



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA EMAIL: commentletters@iasb.org

Mr Jon Nelson
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

4 May 2007

Discussion paper – fair value measurements

Dear Mr Nelson

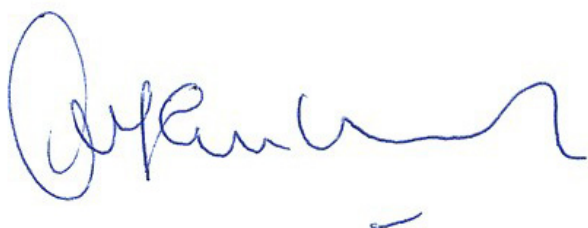
The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the discussion paper: *Fair value measurements* published by the International Accounting Standards Board (IASB). The Committee considers that banking supervisors around the world are an important group of users of financial reports, and it has long supported the development of sound and high quality accounting and disclosure standards for the banking and financial industry.

The Committee believes that sound fair value measurement guidance is particularly needed as part of the IASB's joint convergence programme with the US Financial Accounting Standards Board (FASB). As internationally active banks continue to increase their cross-border activities – and as a substantial percentage of assets and liabilities of such banks are measured, either initially or on a recurring basis, at fair value – it is important that the IASB and the FASB do not give inconsistent fair value measurement guidance. We encourage the IASB to use the comments it receives on this discussion paper as the basis for engaging in a focused dialogue with the FASB to achieve high-quality converged fair value measurement standards. At the same time, the IASB should carefully consider how such a standard could affect other aspects of International Financial Reporting Standards. In this regard, we have highlighted several areas that merit additional dialogue with constituents and further examination and consideration by the IASB as it develops an exposure draft of a fair value measurements standard.

Please find more specific comments in the attached appendix. These comments have been prepared by the Committee's Accounting Task Force (ATF), chaired by Ms Sylvie Mathérat of the Commission Bancaire in France, and approved by the Committee. We trust that you will find our comments useful and constructive. We look forward to contributing further to this effort and are interested in participating in the IASB's round-table meetings to be held in conjunction with the development of a fair value measurements exposure draft.

If you have any questions regarding our comments, please feel free to contact Ms Mathérat (+33 1 4292 6579), Arthur Angulo, who chairs the Financial Instruments Practices Subgroup of the Accounting Task Force (+1 212 720 8859), or Linda Ditchkus of the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Nout Wellink', with a stylized flourish at the end.

Nout Wellink



Appendix

Basel Committee on Banking Supervision comments on IASB's discussion paper – fair value measurements

Rather than answering each of the specific questions raised in the discussion paper, the Basel Committee on Banking Supervision¹ (the Committee) believes it more useful to focus its comments on issues that at this stage were identified as being of particular importance from a banking supervisory perspective. We may provide additional comments or suggestions on these issues, as well as on other issues not commented upon at this time, as future opportunities to offer input arise. Specifically, we may provide additional comments as this project and the conceptual framework project evolve. The *issues* and *questions* below follow the references in the discussion paper.

General comments

The Committee notes that the IASB and the US Financial Accounting Standards Board (FASB) have a shared objective of developing high quality, common accounting standards for use in the world's capital markets. The Committee supports this objective. In this regard, the boards have a specific convergence work programme, which seeks the convergence of US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The current discussion paper on fair value measurements is part of that effort.

The Committee believes that sound fair value measurement guidance is particularly needed as part of the IASB and FASB's joint convergence programme. As internationally active banks continue to increase their cross-border activities – and as a substantial percentage of assets and liabilities of such banks are measured, either initially or on a recurring basis, at fair value – it is important that the IASB and the FASB have fair value measurement guidance that is not inconsistent. In our view, the credibility of the convergence project would suffer if the IASB and the FASB ultimately fail to achieve, through focused dialogue, commonality on an issue as fundamental as fair value measurement guidance. We encourage the IASB to use the comments it receives on this discussion paper as the basis for engaging in this dialogue with the FASB to achieve high quality converged fair value measurement standards.

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank governors of the group of ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

Moreover, in developing a fair value measurement standard, the IASB should carefully consider how such a standard could affect other aspects of IFRSs, even if the impact is unintended. For example, IFRSs require some nonfinancial assets and liabilities to be measured at fair value in certain circumstances; as such, the FASB's Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157) might not be fully applicable and relevant to all of the circumstances under which IFRSs require fair value. As another example, the requirement in International Accounting Standard (IAS) 39 that financial assets and financial liabilities be measured at fair value at initial recognition, when taken together with SFAS 157's acceptance of day-one gains or losses for model-based estimates of fair value, could result in more widespread creation of gains and losses at initial recognition than intended and thereby raise reliability issues. As such, 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.

Finally, we note that the IASB currently is in the process of discussing measurement issues as part of its joint conceptual framework project with the FASB. We are concerned that this discussion paper could be perceived as pre-empting the work on measurement issues ("Phase C"), which is a key element of the conceptual framework project.

Issue 2c: transfer versus settlement of a liability

Question 9: Do you believe 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?

Question 10: Does the transfer measurement objective for liabilities in SFAS 157 differ from fair value measurements required by IFRS as applied in practice? If so, in practice which fair value measurements under IFRS differ from the transfer measurement objective in SFAS 157 and how do they differ?

