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November 21, 2005

Ms. Suzanne Q. Bielstein
Director – Major Projects and Technical Activities
Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities

Financial Accounting Standards Board 401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut, 06856-5116

Re: Working Draft Statement of Financial Accounting Standards, Fair Value Measurements and Proposed FASB Staff Position FAS 133-a

Dear Ms. Bielstein and Mr. Smith:

Citigroup is pleased to comment on the Working Draft, Fair Value Measurements (the Exposure Draft or "ED") and the proposed FASB Staff Position FAS 133-a, Accounting for Unrealized Gains (and Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133 (the "Proposed FSP"). Citigroup participated in and supports the positions taken in the Bond Market Association, the International Swaps and Derivatives Association, and the Securities Industry Association joint letter.

We are broadly supportive of the Board's project to provide a more detailed framework for constituents to (a) better understand fair value measurement goals, and (b) disclose, in a consistent framework, a notion of the precision of measurements used in the financial statements. We only a few suggestions on ED as it nears completion. However, we are concerned that the proposed FSP has many unresolved issues that should be addressed prior to its finalization.

### **FSP FAS 133-a**

We disagree with the notion in paragraph 4(b) that the results from remeasuring a derivative instrument at inception should be treated any differently than the subsequent results from remeasuring the same instrument. This notion implies that a gain or loss at inception is somehow something that should be accounted for in a different manner than any other fair value measurement. We do not understand the conceptual basis for this difference. In other than a quoted market, a fair value measurement estimate is simply that – an estimate. In this regard, the estimate that occurs at inception is no different than the estimate that is made on any other day.



We note that the concept behind the proposed FSP (and EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities") is based on a weak foundation – that the results of an estimate should not be reflected in the income statement, but rather held on the balance sheet. The inception gain or loss has the same level of imprecision regardless of whether it is recorded on the balance sheet or through the income statement. Thus, the solution proposed in paragraph 4(b) does nothing to solve the underlying issue of imprecision.

Many of the issues we raise below would be resolved in much simpler fashion by simply superseding the language in Issue 02-3. We believe that the relative imprecision of such estimates is best communicated to financial statement users through disclosure. The disclosures required by paragraph 36(b) are effective in this regard, and will communicate to investors relevant information regarding the imprecision in certain estimates – whether that imprecision occurs on "day 1" of a transaction or on "day 2" and whether that imprecision relates to a derivative instrument or some other transaction recognized at fair value. \(^1\)

Although we hope the Board accepts our suggestion, we make further comments below in case the Board chooses to reject our view on this issue.

### Scope

The scope of FSP FAS 133-a as drafted is all transactions "involving a derivative instrument." This is impossibly broad in a technical sense, and could include, for example, instruments that meet the definition of a derivative under Statement 133 but are (a) scoped out of the statement under the provisions of paragraph 10, and (b) instruments that do not meet the definition of a derivative in their entirety and that are not required to be bifurcated under the provisions of paragraphs 12-15 (like, for example, callable debt). In addition, some have suggested that the provisions of the FSP could apply to any fair value measurement related to a cash instrument if there is a derivative instrument present in an overall transaction.<sup>2</sup>

As written, the scope of the draft covers a very large number of financial (and non-financial) instruments. We believe that this language does not accurately reflect the Board's intent or deliberations on this issue, and is not consistent with the current scope of Issue 02-03. We

While we use the term "imprecision" here, we want to be clear that the imprecision inherent in derivatives that would be affected by the proposed FSP is typically <u>much less significant</u> than the measurement imprecision inherent in many other fair value measurements currently required by US GAAP (for example, goodwill impairments and the estimated values of long-lived assets).

<sup>&</sup>lt;sup>2</sup> For example, an interest-only strip resulting from a securitization of financial assets may contain an embedded derivative instrument that would be bifurcated under the Hybrids Exposure Draft and the I/O strip would thus fall under the scope of this FSP because it "involves a derivative instrument." Some may conclude that there is a transaction price of zero related to the I/O strip (as it represents a retained interest and no cash was exchanged for it), any estimate of the fair value of both the debt host contract and the bifurcated derivative instrument would be deferred under paragraph 4 of the FSP, rather than recognized as part of the gain on sale. Such a conclusion is clearly inconsistent with Statement 140 and the Board's intent as we understand it.



suggest that the scope of the proposed FSP be limited to freestanding derivative and bifurcated derivative instruments accounted for under the provisions of Statement 133.

Reference Markets - Paragraph 3 of the Proposed FSP should be deleted

Paragraph 3(a) strongly implies that there cannot be an inception profit or loss (or at least this would be rare) for transactions that occur in the same reference market. Although the Board perhaps did not intend this, we reject this notion as simply false. There is considerable empirical evidence (and common sense) that suggests otherwise.

It is true that the likely profit – which would normally represent typical dealer bid-ask spread – is small relative to transactions that take place across reference markets. In other cases, it is quite possible that it is negative and the dealer was willing to give up on price to manage the risk of some other part of its book (perhaps to hedge the profits on a different transaction). But it is not true that the amounts are generally zero (that the entry price equals the exit price).

Further, under paragraph 3(a) as drafted, the transaction price would not be rebutted at initial recognition, but when the instrument is remeasured subsequently, the difference between transaction price and the fair value estimate would be recognized in income under paragraph 5 of the draft FSP. Oddly, that entire amount would be recognized in income even if it were the result of a transaction measured under level 5 of the ED because the minimum reliability thresholds of paragraph 4 apply only when the transaction price is rebutted, which could not occur, according to paragraph 3(a), if the transaction occurs in the reference market for the instrument.

