



International Valuation Standards Council

IVSC Financial Instruments Invitation to Comment

Issued: **7 August 2019**

Comments Due: **26 September 2019**

IVS Financial Instruments Agenda Consultation 2019



Notice to Recipients of This Invitation to Comment

The IVSC Standards Review Board invites feedback on all matters in this Invitation to Comment. We request comments by **26 September 2019** by one of the following methods:

- Emailing comments to comments@ivsc.org or Jeffrey.Scroggs@aicpa-cima.com, File Reference IVSC Financial Instruments Agenda Consultation 2019
or
- Respond using the IVSC Financial Instruments Agenda Consultation 2019 Feedback form and send to comments@ivsc.org or Jeffrey.Scroggs@aicpa-cima.com

All comments received are part of the IVSC's public file and are available at www.ivsc.org.

A copy of this Invitation to Comment is also available at www.ivsc.org.

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Letter from Gavin Francis Chairman, Financial Instruments Board



Dear All

The valuation of financial instruments has been an important and often controversial topic among valuation professionals, investors, prudential and securities regulators and the wider financial services industry over recent years. Financial Instruments valuation practice has continued to evolve and develop, primarily at banks and other financial institutions and in the auditing profession.

It is clear, however, that there is no effective set of international valuation practice standards for financial instruments that has been generally adopted. This has resulted in both inconsistent and sometimes low-quality valuation practices and, in recent years, concerns have been expressed by financial regulators and others about the quality and consistency of financial instrument valuation practice. The IVSC would like to address that gap in effective valuation practice standards for financial instruments, and has created the Financial Instruments Board.

The IVSC has published this agenda consultation to obtain stakeholder feedback regarding the approach the newly established Financial Instruments Board should take, and the prioritisation of that work. The consultation process for this IVS Financial Instruments Agenda consultation is now open. Accordingly, the Financial Instruments Board encourages participation within the 60-day consultation period ending 26 September 2019 from all individuals and organisations. The IVSC is committed to a fully open and collaborative consultation process. Thus, all comments received as part of the consultation process will be published on the IVSC website.

We look forward to your participation in the IVSC Financial Instruments Agenda Consultation and incorporating the views and recommendations from practitioners, valuation professional organisations, academics, investors, corporations and regulators, among others.

Kind regards

A handwritten signature in black ink, appearing to read 'G. Francis'.

Gavin Francis, Chair

Financial Instruments Board of the IVSC



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Introduction

Background

Having established standards for Business Valuation and the valuation of Tangible Assets, the Standards Review Board of the IVSC recognised the need to incorporate guidance for the valuation of Financial Instruments. Thus IVS 500 was created as a holding chapter on financial instruments and initially released as part of IVS 2017. In December of that year several working groups were convened to investigate a number of topic areas relevant to the valuation practice of financial instruments.

The IVSC Financial Instruments Board (the 'FI Board') was formed in December 2018 and met for the first time 15-16 April 2019, hosted on day 1 by Grant Thornton and on day 2 by PwC. In summary, the FI Board agreed:

- (a) to significantly modify and enhance the existing Financial Instrument standard IVS 500;
- (b) to complete an Agenda Consultation by the AGM Singapore meeting 7-9 October 2019 designed to set direction for the FI Board and to obtain feedback from stakeholders on how to modify and enhance the existing IVS 500.

Purpose of the Invitation to Comment

The purpose of this Invitation to Comment (ITC) is to solicit feedback about:

1. The valuation topics the IVSC and its newly established FI Board should address as part of its current agenda, and
2. Additional financial instruments valuation topics that stakeholders feel should be prioritised or added to IVSC's agenda.

Stakeholders are invited to comment on all matters in this ITC. In addition to the questions included, the IVSC welcomes general feedback from respondents particularly in relation to the following:

1. Are the financial instruments valuation topics described in this ITC areas for which there is potential for significant improvement as compared with IVS 2017?
2. What is the priority of addressing each financial instrument valuation topic?
3. What should be IVSC's next step to address each financial instrument valuation topic? For example, should IVSC issue a discussion paper, an exposure draft, or take some other action?

Structure of this ITC

This ITC comprises the following chapters;



IVSC and Financial Instruments Overview: Outlining the output of the IVSC working groups and the formation of the Financial Instruments board. Exploring perceived issues and stakeholder concerns around the valuation of financial instruments.

