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IIF Board of Directors Discussion Memorandum on Valuation in Illiquid Markets

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IIF Board of Directors - Discussion Memorandum on Valuation in Illiquid Markets

Introduction. The turmoil in credit markets since July 2007 is the subject of intensive analysis by both the public and private sectors. Multiple concrete steps have been taken by both sectors. The Institute of International Finance is examining market weaknesses and ways to remedy them through its Committee on Market Best Practices. Senior officers and experts of member firms are contributing substantial time and attention to the effort, reflected in the Interim Report to be published on April 9. The Interim Report includes discussion of valuation issues, and work continues on final recommendations on valuation procedures, to be published as part of a final report in early Summer.

The Interim Report underscores the advantages of fair-value accounting but also points up its difficulties under current interpretations when there is no or severely limited liquidity in secondary markets. Mark-to-market requirements for a very substantial portion of the assets in the system in circumstances of widespread illiquidity have led to reported results that deviate from the underlying purposes of fair-value accounting to provide timely, relevant, reliable and transparent representation of firms' economic situations. There is of course no question that actual or reasonably likely losses or deterioration of underlying cash flows on assets should be reflected in valuations. However, under conditions since July 2007, lack of market activity, expectations of continued downward pressures, extremely high risk premia, uncertainty, and sometimes irrational results (preferences for unsecured over secured obligations of banks, for example) have created a situation where it has become obvious that the market has failed to produce pricing inputs that reflect actual default probabilities of sound assets. In addition, existing guidance has encouraged use of references such as the ABX index that are widely acknowledged to compound the effects of these conditions, exaggerating beyond plausibility the extrapolated losses on many instruments. All this thus results in valuations that do not provide a true picture of the financial positions of firms.

As further discussed in the Interim Report and attached Discussion Notes, often- dramatic write-downs of *sound* assets required under the current implementation of fair-value accounting adversely affect market sentiment, in turn leading to further write-downs, margin calls and capital impacts in a downward spiral that may lead to large-scale fire-sales of assets, and destabilizing, pro-cyclical feedback effects.¹ These damaging feedback effects worsen liquidity problems and contribute to the conversion of liquidity problems into solvency problems.

¹ In addition there are numerous specific technical challenges to valuing assets in such circumstances that have contributed to uncertainty and risk aversion. These are discussed in the Interim Report.

It is urgent to address this downward spiral and to consider transparent, well controlled ways to provide realistic, more stable valuations in a manner that would increase market confidence.

Purposes of this Memorandum. This memorandum has two goals.

First, we propose for immediate discussion an interpretation of current fair-value methodology requirements that would serve as a kind of “circuit breaker” proposed in the Interim Report to arrest the undue devaluation of sound assets, and thus the downward spiral that is making recovery more difficult. Such interpretation would make available a “refined valuation methodology” for financial instruments that meet stringent tests in specified market conditions. It would do so on a fully transparent and well controlled basis, available under tightly limited circumstances, that is intellectually consistent with the structure and spirit of fair-value accounting as it has developed over the past several years. It would thus, under disrupted circumstances, improve alignment of stated valuations with the actual economic value of assets, thus increasing transparency and reducing market skepticism about reported valuations.

The same approach would be feasible under international accounting or US GAAP (and other accounting standards based thereon). It would be consistent with the widely shared goal of convergence of global accounting standards.

It is our belief that the type of flexibility proposed would be more aligned with the asset management intent and would deliver more appropriate valuations over time. It would also have a strong stabilizing and durable impact on the asset prices as they would be then valued and kept with a medium-term investment horizon.

Second, we call upon the standard setters and relevant authorities to undertake urgent consideration of ways to introduce appropriate degrees of flexibility into the present system, to allow assets that would, under appropriate circumstances, be better accounted for on a basis other than mark-to-market to be transferred to another status under strictly defined terms and conditions. This discussion should begin simultaneously with consideration of the refined valuation methodology proposal, which is intended to provide immediately available improvements.

