand for professional judgement to provide disclosures that meet investor needs rather than just comply with formulaic requirements. The comment in paragraph 45 that “Information is not considered useful if it is too generic with little indication of issuer-specific application” is especially relevant. Conversely if information is too instrument-specific, the mass of details is likely to prove overwhelming, and to mask key elements.

It is essential for management to aggregate instruments into common groupings regarding valuation assumptions and fair value sensitivities so that disclosures may be accurately focused to enable users to gain effective information regarding the risks and volatilities associated with each. However, that aggregation should not be at such a low level that the usefulness is then compromised.

The uncertainties surrounding the fair value of illiquid assets increase the focus on disclosure regarding these financial instruments as compared to financial instruments in more liquid markets. Here the concentration of disclosures on level three assets as set out in the SEC’s March 2008 letter to Public Companies¹ provides another example of targeting disclosures to illiquid instruments. In the spirit of convergence there should be value in coordinating these disclosure frameworks so that they each reflect the best characteristics.

We have the following additional observations on disclosures:

- Given the level of disclosure detail CESR is proposing, we question whether the end user will find the information useful or will just see an increase in the volume of information. This is consistent with our earlier suggestion that it may be appropriate to consider the split between information that which is best included within financial statements and that which is better provided in instrument-specific disclosures outside of the statements.
- The disclosure CESR recommends is only for “illiquid market financial instruments”, a term which needs to be clearly defined.
- Paragraphs 57-58 could be read to imply full FV disclosure as required by IFRS 7.27 by class – this is more than just application guidance, it is essentially adding additional requirements to IFRS 7. Although we have sympathy for what CESR is proposing, we would encourage CESR to work with the IASB on their work on enhancing disclosure in IFRS 7, and would prefer the outcome of these enhancements to remain more principles-based.

¹ <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>

- Paragraph 59 seems to imply that credit needs to be disclosed on all financial assets and liabilities held at FV, not just those designated; again this goes much further than existing IFRS 7 in expanding requirements, and we would encourage CESR to work alongside the IASB on this point.
- The disclosures in Box 2 only show that quoted prices are used in active markets, however AG 73 states that active market instruments includes those valued using a valuation technique including quoted rates in active markets. As a result the format looks more like the SFAS 157 hierarchy than IAS 39.

Question 4

Do you agree that benefits of the presentation of disclosures regarding financial instruments in illiquid markets in the example in Box 2 outweigh the costs of preparing this information?

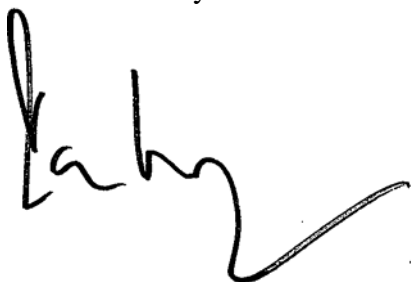
As already noted, financial institutions are highly diverse and complex and it is important for disclosures to reflect this. Different entities have different approaches to business and risk management and should therefore be able to reflect this in their disclosures. Prescribing disclosure structures and formats might not add to transparency, and we therefore believe the disclosure format suggested in Box 2 may not provide users with relevant information relating to underlying risks in each category.

The existing disclosures in IFRS 7 and SFAS 157 provide a principles-based framework for disclosures of this information and we believe that additional disclosures in the background of the current stress environment should be focused on the more sensitive areas such as credit risk and be presented in a format appropriate to each entity. This will ensure a better cost benefit outcome since these targeted disclosures, whilst more costly, will be more relevant to investors and other stakeholders' needs.

Finally, we believe it is for the market to determine what information is required and for entities to decide how to deliver this information. We suggest that continued engagement of industry groups and financial statement users is the most effective way of establishing appropriate approaches to these disclosure formats.

I hope these comments are helpful. We would of course be pleased to expand on any points which you may find unclear, or where you would like further details of our views.

Yours sincerely



Ian Harrison
Director

LONDON INVESTMENT BANKING ASSOCIATION

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