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International Valuation Standards Council
By email: **comments@ivsc.org**

5 March 2021

Dear Sirs

IVS 500 Consultation 2021

Please find attached our comments on the Consultation Draft for a revised IVS 500, Financial Instruments.

We consider that structure and presentation of this paper is something that should be considered for other existing IVSs. It also highlights the problems arising from the lack of distinction currently made in the IVS between matters that should be mandatory and guidance providing examples of how those mandatory requirements may be implemented.

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

Yours faithfully,

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Comments on Consultation Draft

IVS 500 Financial Instruments

Introduction

Our directors were involved in organising and supporting the Expert Working Groups tasked with developing the existing IVS 500 and associated technical guidance on specific aspects of valuing financial instruments between 2009 and 2015. This has provided us with a strategic understanding of the issues involved with producing valuations in the financial sector and of some of the products that present particular challenges. However, we do not claim any expertise on the methodology used and the application of appropriate models. We have viewed this Exposure Draft from the perspective of its intended status as part of the overall IVS and therefore make no comments on any technical content.

We note two significant strategic changes.

- The first is to narrow the scope of the standard by expressly excluding pension liabilities, insurance contracts and lease contracts. Further exclusions are made when the instruments are being valued for certain purposes, equity instruments valued as part of a business or a business interest and the value of any financial asset to measure impairment for financial reporting.

  We believe this is a sensible move as, with the benefit of hindsight, the broad scope of the existing IVS 500 made it too generic to identify all the procedures that would be relevant to the large range of very different products and markets where valuations are required. International Standards for the valuation of pension liabilities and insurance contracts are issued by the International Actuarial Association, and therefore it would not be appropriate for the IVS to imply that these are within the scope of any IVS.

- The second is to design this standard from an entity perspective. This has been made possible by the significant narrowing of scope. The instruments which remain within the scope will mainly be held by large financial institutions or other major businesses with dedicated treasury operations. In the light of this it clearly is inappropriate for the standard to be constructed as a set of rules which an individual valuer must follow.

  We welcome this and believe it sets an example that the other IVSs should follow. We believe that standards for valuation should not be confused with standards for valuers. Valuation standards should simply set the specification for a compliant valuation. The IVSs have previously avoided telling the valuer what to do. Not least this approach was to help differentiate the IVS from the membership rules of professional bodies to which many valuers belong. Many such bodies made it clear that while they supported the development of standard valuation services or products for different purposes, they could not accept IVSC setting rules for their members. However, since 2017 the IVS has been rewritten as a rule book for valuers, which only serves to confuse stakeholders as to their purpose and status and create a barrier to their recognition and use. We are also aware that this creates an obstacle to adoption for potential adopters. It is for those with the power to adopt the standards who need to determine when they apply and to whom they apply.

Responses to Questions

Original explanatory text and questions in the Consultation draft are in plain font.

Our responses to the questions are in bold font.

Objective

As outlined in this introduction, the objective of IVS 500 *Financial Instruments* is to establish principles that will enable entities to derive fit-for-purpose valuations of financial instruments in all market conditions and circumstances, and for whatever purpose it is required, including for financial, tax and regulatory reporting.

Question 1: Do you agree with the proposed objective? Why or why not? If you agree with only parts of the proposed objectives, please specify what you agree and disagree with. If you disagree with the proposal, please explain what you propose instead and why.

Mainly yes, although subject to a caveat regarding the statement that it is intended that the standard apply in all circumstances and for whatever purpose. It is realistic to state that the IVS are suitable for financial reporting under IFRS (or Topic 820 in the USA) because it is accepted by most auditors that fair value as defined in these standards is consistent with IVS Market Value, except where "blockage factors" have to be ignored. However, tax legislation around the world, and regulations for the oversight and stability of banks by the competent authorities, do not have consistent valuation requirements. In many such cases a body of law over the correct use and interpretation of these requirements has been developed. Any legal or regulatory requirements will take precedence over the IVS. While the IVS can set best practice and procedures that may be widely applicable for these purposes, care should be taken not to suggest that this is always the case.

Question 2: The Exposure Draft is focused on the requirements that have to be met for two elements, Governance, and Data, of the proposed standard in order for an entity to arrive at a fit-for- purpose valuation of financial instruments. Do you agree that the requirements are clear, complete and provide adequate guidance to ensure compliance? Why or why not? If you agree with only parts of the requirements, please specify what you agree and disagree with. If you disagree with the requirements, please explain what you propose instead and why. If you think the requirements are incomplete, please explain what you propose should be included and why.

