INTERNATIONAL VALUATION STANDARDS COUNCIL

Proposed Amendments to the International Valuation Standards

EXPOSURE DRAFT

Comments on this Exposure Draft are invited before 19 June 2015. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to:

CommentLetters@ivsc.org

or by post to IVSC, 1 King Street, London EC2V 8AU, United Kingdom.

International Valuation Standards Council
1 King Street
London EC2V 8AU
United Kingdom
Email: contact@ivsc.org
www.ivsc.org

Introduction to Exposure Draft

The IVSC Standards Board has a policy of reviewing and updating as necessary all the standards in issue biennially. This Exposure Draft sets out the proposed changes to the current standards and comments are invited on the proposed changes no later than 19 June 2015.

The Standards Board considers the proposed changes in this Exposure Draft as necessary to reflect feedback and input from a wide range of constituents. In particular some of the proposals reflect responses received to the Structure and Scope consultation in 2014, and points made by various standard setting professional organisations during discussions that led to the signing of the multi-lateral Memorandum of Understanding at the 2014 Annual General Meeting in Toronto.

Further changes may be made to the attached proposals as a result of feedback received from this Exposure Draft. Our process places a high priority on suggestions from our stakeholders regarding how to move towards our objective of accepted, high quality, global valuation standards. The IVSC Board of Trustees has commissioned a Review of the strategic objectives and priorities of the IVSC which may result in further recommended changes to the IVS. The recommendations from this Review will therefore be considered before any amended standards are issued. Depending on the recommendations from the Review, an additional Exposure Draft could result, possibly leading to a deferral in the normal effective date of 1 January 2016 for the revised standards

Some of the proposed changes in this Exposure Draft are consequential on specific projects, for example the ongoing Liabilities project. Others are proposed as a result of requests for clarification or where ambiguities or minor omissions have been brought to the Board's attention.

Changes to Reflect Liabilities Project

The Board commenced a project in 2012 to examine the applicability of the IVSs to liabilities and the need for specific guidance on this topic. A Discussion Paper setting out some of the issues identified was issued in 2013. As a result of the feedback received the Board has agreed that some changes are appropriate to the IVS Framework to make the concepts discussed more clearly applicable to liabilities as well as assets. The proposed changes are included in the Exposure Draft. The Board is intending to produce supporting guidance on the applicability of the IVSs to the valuation of various different liabilities before the next general review of the IVSs.

Changes to Presentation

Following the feedback received in the Consultation on the Structure and Scope of the Standards undertaken in 2014, the Board is proposing certain changes throughout the Standards that are intended to improve the distinction between the requirements that are intended to be mandatory when applying the standards and the guidance and explanatory material that is included to assist the application of the mandatory requirements.

Changes as a Consequence of Previous Consultations

This Exposure Draft does not include changes that have already been agreed by the Board following due process and previous consultation but have not yet been issued. The comment letters received and a summary of the Board's consideration of these can be found on the relevant projects page on the IVSC web site. These are:

- Changes to IVS 230 Real Property Interests resulting from the Investment Property Project.
- The withdrawal of IVS 233 Investment Property Under Construction and its replacement with an annex to IVS 230 providing application guidance on the valuation of development property.

- Changes to IVS 300 Valuations for Financial Reporting resulting from the Investment Property project.
- New interim application guidance on credit and debit valuation adjustments which will be issued as an annex to IVS 250.

Notes for respondents:

The proposed changes to IVS 2013 are marked up in this Exposure Draft as follows:

- new text is underlined
- deleted text is struck through.

In order for us to analyse and give due weight to your comments, please observe the following:

1. Responses should be made in letter format, where appropriate on the organisation's letter heading.
2. It is not necessary to comment on all proposed amendments. However, to enable proper consideration of your comments please clearly indicate the number and title of the proposed amendment, whether you support or oppose the change and if the latter why. If you wish to propose alternative wording please support this with reasons.
3. Comments should not be submitted on an edited version of the Exposure Draft.
4. Unless anonymity is requested, all comments received may be displayed on the IVSC website.
5. Comment letters should be sent as an email attachment in either MS Word or an unlocked PDF format and no larger than 1MB. All documents will be converted to secured PDF files before being placed on the website.
6. The email should be sent to commentletters@ivsc.org

Proposed Amendments

Each proposed amendment is discussed together with the reason for the Board proposing the change. Comments are invited on any of the proposed changes. Respondents are requested to refer to the proposed change by number in their comments.

1. **Changes to Arrangement of Standards**

Responses to the Structure and Scope Consultation in 2014 indicated that the majority of respondents considered the current taxonomy of the standards to be clear. Most also recognised the need for the mandatory requirements to be supported by guidance on their application. However, a number considered that the distinction between the requirements that are intended to be mandatory and the supporting material is still insufficiently clear, as is the relationship between different types of material. It is also clear that the protocol adopted in 2011 of calling supporting guidance "Technical Information Papers" has caused some of this confusion and that some find this title to be misleading.

Accordingly the Board is proposing a number of presentational changes to the IVSs. Each Standard will now clearly identify the General Principle, ie the purpose of the Standard, and a list of Requirements that have to be followed in order to comply with the Standard. All guidance material intended to support the interpretation or application of the Requirements will be included in Annexes to the Standard. This will include the existing Commentaries in the Asset Standards and all material currently issued, or previously proposed to be issued, as Technical Information Papers that is intended to provide guidance in support of a standard.

These proposals will result in some changes to the titles and the introductions of current commentaries and Technical Information Papers, but no material changes to the content are proposed, except as indicated in the proposals in this Exposure Draft. For a schematic illustration of the proposed new arrangement of the standards see Appendix 1 of this Exposure Draft.

2. **Introduction (to the Standards)**

Proposed Change

~~The~~ <u>Each </u>IVS~~s~~ contains ~~either~~ <u>a statement of General Principle and a list of Requirements. An IVS may also include Application Guidance:</u>

1. <u>General Principle: This is a statement of the main objective or purpose of each standard and the rationale for the specific Requirements it contains.</u>

2. Requirements<u>:</u> ~~that have to be followed in order to produce a valuation that is compliant with the standards~~. <u>These are actions that have to be undertaken in order to comply with the standard unless:</u>

   - <u>a specific Requirement conflicts with a law or regulation that governs the subject or purpose of the valuation;</u>
   - <u>the whole of the standard is not relevant to the valuation being undertaken.</u>

3. ~~Information or guidance that does not direct or mandate any particular course of action but which is intended to assist the development of better and more consistent valuation practice or that helps users better understand a valuation on which they intend to rely.~~ <u>Application Guidance: This is included to provide guidance on matters that need to be</u>

considered when applying the Requirements. Although the Application Guidance must be considered in applying the standards, it does not include any action which necessarily has to be taken in order to comply with the Requirements. The Application Guidance may identify approaches, methods or procedures that are appropriate in certain circumstances, but others may also be appropriate. The Application Guidance is intended to assist the consistent application of the standards but does not absolve the responsibility of a valuer to select the most appropriate approaches, methods or procedure based on the facts and circumstances of each valuation.

