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Hans Hoogervorst
Chairman
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30 Cannon Street
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IASB Post-implementation Review of IFRS 13 Fair Value Measurement

Dear Mr Hoogervorst

The European Banking Authority (EBA) welcomes the opportunity to comment on the International Accounting Standards Board (IASB) Post-implementation Review (PIR) of IFRS 13 *Fair Value Measurement* (IFRS 13). The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA welcomes the IASB project to evaluate the effectiveness of IFRS 13 on financial reporting and to focus on those areas which were identified as requiring further investigation by stakeholders during the previous phase of this project. Fair value accounting is one of the cornerstones of the financial statements of banks, as banks' assets are mainly financial assets, a significant portion of which are measured at fair value[1] and all of which are subject to fair value disclosures.

The EBA believes that introduction of IFRS 13 has improved the financial information provided in the banks' financial statements and contributed to the understanding of their balance sheets. The application of the Standard by banks has also highlighted some areas where it would be beneficial to provide further guidance in the Standard or additional disclosures. In particular, the IASB could provide further guidance on the definition of an 'active market', or 'significant unobservable input' as this influences the classification of financial instruments across the different levels of the fair value hierarchy, as further explained in the Annex of this letter, in order to improve consistency in the application of IFRS 13 and comparability across banks.

Our comments on the PIR are set out in the Annex. We have not specifically addressed all the questions raised in the PIR.

[1] Based on the EBA report on the results from the second impact assessment of IFRS 9, on average, 24% of financial assets under IAS 39 are currently measured at fair value (through profit or loss or other comprehensive income) and this will remain similar under IFRS 9 (https://www.eba.europa.eu/-/eba-updates-on-the-impact-of-ifrs-9-on-banks-across-the-eu-and-highlights-current-implementation-issues).

If you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely

(signed)

Andrea Enria

Annex

Question 2—Fair value measurement disclosures

The EBA acknowledges the IASB objective to enhance and harmonise disclosures about fair value measurements.

Part (a) – Usefulness of Level 3 disclosures

The EBA believes that disclosures about Level 3 positions outlined in IFRS 13, when made well and with thoughtful consideration, are crucial to the understanding of banks' balance sheets, particularly disclosures in paragraph 93 that quantify the impact of reasonably possible alternative assumptions. The ability to quantify and fully understand the valuation uncertainty arising from illiquid positions within the balance sheet promotes sound decision making and ensures that the valuations, and the assumptions underlying them, receive an appropriate level of scrutiny both externally and internally within the bank. This can make a strong contribution to financial stability by prompting discussion of alternatives to the consensus assumptions and this prompted us to develop the concept further in a regulatory context through the prudent valuation framework.

Part (d) – Other information that would be useful

The EBA notes that sometimes the decision between the classification of fair value measurements as Level 2 or Level 3 in the hierarchy is difficult (see further our response to question 5) and therefore it would be useful if entities disclosed the basis for determining whether assets or liabilities are classified as Level 2 and 3 and any judgements involved in this regard[2]. In addition, Level 3 disclosures, including the sensitivity disclosures, should be extended to certain Level 2 assets. For example, when due to the unit of account there are unobservable inputs which are not considered significant at an individual position level but which may be significant on an aggregate basis (especially, other valuation adjustments (XVAs)).

IFRS 13.48 permits under certain conditions an entity that holds a group of financial assets and financial liabilities to measure the fair value for the group of financial assets and financial liabilities (meaning to offset these positions). However, the EBA considers that the current IFRS 13[3] does not require specific disclosures for these offset positions and in particular about the

[2] IFRS 13.93 b) only refers to the disclosure of the level of the fair value hierarchy.

[3] According to IFRS 13.96 entities are only required to disclose whether the exception in paragraph 48 is used.

allocation of the portfolio level adjustments to the individual financial assets and liabilities for presentation purposes.

We note that IFRS 13.93 d) requires some information to be disclosed around the use of valuation techniques and inputs in the fair value measurement for Level 2 and 3 financial instruments. As these are highly judgemental areas of significant complexity that are key in fair value measurement, the EBA would welcome more specific requirements. For example, we think there should probably be a requirement for additional disclosures related to the adjustments made for risk under the income approach in the measurement of the financial instruments (e.g. adjustments made to the risk-free rate or to the expected cash flows) and the basis for and the changes in the future cash flow estimations between accounting periods so that it is possible to understand the reason for the changes.

The EBA notes the requirements of IFRS 13.66 in which entities are required to account for revisions resulting from a change in a valuation technique as a change of an accounting estimate in accordance with the relevant requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and the disclosure requirements included in IFRS 13.93 d). However, considering that a change in a valuation technique is not a recurring event and it may lead to a significant impact on the financial position of an entity, we believe that an entity should be required to disclose quantitative information about the value of the financial asset according to the previous and the new valuation technique.

Our responses to questions 3 and 5 below recommend providing further guidance on the application of valuation adjustments and the 'significant' and 'active market' definitions for the classification across the different levels of the fair value hierarchy. We recommend that the standard requires that entities disclose their approaches to these matters, where material.