It is our belief that the type of flexibility proposed would enable better management of assets and more appropriate valuations over time.

Because we have been advised it would require due-process amendments of standards, we understand that such changes may require somewhat more time than a refined valuation interpretation. We urge the standard setters to consider defining expedited procedures for these and other proposals intended to address substantial unintended difficulties under the current regime.

The following discussions provide more specifics about the two approaches.

1. Valuation Issues in Illiquid Markets: Refined Valuation Methodology. The “refined valuation methodology” described more technically in attached Discussion Note A would be straightforward. Discussion Note A, prepared on the basis of deliberations of member firms subject to both international and US accounting requirements, offers a basis of discussion, the details of which could be completed via dialogue with interpreting authorities quite expeditiously.

The interpretation would be available only under rigorously defined criteria. A firm would be required to determine that (1) the market for certain instruments is dislocated or inactive (pursuant to specified tests), (2) its assessment of the true fair value of such instruments is not reflected in valuations arrived at under current interpretations of fair value, and (3) that it does not foresee forced sales of the instruments.

Where such a determination is made, the firm would fair-value the instruments based on expected cash flows discounted at a rate to be specified in the final interpretation, such as the original expected interest rate. Instruments to which the refined methodology would be applied would be carried at the lower of book value at the time of implementation or the value calculated using the refined valuation methodology.

Once the market is no longer illiquid or dislocated as defined by the specified criteria, firms would return to using the otherwise applicable procedures for calculating fair values.

The refined valuation methodology would be subject to stringent governance, internal control, audit, and (where applicable) Sarbanes-Oxley requirements.

Because transparency would be assured by robust disclosure requirements, the application of the interpretation should be well understood by the markets, and firms would be able to show that they are reflecting appropriate values of their assets in a manner to reflect likely cash flows as well as credit losses.

This approach would produce transparent, robust and reliable valuations. Such valuations should, subject to the further determinations of the appropriate prudential and central bank authorities, be the appropriate basis for valuing collateral for purposes of determining margin requirements (including those of central banks), and for regulatory-capital determinations.

2. Flexibility Issues in Asset Classification. As already noted, it is urgent to address mark-to-market problems under the current regime, and the proposed refined valuation methodology should be a way to do so in a short period. We believe it is equally important – and equally pressing – to address more basic asset-classification problems under the current regime to provide firms with greater flexibility to respond to the types of valuation problems encountered over the past several months now and in the future. We present here a brief summary of the conceptual goals to be pursued. The Institute and

firms' experts stand ready to pursue ways to achieve these goals with the standard setters and other relevant authorities.

In summary, the industry calls for greater flexibility with respect to classifications of instruments in "trading book" vs. "banking book" (in accounting terms trading vs. held-to-maturity or loans-and-receivables). This flexibility is important to allow for appropriate management of financial instruments in firms' businesses and also be consistent with the prudential classification. In addition, this flexibility would allow firms to arrive at more appropriate valuations for instruments that may migrate from liquidity to illiquidity and hence from being marked to market in a straightforward manner to having to rely on indirect or mark-to-model valuation techniques that are less straightforward under many circumstances and, as already discussed, may not reflect the true values of instruments.

Instruments transferred from the trading book to the banking book would be valued at the current book value (which would reflect current fair value) as of the time of transfer. After transfer, such instruments would be required to be retained in the banking book for a set period, say two years, or until maturity. Once transferred, they would be valued on an ongoing basis and subject to impairment testing on a discounted cash flow basis.

While the specific technical changes to accounting literature to achieve such greater flexibility are different under international accounting and under US GAAP, the goals under both regimes would be the same: to provide firms with the means to reclassify appropriate assets under an accounting regime that provides sound valuations for all purposes but does not contribute to the danger of downward spirals.

The type of classification flexibility that is advocated would be subject to rigorous, auditable, and transparent conditions to avoid any danger of arbitrage or abuse.