The IVSs are arranged as follows:

The IVS Framework

This serves as a preamble to all the other IVS standards. The IVS Framework sets forth generally accepted valuation principles and concepts that are to be followed when applying the other standards, where appropriate. The IVS Framework does not include any ~~procedural~~ Requirements.

IVS General Standards

These set forth Requirements for the conduct of all valuation assignments, except as modified by an Asset Standard or a Valuation Application. They are designed to be generally applicable to valuations of all types of assets and for any valuation purpose to which the standards are applied.

IVS Asset Standards

The Asset Standards include General Principles, Requirements and ~~a commentary~~ Application Guidance. The ~~requirements set forth any~~ standard will include any additions to or modifications of the Requirements in the General Standards together with illustrations of how the principles in the General Standards are generally applied to the that class of asset. The ~~commentary~~ Application Guidance may also provide background information on the characteristics of each asset type that influence value, ~~and~~ identify ~~ies the~~ common valuation challenges and discuss approaches and methods that may be used to address them.

IVS ~~Valuation~~ Applications~~s~~ Standards

~~Valuation~~ The Application~~s~~ Standards address common purposes for which valuations are required. Each includes General Principles, Requirements and ~~a guidance section~~ Application Guidance. The ~~requirements set forth~~ standard will include any additions to or modifications of the Requirements in the General Standards together with illustrations of how the principles in the ~~General Standards and Asset~~ standards ~~apply~~ may be applied when undertaking valuations for that purpose. The Application Guidance may include reference to the requirements of any other standards or regulations that may apply to valuations for that purpose. ~~The guidance section provides information on:~~

- ~~the valuation requirements of internationally applicable regulations or standards issued by other bodies, eg International Financial Reporting Standards,~~
- ~~other commonly accepted requirements for valuations for that purpose,~~

- ~~appropriate valuation procedures to meet these requirements.~~

~~Technical Information Papers~~

~~Technical Information Papers (TIPs) support the application of the requirements in other standards. A TIP will do one or more of the following:~~

- ~~Provide information on the characteristics of different types of asset that are relevant to value.~~
- ~~Provide information on appropriate valuation methods and their application.~~
- ~~Provide additional detail on matters identified in another standard.~~
- ~~Provide information to support the judgement required in reaching a valuation conclusion in different situations.~~

~~A TIP may provide guidance on approaches that may be suitable but will not prescribe or mandate the use of a particular approach in any specific situation. The intent is to provide information to assist an experienced valuer decide which is the most appropriate course of action to take.~~

~~A TIP is not intended to provide training or instruction for readers unfamiliar with the subject and will be primarily focussed on practical applications. A TIP is not a text book or an academic discussion on its subject, and neither will it endorse or reference such texts.~~

Application of these Standards

When a statement is made that a valuation will be, or has been, undertaken in accordance with the IVSs it is implicit that all relevant ~~standards~~ <u>General Principles and Requirements</u> ~~are~~ <u>have been</u> complied with and due <u>regard has been had of all relevant Application Guidance.</u> ~~account taken of any supporting guidance issued by the IVSC~~. Where a departure from <u>a Requirement</u> is necessary to comply with any legislative or regulatory requirements, this should be clearly explained, see IVS 101 2(k) and IVS 103 5(k). <u>Due regard is had to any relevant Application Guidance if the guidance is considered in the preparation of a valuation. If an alternative approach to one identified in the Application Guidance is used, the preparer of the valuation shall be able to justify this approach by reference to the facts and circumstances of the valuation assignment.</u>

Assets and Liabilities

The standards can be applied to the valuation of both assets and liabilities. To assist the legibility of these standards, the words asset or assets are deemed to include liability or liabilities, except where it is expressly stated otherwise, or is clear from the context that liabilities are excluded.

Effective Dates

The effective date for each standard is shown in the standard. ~~Because TIPs do not require any specific actions to be taken or avoided they have no effective date~~.

Reason: This is being proposed as a consequence of the changes to the arrangement of the IVSs described in proposal 1. They reflect the Board's intention to no longer use the term "Technical Information Paper" for material that is intended for inclusion in the IVSs and to improve the explanation of the status of the different components of the standards. Although most respondents to the consultation supported the need for "application guidance" within the standards, some requested explanation of what was meant by having "due regard" to such guidance and the proposed changes are intended to address this.

3. **Definitions:**

Proposed New Definition

Discharge Value - the estimated value of all economic resources that will be required by a specific entity to discharge a liability on the date that it is due, measured as at the *valuation date*.

Reason: The Discussion Paper issued for the Liabilities project in 2013 asked for views on the applicability of the bases of value currently defined in the IVSs to liabilities. Respondents were generally comfortable that market value was applicable where a liability is assumed to be transferred in a market transaction and fair value (now proposed to be called equitable value, see below) could be applied to a negotiated settlement of a liability between counterparties. However, it was pointed out that the most frequently required measure of a liability outside of financial reporting is specific to the entity holding the liability.

The entity specific basis of value included in IVS is "Investment Value". Respondents indicated that this term and the definition were not really appropriate when valuing a liability, as the holder of a liability can hardly be said to be "investing" in the liability. A number of respondents suggested the term "fulfilment value" as being appropriate to provide an entity specific basis for liabilities. However, it has emerged that the IASB is proposing to use this term to describe an entity specific liability measure in relation to its emerging insurance accounting standard. To avoid confusion with the prosed accounting term the Standards Board is proposing a definition of "Discharge Value" as an entity specific measure of the cost of a liability that falls due in the future. The circumstances when discharge value may be an appropriate basis to use will be covered in future guidance on the valuation of liabilities but the Board considers it appropriate to include the definition in the IVSs and Framework ahead of this guidance being finalised.

As with the other bases of value defined in the IVSs there is no requirement to use this proposed basis in an IVS compliant valuation. The only requirement is to use a basis that is appropriate for the purpose and for the definition and source of that basis to be cited. However, to help promote global consistency the Board considers it appropriate for IVSC to define bases for each of the main types of value that may be required and to support these with appropriate guidance.

4. **Definitions**

Proposed Change

~~Fair~~ Equitable Value - the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.

Reason: This is a proposed change of title for the basis termed "fair value" in the current IVSs. The rest of the definition is unchanged. The potential for confusion with the different definition of fair value now adopted by the IASB in IFRS 13 was raised by the Board during its extensive consultations as part of the comprehensive review of the IVSs in 2010-11. At that time there was no clear preference expressed by consultees for an alternative term and a number made the point that, whilst not ideal, the distinction between the two types of fair value was well understood by professional valuers and no confusion should arise. The Board also noted that there are many other definitions of “fair value” or very similar terms in use for different purposes in different markets and that altering the title of the IVS definition would not deal with the potential for confusion between these other definitions and the IFRS definition.

