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19 April 2007

Dear Mr Enevoldsen

Re: Discussion Paper on Fair Value Measurements

The Groupe Consultatif is pleased to have the opportunity to comment on EFRAG's draft response letter to the IASB's Discussion Paper on Fair Value Measurements of November 2006.

We strongly support the major thrust of EFRAG's response to the IASB as set out in your covering letter. In almost all aspects, this letter reflects the observations of the Groupe Consultatif on the IASB's Discussion Paper.

In only one aspect does the Groupe Consultatif differ from EFRAG's position which is the discussion of a 'settlement' market in paragraph (g) (ii). The Groupe regards the settlement of a liability as a different concept from that of the fair value of a liability. The Groupe accepts the point made by FASB that settlement includes the idea of the termination of the liability while fair value in most circumstances reflects the continuation of the liability. This can lead to significantly different measures in practice.

In the Appendix to our response, we set out our answers to the specific questions posed in the document. For clarity, we have pulled together the key themes from our answers in the following general comments:

(1) the discussion within the paper focuses heavily on liquid financial markets. While the discussion is valuable in these areas, it neglects the far less tractable issues related to establishing reliability and credibility over values containing entity specific values. Much of the work of investment analysts, an important audience for financial reports, relates to the understanding of the entity specific features of an enterprise. The greatest challenges to establishing fair value relate to determining and disclosing entity specific values rather than those relating to liquid financial measures. Further consideration must be given to this topic before it can be said that "fair value" has been fully addressed.

(2) the different references to ‘fair value’ within IFRS literature may prove to be inappropriate once ‘fair value’ is defined in a single way. Replacement of ‘fair value’ with terms such as ‘current entry value’ and ‘current exit value’ measures may well allow more relevant measures to be established.

(3) we believe market participants have a range of views and therefore to discuss a single market participant view is flawed. It is true that, in the most liquid markets, the range of views is restricted and an average view can be obtained which reasonably approximates market views of specific measures such as yield curves. However, it is difficult, to extend this process beyond the liquid financial markets to the wider range of normal transactions.

(4) the paper seems to distinguish the ‘non-performance risk’ for a contract from the ‘non-performance risk’ relating to the entity meeting the liability under that contract. We believe that it is impossible to separate the risk relating to the contract and to the entity responsible for honouring the contract. This is no different from the credit standing of a debt instrument depending on the strength of the issuer of the debt.

    Further, the non-performance risk only affects directly the individual or entity with whom the liability should be settled. It does not directly affect the original settlor nor any third party to which the liability is transferred. The reduction in liability for non-performance risk is a surrogate for recognizing the intangible asset that entities have to default on liabilities in insolvency. However, such a reduction can only operate coherently when there is a comprehensive accounting regime for such intangible assets. A partial system is unworkable.

Please do not hesitate to contact Michael Lucas (the Secretary of the Groupe Consultatif) or Nigel Masters if there are any points you would like to clarify or discuss further.

Yours sincerely,

Bart De Smet
Chairman, Insurance Committee

Appendix

Q1. We believe that much of the complexity and inconsistency related to the measurement of fair value relates to the different measures that are collected together under the term “fair value”. A necessary first step to remove the complexity and inconsistency is to replace the term “fair value” with more clearly defined terms such as “current exit value” or current entry value”.

Q2. While the concepts of FAS 157 are valuable and practical in setting fair value in the context of liquid financial markets, this is not the case for the large number of transactions that necessarily include entity-specific inputs. In this case, the existing approaches are more relevant and practical.

Q3. If the fair value were to be defined as a hypothetical exit price at the reporting date then the exit price would need to be assessed from the perspective of the entity that holds the asset or owes the liability. Any other perspective will contain elements that do not relate to the entity on which the accounts are reporting.

Q4. At any given time a market will encompass a range of views as to the possible inflows or outflows of an asset or liability. Participants will hold not only different views as to the quantities but also different attitudes to risk and liquidity. When these views differ sufficiently, trading occurs. Accordingly it is unlikely that a buyer and seller will view the economic benefits of a trade as the same and hence entry and exit prices will differ amongst market participants. The more complex a trade, the greater the difference required to trigger a trade and the more unlikely it is that a single view on an entry and exit price can be achieved.

We note that in many circumstances a financial institution will acquire an asset or liability in order to repackage it. This could include incorporating it in a larger portfolio in order to balance risk, enhance liquidity or improve its value in use. It is assumed that this circumstance lies outside the scope of question 4.

Q5. Given the complex nature of many trades, it would be better to develop more explicit terminology such as current entry value and current exit value and debate specifically which measure best achieves the aims of the standards concerned. We note that the standards might be best served by some measure defined differently from either of these values.

Q6. We are not sufficiently familiar with the practice under all IFRS standards to answer this question.

Q7. As noted in an answer to Q4, we believe market participants have a range of views and therefore to discuss a single market participant view is flawed. It is true that, in the most liquid markets, the range of views is restricted and an average view can be obtained which reasonably approximates market views of specific measures such as yield curves. However, it is difficult to extend this process beyond the liquid financial markets to the wider range of normal transactions.