Moving Toward a New Standard: Addressing the current scope of IVS 500, the stated purpose of a revised standard, as well as specific questions on the future development of financial instruments valuation standards within IVS.

Appendix: IVSC Overview and Background: A summary of the IVSC Standards Review Board and Assets Board structure and how the newly established Financial Instruments Board fits into this structure and what their purpose is.



IVSC & Financial Instruments Overview

Background

The valuation of financial instruments has been an important and often controversial topic among valuation professionals, investors, prudential regulators and the wider financial services industry over recent years. Financial Instruments valuation practice has continued to evolve and develop, primarily at banks and other financial institutions and in the auditing profession. With the 2008 global financial crisis came an increased understanding of the importance of high-quality valuations of financial instruments that are relevant and reliable. Subsequently calls for international standards that underpin the valuation process have increased.

Succeeding in such an enormous and important practice area requires the leadership and input of a multitude of stakeholders, from international banks and standards bodies to regulators and data providers.

FI Working Groups

In December 2017 the IVSC brought together more than two dozen international stakeholders from across the financial sector in New York to sow the seeds for a major project that aims to set principles-based standards to improve the valuation of financial instruments. The New York meeting resulted in the creation of following four working groups, as proposed by the participants, covering the following areas:

1. Governance Working Group

- Reviewing documentation, transparency and auditability,
- Independence,
- Management information,
- Controls,
- Systems, processes and procedures.

2. Framework for FI Valuation Working Group

- Linkage to accounting, regulatory, other valuation standards,
- Reviewing and leveraging existing frameworks for FI valuation.

3. Valuation Data and Inputs Working Group

- Assessments of data quality and reliability,
- Approaches when markets are illiquid or inactive,
- Approaches to incomplete data eg, extrapolation and interpolation,
- Approaches to an absence of data (eg, proxies),
- Transparency of positions valued with no/low quality relevant data.

4. Financial Reporting Working Group

- Identification of areas of non-compliance with financial reporting with respect to valuations,
- Identification of areas of uncertainty with respect to valuations that lead to a dispersion in practice,
- Identification of areas of conflict between financial reporting requirements and general valuation principles eg, impact of large concentrated positions,
- Valuations not to be driven by levels 1-3 but by the valuation framework.

FI Board

In December 2018 the FI Board was set up. It brings together international leaders from across the world of finance to lead the development of standards for financial instruments, as part of the IVS. The Financial Instruments Board comprises the following members:

- Gavin Francis, Chairman Group Chief Accounting Officer, HSBC
- Thomas Lee, Vice Chair Partner, KPMG
- Raj Brar Head of Division, Bank of England Prudential Regulatory Authority
- Fernanda Diaz Rodriguez Academic, Derivatives and Banking
- Daniel Kahn Principal, Corporate Finance, EY
- Toshiyuki Kitano Director, KPMG
- Cindy Ma Global Head of Portfolio Valuation & Fund Advisory, Houlihan Lokey
- Krishna Nadella Americas Head of Buy-Side Specialists, Bloomberg
- Ben Ryan Head of Global Valuations Group, Bank of America
- Doug Summa Partner, PwC
- CK Zheng Global Head of Valuations, Credit Suisse

Over the course of 2018, each working group met monthly to develop thinking in the four above mentioned critical areas. Their contributions underpinned a white paper which was submitted to the newly formed FI Board for consideration.

During recent conference calls and board meetings, the FI Board reviewed the white paper produced by the working group to determine whether it could form the basis for further development of an FI Valuation Standard or associated general guidance to the industry. A subsequent meeting with the IVSC Standards Review Board in London during April 2019 resulted in the FI Board deciding to issue an Agenda Consultation to engage stakeholders' views on the need and the timing for future financial instruments standards. During the consultation period, the Governance Working Group continues to work on a portion of the



whitepaper.