However, it is clear from more recent responses to other projects and enquiries received from IVS users that, in spite of the distinction made between the IVS and IFRS definitions of fair value and the circumstances under which each is applicable, confusion does arise. The proposed name change is intended to alleviate this.

As with the other bases of value defined in the IVSs there is no requirement to use this basis in an IVS compliant valuation. The only requirement is to use a basis that is appropriate for the purpose and for the definition and source of that basis to be cited. However, to help promote global consistency the Board considers it appropriate for IVSC to define bases for each of the main types of value that may be required and to support these with appropriate guidance.

5. **IVS Framework – Objectivity**

Proposed Change

2 The process of valuation requires the valuer to make ~~impartial~~ judgements as to the reliance to be ~~given to~~ placed on different f~~actual~~ data, ~~or~~the assumptions that may be appropriate or the approach to be adopted~~. in arriving at a conclusion~~. For a valuation to be credible, it is important that those judgements can be seen to have been made in an environment that promotes transparency and minimises the influence of any subjective factors. ~~on the process.~~

Reason: There will be cases where subjective inputs are unavoidable and where a valuer will need to make assumptions about the relevance or weight that can be attached to these inputs. The change emphasises that it is the effect on the valuer’s objectivity that should be minimised.

6. **IVS Framework – Price, Cost and Value**

Proposed Change

6 Price is the amount asked, offered or paid to exchange an asset or liability. Because of the financial capabilities, motivations or special interests of a given buyer or seller, the price paid may be different from the value which might be ascribed to the asset or liability by others.

7 Cost is the amount required to acquire or create ~~the~~ an asset or to cancel a liability. When that asset or liability has been acquired, ~~or~~ created or cancelled, its cost is a fact. Price is related to cost because the price paid for an asset becomes its cost to the buyer and the price paid to cancel a liability is the cost to the holder.

8 Value is not a fact but an opinion of either:

(a) the ~~most probable~~ price to be paid for the exchange of an asset ~~in an~~

~~exchange~~ or for the transfer, settlement or discharge of a liability or

(b) the economic benefits of owning an asset or the economic cost of holding a liability

A value in exchange is a hypothetical price and the hypothesis on which the value is estimated is determined by the purpose of the valuation. A value to the owner is an estimate of the benefits that would accrue to a particular party from o~~wnership~~ owning an asset or of the cost that would be incurred by a particular party from holding a liability.

Reason: The proposed changes are to reflect the feedback received on the Liabilities project. Notwithstanding the statement in the Introduction to the IVSs that the words asset or assets are deemed to include liability and liabilities except where it is stated otherwise or it is clear from the context that liabilities are excluded, it was considered that it would improve clarity if some of the concepts and principles in the IVS Framework were amended to specifically indicate their applicability to liabilities. The proposal to remove the words "most probable" from the definition of value is because it is inappropriate to include a statistical bias in a generic definition. If a most probable estimate of the price is required that is determined in the definition of the appropriate basis of value.

7. **IVS Framework – Market Participants**

Proposed Change

18 References in IVS to market participants are to the whole body of individuals, companies or other entities that are involved in actual transactions or who are contemplating entering into a transaction for a particular type of asset. The willingness and ability to trade and any views attributed to market participants are typical of those of buyers and sellers, or prospective buyers and sellers, active in a market on the valuation date, not to those of any particular individual or entity.

Reason: Willingness has to be accompanied by the ability to trade.

8. **IVS Framework – Entity Specific Factors**

Proposed additional example in list at paragraph 20

(f) the ability to settle a liability using resources that are only available to the holder.

Reason: These proposed changes arise from the Liabilities project – see Introduction and proposal 3 of this Exposure Draft.

9. **IVS Framework**

Proposed new paragraphs to be inserted after 22 (subsequent para numbers will change)

Identifying what is Valued

The subject of a valuation may be a physical item, a legal interest, a right of use, an exclusive economic benefit or any combination of these. It may have components that are separable and capable of separate valuation or be capable of aggregation with other related assets. It is therefore necessary to clearly define what is being valued. What is included or excluded from the valuation may be influenced by the purpose for which the valuation is being prepared.

Where the subject of the valuation comprises a group of separately identifiable assets or where there are components of a single asset that are capable of valuation individually, the sum of the individual assets or components may be greater or less than the value of the whole.

Reason: In the IVS 2013 review the Board initially proposed introducing the concept of a "unit of valuation". While the concept was generally welcomed by respondents, some made the point that this term is already used in US GAAP with a specific meaning that differed from that being proposed. After debate the Board agreed not to make the change and to retain the previous explanation of the need to consider how assets are aggregated for valuation purposes. The current proposal is intended to strengthen the existing explanation of the concept without introducing a defined term such as "unit of valuation".

10. **IVS Framework – Bases of Value.**

Proposed Change:

25 A *basis of value* is a statement of the fundamental measurement assumptions of a valuation.

26 It describes the fundamental assumptions on which the reported value will be based, eg the nature of the hypothetical transaction, the relationship and motivation of the parties and the extent to which the asset is exposed to the market. The appropriate basis will vary depending on the purpose of the valuation. A *basis of value* should be clearly distinguished from:

(a) the approach or method used to provide an indication of value,

(b) the type of asset or liability being valued,

(c) the actual or assumed state of an asset or liability at the ~~point of~~ valuation date,

(d) any additional assumptions or *special assumptions* that modify the fundamental assumptions in specific circumstances.

27 A *basis of valuatio*n can fall into one of three principal categories:

(a) The first is to indicate the most probable price that would ~~be achieved~~ received or paid in a hypothetical exchange in a ~~free~~competitive and open market. *Market value* as defined in these standards falls into this category.

(b) The second is to indicate the benefits that a person or an entity enjoys from ownership of an asset or the penalty incurred by holding a liability. The value is specific to that person or entity, and may have no relevance to market participants in general. *Investment value* and *discharge value* as defined in these standards fall into this category.

(c) The third is to indicate the price that would be reasonably agreed between two specific parties for the exchange of an asset or liability. Although the parties may be unconnected and negotiating at arm's length, the asset or liability is not necessarily exposed in the market and the price agreed may be one that reflects the specific advantages or disadvantages of ownership to the parties involved rather than the market at large. ~~*Fair*~~ *Equitable value* as defined in these standards falls into this category.

Reason: These proposed changes arise from the Liabilities project and the proposed change of title for fair value to equitable value – see Introduction and proposals 3 and 4 of this Exposure Draft.

11. **IVS Framework - Market Value**

Proposed Change

31 The concept of *market value* presumes a price negotiated in a ~~an open and~~ competitive and open market ~~where the participants are acting freely~~. The market for an asset could be an international market or a local market. The market could consist of numerous buyers and sellers, or could be one characterised by a limited number of market participants. The market in which the asset or liability is exposed for sale is the one in which the asset or liability being exchanged is normally exchanged (see paras 15 to 19 above.

