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International Accounting Standards Board
1st Floor
30 Cannon Street
London
EC4M 6XH

Ref.: Exposure Draft / ED/2009/5 / Fair Value Measurement

Dear Sirs,

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the above mentioned Exposure Draft (ED) issued by the International Accounting Standards Board ("IASB").

ISDA has over 820 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective to the work of the IASB.

In this letter we outline our key messages in response to the ED and in the Appendix we provide our more detailed responses to the specific questions.

Key Messages:

- US GAAP (including SFAS 157) and IAS 39 are interpreted by market participants as permitting the calculation of pricing adjustments for derivatives, including costs of close out and credit adjustments, on a portfolio basis. Doing so ensures that risk management and external reporting are globally aligned. Our members are concerned that the ED as drafted is unclear as to whether portfolio based valuations are permitted. Most derivative transactions entered into by financial institutions are not entered into principally to be sold or repurchased individually in the near term but, instead, their risks are managed on a portfolio basis. The portfolio is dynamic and individual instruments will be transacted or closed out, to accommodate customer needs and in order to manage the risks inherent in the portfolio. Thus, calculation of pricing adjustments on a portfolio basis is entirely consistent with the way that such instruments are managed in reality, and is reflective of the way that the related risks are actually transferred.

We therefore encourage the Board to amend the wording in the new IFRS to make it clear that pricing adjustments are acceptable to be made for a portfolio of derivatives, including costs of close out and credit adjustments, on a portfolio basis. We provide specific drafting recommendations in our response to Question 5 for the Board's consideration.

- On a related matter, ISDA members are concerned that the ED proposes that the prohibition on block discounts is to be extended to the valuation of level two and three financial instruments. In addition to the primary objection that not allowing block discounts is inconsistent with the concept of fair value, for level two and three securities block discounts are currently encapsulated in various valuation methodologies when calculating liquidity valuation adjustments. As a result, disallowing block discounts for the valuation of such securities would be extremely difficult, if not impractical, to isolate within current valuation methodologies. Also, prohibition of level 2 and 3 block discounts will create an undesirable difference between IFRS and US GAAP.

- We understand that the recognition of day 1 gains and losses falls outside the scope of the ED (paragraph BC 78) but there is currently no plan to re-examine this issue in the project to replace IAS 39. The majority of our members strongly encourage the IASB to re-debate the deferral of day 1 gains as part of the IAS 39 replacement project. The treatment of day 1 gains and losses in the ED implies that such profits/losses in fact *exist* which the majority of our members believe means that there would be no conceptual basis in IFRS as to why they should not be *recognised* in profit or loss. Meanwhile, as long as the deferral of day one gains remains inconsistent with the requirements of US GAAP, this difference is an obstacle to convergence and is likely to disadvantage banks outside of the United States. Therefore these members urge the Board to re-debate day 1 gains and losses as part of the replacement of IAS 39.

- The ED proposes many new disclosures for fair value and requires certain disclosures to be made on a quarterly (or interim) basis. ISDA reaffirms its long held view that the IASB should develop a coherent disclosure framework to review and consolidate existing disclosure requirements and establish a basis for introducing new disclosures, as opposed to creating piecemeal additions to existing disclosures. Whilst we strongly support having clear and robust disclosures which provide transparency, we are concerned about the piecemeal additions of disclosures with each new standard, as well as the rationale, consistency and understandability of many of the proposed new disclosures in the absence of such a disclosure framework. In particular we do not support the proposal to require day 1 gains on level 1 and 2 financial instruments to be disclosed. As level 1 and 2 instruments are determined using observable market data we do not be believe that this information would provide benefits to users commensurate with the significant costs necessary to collect it. Therefore ISDA recommends that the Board re-consider the disclosures proposed in the ED.

- We appreciate the effort towards convergence with the FASB insofar as guidance from FASB SFAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* has been included in the Appendix to the ED. However, the majority of our

members would encourage the IASB also to incorporate the guidance of the Expert Advisory Panel, established by the IASB. In particular, these members believe that the sections on 'Understanding the Instrument', 'Evaluating available market information and 'Use of Models' could have been more extensively used in drafting the Implementation Guidance in the ED. Therefore we recommend that the Board incorporate at least the above sections of the Expert Advisory Panel document into the final standard.