The following organisations provided insight and expertise to the initiative either through the original task force or subsequent working groups:

- American Institute of Certified Public Accountants (AICPA)
- Bank of America
- Bank of England PRA
- Bloomberg
- BNP Paribas
- CFA Institute
- Citi
- Credit Suisse
- Deloitte
- Duff & Phelps
- EY
- Financial Accounting Standards Board (FASB)
- Goldman Sachs
- Grant Thornton
- Harvest Investments
- Houlihan Lokey
- HSBC
- IHS Markit
- International Accounting Standards Board (IASB)
- International Auditing and Assurance Standards Board (IAASB)
- JPMorgan Chase & Co.
- KPMG
- Morgan Stanley
- MUFG Bank
- PwC
- Public Company Accounting Oversight Board (PCAOB)
- Société Générale
- Securities and Exchange Commission (SEC)
- UBS

Moving Toward a New Standard

Background

Further to discussion with the Standards Review Board and the Business Valuation Board and the Tangible Assets Board, the Boards agreed that the current scope of a gap analysis should be limited to financial instruments, although a further gap analysis including all specialisms may be issued in Q1 2020.

The FI Board views the IVS 2017 definition of a financial instrument as the basis for its review. Therefore any updates and revisions to IVS 500 should be consistent with that standard, applying to any engagement or assignment that involves estimating the value of financial instruments referenced individually or collectively regardless of the measurement objective.

Definition: IVS 2017 defines a financial instrument as a contract that creates rights or obligations between specified parties to receive or pay cash or other financial consideration.

Scope

As noted previously, IVS 500 was intended only as a holding chapter for a more comprehensive standard for the valuation of financial instruments. Following their April meeting, the Financial Instruments Board identified several gaps in the current standards as well as missing practical guidance in the literature on financial instrument valuations.

Discussions between the FI Board, Task Force, Working Groups and other stakeholders, have resulted in a preliminary alphabetised gap analysis on IVS 2017 with the parties agreeing the following for prioritisation for inclusion within future editions of the IVS or associated general guidance to the industry:

- Communication, Escalation and Resolution
- Governance
- Data and Data Integrity
- Valuation Adjustments
- IBOR replacement
- Model Validation
- Model Risk Management
- IVS 500 Revisions

Approach

The FI Board seeks to provide a credible industry valuation practice standard that is relevant to stakeholders for all types and sizes of entities. The Board recognises the complexity of both the variety and types of financial instruments, and that the measurement objective will have meaningful impact on the valuation approach followed by a given entity. For example, it may be necessary for a small entity without adequate internal resources to seek external assistance with valuations, where a large financial institution may have internal resources to value their financial instruments. Similarly, issues



such as the estimation of hard-to-value instruments may only be applicable in certain situations and for certain types of entities.

The Financial Instruments Board agreed the on the following three principles to guide the revision of the IVS 500:

- a. Standards should be relevant for all types and sizes of entities with financial instruments.
- b. Standards should focus on a process for valuation of financial instruments – what is being measured, how is it being measured, and what is being done with the results.
- c. Standards should apply regardless of the measurement objective (GAAP, Tax, Stress testing, Prudential valuations, etc..) and should be fit for use for the measurement objective.

Focus Areas

These principles will be applied to focus areas explored by the Working Groups below:

Governance: A set of overarching principles used to guide the valuation of financial instruments regardless of measurement objective. This includes guidance on roles and responsibilities of management and others, the segregation of duties and independence, as well as the assessment of valuation risk and escalations through the chain of command.

Data: Guidance regarding the data validation, updating of data, determining the quality of data as well as guidance for exercising judgement in the use of data, and instances where limited or no data is available.

Methods and Models: Guidance regarding how methods and models are selected, validated, monitored and controlled, including consistency and granularity. In addition, guidance for addressing evolving market practices, such as valuation adjustments ('XVAs').

Controls: Guidance on the valuation control infrastructure, end-to-end valuation process and independent price verification.



Questions for Respondents

The FI Board, Working Groups and IVS stakeholders have observed a number of issues related to the valuation of Financial Instruments. These unique issues and concerns related to the valuation of Financial Instruments include the following:

Question 1: To what extent is the scope of revisions to IVS 500 as outlined above appropriate?

Question 2: Should IVS 500 keep the current definition of a financial instrument? If not, should the definition be removed or revised? If revised, what should the definition be?

Question 3: When considering guidance on governance as it applies to financial instruments, to what extent should detail be provided on the areas outlined in the previous section: management and others roles and responsibilities, segregation of duties, and valuation risk and escalations through the chain of command?