Reason: The proposed reference to a competitive and open market is for consistency with the revised wording in para 27 – see proposal 10 of this Exposure Draft.

12. **IVS Framework - Market Value**

Proposed new paragraph to be inserted after para 34 (subsequent numbers will change)

Some types of asset or liability may not have an identifiable "use" but the economic principle that the *market value* will reflect the maximum potential that is possible, legally permissible and financially feasible still applies. In the case of a liability this involves consideration of any potential alternative approaches that could be used to mitigate the cost that would be considered by a market participant.

Reason: This proposed new paragraph is to explain how the economic principle underlying "highest and best use" applies to the valuation of liabilities. The prudent and knowledgeable parties in the *market value* definition would always consider how a liability could be minimised when agreeing a price in exchange.

13. **IVS Framework Discharge Value**

Proposed new paragraphs to be inserted after para 37 (subsequent numbers will change)

Discharge Value is the estimated value of all economic resources that will be required by a specific entity to discharge a liability on the date that it is due, measured as at the *valuation date*.

This is an entity specific *basis of value* that is applicable when establishing the value of a liability to a particular party, normally the holder. It does not assume a transfer of the liability or the potential for price that could be agreed between the obligor and obligee to settle the liability at a date before it becomes due. Because it is an entity specific measure it can reflect ways of discharging the liability that might not be available to parties other than the holder.

Reason: These proposed changes arise from the Liabilities project – see Introduction and proposal 3 of this Exposure Draft.

14. **IVS Framework: Fair Value**

Proposed Change to paragraphs 38 - 42:

~~Fair~~ Equitable Value

38 *~~Fair~~ Equitable value* is the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.

39 ~~The definition of fair value in IFRS is different from the above. The IVSB considers that the definitions of fair value in IFRS are generally consistent with *market value*. The definition and application of fair value under IFRS are discussed in IVS 300 *Valuations for Financial Reporting.*~~

40 ~~For purposes other than use in financial statements, *fair value* can be distinguished from *market value*. *Fair*~~ This is a *basis of value* that requires the assessment of a ~~the~~ price that is ~~fair~~ reasonable between two identified parties, taking into account the respective advantages or disadvantages that each will gain from the transaction. It is commonly applied in judicial contexts. In contrast, *market value* requires any advantages that would not be available to market participants generally to be disregarded.

41 *~~Fair~~ Equitable value* is a broader concept than *market value.* Although in many cases the price that is fair between two parties will equate to that obtainable in the market, there will be cases where the assessment of *~~fair~~ equitable value* will involve taking into account matters that have to be disregarded in the assessment of *market value*, such as any element of *special value* arising because of the combination of the interests.

42 Examples of the use of ~~*fair*~~ *equitable value* include:

(a) determination of a price that is fair for a shareholding in a non-quoted business, where the holdings of two specific parties may mean that the price that is fair between them is different from the price that might be obtainable in the market,

(b) determination of a price that would be fair between a lessor and a lessee for either the permanent transfer of the leased asset or the cancellation of the lease liability.

Reason: To reflect the proposed change of title for fair value – see proposal 4 of this Exposure Draft.

15. **IVS Framework: Synergistic Value**

Proposed new paragraph to be inserted after para 47 (subsequent numbers will change)

Synergies can also arise when a liability is being transferred, eg where the party assuming the liability has other similar liabilities that can provide economies of scale when complying with its obligations.

Reason: These proposed changes arise from the Liabilities project – see Introduction and proposal 3 of this Exposure Draft.

16. **IVS Framework: Assumptions**

Proposed Change

48 In addition to stating the *basis of value*, it is often necessary to make an assumption or multiple assumptions to clarify either:

a) the state or condition of the asset in the hypothetical exchange where this is not fully known at the valuation date, or

b) the circumstances under which the asset is assumed to be exchanged.

Such assumptions can have a significant impact on value.

Reason: The additional words are intended to clarify the use of assumptions.

17. **Proposed Change to IVS 102 and IVS 103**

Introduce the heading "Requirements" beneath the "General Principle" in IVS 102 Implementation and IVS 103 Reporting.

Reason: To clarify which of the provisions are intended to be mandatory and for consistency with other standards.

18. **Proposed Change to IVS 102**

Proposed Change:

1 Valuation assignments, including valuation reviews, shall be conducted adopting procedures and principles that are necessary in order to produce a valuation that is suitable for the intended purpose. This includes following such of those ~~in accordance with the~~ principles set out in the IVS Framework that are appropriate for the intended purpose for which the ~~assignment~~ valuation is required and the terms and conditions for the assignment set out in the scope of work.

Reason: To strengthen the statement by making it explicit that the objective is to produce a valuation that is fit for purpose. This is achieved by considering all relevant matters, not just by following the principles in the IVS Framework and the terms and conditions agreed at the outset of the assignment.

19. **Proposed Change to IVS 103**

Proposed Change:

1. ~~The final step in the valuation process is communicating the results of the assignment to the commissioning party and any other intended users.~~ It is essential that the valuation report communicates the information necessary for proper understanding of the valuation or *valuation review*. A report shall not be ambiguous or misleading and shall provide the intended reader with a clear understanding of the valuation or other advice provided.

Reason: The deleted sentence does not address the principle and its deletion simplifies the statement.

20. **Proposed Change to all Standards**

Change references to "para #" of a Standard to "Requirement #" when the reference is to a Requirement. Example from IVS 200:

2 ~~To comply with the requirement to identify the asset or liability to be valued in IVS 101 para 2(d)…~~

2 <u>To comply with Requirement 2(d) in IVS 101 to identify the asset or liability to be valued…</u>

Reason: In the current standards the mandatory section is generally headed "Requirements". The proposed change is consistent with this and helps reinforce the distinction between the Requirements and the accompanying guidance.

21. **Amendments to IVS 230 *Real Property Interests.***

Proposed changes to IVS 230 to better reflect issues that arose in the valuation of investment property were exposed in January 2014 and after redeliberation were approved by the Board in October 2014.

Reason: Included here for information only – details can be found in the project page on the IVSC website.

22. **Retirement of IVS 233 *Investment Property under Construction* and replacement with application guidance on property under development generally.**

This proposal and the proposed new guidance on Development Property were exposed in January 2014, and after redeliberation both were approved by the Board in October 2014.

Reason: Included here for information only – details can be found in the project page on the IVSC website.

23. **Proposed Improvements to IVS 250 *Financial Instruments*.**

The Board has reviewed the entirety of IVS 250 and is proposing a number of changes to reflect changes in the markets since the standard was first developed in 2010. For ease of reference the changes are shown at Appendix 2.

Reason: Work on developing guidance on a number of financial instrument projects has indicated scope for improving some of the detail in IVS 250 – see Appendix 2 of this Exposure Draft.