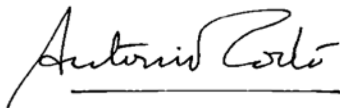
We would also like to take this opportunity to urge the Board to address the topic of offsetting of assets and liabilities as a matter of urgency. There is a significant lack of comparability in balance sheet size between entities reporting under IFRS and US GAAP as a result of the differences on this topic, specifically due to US GAAP allowing the offsetting of derivative assets and liabilities with the same counterparty traded under a master netting agreement. The US practice of offsetting on this basis is also consistent with regulatory capital requirements. The unlevel playing field between IFRS and US banks in the area of offsetting will become an increasingly important issue now that regulators are sharply focused on balance sheet size and leverage ratios. We believe that the Board's project to replace the financial instrument accounting model provides an opportunity to address differences in offsetting and achieve a converged position. Therefore we strongly urge the Board to take this issue up as part of the current efforts to address financial instrument accounting.

Finally, ISDA would be pleased to participate in the Fair Value Measurement Roundtables scheduled on 11 December 2009.

We hope you find ISDA's comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

Charlotte Jones
Deutsche Bank AG
Chair, European Accounting Policy Committee



Antonio Corbi
International Swap and Derivatives Association
Risk and Reporting

Appendix – Responses to specific questions raised by the IASB

Attachment:

Appendix – Responses to specific questions raised by the IASB

We set out below our comments relating to specific questions outlined in the invitation to comment.

Question 1

The exposure draft proposes defining fair value as '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' (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs. Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

ISDA members agree with the definition of fair value as an exit price as defined in the ED.

Question 2

In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts:

(a) In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 *Share-based Payment* and reacquired rights in IFRS 3 *Business Combinations*) (see paragraph BC29 of the Basis for Conclusions).

(b) The third context is the requirement in paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement* that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

Our members support the proposed approach to amend paragraph 49 of IAS 39 as outlined in the ED.

Another issue identified by certain members is paragraph 43 of IAS 39 and the use of fair value for the initial recognition of financial instruments, which are not recorded at fair value through profit or

loss. Paragraphs BC28 and 29 of the ED consider that entry and exit prices will normally only differ due to transaction costs and that these are excluded from measurement. However, the same logic cannot be applied to instruments such as loans, which are not purchased but originated by the entity. The exit price of a loan would be derived from a completely different market than that in which loans are extended and prices would not differ only due to transaction costs. AG77 of IAS 39 currently allows for this issue by specifying that the fair value of a debt instrument can be determined by reference to "interest rates currently charged by the entity or by others for similar debt instruments", but this guidance would be removed by the ED. For financial instruments not recorded at fair value through profit and loss and which are not purchased, ISDA recommends that the reference to fair value in paragraph 43 be amended to include the following wording:

> *"The fair value of financial instruments which are not recorded at fair value through profit or loss is estimated by discounting the future cash flows using the current rates at which similar instruments would be made to borrowers with similar credit ratings and for the same remaining maturities".*

This would allow the current practice of recognising on–market rate loans at their transaction price to continue.

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions). Is this approach appropriate? Why or why not?

A majority of our members believe that if it is the intent of the IASB that the 'most advantageous market' should mean the same as the US GAAP concept of the 'principal market', then the IASB should replicate the wording of SFAS 157, so as not to create an unnecessary GAAP difference. These members believe that the wording of SFAS 157 is both clear and understood by the market, particularly in the context of financial instruments. Use of 'most advantageous market' raises issues such as the need to search the possible methods of disposal, which are best avoided, particularly as the 'most advantageous market' may be illiquid and will change from day to day depending on arbitrage opportunities.

Our members are also concerned with the reference to the 'reporting entity' in the last sentence of paragraph 9 of the ED and note that this sentence is not used in SFAS 157. If this sentence is carried forward to the final standard, we believe the reference should be solely to the 'entity' or the referenced changed to 'the business unit holding the asset'. The risk is that while there may be a most advantageous market from the perspective of the consolidated reporting entity, the entity within the consolidated entity holding the asset may not in practice have access to that most advantageous market as there could be regulatory or other constraints which would prevent that market being used by all entities within the group.

Question 4
The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions). Is the description of market participants adequately described in the context of the definition? Why or why not?

ISDA supports the description of market participants as defined in the ED. This definition is consistent with how the assumptions used to determine the fair values of financial instruments are derived in practice.