Question 4: When considering guidance on data as it applies to financial instruments, to what extent should IVS standards address measuring the quality of data, exercising judgement in the use of data, and producing valuations when insufficient data are available?

Question 5: When considering guidance on methods and models as it applies to financial instruments, to what extent should details be provided regarding how methods and models are selected, validated and risk managed? To what degree should the evolving market practices, such as XVAs, be addressed?

Question 6: When considering guidance on controls as it applies to financial instruments, to what extent should the IVS detail controls needed for the end-to-end valuation process?

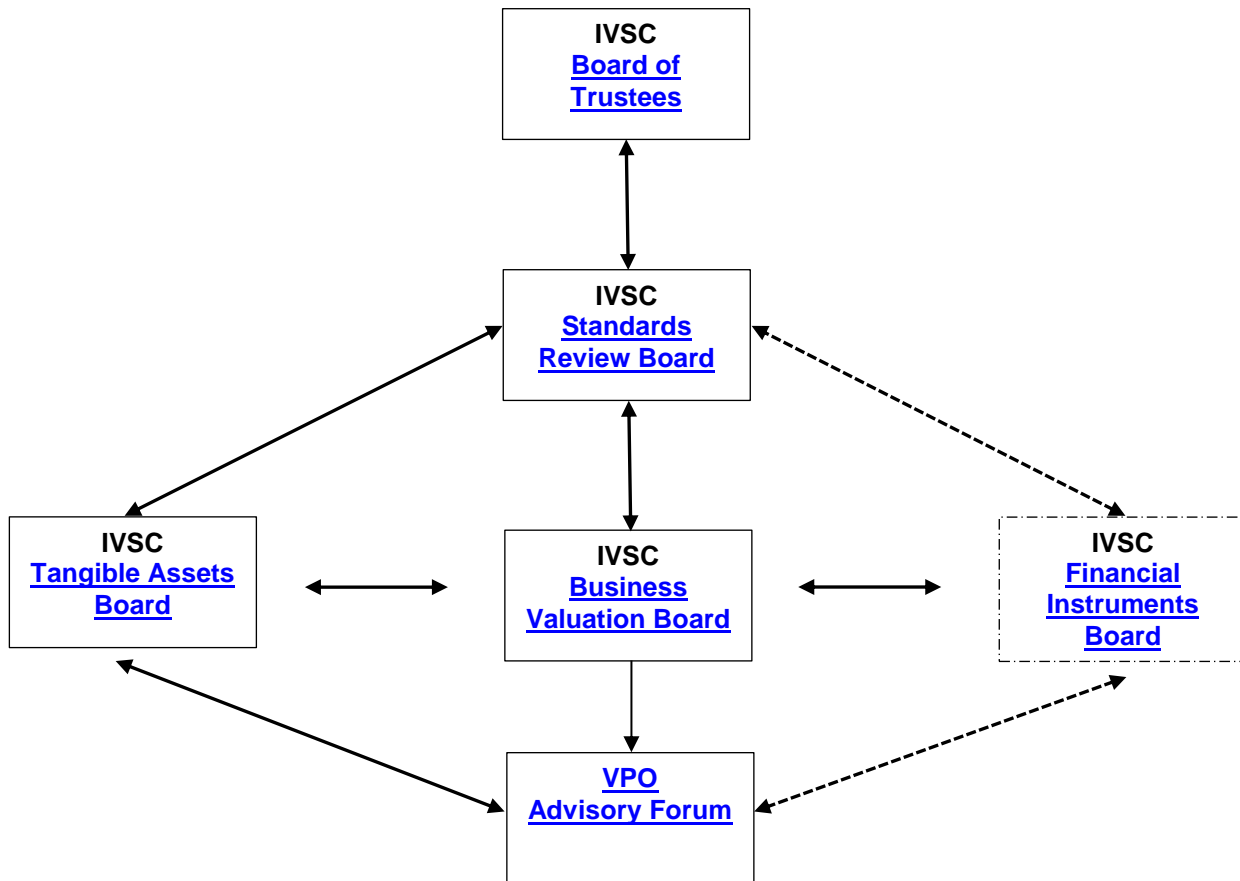
Question 7: Are there additional gaps in the standards that need to be addressed? If so, what are they?