24. **Inclusion of application guidance on CVA/DVA.**

> Following a project to develop guidance on credit and debit valuation adjustments, the issuance of an Exposure Draft in December 2013, consideration of the responses and further consultations, the Board approved Interim Guidance in October 2014. It is to be issued as Interim Guidance as changes are anticipated once the current project on funding valuation adjustments is concluded. It will be issued as an annex to IVS 250

Reason: Included here for information only – details can be found in the project page on the IVSC website.

25. **Amendments to IVS 300 *Valuations for Financial Reporting* to include reference to requirements in IAS 40 previously appearing in IVS 233.**

> This proposal and including the proposed new TIP on Development Property was exposed in January 2014, and after redeliberation were approved by the Board in October 2014.

Reason: Included here for information only – details can be found in the project page on the IVSC website.

26. **Proposed Amendment to TIP 1 Discounted Cash Flow**

> **Proposed new paragraph to be inserted after para 27 (subsequent numbers will change)**
>
> A discount rate derived from either the WACC or cost of equity may not be appropriate for application to a single asset without adjustment and other methods may need to be considered.

Reason: A number of respondents to the Development Property exposure draft indicated that they would like to see this caveat added to the related document: TIP 1 Discounted Cash Flow.

27. **Merger of current Commentary in IVS 210 *Intangible Assets* with current TIP 3 The Valuation of Intangible Assets**

> To combine the guidance in the Commentary to IVS 210 with the guidance in TIP 3. No material change to the guidance is proposed. Changes will be confined to the elimination of duplication between the two current documents and minor changes to reflect the proposed changes in presentation.

Reason: The IVSC undertook a major project between 2006 and 2009 to improve and update the standards and guidance for the valuation of intangible assets. This resulted in the issue of Guidance Note 16 (GN16) in early 2010. When IVS 2011 was published the contents of GN16 were left materially unchanged. However, in order to conform to the style then adopted of issuing more extensive application guidance in TIPs and issuing these separately from the standards, the material was divided between IVS 210 and TIP 3. This resulted in duplication of material in order for each document to be read on a standalone basis. Given the proposals to include all application guidance within the standards the previous distinction between TIPs and other guidance would no longer be relevant.

Proposed New Arrangement of the IVSs

	Section		Application Guidance	
	IVS Framework	Principles and concepts – no requirements	None	
General Standards	IVS 101 Scope of Work	General Principle, Requirements	None	
	IVS 102 Implementation	General Principle, Requirements	None	
	IVS 103 Reporting	General Principle, Requirements	103.01	Valuation Uncertainty (current TIP 4)
Asset Standards	IVS 200 Businesses and Business Interests	General Principle, Requirements	200.01	General Considerations (Current Commentary)
	IVS 210 Intangible Assets	General Principle, Requirements	210.01	General Considerations (current commentary combined with TIP 3)
	IVS 220 Plant and Equipment	General Principle, Requirements	220.01	General Considerations (Current Commentary)
	IVS 230 Real Property	General Principle, Requirements	230.01	General Considerations (Current Commentary)
			230.02	Development Property (as per paper approved in 2014)
	IVS 250 Financial Instruments	General Principle, Requirements	250.01	General Considerations (Amended Current Commentary – see Appendix 2)
			250.02	CVA DVA (as per paper Approved in 2014)
Application Standards	IVS 300 Financial Reporting	General Principle, Requirements	300.01	Current App Guidance
	IVS 310 Secured Lending	General Principle, Requirements	310.01	Current App Guidance
	IVS 320 Recovery and Resolution	*General Principle, Requirements*	*320.01*	*New guidance on Recovery and Resolution for financial institutions*
Liability Standard	*IVS 400 Liabilities)*	*General Principle, Requirements*	*400.01*	*New guidance to be developed – possibly subdivided by type of liability*

Text in italics signifies future standards that are in the course of development

Proposed Amendments to IVS 250 Financial Instruments (see proposal 23 of Exposure Draft)

Notes for Respondents:

1. Only proposed changes to the text are shown. The draft also contains some changes to the order of paragraphs. For example, the guidance on the need for a control environment has been brought forward and the discussion on credit risk moved to the end of the Annex in order to better reflect the order in which these matters have to be considered in the valuation process. These positional changes are not marked.
2. Specific requirements are being proposed to apply the principles in IVS 102 to financial instruments (Requirements 4 and 5)
3. Consistent with Proposals 1 and 2 in this Exposure Draft, the former Commentary is now presented as the first of the Annexes containing Application Guidance. Guidance on further topics relating to financial instruments, eg CVA/DVA, FVA will form future additional Annexes.
4. Proposals are made to update the guidance on Control Environments (See G5 – G8)

IVS 250 Financial Instruments

Contents

GENERAL PRINCIPLE

1. Valuations of Financial Instruments shall be undertaken in accordance with the General Principles and Requirements in the General Standards, except as may be expressly modified by the Requirements of this standard.

REQUIREMENTS

Scope of Work (IVS 101)

2. When valuations are being undertaken by the holding entity that are intended for use by external investors, regulatory authorities or other entities, to comply with the requirement to confirm the identity and status of the valuer in IVS 101 para 2(a), reference shall be made to the control environment in place, see ~~Commentary~~ Application Guidance paras ~~C31~~ G5 to ~~C35~~ G9 below.

3. To comply with the requirement to identify the asset or liability to be valued as in IVS 101 para 2(d) the following matters shall be addressed:

- the class or classes of instrument to be valued,
- whether the valuation is to be of individual instruments or a portfolio. ~~of identical instruments or a whole portfolio of assets.~~

Implementation (IVS 102)

4. ~~There are no additional requirements for financial instruments.~~ Requirements 2 – 4 of IVS 102 provide that the investigations required to support the valuation must be adequate having regard to the purpose of the assignment. To support these investigations, sufficient evidence supplied by the valuer and/or a credible and reliable third party must be assembled.

5. To comply with these requirements:

- All data used or considered as an input into the valuation process must be understood and properly validated.
- Any model used to calculate the value of a financial instrument shall be calibrated by reference to an observable price of comparable financial instruments.
- Where the characteristics of a financial instrument can be replicated by the combination of other financial instruments, any model used to calculate its value shall also be calibrated to comparable component financial instruments.

Reporting (IVS 103)

6. To comply with the requirement to disclose the valuation approach and reasoning in IVS 103 para 5(l), consideration shall be given to the appropriate degree of reporting detail. This will differ for different categories of financial instrument. Sufficient information should be provided to allow users to understand the nature of each class of instrument valued and the primary factors influencing the values. Information that adds little to a users' understanding as to the nature of the asset or that obscures the primary factors influencing value shall be avoided. In determining the level of disclosure that is appropriate, regard shall be had to the following:

- Materiality

  The value of an instrument or class of instruments in relation to the total value of the holding entity's assets and liabilities or the portfolio that is valued.