Question 3— Prioritising level 1 inputs or the unit of account

Although the standard is clear that blockage discounts are not part of the fair value of an asset or liability, we have experience of inconsistent practice amongst preparers in the distinction between blockage factors and liquidity discounts for Level 2 and 3 instruments and we recommend that the standard adds more guidance to clarify the distinction between the two.

Question 5— Applying judgements required for fair value measurements

We support the improvement of the application of the notions of 'active market' and the assessment of whether an input is a 'significant unobservable input' as highlighted by stakeholders during the previous phase of the PIR. Indeed, these are highly judgemental areas and different application practices may lead to significantly different outcomes in terms of the fair value measurement and the classification of financial assets across the different fair value levels.

IFRS 13 (Appendix A) defines an active market as ‘a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis’. However, we concur with the feedback received in the previous phase of the PIR and believe that the assessment of sufficient frequency and volume is a judgemental area for which further guidance is needed considering that the frequency and the volume of transactions differ across markets, products and geographies (for example, when increases in the volume and frequency of the transactions occur close to the valuation dates).

In addition, IFRS 13.73 requires that ‘the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement’. This is an area which requires the application of judgement in particular to decide whether to categorise the fair value measurement as Level 2 or Level 3, considering the nature of the financial instruments, and for which we believe that further guidance is needed in order to improve consistency in the application of IFRS 13 and comparability across entities.

For instance, more guidance on ‘significant’ would be welcomed as we see inconsistent practice – where this is determined in terms of the carrying value of the instrument an input may be equally material to the income statement but be deemed significant for one balance sheet position and not for another. While the majority of banks apply a criterion that the valuation uncertainty range exceeds a certain percentage of the position value, there are some differences in the percentage threshold across banks. In addition, there is variation in whether portfolio level adjustments are considered (e.g. credit valuation adjustment (CVA) on an uncollateralised OTC derivative may have been a key unobservable when pricing the deal but some banks do not consider it as an input for the Level 2 / Level 3 determination because CVA is calculated on a portfolio basis).

Furthermore, there is different practice in terms of determining what is more important to assess a ‘significant unobservable input’: the size of the unobservable input or the size of the position. For example, suppose the fair value of an instrument is being estimated by taking the observable quoted price of a similar instrument (for example, 10) and adjusting for differences between the two instruments (for example, adjustment of 2) to take into consideration unobservable inputs. Some banks interpret IFRS 13 as requiring them to treat only the 2 as unobservable and some interpret it as requiring them to treat the whole of the 8 as unobservable. The proper treatment should therefore be clarified.

Question 7— Effects and convergence

As mentioned in the PIR, the introduction of IFRS 13 has provided a common framework to improve the comparability of financial statements, reduce diversity in practice and simplify financial reporting. Convergence of IFRS with US GAAP in the context of fair value measurement requirements was also important in support of a level playing field across entities.

The EBA believes that IFRS 13 overall improved users' ability to assess future cash flows, as common and more specific requirements were introduced leading to more consistency in the fair value measurements between different reporting periods for an individual entity and between different entities in the same reporting period. The requirements of IFRS 13 for additional information to be disclosed about the components of fair value measurements and the classification of financial instruments across the fair value hierarchy have been important in providing useful information to assess among other things the degree of subjectivity of the accounting estimates performed by an entity, especially regarding the potential concerns surrounding reasonableness of judgments on "hard to value" exposures measured at fair value (through profit or loss or other comprehensive income) and understand better the information provided.

Question 8 — Other Matters

A key valuation issue for bank regulators is day 1 P&L recognition. This can be material to bank's financial statements and inappropriate recognition of day 1 P&L concerns us because of its impact on the alignment of risk and reward in the business models of bank's trading operations. We note that the IASB staff assessment of this issue was 'Low' following phase 1 of the PIR. This was mainly on the grounds that the Standard is clear and that the issue is not pervasive. In our experience, this is actually both a pervasive and material issue. Although IFRS13.64 of the Standard appears to be clear, we see evidence of banks recognising a profit on initial recognition on the basis of exceptions in IFRS13.B4, which can interpreted in a manner that we believe is contrary to the spirit of IFRS13.64[4]. Two arguments typically employed are:

- Dealers using paragraph B4(d) to refer to a 'dealer market' but where there is no active dealer market and where it is optimistic to assume that another dealer would not price the transaction like a 'retail' customer. The wording of B4 should be amended to guard against inappropriate use of this exception by precluding use of hypothetical 'dealer markets' without evidence in the form of actual transactions in the relevant instrument

[4] IFRS 9.5.1.1A and IFRS9.B5.1.2A are also relevant as they establish the rules for the initial measurement of financial instruments and how to account for differences between the transaction price and the fair value at initial recognition.

that demonstrate that the dealer market trades at different levels from non-dealer markets.

- Other valuation adjustments (XVAs) are generally calculated at a portfolio level and we have seen practice of banks determining that they are therefore not an unobservable input to the measurement of the fair value of an individual transaction for the purpose of IFRS13.64, even where they were a significant component of the transaction price. Provided all the non-XVA related inputs to the position value are observable this results in the recognition of day 1 P&L. This exploits exception B4(c): unit of account for the transaction price is not the same as the unit of account for fair value, in a way which we believe is against the spirit of IFRS 13.