There is already a limited degree of flexibility on this point under US GAAP, but virtually none under International Accounting Standards. The solution should aim for greater flexibility under both accounting standards in a way that will achieve a level playing field, consistently with the goals of global accounting convergence.

Full disclosure of a firm's use of the flexibility so proposed would be required and, of course, ongoing disclosures of instruments would be required in the normal course.

Making the changes necessary to permit such classification flexibility would both enable banks to manage their credit business more effectively and produce more relevant, reliable valuations reflecting the value in use of financial instruments in the business.

3. Additional Considerations.

It would be necessary under either alternative to examine the treatment of fair-valued instruments that are own liabilities as well as those that are assets, in order to assure appropriately balanced presentations of results.

While the present proposal addresses accounting issues, not regulatory capital considerations, we note that application of either proposal would raise capital questions, and these would have to be worked through in finalizing either approach. Moreover, we note that many of the same concerns about procyclical effects apply to regulatory capital determinations. Similar approaches to developing ways to contain those procyclical effects in ways that are intellectually consistent with existing international capital arrangements are equally important.

Conclusions. We have made two suggestions to address a critical problem in a critical situation. The first should make possible quick interpretative adjustment. We have developed it in some detail in order to launch immediate discussion. The second offers a more fundamental approach that would address the issues on an ongoing basis. While it is urgent to find immediate improvements of accounting for financial instruments, the longer-range proposal is equally important. The Institute stands ready to do everything it can to advance dialogue on both fronts.

Attachments:

Technical Discussion Note A: Valuation Issues in Illiquid Markets

Technical Discussion Note B: Flexibility Issues in Asset Classification

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Technical Discussion Note A: **Valuation Issues in Illiquid Markets**

Executive Summary

Fair value in illiquid markets. Over the past decade, fair-value / mark-to-market accounting has proven useful in promoting transparency and market discipline and continues generally to be a reliable accounting method for securities that have liquid markets. However, when there is no or severely limited liquidity in secondary markets, it has the potential to create self-reinforcing effects that both make valuation more difficult and increase market uncertainties. There is a question whether marking to market may have increased the severity of the market stress, and if so, whether this reflects weaknesses in the current state of the implementation of fair-value requirements. While there is no desire to move away from the fundamentals of fair-value accounting, we believe that it is necessary to identify and address unintended consequences.

The dislocation in the current markets for certain financial instruments has resulted in significant write-downs under existing interpretations of FAS 157 and IAS 39. Where such write-downs reflect realized or reasonably likely losses, this is, of course, entirely appropriate; but, as further discussed below, under certain market conditions, the write-downs required under current interpretations may be substantially in excess of any actual or reasonably probable economic loss on many instruments.

Proposal. One way to manage the firm-specific and systemic effects of write-downs that are excessive relative to fundamentals would be for firms to have the option under recognized interpretations of applicable standards to value financial instruments in dislocated markets using a refined valuation methodology. A conceptual proposal for such a refined methodology is offered to engender discussion on the topic, although technical details would need to be fleshed out and there may be other appropriate ways to achieve the same goal. The intent is to suggest a way that applicable accounting could be enhanced and clarified to reflect the true fair value of financial instruments in inactive markets.

This methodology would arrive at the “fair value” of an instrument based upon its expected future cash flows discounted at its original effective interest rate. This proposed approach would be available only for instruments in dislocated and inactive markets where an entity’s assessment of the instrument’s true fair value based on expected cash flows is not consistent with measurement under the current interpretations of FAS 157 or IAS 39. This approach would enable entities to identify and apply to instruments meeting certain rigorously defined criteria a refined valuation methodology subcategory within the existing fair-value hierarchy. Entities would continue to apply this methodology as long as certain market criteria are met. While an instrument is being accounted for under the refined valuation methodology, it would not be written up above its book value as of the date the refined valuation methodology was first applied. An advantage of this approach is that

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an entity would be permitted to use an assessment of the reasonable fair value of the instrument without being forced to make assumptions about how hypothetical market participants might view pricing in a dislocated market.