- Uncertainty[1]

  The value of the instrument may be subject to material uncertainty on the *valuation date* due to the nature of the instrument, the model or inputs used or to market abnormalities. Disclosure of the cause and nature of any material uncertainty should be made.

- Complexity

  ~~For complex instruments a more detailed description of the nature of the instrument and the factors influencing value is normally appropriate.~~ The greater the complexity of the instrument, the greater the appropriate level of detail that shall be required to ensure that relevant variables affecting value are identified and explained.

- Comparability

[1] See IVS 103.01 *Valuation Uncertainty*

The instruments that are of particular interest to users may differ with the passage of time. The usefulness of the valuation report, or any other reference to the valuation, is enhanced if it reflects the information demands of users as market conditions change, although to be meaningful the information presented should allow comparison with previous periods.

- Underlying ~~assets~~ instruments

  If the cash flows of an instrument are generated from or secured by ~~specific~~ identifiable underlying ~~assets~~ instruments, ~~information about matters affecting the current~~ factors that influence the value of those underlying ~~assets~~ instruments shall be provided in order to help users understand the reported value of the overarching instrument.

~~When financial instruments are valued for inclusion in a financial report prepared under IFRS, IFRS 7 requires specific disclosures depending upon where the instrument is classified within the hierarchy of valuation inputs, see IVS 300 *Valuations for Financial Reporting.*~~

Effective Date

7. ~~This effective date of this standard is 1 January 2012, although earlier adoption is encouraged.~~ The effective date of this standard is 1 January 2016, although earlier adoption is encouraged.

~~**COMMENTARY**~~

~~**Introduction**~~

<u>**Annex 250.01**</u>

<u>**APPLICATION GUIDANCE**</u>

<u>**GENERAL CONSIDERATIONS**</u>

G1. <u>This Application Guidance forms part of IVS 250 *Financial Instruments*. It provides guidance on the characteristics of common types of instrument that can influence value, some common approaches to valuation and other matters that commonly need particular attention or consideration when valuing financial instruments.</u>

G2. A financial instrument is a contract that creates rights or obligations between specified parties to receive or pay cash or other financial consideration, or an equity instrument. An equity instrument is any contract that creates a residual interest in the assets of an entity after deducting all of its liabilities. ~~The contract may require the receipt or payment to be made on or before a specific date or be triggered by a specified event~~. <u>A financial instrument can also be created through the combination of other financial instruments in a portfolio to achieve a specific net financial outcome.</u>

G3. Valuations of financial instruments ~~are required~~ <u>conducted under IVS 250 can be performed</u> for many different purposes including, but not limited to:

- acquisitions, mergers and sales of businesses or parts of businesses,
- financial reporting,
- regulatory <u>requirements (subject to any specific requirements set by the relevant authority),</u>
- internal risk and compliance procedures,
- ~~establishing the net asset value of insurance company funds,~~
- ~~pricing and performance measurement of investment funds.~~
- <u>measuring the performance and net asset value of funds.</u>

~~Financial instruments can be broadly divided into either "cash instruments", which include loans, deposits, securities and bonds, or "derivative instruments", which derive a return from one or more underlying assets.~~

G4. A thorough understanding of the instrument being valued is required to identify and evaluate the relevant market information available for identical or similar instruments. Such information includes prices from recent transactions in the same or a similar instrument, quotes from ~~dealer~~ brokers or pricing services, indices or any other inputs to the valuation process, such as the appropriate interest rate curve ~~or pricing volatility~~.

~~**Markets for Financial Instruments**~~

~~Liquid instruments, such as stock in a major company, a government bond or a futures contract for a recognised commodity, are traded on major exchanges and real time prices are readily available, both to active market participants and through various media outlets. Some liquid derivative instruments, eg forward stock options or commodity futures, are also traded on exchanges.~~

~~Many types of instruments, including many types of derivatives or non-liquid cash instruments, are not traded on public exchanges and have varying degrees of illiquidity. Trades of these instruments are negotiated in what is termed the over the counter (OTC) market.~~

~~Although the overall size of the market for OTC traded instruments is many times greater than that for instruments traded on public exchanges, the volume of trades varies significantly. Some common or "vanilla" swaps are traded daily in large volumes whereas for some bespoke swaps, there is often no trade at all after the initial deal is struck, either because the terms of the contract prohibit assignment or because there is no market for that class of instrument.~~

~~Valuation techniques are most likely to be required for instruments that are traded in the OTC markets or that are normally traded on a public exchange but where that market has become inactive. It is these situations that are the main focus of this standard.~~

Control Environment

G5. The control environment consists of the internal governance and control procedures that are in place with the objective of increasing the confidence of those who may rely on the valuation in the valuation process and conclusion.

~~Compared with other asset classes, the volume of financial instruments in circulation is vast but the number of active market participants relatively few. The nature and volume of instruments and their frequency of valuation means that valuation is often undertaken using computer-based models linked to trading platforms. As a consequence of these factors, many instruments are routinely valued by the holding entity, even where the valuation is to be relied upon by external parties, eg investors or regulatory authorities. The incidence of valuation by independent third party experts is less common than for other asset classes.~~

~~Valuation by the holding entity creates a significant risk to the perceived objectivity of valuations. Where valuations are for external consumption, steps should be taken to ensure that an adequate control environment exists to minimise threats to the independence of the valuation.~~

~~The control environment consists of the internal governance and control procedures that are in place with the objective of increasing the confidence of those who may rely on the valuation in the valuation process and conclusion.~~

~~As a general principle, valuations produced by an entity's "front office" brokerage and market making activities that are to be included in financial statements or otherwise relied on by third parties should be subject to "back office" scrutiny and approval. Ultimate authority for such valuations should be separate from, and fully independent of, the risk taking functions. The practical means of achieving a separation of the function will vary according to the nature of the entity, the type of instrument being valued and the materiality of the value of the particular class of instrument to the overall objective. The appropriate protocols and controls should be determined by careful consideration of the threats to objectivity that would be perceived by a third party relying on the valuation.~~

G6. In comparison to other asset classes, financial instruments are more commonly valued internally by the same entity that creates and trades them. This creates a significant risk to the perceived objectivity of valuations. Where valuations are for external parties, steps should be taken to ensure that an adequate control environment exists to minimise threats to the independence of the valuation.

G7. Many entities which deal with the valuation of financial instruments are registered and regulated by statutory financial regulators. Most financial regulators require banks or other regulated entities that deal with financial instruments to have independent price verification procedures that operate separately from trading desks to produce valuations required for financial reporting or the calculation of regulatory capital.

G8. Guidance on the specific valuation controls required by different regulatory regimes is outside the scope of this standard. However, as a general principle, valuations produced by one department of an entity that are to be included in financial statements or otherwise relied on by third parties should be subject to scrutiny and approval by an independent department of the entity. Ultimate authority for such valuations should be separate from, and fully independent of, the risk taking functions. The practical means of achieving a separation of the function will vary according to the nature of the entity, the type of instrument being valued and the materiality of the value of the particular class of instrument to the overall objective. The appropriate protocols and controls should be determined by careful consideration of the threats to objectivity that would be perceived by a third party relying on the valuation.

