Level 2 Assets: Definition, Examples and Vs. Level 1 and 3 Assets

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What Is a Level 2 Asset?

Level 2 assets are financial assets and liabilities that are difficult to value. Although a fair value can be determined based on other data values or market prices, these assets do not have regular market pricing. Level 2 asset values, sometimes called "mark-to-model" assets, can be closely approximated using simple models and extrapolation methods. These methods use known, observable prices as parameters.

KEY TAKEAWAYS

- Level 2 assets are financial assets and liabilities that do not have regular market pricing, but whose fair value can be determined based on other data values or market prices.
- Level 2 assets are the middle classification based on how reliably their fair market value can be calculated.
- Level 2 assets are commonly held by private equity firms, insurance companies, and other financial institutions with investment arms.

Understanding Level 2 Assets

Publicly traded companies are obligated to establish fair values for the assets they carry on their books. Investors rely on these fair value estimates to analyze the firm's current condition and future prospects. According to generally accepted accounting principles (GAAP), certain assets must be recorded at their current value, not historical cost. Publicly traded companies must also classify all of their assets based on the ease with which they can be valued in compliance with the accounting standard Financial Accounting Standards Board (FASB) 157.

Three different asset levels were introduced by the U.S. FASB to bring clarity to corporations' balance sheets. Level 2 assets are the middle classification based on how reliably their fair market value can be calculated. Level 1 assets, such as stocks and bonds, are the easiest to value, while Level 3 assets can only be valued based on internal models or "guesstimates" and have no observable market prices.

Level 2 assets must be valued using market data obtained from external, independent sources. The data used could include quoted prices for similar assets and liabilities in active markets, prices for identical or similar assets and liabilities in inactive markets, or models with observable inputs, such as interest rates, default rates, and yield curves.

An example of a Level 2 asset is an interest rate swap. Here, the asset value can be determined based on the observed values for underlying interest rates and market-determined risk premiums. Level 2 assets are commonly held by private equity firms, insurance companies, and other financial institutions that have investment arms.

Real World Example of Level 2 Assets

The Blackstone Group L.P. (BX) breaks down its Level 2 assets in the firm's 10-K and 10-Q filings for shareholders. The asset manager disclosed the following information in the filings:

"Fair value is determined through the use of models or other valuation methodologies. Financial instruments which are generally included in this category include corporate bonds and loans, including corporate bonds and loans held within CLO vehicles, government and agency securities, less liquid and restricted equity securities, and certain over-the-counter derivatives where the fair value is based on observable inputs. Senior and subordinated notes issued by CLO vehicles are classified within Level II of the fair value hierarchy."

Observable vs. Unobservable Inputs

Investors and analysts sometimes struggle to identify the difference between Level 2 and Level 3 assets. However, the difference is important, particularly as GAAP requires additional disclosures for Level 3 assets and liabilities.

Whether an asset or liability is Level 2 or Level 3 is dependent on the valuation inputs and whether the market data used is available to the public. Consider the following points:

- Is the value supported by real market transactions?
- Is a price obtained from outside the organization and readily available to the public?
- Is the valuation distributed at regular intervals?

If the answer to any of these questions is no, the input may be considered unobservable and, as a result, Level 3 in the fair value hierarchy.

Related Terms

Financial Accounting Standard 157 (FAS 157)
Now known as Accounting Standards Code Topic 820, FAS 157 is the Financial Accounting Standards Board (FASB)'s fair value accounting standard. more

Level 3 Assets: Definition, Examples, Vs. Level 1 and Level 2
Level 3 assets are financial assets and liabilities whose fair value cannot be easily determined. more

Level 1 Assets
Level 1 assets include listed stocks, bonds, funds or any assets that have a regular market-based price discovery mechanism. more

Fair Value: Its Definition, Formula, and Example
Fair value can refer to the agreed price between buyer and seller or the estimated worth of assets and liabilities. more

Mark-to-Model
Mark-to-model is a pricing method for a specific investment position or portfolio based on internal assumptions or financial models. more

What Is Valuation?
A valuation is a technique that looks to estimate the current worth of an asset or company. more

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