Both the suggested governance structure and the discussion of different categories of data and their usage is well written and clear. However, the whole standard, including these sections is described as "guidance". In our opinion, this is the appropriate status for this material. However, the introduction to the IVS states:

> ***The IVS consist of mandatory requirements that must be followed in order to state that a valuation was performed in compliance with the IVS. Certain aspects of the standards do not direct or mandate any particular course of action but provide fundamental principles and concepts that must be considered in undertaking a valuation.***

Unfortunately the way in which the standards are now written do not make it clear what are mandatory requirements and what are principles and concepts that do not direct any

particular course of action but must be considered. This is compounded by the narrow definition of the modal verb "should" which is now narrowly defined in the IVS glossary as meaning "presumptively mandatory". This fundamental problem with the structure of the current standards is highlighted by this draft. We strongly recommend that the FI Board draws this to the attention of the Review Board and also makes the recommendation that other standards revert to a structure which clearly differentiates requirements from guidance, as used to be the case with the IVS published prior to 2015.

Scope

Para 20.1 outlines the scope of application of IVS 500 *Financial Instruments*. In arriving at the proposed scope, the FI Board focused on limiting the application of IVS 500 to only those instruments intended by the Board and on ensuring, as far as possible, that all definitions are clear to avoid ambiguity in practice.

In addition, in order to avoid overlaps with extant IVS requirements and the inclusion of instruments that could potentially meet the definition of a financial instrument but are not valued as such within the scope of IVS 500, the FI Board has proposed a number of exceptions to the scope requirements in IVS 500 as outlined in para 20.1 of this Exposure Draft.

Question 3: Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We agree with the desire to avoid overlapping with existing standards by clearly defining the instruments subject to IVS 500. However, the new standard should also avoid redefining terms used elsewhere in the standards, which has been done on more than one occasion. It is important for the overall integrity and clarity of the standards that terms are used consistently.

Definitions

Paras 30.1 to 30.5 provide definitions for the purpose of applying IVS 500 *Financial Instruments*. More specifically they define:

- fit-for-purpose valuations
- financial assets
- financial liabilities; and
- equity instruments

Question 4: Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We have no comment on the proposed definitions for financial assets, financial liabilities or equity instruments. However, the proposal to define "*fit-for- purpose valuations*" is inappropriate and unnecessary for the following reasons:

1. **IVS 500 is part of the overall IVS and the provisions of these other standards apply, subject to any specific exemptions or modifications that are needed for the valuation of financial instruments IVS 101 20.1 states that:**

   > ***"All valuation advice and the work undertaken in its preparation must be appropriate for the intended purpose."***

   The need for the investigations undertaken, the methods and basis used and format for reporting to be suitable for the for the intended purpose is also stated in IVS 102, 103, 104 and 105. The use of the term "fit for purpose valuations" in IVS 500 is therefore unnecessary as this is inherent in the General Standards.

2. **The phrase and the words it contains are used in this proposed standard in accordance with normal everyday usage. There is no need to either explain or restrict its use through a formal definition.**

3. **Likewise, there is no need to keep repeating the phrase throughout the standard. The whole purpose of following or adopting the IVS is to produce a valuation suitable for the purpose for which is required. There is no need to state that this is the objective of every required or suggested action.**

4. **Although there is no need to explain or restrict the use of the phrase in this standard, if it becomes an IVS defined term it may have unintended consequences as far as the drafting or application of other standards are concerned.**

In paras 30.6 to 30.8, valuation uncertainty and valuation risk are defined for the purposes of IVS 500 *Financial Instruments*. This Exposure Draft uses valuation risk to set proportionality parameters (para 30.9) that determine the level of effort and the nature and extent of processes and controls needed in order to arrive at a fit-for-purpose valuation of a financial instrument. The objective of the FI Board in outlining the above concept is to enable constituents to evaluate in a consistent manner the extent and rigour of the processes necessary to ensure a fit-for-purpose valuation of financial instruments given the requirement for which it is needed, market conditions and other circumstances prevailing at the valuation date.

Question 5: Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We do not agree with either of these definitions.

Between 2009 and 2013 the IVSC undertook an extensive project to develop guidance on valuation uncertainty. The G20 had called on the accounting standard setters to produce this in the wake of the financial crisis, but neither IASB nor FASB saw this as a matter that fell within their remit and suggested IVSC should take this on.