Transparency. Application of the refined valuation methodology would be subject to sound documentation, governance and audit standards. Most importantly, the disclosures envisioned in the proposal would ensure that use of the proposed methodology would be completely transparent to regulators and the market. While any new interpretation in times of turmoil would legitimately require widespread discussion by all stakeholders, it is believed that application of the proposal in a context of rigorous governance and disclosure requirements should obviate any implication of “hiding losses”. In fact, it would enhance awareness of underlying economic losses and values and thus remove uncertainty in the market.

Given the importance of communication of the uncertainties surrounding fair valuation in current markets, firms would be allowed to use the principles enumerated here in management explanation of their valuation policies, procedures, and determinations (in Management’s Discussion and Analysis or equivalent reporting). Such disclosures may be useful even whilst the present proposal is being debated and before authoritative interpretations along the lines of this discussion are finalized.

Background

As discussed further below, the valuation issues addressed in this paper are substantially the same under international and US accounting standards.

The fair value measurement requirements of FASB Statement No. 157, *Fair Value Measurements* (FAS 157) and International Accounting Standard No. 39, *Financial Instruments: Recognition and Measurement* (IAS 39), have resulted in significant write-downs of certain financial instruments in markets where trading activity is limited, but where current cash flows on such instruments remain strong. Such write-downs are not reflective of prices observable in an active market, but are instead based on assumptions about how hypothetical market participants may view pricing in a dislocated market. As investors and holders of these instruments “fair value” their assets on the basis of distressed market prices, their capital is reduced accordingly, which then may lead to a cycle of actual fire sales and additional write downs in the system. These unprecedented market conditions have fueled the rise of risk and liquidity premiums on financial instruments to levels that have resulted in fair values reported under FAS 157 and IAS 39 in many cases having little or no correlation to the value an entity expects to realize upon sale or maturity of that asset (i.e., something more reasonably approximating the true fair value of an instrument). In other words, the valuation may refer to the market or to reference securities, rather than the instrument being valued itself. We believe that this aspect of current applications of mark-to-market approaches has the potential effect of compounding liquidity problems and, because of effects on capital, extending liquidity issues to solvency issues.

Moreover, existing guidance encourages the use of reference indices such as the ABX index that have technical flaws discussed below and are widely acknowledged to compound the effects of market conditions, exaggerating the extrapolated losses on sound instruments. Thus, an RMBS

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security that is well and truly rated AAA on the basis of underlying assets might on this basis show an extrapolated PD of 50 or more, which would require an almost complete cessation of US economic activity to be encountered in actual fact.

While all accounting models have their limitations and while the fundamental principle behind fair value accounting is its generally assumed timeliness and transparency, in times of severe market dislocation, the few if any available market prices based on distressed sales lose the most important aspect of fair value, which is reliability.

In an attempt to break this spiral and to provide investors an appropriate assessment of the value of financial instruments, we propose that the applicable interpretations of the fair value measurement requirements of FAS 157 and IAS 39 be enhanced and clarified to provide preparers flexibility in assessing fair value in an inactive or dislocated market. We believe that in an inactive market, such as what we are experiencing for certain financial instruments today and as defined below, the notion of an exit price is not necessarily aligned with the true economic value of an instrument reflected in fundamental analysis of its cash flows.

Therefore, for those instruments that meet certain criteria, we propose that an entity would have the option to value those instruments based on a model which preserves the fundamental principles of a good accounting model, i.e., reliability and timeliness.

As defined by FAS 157, fair value is based on an “exit” price notion or the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In recent months, increased delinquencies and defaults of sub-prime mortgage loans and the uncertainty of future default levels have led to increased credit losses and an overall withdrawal of investors from all corners of the credit markets. This withdrawal has left credit markets in a liquidity blockage, where there is no active market for certain financial instruments and very little ability to obtain non-distressed price information. The result is an extremely challenging environment in which to accurately determine a fair value measurement.

