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SUBJECT: **COMMENTS ON IVS EXPOSURE DRAFT**

ABSTRACT: Comments related to the valuation approaches defined in the IVS Exposure Draft

I - INTRODUCTION

BNP Paribas appreciates the opportunity to comment on the Exposure Draft of the proposed New International Valuation Standards on valuation framework and reporting, application and asset standards.

The existence and the development of appropriate valuation standards and the contribution they bring to the proper understanding of valuation by users are an essential part of the confidence that market participants need to have in capital markets to avoid or at least mitigate such crisis our economies have recently suffered.

We are fully convinced that a set of high-quality valuation standards on the basis of clear principles will result in a significant improvement in global financial reporting and in this context, we welcome the addition of financial instruments in the series of Assets Standards which was missing in the previous editions of the IVS.

The goals of the G20 and Financial Stability Board to ensure we have robust international markets and financial stability have lead these institutions to plead for convergence towards a set of high-quality accounting standards. In the same vein, we think it is of the utmost importance that consistency exists between these accounting standards and the valuation standards produced by IVSC, especially on financial instruments in terms of concept, definition, names and approaches as far as possible, in the context of a global harmonisation.

The IVSC valuation standards for financial instruments identify the principles that should be applied in their valuation as well as the different valuation approaches in terms that are rather general. Due to the complexity of financial instruments currently developed, it will probably be necessary to take further steps to be more practitioner oriented and help in establish comparability in financial reporting of similar instruments used in similar business models.

We wish to comment one particular subject related to Valuation Approaches that is both relevant to valuation standards and accounting standards and we think that a convergence should be reached in this area between these two sets of standards. Additional general comments are provided in the following section.

II - VALUATION APPROACHES

The followings are comments to the proposed questions 6, 7 and 8 of the International Valuation Standard Exposure Draft. They relate to the valuation approaches in IVS 102 as

well as in other asset standards. Although our comments could apply to any types of assets, they have been made essentially with financial instruments in mind.

Questions 6 and 8

The valuation approaches are very general concepts that are also used in accounting standards such as IFRS Fair Value Measurement standard proposal and FASB Topic 820 (formerly SFAS 157). They both use the decomposition into the Market Approach, the Income Approach and the Cost Approach. It should be desirable that a single universal decomposition of valuation approaches with identical vocabulary is used by all standard setters, so we wonder if it is necessary that IVSC to designate the first approach as the “Direct market Comparison Approach”

One issue is that the frontier between the Market Approach and the Income Approach is not so clear cut as the Income Approach is also generally based on market information in particular for financial instruments. The term proposed by IVSC “Direct Market Comparison Approach” is fairly long and complex and links the words “Direct” and “Comparison” that are in opposition and refer to different methods. If we need to rely on a comparison, then a methodology is required and the valuation is somewhat indirect.

In fact, what is often referred to as the “Market Approach” includes two different methods:

1. The **Direct Price Method** that uses observable prices for identical and fungible assets, in general financial instruments such as shares, bonds, futures, but it can also apply to standardised commodities that are fungible. This method applies to “Level 1” assets where the value is equal to the market price (note that IVS rightfully distinguishes value and price, but in this case, they coincide).
2. The **Comparison Method** that values assets for which the price is not directly available, using relationships with similar assets for which price information exists (recent transactions or quoted price). These relationships can use several factors and require a unit of comparison and various metrics. Such methods can use of earning multiples for business or private equity valuation, price per square meters for properties, credit spreads for given ratings or any multi criteria method known as matrix pricing used for complex debt instruments. The common feature is that the price of each unit is derived from market information. However, the assessment of how a product is similar to another and how many criteria are relevant require strong judgmental assumptions. One issue is what seems comparable at a moment in time, might not be comparable anymore under other market circumstances.

We do not know which of “Market Approach” or “Direct Market Comparison Approach” is the most suitable term, but we think it could create confusion if accounting standards and IVCS are not using the same terms, especially when they talk about the same thing.

The Income Approach includes two fundamental methods:

3. The **Discounted Expected Cashflow Method (DECM)** that requires the prediction of future cashflows or incomes or rents as well as a discount rate that measures the value of time and risk. This is a valuation with a risk premium. Both the expected cashflows and the value of the risk premium can be derived from market information. This method is called “Present Value techniques” by IFRS, but we find this term too general for such particular method.
4. The **Replication Method** that is the fundamental method used for financial derivative valuation and includes the Black-Scholes formula for option pricing. This method synthesises the pay-off structure of an asset or liability using a combination of instruments with known prices, so that most of the risks are offset either statically or dynamically. In a way, it can be seen as the cost of manufacturing a financial

instrument using simpler components. Although we aim at replicating cashflows, most parameters required in the method are calibrated from market information.

Comments

The replication method is omitted in the Fair Value Measurement standards, but they quote Option pricing models such as Black-Scholes within the Income Approaches. It is true that some numerical methods are based on a measure of discounted expected cashflows under a risk neutral probability, but the fundamental reason of being able to do that is the capacity to replicate all risks of the instruments.

