European Banking Federation

Secretary General

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E-mail

Carlo Comporti
Secretary General
Committee of European Securities Regulators
11-13 Avenue de Friedland
75008, Paris
FRANCE

ccomporti@cesr.eu

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Draft CESR statement on Fair value measurement and related disclosures of financial instruments in illiquid markets

Dear Mr Comporti,

Thank you very much for providing us with an opportunity to comment on the draft statement on fair value measurement and related disclosures of financial instruments in illiquid markets. Please find below comments of the European Banking Federation (EBF)[1] on the above-mentioned statement and the respond to the questions raised in the document.

We acknowledge that supervisors have a legitimate role to play in times of financial turbulence. It is important for regulators' to respond early to ensure that market participants receive comprehensive information and properly apply the rules in abnormal circumstances. It is also the role of regulators to ensure that the impact of the market crisis is correctly reflected in the entities' accounts.

However we agree that it is not appropriate for regulators to provide any interpretation of International Financial Reporting Standards or to propose any amendments/clarifications to be applied at local or regional level. We welcome the acknowledgement of this in the statement. The international accounting standards should be principle based and their interpretation is solely reserved to IFRIC.

Notwithstanding this, we do believe that there is room for improvement to be made to current valuation standards. We believe that the IASB should do this in close cooperation with all interested parties: auditors, supervisors, financial institutions and analysts. As the latest are concerned, it is important to ensure that the opinion of wide range of analysts groups is considered as opposed to a particular analysts' organisation when referring to the views of analysts.

[1] Set up in 1960, the European Banking Federation is the voice of the European banking sector, with over 30 000 billion EUR assets and 2.4 million employees in the 31 EU and EFTA countries. The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.

Therefore we are pleased that CESR has undertaken this initiative to consult the IASB's European constituents on issues related to accounting standards. It is important that CESR, in consultation with other European bodies and L3 committees, engages with and cooperates with the IASB to ensure that the European views are taken into account. In doing so, we believe that the following principles should be applied:

- Changes to the standards need to be principles-based. Rules based standards must be avoided. We are not convinced that more details will be useful.
- The current standards need to include guidelines for valuation of financial instruments in illiquid market conditions, taking into account the entity's business model.

Before entering into discussion on the calculation of fair value in illiquid markets, we believe it is necessary to clarify the circumstances where it is appropriate to apply the fair value as a measurement basis. Otherwise a misleading picture could emerge that supervisors are in favour of supporting a more general use of fair value. There is no doubt that the fair value is relevant for trading instruments or instrument managed on fair value basis. However, when an entity does not manage instruments on a fair value basis, amortised cost is the more appropriate way to estimate future cash flows. Fair value information is already disclosed in footnotes, which are an integral part of financial statements and is a more suitable format for providing the information to investors. Supervisors should clearly state their position on the relevance of fair value when the instruments are not managed on fair value basis or where the intent of the business changes.

Question 1: Do you agree with CESR's views above regarding the distinction between active and non active markets for fair value measurement?

The statement is in line with the section of IAS 39 on the identification of 'active' and 'non active' markets. All the factors mentioned by CESR are correct and are important to distinguish whether a market should be considered active or not. In this context we would like to highlight that criteria for identifying active markets are not limited to those identified in par. 23 but can be inferred by other factors besides the number of transaction or the spreads.

However, it is important to examine on a case-by case basis whether an active market can still be assumed to exist.

Finally we would like to mention a remark on paragraph 28. The last part of the paragraph seems to imply that, absent strong contrary evidence, observed prices are the best evidence of fair value also in a market with few transactions (i.e. illiquid).

According to IAS 39, however, prices arising from forced sales don't represent fair value. In this context if such few transactions include prices arising from forced sale, the final price would be affected by forced transactions. Accordingly prices observed in the market are representative of fair value only when there is a significant number of transactions, reduced bid/ask spread, continuous quotations and reliable contributors. Absent such features prices observed could be affected by transaction occurred not on an "arm's length basis" that incorporates expectations and assumptions specific of the party that has put the transaction in place and different from "market" expectations.

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In such circumstances we think it's more correct to refer to valuation models employing entity's assumption. Market prices can be a benchmark of the prices determined using valuation models. Additionally for structured credit products it is also complex to identify comparable transactions due to the particular features associated with each product.

Accordingly because valuation of financial instruments should be "on a going concern basis" we think that the concept described in paragraph 28 shall be reversed. In an illiquid market, published price quotations can be used only if evidence exists that they are determined arm's length transactions.

Question 2: Do you agree with CESR's views above regarding inputs to valuation techniques for financial instruments in illiquid markets?

The relevant sections of IFRS are quoted. All the available inputs to the models need to be carefully considered in particular in case of illiquidity in markets where there is a need for regular review of the models. If the models do not produce reliable numbers, procedures must be in place to amend the models so that they more accurately reflect fair value. The models have to take adequate account of the individual characteristics of the financial instruments involved.

Question 3: Do you agree with CESR's views above regarding disclosures of financial instruments in illiquid markets?

The financial turmoil showed the need for improved disclosures and transparency. The trend towards more information and disclosures continued during the 2007 reporting season where European banks applied IFRS 7 which requires disclosures about the significance of financial instruments to an entity's financial position and performance and information about the exposure to risks arising from financial instruments and how these risks are managed.

We support greater transparency, which in our view means better quality rather than simply more disclosure. We are of the opinion that it would not be appropriate to prescribe a rigid disclosure framework. In general we have the feeling that there is already a lot of information distributed towards the market and more disclosure do not necessary mean greater transparency. To be relevant, the information disclosed must be also useful and understandable. The usefulness of the information may be different, depending on the business model of the entity.

We note that box 1 inappropriately mixes IAS 39 guidance on determining fair value with IFRS 7 disclosure requirements. We do not agree that IAS 39 provides guidance on IFRS 7 disclosures as implied by the box.

Question 4: Do you agree that the 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?

We do not believe that any prescribed common format for disclosures could be considered as an improvement and believe that any potential benefits would be outweighed by the cost.

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We are also not aware that users of financial statements are asking for a common format for disclosures. What users need is more high quality and useful disclosures. As stated earlier we believe the principles-based character of IFRS has to be preserved and that the prescription of a common format would represent a move away from principles-based IFRS.

In addition, in our opinion the disclosure proposed in Box 2 goes beyond current IFRS 7 requirements. By introducing sub-level to the three main hierarchy levels, Box 2 introduces a fair value hierarchy that is even more extended if compared with FAS 157 hierarchy which has already been applied in US but is still under the discussion by the IASB.

Implementation of proposed Box 2 would, accordingly, be difficult to do in the short term as it would require attribution of level and sublevels to every financial instruments held and measured at fair value.

Additionally, to achieve greater clarity on the hierarchy, disclosure of any kind of fair value hierarchy should be aligned with IFRS 7 requirements (published price quotation, valuation model using observable inputs and valuation model using unobservable inputs).

Yours sincerely,

Guido Ravoet