IAS 39 defines fair value as “a price agreed by a willing buyer and a willing seller in an arm's length transaction”, which is not dissimilar to the FAS 157 definition of an exit fair value. It also considers active and inactive markets and addresses the recognition of Day 1 profits. The International Accounting Standards Board (IASB) is developing a new accounting standard on fair value, but the principles of IAS 39 are already largely in line with those of FAS 157. Many of the key aspects, such as the three levels of fair value hierarchy, and the disclosure of the hierarchy levels, are largely the same, with some differences in the details.¹

For those financial instruments for which there is no active market, entities have been considering their own expectations of future cash flows based on their internally developed models and discounting those amounts by a rate that is extrapolated using recent trades, if any, and applicable

¹ Focusing on the subject of Day 1 profits, the current IFRS standard does not adopt an exit price concept in the absence of observable inputs to models. In this case it defaults to transaction price (entry price) being the best evidence of fair value. In this case, Day 1 profits cannot be recognized for Level 3 (unobservable) products. This is the key difference to FAS 157, though it would not be material for purposes of the proposal made in this paper.

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pricing indices. This approach has been widely used following the issuance of the CAQ white paper *Measurements of Fair Value on Illiquid (or less Liquid) Markets* in October 2007. Broadly similar recommendations have been made for the international accounting context by the Global Public Policy Committee of the six largest international accounting networks (December 2007). The CAQ paper states “When quoted market prices in an active market do not exist, entities often employ valuation techniques, typically discounted cash flow models that utilize Level 2 and Level 3 inputs. For financial instruments such as mortgage-backed securities backed by sub-prime mortgage loans, an entity must consider what information is available about some or all of the assumptions that marketplace participants would use in assessing the current fair value of an asset at the reporting date”.

However, given the uncertainties in the credit markets, the liquidity and risk premiums reflected in the currently implied discount rates do not accurately reflect the true fair value of many instruments in terms of their strong underlying fundamentals. For example, some firms use the ABX index to mark-to-market their holdings of ABS, even though the ABX itself is not very liquid, narrowly constructed (based on 20 ABS deals in the first or second half of each year) and thus not necessarily representative of the diverse cash flow and risk profiles of a wide range of ABS held by firms. Consequently, using the ABX index to mark-to-market firms’ ABS portfolios could even be misleading. Instead these discount rates are, under present circumstances, a reflection of distressed transactions by entities with drastically different characteristics from an entity which would be transacting in an orderly fashion in an active market.

Proposed Solution

Within the framework of existing FAS and IAS approaches we believe it is possible to identify refinements and clarifications to enable firms’ managements and auditors to apply a refined valuation methodology to financial instruments in dislocated or illiquid markets. Given that the principles of FAS 157 and IAS 39 are largely aligned, we believe that the proposed refined valuation methodology could be applied under both FAS and IAS frameworks. The discussion below uses FAS 157 terminology for convenience but would apply to international accounting, *mutatis mutandis*, and as further discussed below.

As a possible solution, we would suggest the creation of a sub-category within each of the Level 2 and Level 3 classifications under FAS 157 and IAS 39, which we will refer to as the refined valuation methodology. Such instruments would continue to follow the appropriate balance sheet and income statement classifications under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or other applicable guidance (i.e., AICPA Audit and Accounting Guide: Brokers and Dealers in Securities, etc.), with enhanced disclosures discussed below. Instruments eligible for such proposed measurement would need to meet clearly defined criteria, including especially with respect to the determination that dislocated or inactive markets exist. Application of the criteria would be subject to generally applicable governance and auditing requirements.

The following suggests in summary terms the type of criteria that would need to be applied to develop rigorous tests for the availability of the methodology:

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- **For fair value measurements that are classified as Level 2 under FAS 157 (or equivalent under IAS),** the refined methodology would be available for relevant instruments if:
 - a) The market for these instruments is dislocated such that it does not qualify as an active market under applicable accounting rules and either criterion 1 or 2 below is met.
 - b) The entity's assessment of the true fair value of the instrument is not aligned with the currently required value (e.g., exit price valuation) of the instrument.
 - c) The entity does not foresee forced sales of these instruments in that market. [If it is not the intent of the entity to sell these instruments, the expected cash flows given the intent to hold (although not to maturity) are different from those when the intent is to sell in a forced sale or liquidation scenario.]