G9. Examples of typical components of ~~the~~ an appropriate control environment include:

- establishing a governance group responsible for valuation policies and procedures and for oversight of the entity's valuation process, including some members external to the entity,
- systems for regulatory compliance if applicable,
- a protocol for the frequency and methods for calibration and testing of valuation models,
- criteria for verification of certain valuations by different internal or external experts,
- identifying thresholds or events that trigger more thorough investigation or secondary approval requirements, and
- identifying procedures for establishing significant inputs that are not directly observable in the market, eg by establishing pricing or audit committees.

Liquidity and Market Activity

G10. The liquidity of financial instruments range from those that are ~~normally~~ standardised and regularly ~~traded~~ transacted ~~on public exchanges~~ in high volumes to those that are ~~bespoke instruments~~ agreed between ~~two parties~~ counterparties that are incapable of assignment to a third party. This range ~~of instrument types~~ means that consideration of the liquidity of an instrument or the current level of market activity is important in determining the most appropriate valuation approach.

G11. Liquidity and market activity ~~can be distinguished~~ are distinct . The liquidity of an asset is a measure of how easily and quickly it can be transferred in return for cash or a cash equivalent. Market activity is a measure of the volume of trading at any given time, and is a relative rather than an absolute measure; see the IVS *Framework.*

G12. Although separate concepts, illiquidity or low levels of market activity pose similar valuation challenges through a lack of relevant market data, ie data that is either current at the *valuation date* or that relates to a sufficiently similar asset to be reliable. The lower the liquidity or market activity, the greater the reliance that will be needed on valuation approaches that use techniques to adjust or weight the inputs based on the evidence of other transactions to reflect either market changes or differing characteristics of the asset.

Valuation Inputs

G13. ~~Except for liquid instruments that are traded on public exchanges, where current prices are both observable and accessible to all market participants,~~ Valuation inputs may come from a variety of ~~or sources of data may come from different~~ sources. Commonly used valuation input sources are broker ~~dealer~~ quotations, ~~and~~ consensus pricing services and the prices of comparable instruments.

G14. As with any data set used as a valuation input, understanding the sources and how these are statistically adjusted by the provider is essential to understanding the reliance that should be given to it in the valuation process.

G15. ~~Although not as reliable as the evidence of a contemporary and relevant trade, where such information is not available~~, Broker ~~dealer~~ quotations ~~can~~ provide ~~the next best~~ evidence of how market participants would price the asset. However, ~~problems associated with broker dealer quotations that~~ there are factors that can affect their reliability as a valuation input, including the following:

- Brokers ~~dealers~~ will normally only be willing to make markets and provide bids in respect of more popular instruments and may not extend coverage to less liquid ~~assets~~ instruments. Because liquidity often reduces with time, quotations may be harder to find for older instruments.
- A ~~dealer~~ broker ~~prime interest is in dealing~~ is concerned with trading, not supporting valuation, and they have little incentive to research an indicative quotation ~~provided for a valuation~~ as thoroughly as they would ~~for an actual buy or sell enquiry~~ an executable quotation. This can impact on the quality of the information.

- There is an inherent conflict of interest where the broker ~~dealer~~ is the counterparty to an instrument.
- Brokers d~~ealers~~ have an incentive to ~~weight advice to buyer clients in a way that favourably reflects the holding~~ encourage trading.

G16. Consensus pricing services operate by collecting price information about an instrument from several participating subscribers. They reflect a pool of quotations from different sources, sometimes with ~~or without~~ statistical adjustment to ~~reflect standard deviations or the distribution of quotations~~ compensate for any sampling bias. ~~Consensus pricing services~~ This overcomes the conflict of interest problems associated with single brokers ~~dealers~~. However, ~~the coverage of such services is at least as limited as that for single broker dealer quotations~~ as with a broker quotation; it may not be possible to find a suitable input for all instruments in all markets. Additionally, despite its name, a consensus price may not necessarily constitute a true market "consensus", but rather is more of a mean or median of recent market transactions or quoted prices. Therefore the resulting price may not necessarily be representative of real market activity.

G17. Comparable financial instrument prices serve to provide information regarding financial instruments that share certain base characteristics. Assumptions regarding the valuation of an illiquid instrument can often be gleaned through comparable transactions.

Valuation Approaches

G18. Many types of financial instrument, particularly those that are ~~traded~~ transacted on exchanges, are ~~routinely~~ valued using ~~computer based~~ automated valuation models. ~~that~~ These types of model use algorithms to analyse market transactions and produce valuations on the required asset. ~~These models are often linked to proprietary trading platforms~~ It is beyond the scope of these standards to examine the technical aspects of such models in detail, although as with other semi- or non-automated valuation models or approaches, these standards set a context for their use and the reporting of the results.

G19. Whether automated or manual, the various valuation methods used in financial markets are ~~mostly~~ based on variations of ~~either~~ the *market approach,* the *income approach* or the *cost approach* as described in the IVS *Framework.* This standard describes the commonly used methods and matters that need to be considered or the inputs needed when applying these methods.

G20. ~~It is important~~ When using a particular valuation method or model, it is important to ensure that it is calibrated with observable market information on a regular basis. This ensures that the model reflects current market conditions and identifies any potential deficiencies. As market conditions change, it might become necessary either to change the model(s) used or to make additional adjustments to the valuation inputs. Those adjustments should be made to ensure that the outcome ~~most closely results in~~ is consistent with the required valuation ~~objective~~ basis, which in turn is determined by the purpose for which the valuation is required; see the IVS *Framework*.

Market Approach

G21. A price obtained from trading on an ~~recognised~~ exchange ~~platform~~ on or very close to the time or date of valuation is normally the best indication of the *market value* of a holding of the identical instrument. In cases where there have not been recent relevant ~~trades~~ transactions, the evidence of quoted or ~~offered~~ consensus prices may also be relevant.

G22. ~~Although there will be no need for adjustment of the price information~~ It may be necessary to make adjustments to the price information if the observed instrument is dissimilar to that being valued or if ~~identical~~ the information is not recent enough to be relevant. Examples of where adjustment or weighting of the evidence of ~~traded~~ transacted prices may be required are:

- where the instrument being valued has different characteristics to the ones for which prices are available,
- where there are differences in the size or volume of the reported ~~trade~~ transaction or liquidity of the transacted instrument to the holding being valued,
- where the ~~trade~~ transaction was not between willing parties acting independently,
- the timing of the ~~trade~~ transaction, which may be accentuated by the closure of exchanges,
- where transfer of an instrument results in either the creation of a controlling interest or the prospect of a change of control.