Paragraphs 22 and 23 of the discussion paper attempt to explain why the term *transfer* of a liability is preferable to the term *settlement* of a liability. This transfer concept may represent a significant departure from existing practice based on IAS 39. Moreover, many entities for whom trading activities are not a major part of their business may find it difficult to apply this concept. Therefore, any decision on this topic should be based on additional dialogue with constituents, including how it would be applied in practice.

The IASB's constituents also would benefit from examination and consideration of the potential implications of a transfer measurement objective. For example, it is not clear whether a transfer notion would affect the valuation of financial liabilities with a demand feature (eg demand deposits) given the existing restrictions in IFRSs on the valuation of such liabilities. In addition, we are uncertain about the transfer notion for liabilities in situations in which the entity is contractually or legally prohibited from transferring the liability to a third party. In such cases, we assume that the transfer notion would require an entity to assume that market participants would take into account such prohibitions.

We suggest that the IASB explore these and other related issues in greater depth as it develops an exposure draft.

Issue 3: transaction price and fair value at initial recognition

Question 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 this 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?

In general, transaction price is the best evidence of fair value at initial recognition. Nevertheless, for certain financial activities (eg dealing in derivatives), it is possible that fair value (defined as the exit price in the principal or most advantageous market) at origination is different from the transaction price. However, this valuation difference raises two issues: reliability and the timing of the recognition of unrealised gains or losses.

Strong risk management and valuation controls are necessary to ensure that fair values are measured and reported in a sound manner, especially when there are not established valuation techniques with a clear and rigorous basis or where one or more important inputs to valuation are not observable, even indirectly, from liquid markets.² Furthermore, as indicated in our general comments, we are concerned that the application of the SFAS 157 approach to IFRSs could result in the creation of day-one gains and losses on a wide range of financial instruments (including banking book instruments). This would represent a departure from existing practice under IAS 39 and would therefore result in significant additional near-term measurement challenges associated with the expansion of valuation techniques that rely on unobservable inputs. This would add to our concern about the reliability of fair value measurements in such cases.

Under IFRSs there are situations when, in the absence of observable inputs, it is necessary to rely on a valuation technique that utilises unobservable inputs when estimating fair value on subsequent re-measurement. In such situations, the resulting unrealised gains and losses are recognised in income (or, in some cases, directly in equity). Therefore, there is an issue of whether the concept of fair value should differ according to whether fair value is applied at initial recognition or on subsequent re-measurement. This would seem to be an issue that should be addressed in the measurement issues phase of the IASB-FASB conceptual framework project. As such, consistent with our suggestion that the IASB engage in a dialogue with the FASB to achieve sound, converged fair value measurement guidance, the issue of day-one profit and loss should be evaluated as part of that discussion, which, in turn, should take place in the context of the measurement issues phase of the conceptual framework project.

In view of both of these issues – uncertainty regarding the extent to which the application of the SFAS 157 approach to IFRSs will result in the creation of day-one gains/losses and the conceptual issue of whether fair value should differ according to whether it is applied at initial recognition or on subsequent re-measurement – the Committee believes this topic merits additional examination.

² In this respect, we refer to our June 2006 publication, *Supervisory guidance on the use of the fair value option for financial instruments by banks*.

Issue 6: valuation of liabilities

Question 16: Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value a liability?

The Committee has expressed, on a number of occasions, its concern regarding the recognition in capital of unrealised gains that arise from deterioration in own credit standing. We continue to believe that allowing an entity to effectively discount the value of its own debt as the entity's credit condition worsens would have the counterintuitive effect of increasing its reported net worth at the same time the entity's financial condition is deteriorating, which may be misleading to investors and creditors.

Issue 9: large positions of a single financial instrument (blocks)

Question 20: Do you agree with the provision of SFAS 157 that a blockage adjustment 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?

The Committee believes that realistic (and appropriately documented) valuation adjustments, including liquidity adjustments, are critical to ensuring that assets, liabilities and the resulting amount of shareholders' equity are not systematically overstated or understated. Thus, we believe mark-to-model adjustments are critical to the reliability of fair value measurements.

For this reason, the Committee's position is that the prohibition of a blockage adjustment for a large position in a single financial instrument when there is a price for the instrument in an active market (Level 1) should **not** be extended to Levels 2 and 3 of the hierarchy, as doing so would not permit valuation adjustments, including mark-to-model adjustments, as discussed in the preceding paragraph. Moreover, we note that SFAS 157 specifically removes prohibitions in pre-existing GAAP that preclude liquidity adjustments for positions that trade in thin or inactive markets.

Issue 10: measuring fair value within the bid-ask spread

Question 22: 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?

The discussion paper states that the IASB has reached the preliminary view 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 provided in paragraph 31 of SFAS 157. The discussion paper also notes that the IASB has not yet reached a preliminary view on whether it is appropriate to use mid-market pricing or another pricing convention as a practical expedient for fair value measurements within a bid-ask spread, and it asks for comments on this issue.

The Committee recognises that practical expedients are at times justified to avoid undue operational burden and thus supports the flexibility provided by allowing the use of mid-market pricing or other pricing conventions *when consistently applied*.