Question 5
The exposure draft proposes that:

(a) the fair value of an asset should consider a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).

(b) the highest and best use of an asset establishes the valuation premise, which may be either 'in use' or 'in exchange' (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).

(c) the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

The proposal in the ED:

Paragraph 24 of the ED states that "the in-use valuation premise is not relevant for financial instruments" and paragraph BC 33 states that "the unit of account for a financial instrument is the single instrument". This differs from US GAAP, in that SFAS 157 does not prohibit an in-use premise for financial instruments and SFAS 159 *The Fair Value Option for Financial Assets and Financial Liabilities* paragraph A18, which states that the unit of valuation may differ from the unit of account. US banks and other dealers in derivatives, rely on these two principles to make pricing adjustments to mid-market model prices for a portfolio of derivatives, including costs of close out and credit adjustments, on a portfolio basis. Meanwhile the ED proposes to eliminate paragraph AG 72 of IAS 39 which specifically permits a bid-ask spread to be calculated on a net basis for offsetting positions.

Consequently the members of ISDA are concerned that the different approach taken in the ED may be taken to indicate that it is not possible to make a portfolio calculation under IFRS and therefore, we strongly urge the Board to word the final standard to make it clear that this is possible.

Passages in the ED which could be read to address this issue include:

- Paragraph 55: "...the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used...This [draft] IFRS does not preclude the use of mid-market pricing or other pricing conventions used by market participants as a practical expedient for fair value measurements within a bid-ask spread."

- Paragraph BC 96: "...the use of bid... and ask prices... is permitted but not required...Moreover, because the ED does not propose the use of bid...and ask prices.., it does not contain guidance for offsetting positions."

- Paragraph BC 97: "IAS 39 defines 'bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (e.g. for counterparty credit risk) are not included in the term 'bid-ask spread'...The Board decided not to specify what, if anything, is in a bid-ask spread in addition to transaction costs. Rather, an entity will need to make that assessment when determining the point within the bid-ask spread that is most representative of fair value in the circumstances."

The above paragraphs may possibly be read to suggest that it is possible to make pricing adjustments on a portfolio basis, but it is not entirely clear and may also be interpreted in different ways. Furthermore, a portfolio approach to pricing adjustments is a 'pricing convention used by market participants' and therefore, it is not a 'practical expedient'. Our members also see that, while the bid-ask spread is to be no longer defined to include only transaction costs, it is not clear from the current wording as to whether it can be taken to include counterparty credit risk.

The management of Derivative Portfolios in Practice:

As stated in our May 2007 letter to the IASB on the Discussion Paper for Fair Value Measurement, a portfolio approach to pricing adjustments is consistent with the way derivative instruments are managed and priced in the marketplace and allows the financial statements to reflect decision-useful information for users.

In practice, dealers manage and account for derivatives on a portfolio basis. The main impact of a portfolio approach is the determination of the valuation adjustments that reflect the components of credit and also the bid-ask spread. The following examples illustrate the use of a portfolio approach taking into consideration the costs of close out and also counterparty risk, on an interest rate derivative position:

- A dealer has a portfolio of interest rate swaps where the risks are managed on a portfolio basis, with some of the risks naturally offsetting each other. Assume that the dealer has executed a three year, CU 3 million notional which pay 5%, and receive LIBOR interest rate swap with one counterparty, and a three year , CU 2 million notional which receive 5%, and pay LIBOR interest rate swap with another counterparty. The dealer has, therefore, an open interest rate position of CU 1 million. To close out the net position, the dealer may decide to enter into a

further three year swap to receive fixed and pay LIBOR on CU 1 million. In this situation, the dealer will consider and agree the price of this new transaction in the context of the entire portfolio. Until this new trade is entered into, the dealer would value the portfolio so as to include the "cost" of closing out the net risk position, which will be smaller than for the two swaps individually.

- If a dealer has entered into two derivative transactions with the same counterparty, which have offsetting counterparty risk (e.g. a purchased and written option or two swaps with offsetting risk profiles) and transacted according to an ISDA Master Netting Agreement, the credit adjustment on a portfolio basis would be less than those calculated if the two instruments were to be considered separately. This is because the credit risk actually faced by the entity, i.e. at the portfolio level, is considerably lower than that implied by considering the derivatives separately. Requiring a credit adjustment to be calculated on an instrument-by-instrument basis would overstate the counterparty losses that are likely to be incurred and may result in an immediate accounting loss on the execution of the second derivative if it is priced to reflect the portfolio reduction in credit risk.