An inactive market would be characterized by the following:

- 1) The current trading volume in the principal market for the specific financial instrument, or markets for similar instruments, is significantly less than the historical weighted average trading volume (e.g., less than perhaps 50% of historical volume);
or
- 2) The entity believes that the current market for a financial instrument is unable to rapidly absorb the quantity held by the entity or entities holding similar instruments, without significantly affecting the price of that instrument.

- **For fair value measurements that are classified as Level 3 under FAS 157 (or equivalent under IAS),** the refined methodology would be available for relevant instruments if:
 - a) The relevant market for these instruments (or relevant comparable instruments) is dislocated or non-existent such that the entity's assessment of current market activity is that the activity is not indicative of an orderly market as (i.e., where model inputs result in a valuation of a reference security and not the instrument actually being valued).
 - b) The entity does not foresee forced sales of these instruments. [As above, the intent of the entity is key.]

An entity's determination regarding the identification of dislocated markets would consider:

- 1) The volume of activity on both an absolute basis and a relative basis (compared to historical levels);
- 2) The number of current participants in market activity and whether those participants are active in both sides of positions;
- 3) The level of implied liquidity/risk aversion premium compared to the entity-specific assessment of an appropriate risk-adjusted discount rate that reflects the uncertainty of expected cash flows (without incorporating current market liquidity issues).

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The refined methodology would not apply to new trades resulting in an asset valued in level 3, undertaken after an entity has determined that there is a market dislocation, where there is a trade-date profit.

Current judgments regarding “orderly transactions” are made in accordance with the relevant CAQ or GPCC whitepaper, which instruct companies to presume that any market activity is not a forced or distressed transaction. Thus, a high burden of proof is placed on an entity seeking to disregard any observed market transactions. The CAQ paper states, “Even if the volume of observable transactions is not sufficient to conclude that the market is ‘active,’ such observable transactions would still constitute Level 2 inputs that would be required to be considered in the measurement of fair value”.

It is the principle of IIF member firms to achieve consistency around the application of the refined valuation methodology on similar instruments. One way in which such consistency could be achieved would be to use independent industry pricing services to determine when the refined valuation methodology should be applied.

The scope articulated above would permit entities to acknowledge the realities of the current market (i.e., certain markets may be so illiquid or dislocated that market activity is representative of forced transactions and should not be used to estimate the fair value of the instruments within that market).

Adequate contemporaneous documentation would be required to be maintained in order to satisfy audit and Sarbanes-Oxley (Section 404) requirements.

Financial instruments meeting the above criteria would be fair valued based upon an entity’s expected future cash flows discounted for each instrument at the instrument’s original effective interest rate and would be carried at the lower of current book value or the value calculated using the refined valuation methodology. As discussed further below, there could be no increase of valuation as a result of resorting to the refined valuation methodology.

This approach is consistent with the provisions of FASB Statement No. 114, *Accounting By Creditors for Impairment of a Loan* (FAS 114) that require an entity to measure impairment of a loan based on its original effective interest rate and not a discount rate implied from stressed transactions or indices that incorporate irrational risk liquidity premiums. Although FAS 157 prohibits an entity from using entity-specific information where “higher level market observable information exists”, FAS 114 acknowledges that, “creditors should have the latitude to develop measurement methods that are practical in their circumstances.”² As a result those entities that have no intention of exiting a position are not obligated to recognize a write-down based on infrequent transactions occurring in a highly dislocated market. The same principles could be applied in this context consistently with the overall intellectual basis of current accounting standards.