The project was led by an FI valuation expert although the guidance applied across all asset types and the Expert Group formed reflected this. All the major accounting

networks were engaged together with the valuation control departments of many global banks and financial regulators. One of the key points made during these consultations was that valuation risk and valuation uncertainty should not be confused.

The distinction between uncertainty and risk has long been recognised by leading economists, not least John Maynard Keynes, so this is not a novel concept. Risk is when all possible future events or consequences of an action or decision are known, thus enabling probabilities to be calculated. On the other hand, uncertainty is where events occur, or decisions are made, when the outcomes are unknown or unknowable in advance.

Valuation Certainty was defined in the resulting IVSC guidance as:

> *The possibility that the estimated value may differ from the price that could be obtained in a transfer of the subject asset or liability taking place on the valuation date on the same terms and in the same market.*

The use of a different definition of valuation uncertainty to that previously approved by the IVSC after extensive and prolonged consultations is, to say the least, unhelpful. The definition now proposed for IVS 500 is also problematic for the following reasons:

1. It refers to valuation uncertainty as form of valuation risk.
2. The second example of different estimates arising under stressed market conditions is redundant as this is a reason why the different estimates in the first example may arise. There is a degree of uncertainty inherent in all valuations but it can become material in a number of different situations, of which stressed or illiquid markets are just two examples.

Valuation risk was not precisely defined in the IVSC guidance but was explained as the exposure that the owner of an asset has to potential future losses. Examples of valuation risk were provided in the guidance. The common factor is that such risks are taken into account by informed buyers and sellers and balanced against the expected benefits of ownership when setting market prices.

The definition of Valuation Risk proposed in this draft completely blurs the difference between uncertainty and risk. It indicates that factors contributing to valuation risk include the complexity of the financial instrument, incomplete or inaccurate data, market instability or lack of liquidity, financial modelling uncertainties and inadequate infrastructure, processes and controls. Only the complexity of an instrument is a potential source of valuation risk, for example because its value can be adversely affected by changes to multiple factors outside the control of the holder. The others are potential causes of valuation uncertainty.

Valuation risk of course affects asset other than financial instruments and if it is felt necessary to define it in this standard a definition which is applicable to all assets covered in the IVS should be agreed.

Additional Comment:

Although not the subject of a specific question about the “Definitions” section, “Proportionality” is another unnecessary definition as it is only used with its normal everyday usage.

Governance

The Exposure Draft provides guidance on the processes that entities should follow to ensure proper governance around financial instrument valuations. The guidance requires that a valuation process should be:

- systematic
- consistently applied
- economically sound; and
- controlled

In order for the valuation process to meet the above objectives it should require:

- ownership
- accountability
- transparency
- consistency
- review and challenge
- diversity; and
- documentation

Question 6: Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

While the governance structure described, and in particular the various roles such as "developer", "challenger " and "assessor" may be suitable for a large bank or other regulated financial institution, it would not be for other types of business running treasury operations in support of their major activity, for example a manufacturer holding swaps to hedge against currency movements. This type of instrument will require valuation, not least for financial reporting and some guidance on less complicated governance procedures would be appropriate.

We note the short section right at the end of this Exposure Draft which accepts that proportionality is required in the application of the standard. We suggest this should be at or close to the beginning of the document, say in Section 4.

Data

For the purposes of this Exposure Draft, data is considered to be any input to a process undertaken to arrive at a fit-for-purpose valuation. Firstly, the section on data outlines the principles for creating a data taxonomy or dictionary to categorise, assess and control all data that is used in valuations. Secondly, the specific requirements that need to be met for the following data types are outlined:

- internally sourced data
- market data
- transaction data
- model-based/indicative market data

- judgement-based data;
- historical data; and
- performance data

The section further describes the controls necessary for aggregating and managing data in an organisation and how the concept of proportionality applies in determining the requirements concerning the use of data.

Question 7: Do you agree with the principles outlined in paras 60.5.1 to 60.5.3 regarding the development of a data taxonomy? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We have no comment on these proposals.

Question 8: Paras 60.6.2 to 60.6.8 outline the specific requirements for the data-types listed above. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We have no comment on these proposals.

Question 9: Paragraphs 60.7.1 to 60.7.6 outline the principles for controlling and aggregating data across an organisation. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We have no comment on these proposals.