Question 8: Do you use IVS 500 today? If so, how is it used?

Question 9: Would your organisation like to contribute to this process? If so, who would you nominate to be considered?

Appendix A: IVSC Overview and Background

IVSC Standard Setting Board Structure



IVSC Standards Review Board and IVSC Board Structure

The Standards Review Board is the overarching IVS Standards Board comprising a Chair and twelve other members including the Chair of each subject matter expertise board (collectively, the “Boards”), which are as follows;

- IVSC Tangible Assets Board
- IVSC Business Valuation Board
- IVSC Financial Instruments Board

IVSC Standards Review Board Structure and Purpose

- Setting strategy through the issuance of Discussion Papers and market engagement,
- Identification of new market issues,
- Prioritisation of work for IVS,



- Providing technical input to ensure the quality, level and appropriateness of all IVS Asset Standards Exposure Drafts and future IVS,
- Monitoring the standard setting and consultation process,
- Communicating with the Trustees and providing final approval for IVS,
- Helping achieve stakeholder recognition of IVS,
- Input on technical matters that transcend the scope of the individual boards such as the IVS General Standards,
- Collaborating with the AFWG and National Standard Setters to agree implementation and effective dates for future IVS,
- Advising AFWG on the need for future Guidance Notes to be issued by VPOs,
- Helping achieve stakeholder recognition of IVS through presentations and market engagement,
- Collaborate with the IASB and other standard setters on value measurements for financial instruments with multiple measurement objectives.

IVSC Business Valuation Board Structure and Purpose

The Business Valuation Board covers businesses and intangible assets including intellectual property and comprises a Chair and eight other members. The general purpose of the Board is as follows:

- Communicating with the Standards Review Board and agreeing the agenda for future Business Valuation Standards (BVS),
- Identification of new market issues,
- Prioritisation of future Business Valuation Standards through market engagement,
- Setting up and leading Business Valuation Standards working groups if required,
- Working with IVSC staff to provide technical input to ensure the quality, level and appropriateness of all future Business Valuation Exposure Drafts,
- Leading and monitoring a transparent and inclusive Business Valuation Exposure Draft consultation process,
- Finalising IVS Business Valuation standards post consultation,
- Providing market feedback through publication of Basis for Conclusions and post implementation review,
- Collaborating with the Advisory Forum Working Group (AFWG) and National Standard Setters to agree implementation and effective dates for future IVS.

IVSC Tangible Assets Board Structure and Purpose

The Tangible Assets Board covers all tangible assets including real estate, plant and machinery and comprises a Chair and seven other members. The general purpose of the Board is as follows;

- Communicating with the Standards Review Board and agreeing the agenda for future Tangible Assets Standards,

- Prioritisation of future Tangible Assets Standards through market engagement,
- Setting up and leading Tangible Assets Standards working groups if required,
- Drafting and providing technical input to ensure the quality, level and appropriateness of all future Tangible Assets Exposure Drafts,
- Leading and monitoring a transparent and inclusive Tangible Assets Exposure Draft consultation process,
- Finalising IVS Tangible Assets Standards post consultation,
- Providing market feedback through publication of Basis for Conclusions and post implementation review,
- Collaborating with the AFWG and National Standard Setters to agree implementation and effective dates for future IVS.

IVSC Financial Instruments Board Structure and Purpose

The Financial Instruments Board covers all financial instruments which can be defined as cash, or a contract that creates rights or obligations between specified parties to ultimately settle the rights and obligations in cash or another financial instrument. The Financial Instruments Board comprises a Chair and ten other members. The general purpose of the Board is as follows:

- Communicating with the Standards Review Board and agreeing the agenda for future Financial Instruments Standards,
- Prioritisation of future Financial Instruments Standards through market engagement,
- Setting up and leading Financial Instruments Standards working groups if required,
- Drafting and providing technical input to ensure the quality, level and appropriateness of all future Financial Instruments Exposure Drafts,
- Leading and monitoring a transparent and inclusive Financial Instruments Exposure Draft consultation process,
- Finalising IVS Financial Instruments standards post consultation,
- Providing market feedback through publication of Basis for Conclusions and post implementation review,
- Collaborating with the AFWG and National Standard Setters to agree implementation and effective dates for future IVS.