² For the purposes of determining available capital in the economic balance sheet, such methods could include alternative measurement methods that value the instruments’ expected future cash flows discounted at the sum of the “risk free” (or swap) rate at the valuation date plus a risk margin. The risk margin would be determined from a fundamental analysis of the risks to which the entity is exposed under the financial instruments.

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Because of the existing similarities (discussed above) and the planned convergence between IAS and US GAAP, a solution to valuation under extreme market conditions that can be applied under US GAAP should be applicable under IFRS.

We note that an alternative measurement methodology for instruments lacking an active market is provided for in IAS 39 *Financial Instruments: Recognition and Measurement*, where certain equity instruments with no active market are accounted for at cost irrespective of their classification as “Held for Trading”. Paragraph 54 of IAS 39 states that “If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available or because the ‘two preceding financial years’ have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortized cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortized cost, as applicable”.

Thus, under IFRS, the principle reflected in current relief for inactive equity instruments in IAS 39 could be extended to cover inactive debt securities. Under IFRS, equity securities that revert to a cost valuation due to difficulty in obtaining fair values and reclassifications to the held to maturity classification are done at the fair value (deemed new cost) as of the recategorization date. “Application Guidance” within IAS 39 could be given concerning measurement and how to determine transfers in and out of the category. Further an insertion into the “Effective date and transition” section of IAS 39 could explain as of when the amendments are effective.

Principles along the lines of the proposal would apply to all financial instruments as defined in applicable accounting literature. Thus, they would apply to liabilities as well as assets, where the dislocated-market criteria apply. Under present circumstances, it may be that the criteria would be more likely to apply to assets, especially structured products, than to own-liabilities of major firms, as markets for debt instruments of major financial institutions have, as a broad generalization, remained more liquid.

An important goal would be to achieve final interpretations regarding fair valuation in illiquid markets that would be equally applicable under both IAS and US GAAP (and, insofar as possible other major accounting standards) on a level-playing-field basis.

Transition

Financial instruments meeting the requirements above would be identified and transferred into the refined valuation methodology sub-category at the lesser of current book value or the value determined using the valuation methodology described above. This value might be termed the “Transferred Cost Basis”.

Ongoing Accounting

- At each reporting date, instruments would be evaluated to determine if they meet the requirements for the refined valuation methodology.
- Instruments meeting the above requirements would be carried at the lower of book value or the value calculated using the refined valuation methodology.

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- Additional impairment would be recorded on an on-going basis by creation of a valuation allowance.
- Subsequent increases in fair value would be recorded by reversing the valuation allowance, but will not result in increases above the Transferred Cost Basis as long as the instrument is valued using the refined valuation methodology.
- Instruments that do not meet the requirements outlined above will be evaluated using observable inputs and unobservable inputs based on existing guidance in FAS 157.

Once the market is no longer considered illiquid or dislocated, firms would apply existing rules under FAS 157 or IAS 39 in calculating fair value.

Disclosures

For those instruments that meet the above requirements, the following disclosures would be required:

- A statement of the entity's exercise of the election of the refined valuation methodology.
- A description of those instruments valued using the refined valuation methodology outlined above.
- A description of those markets which the entity considers dislocated or illiquid.
- A description of why the entity believes that the value determined using the refined valuation methodology is more appropriate (i.e. that a price using currently available inputs under otherwise applicable rules does not accurately reflect the true fair value of the instrument).
- Instruments valued using the refined valuation methodology would be disclosed separately within the Level 2 and Level 3 fair value disclosures. (To be termed, for example, Assets valued using refined valuation methodologies.)
- The effective interest rates applied.
- A statement that the entity does not foresee forced sales of these instruments.

Further considerations

The above proposal is made in the context of valuing instruments and communicating financial position to investors, regulators and other stakeholders. This proposal does not specifically address whether or not it would be appropriate to accept valuations under this methodology for other purposes, including counterparty (including central bank) margining requirements, or for determination of regulatory capital.