In fact, we believe that, putting aside the cost approach that does not directly apply to financial instruments, the Market and Income Approaches would be better decomposed using the 4 categories listed above, because the frontier between the Market and Income approaches is not so clear cut.

Note that in reality, there is often a mixture of methods used for a given instrument, as we often need to combine a Replication Method and a Comparison Method for different features of the instrument. For example, a corporate CDO can be valued with a method replicating the credit spread risk with single name CDS using a dynamic hedging strategy similar to option pricing, but the correlation element is rather derived from a comparison with index tranches where criteria of similarity between bespoke baskets are required. Also, many complex derivatives valued with the replication method contain risk factors that cannot be hedged and require a measure with historical data like in the Discounted Expected Cashflow method. We should not forget that valuation can often be calculated with several layers, including portfolio adjustments.

In conclusion, we recommend IVSC, IASB and FASB to agree together on common names and use similar descriptions of these different valuation approaches, because these are universal concepts that need to have a unique definition in all standards, be they valuation or accounting standards. We also recommend an explicit reference to the replication method that has been intensively used in derivative instruments valuation in the past 3 to 4 decades.

Question 7

Although the Direct Price Method is usually preferable when such prices are observable, we do not think that the Market Approach is systematically superior or preferable to the Income Approach. In fact it is often the case that the Replication Method is stronger than the Comparison Method, because the latter requires the analysis of risk and sets a strategy to hedge these risks. This is where models defining relationships between risk factors are used. The crucial element is the identification of all relevant risk factors and the relationship between them.

Comparison Methods are valuation techniques that require assuming the metrics of comparison that may not be valid permanently (e.g. assumption that two bonds with identical rating should have the same credit spread).

However, it is generally the case that methods that do not require the determination of risk premium, such as the Replication or Comparison methods have less uncertainty than methods such as DECM requiring to derive or assume a risk premium, especially when this risk premium is not directly observable.

We think that it may be dangerous to explicitly state that there is a hierarchy between the Market Approach and the Income Approach.

IVS 304.01

We are quite satisfied that in IVS 304.01, the Discounted Cashflow method and the Risk Replication methods have been described separately. But, as we do not list them under the

Income Approach, we may create an inconsistency with IVS 102 and the reader may not find the decomposition in the valuation approaches. We should probably have a section title named “Income Approaches” before paragraph 27.

Under the Direct Market Comparison Approach section, it is clear that paragraph 25 relates to the “Direct Price Method” and paragraph 26 relates to the “Comparison Method”. This latter paragraph deserves to be further detailed.

III - OTHER GENERAL COMMENTS

We do not wish to answer precisely to all the other proposed questions, but we would like to make the following brief comments:

1. The standards remain quite general and there may be a need for more precise application guidance. In particular, the Financial Instruments standard (IVS 303.04) could provide more precisions relevant to practitioners.
2. There is a need for convergence between IVS and Fair Value Measurement standards so that no inconsistency is created in the definition of general concepts.
3. In IVS 303.04, paragraph 14 introduces an important difference between liquidity (ability to transform into cash) and market activity (turn over between market participants). In this area, it is important to formalise and standardise the vocabulary.
4. IVS 303.04 paragraph 11 raises the important issue of Own Credit. We think that the value needs to be realisable by the entity to be relevant. This paragraph may contrast with solutions brought by the Fair Value Measurement Standards (value a liability as the symmetric asset).
5. In IVS 103, paragraph 3, we do not see a big difference between Market Value defined in (a) and Fair Value defined in (c). One can argue that Market Value is only relevant if there is an active market, while accounting standards require the measure of a Fair Value even when the market is not active, using hypothetical transactions. IVS 202.01 paragraph 5 analyses that Fair Value under IFRS should be consistent with Market value under IVS 103. However, it is not clear if IVS wishes to introduce a notion of Fair value that would not be under IFRS.
6. We think that the value should be realisable either by transfer of the asset against cash (i.e. sale) or by transfer of all its risks (replication or hedge) or by collection of income related to the asset.
7. IVS 101, paragraph 15 discusses the entity specific factors in valuation. We think it is important to distinguish what an entity intends to do with an asset (and whether the value depends on its usage) and what an entity is able to do with an asset (i.e. what market it can access and how the assets fits in the portfolio of the entity). Although Fair Value Measurement standards state that Fair Value is not an entity specific measurement, we understand that they mean that it should not depend on the entity’s intention to use the asset, but it can depend on the ability of the entity to realise the value in terms of market access and compensation with other positions own by the entity. In this respect, Fair value is somewhat entity specific.
8. Overall, we recommend that a study should be carried to compare the International Valuation Standards and the Fair Value Measurement standards in order to ensure that there is no inconsistency between the two and that these standards are fully complementary. Necessary modifications should be made in either standard.