

E-mail

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Subject: *EBF position on valuation of financial instruments in illiquid markets*

Dear Sir David,

The current crisis has put more emphasis on the issue of valuation of financial instruments in crisis situations. The pro-cyclical nature of the fair value measurement of financial assets is perceived as worsening the impact of the US sub-prime crisis on European banks. While we agree that fair value was not at the source of the financial crisis, it may exacerbate market confusion and irrationality in crisis situations by requiring institutions to mark down their assets by reference to existing quotations, even when the latter have fallen significantly below a conservative economic value (fundamental value based on the net present value of future cash flows) and are no longer decently correlated with it. We believe that there is an urgent need for a global initiative aimed at preventing further write-downs of financial instruments resulting from the application of the fair value.

The SEC and the FASB have taken this week an initiative to address the uncertainties in regard to valuation. By contrast to the draft IASB document of 16 September 2008, the FASB and the SEC support in their clarification document the use of management internal assumptions (e.g. expected cash flows) to measure fair value when relevant market evidence does not exist. In the view of the SEC and FASB the possibility to include expected cash flows in calculation of fair value is already provided in FAS 157. They also consider that under FAS 157 it is more appropriate in certain cases to use unobservable inputs rather than observable inputs.

We understand that the IASB draft document refuses the use of fundamental value as it takes the view that transaction prices continue to reflect the fair value and cannot be ignored, even in a market crisis. Accordingly, a value measured using a 'fundamental value' approach might not represent an estimate of a current transaction price. The FASB/SEC however are of the view that disorderly transactions are not determinative when measuring fair value as the fair value measurement concept assumes an orderly transaction, which involves market participants who are willing to transact and allows for adequate exposure to the market. The FASB and the SEC acknowledge that the determination as to whether a transaction can be considered as forced or disordered and whether a market can be considered active or not requires judgment.

We fully support the FASB/SEC clarification which is in line with the position we issued in June 2008¹ on valuation in illiquid markets. We were therefore pleased to read in the IASB press release of 2 October 2008 that the FASB/SEC clarification is considered consistent with the IFRS and that the IASB recognizes the need to provide additional guidance on determining the fair value of financial instruments in illiquid markets consistently with the FASB/SEC clarification.

We call the IASB to issue such guidance that would clarify the existing IAS 39 provisions in line with the SEC/FASB and allow banks to report their holdings in a way that is more representative of the fundamental value of the instruments without any delay. At the same time level playing field for the entities preparing their financial statements using IFRS will be ensured.

As indicated in our comment letter to the IASB DP "Reducing complexity in accounting for financial instruments", there will also be a need to reconsider the restrictions of reclassification of the trading category, as already authorized under the US GAAP (albeit limited in its scope and therefore not widely used). We therefore welcome the announcement made today by the IASB that this question has been put on their agenda.

In our view, transfers between categories should be permitted. In particular, we believe that the IASB should act immediately to eliminate the prohibition on reclassification from trading. Such transfer should be made on the basis of fair value on the date of reclassification and on a fully disclosed basis. This would require the deletion of paragraph 50 of IAS 39.

As indicated in many responses to the DP on Reducing Complexity, the tainting rules of the HTM category must be removed at the same time and replaced with disclosure requirements. Such change would result in reporting which would better reflect the business model for many of the instruments being reported currently in categories no longer corresponding to the nature of the instruments.

In addition it is important to examine possible changes to the impairment rules for AFS category in respect to the basis for impairment calculation for equity instruments and the possibility of their reversal through P&L. We believe that impairment should be recognized only to the extent to which the investment will not be recovered.

We have submitted separately our detailed comments on the IASB Expert Advisory Panel Report of 16 September.

I hope that this letter will have drawn your attention on the very urgent need to take immediate action.

Yours sincerely,



Michel Pébereau