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IFRS IC - POTENTIAL AGENDA ITEM REQUEST

IFRS 13

The Fair Value Hierarchy – Using quoted prices provided by third parties

1 The Issue

IFRS 13 Fair Value Measurement defines fair value, sets out a framework for measuring fair value, and requires disclosures about fair value measurement. IFRS 13.72-90 define the concept of the fair value hierarchy (FVH) based on Level 1, 2, and 3 inputs. There are different views of how to place liquid debt securities in the Fair Value Hierarchy when the securities are measured based on third party pricing, especially consensus prices. These different views can be demonstrated by two simple examples: IFRS 13.IE60 generally puts “Risk-free government securities” in Level 1 of the FVH, whereas “Collateralised Debt Obligations” (“CDOs”) based on consensus pricing of offered quotes are categorised in Level 3 of the FVH in example IFRS 13.IE63. What is the correct fair value hierarchy level for debt securities like government bonds that are traded in active markets but are priced using third party consensus pricing?

Reporting entities often price debt securities by using quotes from third party providers as they are not commonly traded on exchanges. Instead, the majority of debt securities is traded over-the-counter (OTC). Consequently, the OTC market is the principal market for these products. OTC markets are dealer markets in which multiple dealers quote bid and ask prices, representing the price at which the dealer is willing to buy and sell, respectively (IFRS 13.B34(b)).

Though dealers in the OTC bond market are not legally bound by the bid and ask prices they quote, market practice dictates that they provide accurate prices and stand ready to trade at those prices. Trade information and trade volume is publicly available only to a limited extent in specific asset categories. The global bond market’s structure, specifically its lack of trade dissemination, does not imply that these OTC markets are inactive, but it does mean that market activity must be gauged using aggregated surveys of trade activity and market quotations which cannot be provided by exchanges.

Based on available market data, pricing services like Bloomberg or Thomson Reuters daily publish broker/dealer quotes, or consensus prices, or evaluated prices. A broker/dealer quote is understood as based on a single source, whereas a consensus or evaluated price is based on multiple sources (generic term "composite price").

A price quotation from a broker/dealer to a client (financial reporting entity) provided as a courtesy, represents the broker's/dealer's best estimate of fair value at the close of business on the date requested. Such prices are often accompanied by a disclaimer that the price is not an offer to buy or to sell, and it is not legally binding.

Consensus prices represent the (weighted) average of quotes from multiple subscribers who each submit quotes to the pricing service. The calculation methodology and nature of input parameters vary among the pricing services and depend on the consensus price category, the availability of underlying market information, and the respective financial instrument. Commonly used consensus prices are e.g. MarkIT, R RICs by Thomson Reuters, Bloomberg Generic (BGN), Bloomberg CBBT.

Evaluated prices are often based on a combination of directly observable price information and theoretical model-based prices. Therefore, such prices are not solely based on a model in order to derive a fair value but also on up-streamed algorithms which assess and rank the available direct prices indication. Examples of commonly used evaluated prices are Bloomberg Valuation (BVAL) and Reuters Evaluated Price.

All consensus and evaluated prices are based on an algorithm and are, as such, theoretical values that cannot be executed. The respective input parameters vary and range from actual trade data to indicative quotes and other market information. The exact methodology of the calculation is proprietary for all consensus and evaluated prices, and only limited information is publicly available.

Large institutions may have significant holdings in liquid debt instruments like government, government agencies and certain corporate bonds that need to be classified within the FVH of IFRS 13. In practice, financial statement preparers make use of third party provided pricing, especially consensus pricing, for measurement purposes of these instruments. As all vendor prices are based on algorithms with a wide range of input parameters (reaching from actual trade data, to executable quotes, to indicative quotes and other market information), the requirements for Level 1 of the FVH (IFRS 13.76) on unadjusted quoted prices when read in conjunction with IFRS 13.70, 71, 79, B45-47 leave room for interpretation. The application of IFRS 13 for determining the fair value hierarchy level of such debt securities does not seem to be straight forward given the breadth of market activity and narrow price range for these debt securities.

2 The Question

Under which circumstances do third party provided prices (especially consensus prices) qualify as Level 1 input of the fair value hierarchy of IFRS 13?

3 The Views

3.1 View A

If prices from pricing services are *unadjusted* quoted prices from an active market for an identical instrument, a fair value measurement based only on that price would be a Level 1 measurement. Prices from pricing services based on in-house models (consensus and evaluated prices) are to be qualified as Level 2 or 3 inputs.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date (IFRS 13.76, IFRS 13.A).

When quoted prices are provided by third parties, e.g. a broker or a pricing service, the entity must understand the source of the inputs used by the third party in order to properly categorise any fair value measurement based on those inputs (IFRS 13.B45).

Proponents of this view A argue that an individual bid or ask price (quote) derived from a broker can qualify as Level 1 input, provided that the respective security is traded in an active market and the quote represents an observable price. Similarly, if a pricing service provides an *unadjusted* quoted price from an active market for an identical instrument, a fair value measurement based only on that price would be a Level 1 measurement. Otherwise, if the pricing service provides prices based on in-house models (consensus price algorithm or evaluated price model), any resulting fair value measurement would be a Level 2 or Level 3 measurement, depending on the observability and significance of the inputs used (IFRS 13.73, IFRS 13.A). A price based on an in-house model is an *adjusted* quoted price and, thus, can never be a Level 1 measurement (IFRS 13.76, IFRS 13.A). An entity cannot enter into a transaction for the asset at this price at the measurement date (IFRS 13.78(b)).