It is important to emphasise that most derivative transactions are not entered into principally for the purpose of selling or repurchasing in the near term. The risks arising from derivatives are not managed on the individual contract level, but on a portfolio basis. The portfolio is dynamic and individual instruments will be entered into or closed out to accommodate new business and in order to manage the entity's risks. To reduce its risks, it is more likely that a dealer will enter into a new, offsetting contract, than to close out an existing one. However, if the dealer wishes to dispose of a significant proportion of a portfolio, it would normally dispose of the instruments as a portfolio, rather than as individual contracts with the marketplace. In addition, from time to time, two entities may seek to reduce the number of derivatives open between them (so as to reduce the number of cash flows and accounting complexity). In this situation, they will close out the portfolio of transactions and replace them with a single trade that has the same risk exposure as that of the portfolio that is being closed out.

In 2003 ISDA met with representatives of the Board to discuss the use of a portfolio valuation approach for determining the fair value of certain financial instruments. Subsequently, AG 72 was added to IAS 39, permitting a portfolio approach for determining the fair value of off-setting risk positions within the bid-ask spread. This guidance, and the absence of any prohibition on the use of portfolio valuation elsewhere in IAS 39, has resulted in entities continuing to value certain financial instruments, such as derivatives, on a portfolio basis, as originally set out in the 1993 G-30 Report and as it is applied in practice under SFAS 157.

Drafting Suggestions from ISDA:

We recommend that paragraph 55 of the ED is amended to read as follows (added text is underlined):

> "If an input used to measure fair value is based on bid and ask prices (e.g. in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where the input is categorised in the fair value hierarchy (Level 1, 2 or 3). This draft IFRS

> does not preclude the use of mid-market pricing or other pricing conventions that are either used by market participants to determine fair value or are a practical expedient for fair value measurements within a bid-ask spread. If a bid ask-spread for an asset or liability is not observable directly or indirectly (e.g. a bid-ask spread for a similar asset or liability), an entity need not undertake exhaustive efforts to estimate a bid-ask spread. An example of an acceptable convention to determine fair value is the calculation of the pricing adjustments for a portfolio of derivatives, including costs of close out and credit adjustments, on a portfolio basis. When an entity has derivative contracts with offsetting market and credit risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate."

Furthermore, if paragraph 24 is not removed from the final standard, we recommend that this paragraph be amended to make clear which instances were contemplated by the Board.

Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components:
(a) the value of the assets assuming their current use and
(b) the amount by which that value differs from the fair value of the assets (i.e. their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions).

Is the proposed guidance sufficient and appropriate? If not, why?

We have limited our response in this letter to accounting issues pertaining to financial instruments.

Our members do not believe this is an issue for financial assets and therefore make no comment on the proposed guidance.

Question 7

The exposure draft proposes that:
(a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).
(b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).

(c) if there is no corresponding asset for a liability (e.g. for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

We believe that the proposals are appropriate but also draw your attention to our response to the Discussion Paper on *Credit Risk in Liability Measurement,* dated 1 September 2009.

Our members highlight that there may be instances when it is not appropriate to use a financial asset price to determine the fair value of a financial liability, because there may be features inherent in the financial liability which do not exist in the corresponding financial asset. Please note, that this issue was addressed by the FASB in their Exposure Draft *Fair Value Measurements and Disclosures* (Topic 820), which sets out a number of examples where this is the case, such as when the asset is subject to restrictions which would not apply to the transfer of the liability.

Consequently, we recommend that paragraph 27 of the ED be amended to read: *"If there is an active market for transactions between parties who hold debt securities as an asset, the observed price in the market* <u>is likely</u> *to also represent the fair value of the issuer's liability"*.

Question 8
The exposure draft proposes that:
(a) the fair value of a liability reflects non-performance risk, i.e. the risk that an entity will not fulfill the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).
(b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

ISDA has previously commented on these issues in our response to the Discussion Paper *Credit Risk in Liability Measurement,* dated 1 September 2009.

Question 9
The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced

by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions).
Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

ISDA notes the Board views that day one profits and losses are an issue of when, and not how, to measure fair value. The majority of our members strongly encourage the IASB to re-debate the deferral of the upfront gain as part of the IAS 39 Replacement project.