Technical Discussion Note B: **Flexibility Issues in Asset Classification**

Fair value accounting has proven relevant over the past decade to represent trading activity performance of financial institutions. It offers an appropriate decision making framework for management as well as for investors. However the current crisis has highlighted the limitations of this accounting model in situations where there is no or severely limited liquidity in the market and it is now seen by market participants as a catalyst for a market crisis in certain circumstances.

In a first phase of the subprime crisis, in accordance with existing accounting rules financial institutions have followed the dramatic market price decrease and have impaired their assets accordingly.

It appears now that we have reached a second phase of the market reaction in which accounting frameworks are playing a key role. Indeed stress and uncertainties surrounding financial markets are amplified by the existing accounting rules that oblige institutions to mark down their assets by reference to existing quotations even if those quotations have fallen far below their reasonable conservative economic value.

The conservative economic value could be described as the amount of discounted cash flows an entity expects to recover in a worst case scenario using prevailing market rates.

This is due to the fact that for some categories of assets supply and demand are highly unbalanced. At present, it is clear that some observed quotations on the market do not represent a price at which it is reasonable to think that a transaction can occur. It is instead a dissuasive quotation which aims at preventing trade intents.

This situation has lead financial institutions to reconsider their management of those instruments and their estimate of the best use to optimize the amount of cash flow they will produce. Accordingly, they have strengthened their risks-management policies and restricted their exposures on those instruments at the current level.

In fact, it has become clear for many participants in the market that the only outcome of the current crisis is to “sit” on their remaining exposure until the liquidity comes back or in the most pessimistic scenario they mature. Accordingly, accounting standards should allow a faithful representation of this situation.

Proposed Solution

We consider the existing classification of assets and liabilities relevant for decision-making and sufficiently transparent and detailed to provide valuable and relevant information for the users of financial statements.

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This is because for each category of financial instruments the measurement basis is relevant to faithfully represent the performance of the various business models of the entities holding those instruments and the measurement basis of the instruments are consistent within each category.

The existing US GAAP and IFRS frameworks do not offer the possibility to reflect those management changes or to represent the performance of the institutions faithfully. But, if both standards explain in detail how to measure the fair value, they don't recognize the possibility to exit the trading category and to change the measurement basis of the instrument when the entity changes its management intention at a point in time. It is important though that management is adaptive and takes into consideration changes in the economic environment in decision making.

We propose to allow the reclassification of an instrument from the trading category to the "held to maturity category". This transfer would apply only for those assets the entity is no longer able to sell in the market at a price representative of its conservative economic value.

Due to the exceptional circumstance that lead to classify those assets in the held-to-maturity category it also seems that it would be appropriate to release the excessively demanding rules of that category. Indeed it should be permitted to sell reclassified assets if market conditions have reverted without having to declassify the whole held-to-maturity portfolio.

However, to avoid technical accounting arbitrage, we suggest that a quarantine period of two years be respected until it is possible to sell the assets on the market. This two-year period should allow the market to come back to normal trading conditions.

An appropriate set of disclosures would be defined to provide investors with clear and detailed information on the activity of the entity.

Transition

Financial instruments the entity elects to reclassify are transferred at fair value at the transfer date. This would provide continuity to the measurement of the instrument within the financial statements. The fair value at that date would become the new amortized cost of the asset.

Following the requirements of the held to maturity category, the asset will be measured at amortized cost.

At the transition date the entity measures the transfer effective interest rate in accordance with IAS39 paragraph 9: "*The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument*".

Subsequent Measurement

- At each reporting date, the amortized cost is equal to the expected future cash flows discounted at the transfer effective interest rate.
- If the entity revises its estimate of the future cash flows the carrying amount is adjusted in the income statement.
- Additional impairment will be recorded if the instruments meet the impairment criteria.

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Disclosures

Such transfer allowance would require expanded disclosure providing investors with information on:

- The amount of transferred assets reported separately.
- The average transfer interest rate.
- Qualitative information on the reason for the transfer.
- The amount of transferred assets that have been sold after the 2 year period.