Q8. “Willing buyer” and “willing seller” captures the concept of a range of views while “market participant” suggests a single view. For this reason, we see the concepts as different in theory, although for the reasons given in Q7, the concepts may be similar in practice when dealing with the most liquid financial markets.

Q9. The concept of ‘transfer’, rather then settlement is closer to the idea of a ‘current exit value’ between willing buyers and sellers and is a useful improvement to IFRS in those circumstances where the term ‘fair value’ is most appropriately interpreted as ‘current exit value’.

Q10. Certain interpretations of the application of IAS 39, notably the importance of ‘deposit floors’ rest on the importance of ‘settlement’ rather then ‘transfer’. This would need further consideration.

Q11. As noted above, where markets are not deep or liquid, it is normal for market participants to hold a range of views and this would relate most notably to inputs that cannot be observed. If fair value at inception is regarded as a current exit price, the fair value and the transaction price could be the same if buyer and seller agree the inputs. If alternatively, it is unreasonable to believe that any market participant would regard the unobservable inputs to the transaction price as appropriate, then a different input must be selected and a day-one profit or loss incurred. This is most likely to happen in circumstances where individuals transact with institutions and the former have very different motives to trade from the motives of the institutions.

Q12. The idea of transfer rather then settlement would tend towards the portfolio based valuation.

Q13. For the most liquid markets, the principle market and the most advantageous market are unlikely to differ significantly. For transactions occurring away from such markets, the concern is of marginal relevance compared with the selection of appropriate entity specific inputs.

Q14. Assuming that the fair value is most appropriately reflected by the current exit value, it is agreed that the measurement should consider attributes specific to the asset or liability.

Q15. Agreed. It is noted that this follows more easily from the concept of transfer rather than settlement as the costs of settlement are more easily seen as inherent in the settlement process.

Q16. The discussions at paragraph 15 of SFAS 157 as set out in paragraph 39 do not make a distinction between settlement and transfer. The ‘non-performance risk’ only affects directly the individual or entity with whom the liability should be settled, not the original settlor nor any third party to which the liability is transferred.

Theoretically, the apparent imbalance reported between the original borrower (the settlor) and lender could be removed by the settlor accounting for not only the liability but also the asset created by the settlor having the ability to default on the liability (sometimes referred to as the default asset). Again theoretically, if the liability is transferred to a new settlor then a new default asset is created for the new settlor and the value of the asset held by the lender would be adjusted for the risk of non-performance by the new settlor.

While such an approach would work in theory, it could only operate in the context of a complete accounting system for default assets. For example, every time a settlor reported a profit its ability to settle the liability would increase and the default asset and non-performance risk would decrease. In practice, this would be unworkable under the current accounting framework.

In summary, the introduction of ‘non-performance risk’ into the valuation of liabilities is impractical until a complete and coherent system of default assets or similar is created. The introduction of a partial system of non-performance risk is unworkable and theoretically wrong.

Q17. Theoretically, it is possible to see how an asset might have a different in-use value from its value in use. For example, a building currently in use as a warehouse might be converted into a block of apartments and used to create greater income. However, the uncertainty attached to achieving the conversion and to finding other warehouse facilities to maintain the current operations make such an assessment at best subjective and potentially unreliable. In practice, it is likely that an asset in-use value would default to a value-in-use in most instances.

Q18/Q19. On the assumption that the appropriate interpretation for any given standard is a current exit value, the introduction of a hierarchy is useful. We note, however, that the availability of observable data is in practice limited and the hierarchy will be of limited use in many of the more challenging valuations.

Q20. Given our response to Q12 that a portfolio-based valuation would arise, it would be illogical to ignore the concerns over illiquidity or the potential value, in terms of controlling interest that large blocks of shareholdings create. Having noted this, we recognize the practical advantages of prohibiting a blockage factor adjustment.

Q21. The concept of using a price that sits within the bid-ask spread is consistent with our earlier response to Q4, namely that a range of views on value exist amongst participants in markets and that different views within that range are relevant in different circumstances.

Q22. The use of mid-market pricing in the circumstances of offsetting market risk is a meaningful approach to reporting the finances of institutions with largely matched asset and liability portfolios. We support the use of this pricing convention and therefore the usefulness of pricing conventions generally.

Q23. The availability of bid-ask pricing guidance throughout the hierarchy is consistent with our general approach of the existence of a range of views amongst market participants. However, we question whether the concept can be made relevant in the context of unobservable inputs.

Q24. Experience in the preparation of disclosures for performance measures such as embedded values consistent with observable market data suggests that investment analysts value disclosure related to business drivers as much as, if not more than, large volumes of unobservable inputs.

Q25. A number of issues that are currently under discussion in relation to the insurance contracts standards are also relevant to certain liabilities under IAS 39. These issues, notably cash flow recognition and discretionary participating features, are not addressed in SFAS 157 and will need to be considered before it can be applied to fair value contracts under IAS 39.

Q26. Yes.

Q27. We comment additionally that the standard assumes that liabilities are for settlement amounts at fixed points in the future. In many, if not most, cases liabilities relate to variable settlement amounts of uncertain timing. The discussion of the valuation of liabilities needs to address these elements directly.