The proposal in the ED will require financial instruments whose fair value is not evidenced by observable market prices or by observable market data, to be reflected in the balance sheet at the exit price. However, any difference between the exit price and transaction price at initial recognition must be recorded in deferred revenue (i.e., a liability) and any negative difference must be recorded as deferred expense (i.e., an asset). The treatment of day 1 profits and losses in the ED implies that they *exist*, which the majority of our members believe means that there would be no conceptual basis in IFRS as to why they should not be *recognised* in profit or loss. Also, these members do not see a conceptual basis for, on the one hand, recognising changes in exit prices between day 2 and day 3 through profit or loss yet deferring the difference between the transaction price and the exit price determined at inception. Further, they question whether the separate assets and liabilities that would be recognised are consistent with the Framework. These members believe that the deferral of day 1 profits creates an artificial dividing line between, a deemed 'good' measure of fair value based on quoted market prices and, a 'bad' measure of fair value based on a mark-to-model technique.

ISDA believes the disclosures currently required by IFRS 7 on level 3 measurements, and the resulting profit or loss, provide robust and transparent information, obviating the perceived need to defer day 1 profit or loss. Also, while the deferral of day one gains remains inconsistent with the requirements of US GAAP, this difference is likely to disadvantage non-US banks. This is a particularly disappointing outcome given the convergence project between the IASB and the FASB.

In addition, our members are concerned with the wording used in paragraph 36 of the ED. Specifically paragraph 36 states that "the transaction price is the best evidence of fair value …*unless*", and then, lists four specific situations when the transaction price does not equal fair value, which implies that day 1 gains might not be recognised in any other situation. We believe it was the Board's intention that the situations listed in paragraph 36 are examples only, and as such, we recommend that this be made clear in the standard. We prefer the wording in paragraph 16 SFAS 157 and we therefore suggest that the first two sentences of paragraph 36 in the ED be replaced with the following words, to better reflect the Board's intentions:

> *"In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:"*

Question 10
The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples).
Is this proposed guidance appropriate and sufficient? Why or why not?

In response to the recommendation of the Financial Stability Forum, the IASB formed the Expert Advisory Panel (EAP) comprised of measurement experts from preparers, auditors, users of financial statements and regulators. The panel met several times and produced a high quality document addressing the measurement of fair value when markets are no longer active (the EAP paper). A number of ISDA members participated in the expert advisory panel. More recently, the FASB issued SFAS 157-4 'Determining Fair Value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly'. The guidance on fair value for forced or distressed transactions had a different emphasis between the EAP paper and SFAS 157-4, although we do not believe this would result in differences in practice. We appreciate the effort towards convergence that the guidance from SFAS 157-4 has been taken into the Appendix to the IASB fair value measurement exposure draft.

However, the EAP paper included other useful and practical implementation guidance for fair value measurement, which has not been replicated in the ED. Particularly, the majority of our members believe that the sections on 'Understanding the Instrument', 'Evaluating available market information and 'Use of Models', would be valuable and our recommendation is that the guidance in at least these sections should be incorporated into the Implementation Guidance, so that the guidance is codified in the fair value measurement standard. We believe this practical guidance would help less sophisticated financial institutions in determining fair value where markets are no longer active, since it provides an easy-to-understand discussion on implementing the principle of fair value measurement. Whilst we understand the concern that detailed guidance has the risk of becoming obsolete as markets change, and the EAP paper was focused on the fair value measurement of financial instruments, we believe that more use could have been made of this valuable document.

Question 11
The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions).
Are these proposals appropriate? Why or why not?

The ED proposes many new disclosures for fair value and requires certain disclosures to be made on a quarterly basis. Whilst we strongly support having clear and robust disclosures, which provide transparency, we are concerned with the piecemeal addition of disclosures with each new standard. We would encourage the IASB to develop a disclosure framework, to review and consolidate current disclosures and to assess proposed disclosures. We note that the FASB has recently introduced such a

project and we would encourage that this project be taken as a joint initiative. Introducing additional disclosures on a piecemeal basis, with a new change in every new accounting standard, does not allow preparers to adequately plan system development and creates a large volume of inconsistent, sometimes irrelevant, and overlapping disclosures, which are increasingly hard for users to understand.