The standard sets out that an entity shall not make an adjustment to a Level 1 input except in certain circumstances that are listed in IFRS 13.79. According to IFRS 13.79(a), an entity may, as a practical expedient, measure fair value using an alternative pricing method that does not rely exclusively on quoted prices. However, the use of an alternative pricing method results in a fair value measurement categorised within a lower level of the fair value hierarchy. In-house models, as described above, are alternative pricing methods that do not rely exclusively on quoted prices.

If the estimates provided to the pricing service do not represent legally binding quotes and are not based on observable prices, a fair value measurement derived from the consensus price would be a Level 3 measurement. (In this context, we refer to IFRS 13.IE63, where offered quotes as input factors to consensus pricing are treated as unobservable inputs.) However, if the inputs to the price received from the pricing service are Level 1 or Level 2 inputs, the use of those prices will generally result in a Level 2 measurement (IFRS 13.73).

Against this background, any prices based on in-house models (consensus and evaluated prices) are to be qualified as Level 2 or 3 inputs.

3.2 View B

IFRS 13 allows certain adjustments to quoted prices – even for Level 1 inputs. The main focus and key aspect of the FVH is on the relative certainty of the fair valuation as an exit price and on the liquidity of an instrument. It is assumed that a third party price is determined by the reporting entity following appropriate due diligence as a practical expedient for fair value measurement within a bid-ask spread. If such a security had a verifiable high market activity, it should be categorised in Level 1 of the FVH.

Proponents of this view B would base their rationale on paras. 70 and 71 of IFRS 13. Firstly, IFRS 13.71 does not preclude pricing conventions that are used by market participants for fair value measurements within a bid-ask spread. Further, IFRS 13.70 defines fair value as the most representative value between the bid and the ask price. It seems common understanding that a consensus price is most representative of a fair value. Secondly, as IFRS 13.70 clarifies that such a price may be categorised in any level of the FVH, an evaluated price is necessarily to be seen as an "adjusted" price in the sense of IFRS 13.76 and can, consequently, qualify as a Level 1 input – if transactions occur with sufficient frequency, volume and pricing consistency on an ongoing basis, i.e. are traded in an active market.

An OTC security, which is traded on an active market, with a single trade or broker quote may be classified as a Level 1 instrument. However, if the same security were categorised as a Level 2 instrument - at best - when using consensus pricing, this outcome would be inconsistent. Furthermore, the fair value for a security that is based on a single broker quotation may be categorised in any level and may also change its level from quarter to quarter depending on the level of activity in the market. On the other hand, a preparer would need to classify a security whose fair value is based on a consensus price in Level 2, regardless of whether the underlying market being more or less liquid and not taking into account whether market conditions have changed or not.

Levelling determinations based purely on the pricing source seems neither reasonable nor useful to a reader of financial statements, since it encourages the use of smaller amounts of market data. We refer to the appendix of this request for an overview regarding the use of Level 1 for liquid debt securities.

Evaluated pricing services have developed transparency data to allow reporting entities understand whether the data used is executable or indicative and how many pieces of data are used, as well as how old these observations are. Consensus prices accompanied by data transparency based on evaluated pricing services may qualify for disclosure as Level 1, if the reporting entity knew that the valuation was mainly based on executable observations of identical securities that formed a robust and established pricing model as defined by a small standard deviation, consistent with the reporting entity's understanding of an acceptable bid-ask spread for the instrument (IFRS 13.70, 71).

4 Reasons for the IFRS Interpretations Committee to address the issue

4.1 Is the issue widespread and has, or is expected to have, a material effect on those affected?

Yes. Large institutions in the banking and insurance business rely heavily on very liquid debt securities priced by third party pricing providers like Bloomberg or Thomson Reuters - for some entities up to a three digit billion Euro amount. The hierarchy level classification of these instruments according to IFRS 13 is not consistent between different preparers. Some follow view A, some view B. Depending on the IFRS IC's conclusion, reporting entities might need to (re-)classify a significant portion of their investment portfolios. We are also aware of diversity in practice between industries and jurisdictions.

4.2 Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes. Comparable and consistent FVH information is an important factor in analysing and interpreting financial statements.

4.3 Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

Yes. It might be sufficient to develop additional guidance within the confines of IFRS 13 on how to determine whether consensus or evaluated prices (being third party prices) are level 1 inputs or not.

4.4 Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?

Yes, the question raised is fairly narrow in scope. Only a few paragraphs in IFRS 13 deal with "third-party pricing" services and "adjustments" in fair value measurement. With the clarification of the interrelation between maximising market data and price adjustments by pricing vendors as related to levelling determinations, the Interpretations Committee should be able to solve the issue in short time.

4.5 Will the solution developed by the Interpretations Committee be effective for a reasonable time period?

Yes. The questions raised relate to a fundamental issue, which is of importance for the application of IFRS 13 now and in the foreseeable future.

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