~~A further factor that can create a difference between an exchange traded price and the instruments to be valued can arise where transfer of the holding results in either the creation of a controlling interest or prospect of a change of control.~~

Income Approach

G23. The value of a financial instrument may be determined using a discounted cash flow method. ~~The cash flows may be fixed for the life of the instrument or variable~~. The terms of an instrument determine, or allow estimation of, the undiscounted cash flows. The terms of a financial instrument typically set out:

- the timing of the cash flows, ie when the entity expects to realise the cash flows related to the instrument,
- the calculation of the cash flows, eg for a debt instrument, the interest rate that applies, ~~ie the coupon~~ or for a derivative instrument, how the cash flows are calculated in relation to the underlying instrument or index (or indices),
- the timing and conditions for any options in the contract, eg put ~~or~~, call, prepayment, extension or conversion options,
- protection of the rights of the parties to the instrument, eg terms relating to credit risk in debt instruments or the priority over or subordination to other instruments held.

G24. In establishing the appropriate discount rate, it is necessary to assess the return that would be required on the instrument to compensate for the time cost of money and risks related to:

- the terms and conditions of the instrument, eg subordination,
- the credit risk, ie uncertainty about the ability of the counterparty to make payments when due,
- the liquidity and marketability of the instrument,
- the risk of changes to the regulatory or legal environment,
- the tax status of the instrument.

G25. Where future cash flows are not based on fixed contracted amounts, estimates of the probable income will need to be made in order to provide the necessary inputs. The determination of the discount rate will also require assumptions about the risks. The discount rate also needs to be consistent with the cash flows, eg if the tax flows are gross of tax then the discount rate should be derived from other gross of tax instruments.

G26. Depending upon the purpose of the valuation, the inputs and assumptions made into the cash flow model will need to reflect either those that would be made by market participants, or those that would be based on the holder's current expectations or targets. For example, if the purpose of the valuation is to determine *market value*, or fair value as defined in IFRS, the assumptions should reflect those of market participants. If the purpose is to measure performance of an asset against management determined benchmarks, eg a target internal rate of return, then alternative assumptions may be appropriate.

Cost Approach

G27. The substitution principle inherent in the *cost approach* is applied to the valuation of financial instruments through the use of the replication method. This method provides an indication of the current value of an instrument or portfolio by reproducing or "replicating" its risks and cash flows in a hypothetical, or synthetic, alternative. This alternative is based on a combination of securities and/or simple derivatives in order to estimate the cost of offsetting, or hedging, the position at the *valuation date*. Portfolio replication is often used to simplify the procedures applied to value a portfolio of complex financial instruments (eg expected insurance claims or structured products) by substituting a replicating portfolio of assets that are easier to value and therefore more efficiently risk managed on a daily basis.

Credit Risk

G28. Understanding the credit risk is an important aspect of valuing any ~~debt~~ financial instrument[2]. Some of the common factors that need to be considered in establishing and measuring credit risk include the following:

- Counterparty risk

  The financial strength of the issuer or any credit support providers will involve consideration of not only the trading history and profitability of the relevant entity but also consideration of performance and prospects for the industry sector generally. Many

[2] See Interim Application Guidance on Credit & Debit Valuation Adjustments for further guidance concerning derivatives.

jurisdictions now require certain derivatives to be transacted through a central counterparty (CCP). Although a CCP mitigates risk, the residual counterparty risk needs to be considered.

- Collateral ~~asset quality~~

  The assets to which the holder of an instrument has recourse in the event of default ~~must~~ need to be considered. In particular, it needs to be understood whether recourse is to all the assets of the issuer or only to specified assets. The greater the value and quality of the assets to which an entity has recourse in the event of default, the lower the credit risk of the instrument. Additionally, the more frequently any collateral is exchanged between entities, the lower the resulting credit risk.

- Subordination

  Establishing the priority of an instrument is critical in assessing the default risk. Other instruments may have priority over an issuer's assets or the cash flows that support the instrument.

- Leverage

  The amount of debt used to fund the assets from which an instrument's return is derived affects the volatility of returns to the issuer and can affect credit risk.

- Netting agreements

  Where derivative instruments are held between counterparties, credit risk may be reduced by a netting or offset agreement that limits the obligations to the net value of the transactions, ie if one party becomes insolvent, the other party has the right to offset sums owed to the insolvent party against sums due under other instruments.

- Default protection

  Many instruments contain some form of protection to reduce the risk of non-payment to the holder. Protection might take the form of a guarantee by a third party, an insurance contract, a credit default swap or more assets to support the instrument than are needed to make the payments. The ~~default~~ credit risk is also reduced if subordinated instruments take the first losses on the underlying assets and therefore reduce the risk to more senior instruments. When protection is in the form of a guarantee, an insurance contract or a credit default swap, it is necessary to identify the party providing the protection and assess that party's creditworthiness. Considering the credit worthiness of a third party involves not only the current position but also the possible effect of other guarantees or insurance contracts that it might have written. If the provider of a guarantee has also guaranteed many correlated debt securities, the risk of its non-performance might increase significantly.

G29. For parties for which limited information is available, if secondary trading in structured debt exists, there may be sufficient market data to provide evidence of the appropriate risk adjustment. If not, it might be necessary to look to credit indices or information available for entities with similar risk characteristics. ~~Credit indices are published that may assist this process. If secondary trading in structured debt exists, there might be sufficient market data to provide evidence of the appropriate risk adjustment.~~ The varying sensitivities of different liabilities to credit risk should be taken into account in evaluating which source of credit data provides the most relevant information. The risk adjustment or credit spread applied is based on the amount a market participant would require for the particular instrument.

~~Own Credit Risk~~

G30. ~~Because the credit risk associated with a liability is important to its value, it might appear to follow that when valuing the interest of the issuer of a liability, the credit risk of the issuer is relevant to its value in any transfer of that liability~~ The credit risk associated with a liability is important to its value as the credit risk of the issuer is relevant to the value in any transfer of that liability[3]. Where it is necessary to assume a transfer of the liability regardless of any actual constraints on the ability of the counterparties to do so, eg in order to comply with financial reporting requirements, there are various potential sources for reflecting own credit risk in the valuation of liabilities. These include the yield curve for the entity's own bonds or other debt issued, credit default swap spreads, or by reference to the value of the corresponding asset. However, in many cases the issuer of a liability will not have the ability to transfer it and can only settle the liability with the counterparty.

G31. When adjusting for an entity's own credit risk, it is also important to consider the nature of the collateral available for the liabilities being valued. Collateral that is legally separated from the issuer normally reduces the credit risk. If liabilities are subject to a frequent collateralisation process, there might not be a material own credit risk adjustment because the counterparty is mostly protected from loss in the event of default. However, collateral provided to one counterparty is not available to other counterparties. Thus, although some collateralised liabilities might not be subject to significant credit risk, the existence of that earmarked collateral may reduce the overall collateral available to other creditors which might affect the credit risk of other liabilities.

[3] See Interim Application Guidance on "Credit & Debit Valuation Adjustments" for further guidance concerning derivatives.