ISDA does not believe that the following disclosures are decision useful information for users. As such we urge the Board to reconsider the proposed disclosures. (Note: the first two disclosures have been newly introduced in the ED, while the latter two are already requirements in IFRS 7 and are replicated in the ED):

- Paragraph D12 of the ED proposes that day 1 profit which has been recognised upfront be disclosed, along with the level in the fair value hierarchy where the related financial instrument is categorized. We do not believe that this information is useful to users of financial statements since the instruments will be valued using observable parameters. The day 1 profit represents the ability of financial intermediaries to cross different markets and where it can be recognised upfront, the fair value measurement will be robust. Additionally this information is not collected by entities, thus, to make this disclosure would require significant system development to capture the information, so that the costs outweigh the benefits. This disclosure is not required by US GAAP and we do not believe it should be introduced into IFRS.

- Paragraph 58 of the Exposure Draft requires a fair value hierarchy analysis to be provided for instruments not carried on the balance sheet at fair value. Our members note that the Basis of Conclusions for the recent amendments to IFRS 7 had rejected such disclosure, therefore our members do not understand why it has been reintroduced in the current ED. Additionally, this will become a quarterly requirement due to the amendments to IAS 34. We do not believe that this is beneficial on a cost benefit basis, as such instruments are not managed on a fair value basis and the fair values do not represent the expected return to the entity on these instruments.

- Paragraph 57c states that reclassification between levels 1 and 2 must be disclosed. Such reclassifications only result from a financial instrument becoming or ceasing to be quoted, therefore making any explanation of this movement redundant. We note that the Expert Advisory Panel, which was comprised in part of users of financial statements in addition to preparers and others, identified that the most useful fair value information relates to those instruments which are most difficult to measure – the level 3 instruments. As such we question the relevance of this disclosure and urge the Board to re-consider this requirement.

- Additionally, in the level 3 roll forward table we do not believe the segregation of cash movements between issuances, settlements, purchases and sales (para. 57eiii) is useful information for a trading book. It is not information internal management uses to review their fair value portfolios and cash flows are not necessarily tagged in this manner, so it would require significant additional system development for most reporters.

Therefore, in addition to developing a disclosure framework, we urge the Board to reconsider the above disclosures and, in particular, the disclosure of the day profits and losses on all instruments in the hierarchy.

Question 12
The exposure draft differs from Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157.
Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

Our members do not agree that all departures from SFAS 157 result in an improved accounting outcome. Specifically, we do not agree that divergence in the following areas is an improvement to SFAS 157:

- The accounting and disclosure of day one profits and losses. This is explained more fully in our responses to Questions 9 and 11 respectively;

- The possible inability to determine pricing adjustments for derivatives on a portfolio basis, given the explicit statement in the ED that the in-use premise is not available for valuation of financial instruments. This issue is explained more fully in our response to Question 5;

- The possible extension of a prohibition of block discounts into level 2 and level 3 instruments. This issue is explained in our response to Question 13.

- We note that paragraph 58 of the ED requires that a reporting entity separately discloses the fair value of instruments not carried at fair value on the balance sheet by level in the fair value measurement hierarchy. This is not a requirement of SFAS 157 or SFAS 107 and we believe that the limited benefit that users may obtain is minimal compared to the significant costs that preparers will incur in preparing this information.

Question 13
Do you have any other comments on the proposals in the exposure draft?

ISDA members continue to believe that fair value is not always most appropriately determined as "price times quantity". There are many instances where a market participant would, for example, pay a premium or require a discount to obtain a sufficiently large block of a single security. This premium would reflect the strategic advantage obtained from holding a sizeable or controlling block of that security.

We reaffirm the view that the observable quoted price for a security reflects the fair value of that security at a given volume and is not, therefore, necessarily reflective of the fair value of larger

positions. Despite its principled objection, ISDA acknowledges the strong Board support for determining the fair value of quoted financial instruments as “price times quantity”.

ISDA members are concerned that the prohibition on allowing block discounts for level 1 financial instruments is now proposed to be extended to the valuation of level two and three financial instruments. In addition to the primary objection that not allowing block discounts is inconsistent with the concept of fair value, for level two and three instruments, block discounts are currently encapsulated in various valuation methodologies as a liquidity adjustment. Disallowing block discounts for the valuation of such instruments would be extremely difficult, if not impractical, to isolate within current valuation methodologies. Furthermore, prohibiting block discounts for level 2 and 3 instruments, will create a new difference between IFRS and US GAAP.