We believe that these issues are best resolved by deleting paragraph 3. On balance, we do not see the whole discussion of reference markets here as helpful. The guidance in the ED includes appropriate discussions regarding reference markets and is sufficient. Users should simply follow the guidance in the ED.

### Disclosures

We strongly object to the proposed disclosures in paragraph 6(a). Paragraph 6(a) would require that an enterprise differentiate between "initial recognition" unrealized gains and losses and unrealized gains and losses that are generated subsequently (even later on the same day). The data required for this proposed disclosure is not currently directly tracked at all by dealers (presumably those most affected by the proposed FSP). We believe that preparers could comply with this data requirement only at a very significant cost involving redesign and programming of derivative systems.

Current systems do not track these amounts because there is no business or economic reason to do so. There is no economic difference to us or to our traders between a gain or loss at inception and a gain or loss later in the day or measurement period.



Furthermore, we do not see the benefit of such information to financial statement users. We are concerned that the Board (and financial statement users) may incorrectly infer that this data is a measure of measurement imprecision. It is not. The vast majority of "inception" gains and losses relate to trades of contracts in relatively liquid markets – literally thousands of instruments – and are not subject to significant levels of measurement imprecision. We have seen no case made for this disclosure, nor do we recall our analysts requesting such information on a supplemental basis.

We believe that the information in this disclosure is of minimal benefit to financial statement users, and potentially misleading. In contrast, the costs to preparers would be significant, and would require a significant amount of time to make the necessary adjustments to derivative systems.

#### Other Matters

One example of the odd issues that the deferral concept causes that we have encountered in applying Issue 02-3 is that in certain transactions the estimate of inception gain or loss is positive, regardless of the assumption used in the valuation model. So while a certain input to the valuation model may not be readily observable, any reasonable estimate of the input results in a valuation higher than the transaction price. For example, we have encountered fact patterns under Issue 02-3 where the correlation measurement, while significant to the measurement would have needed to be greater than 1 for the initial profits to be zero.3 In other situations, using input assumptions that are extremely conservative relative to available historical data still yields a valuation estimate that is greater than the transaction price. Said another way, the measurement imprecision may exist, but all reasonable estimates are within a range that is higher than the transaction price. The FSP is currently drafted to suggest that if there is measurement imprecision related to any significant input (i.e., Level 5), the estimated gain or loss should be deferred in its entirety. In such situations, does the Board really believe it is appropriate to defer all income? Conceptually, we believe it is more rational to defer the portion of the inception gain or loss that is subject to the measurement imprecision - or to record a "minimum" value in income. This is consistent with the guidance in FASB Statement No. 5, Accounting for Contingencies, where the minimum amount in a range of potential losses is recorded in income in many circumstances. Consistent with the discussion above, the measurement imprecision for derivatives is much less significant than the imprecision inherent in most estimates under Statement 5.

We agree with the comments in the Joint Trade Association letter on the proposed revisions to DIG Issue B6. We also believe that paragraph 19 of the proposed FSP should be deleted. The concept the Board is trying to articulate is clear in paragraph 18; paragraph 19 is confusing rather than helpful.

<sup>&</sup>lt;sup>3</sup> We are not suggesting that correlation is an insignificant factor in the measurement in this fact pattern. We are simply suggesting the range of values indicated by the model does not include the transaction price, meaning that at least some of the profit indicated by the model cannot be reasonably attributed to the unobservable input.



# Fair Value Measurements ED

Reference Markets

# Paragraph C48 states:

In this Statement, the Board agreed that in a transaction in which the entity acquires an asset or assumes a liability, the transaction price (the price paid for the asset or received to assume the liability) is an entry price. In contrast, the price that forms the basis for a fair value estimate (the price that would be received for the asset or paid to transfer the liability) is an exit price. The Board agreed that, conceptually, entry and exit prices are different. However, those prices are presumed to be the same at initial recognition, absent persuasive evidence to the contrary. In other words, the transaction price represents the clearing (or equilibrium) price in the reference market for the asset or liability. Therefore, this Statement incorporates the transaction price presumption in Concepts Statement 7, referring generally to situations in which the transaction price presumption might be rebutted from the perspective of the entity. This Statement does not identify when the transaction price presumption would be rebutted in any specific situations. The Board plans to separately consider those situations in individual accounting pronouncements on a project-by-project basis. [Emphasis added]

We support the overall concept in the paragraph that the goal in fair value measurements is an exit price. However, we disagree with the relatively sweeping statement emphasized in the above paragraph. We believe that this statement is simply not true in many or most markets where, for example, there is an observable bid-ask spread.

For many, if not most, financial markets, there would be "persuasive evidence to the contrary" that the entry price and exit price are not equal. Although it may not be the Board's intent, constituents are already reading this language to suggest that rebutting the "presumption" will be very difficult. We suggest that the Board clarify its intent by deleting or editing the language in paragraph C48 and adding an example to paragraph 15 of the ED illustrating that, in a market with bid-ask, the presumption that entry and exit prices are equivalent would be rebutted.

Distinguishing Characteristics in Classifying Instruments among Levels

We are having difficulty distinguishing between Levels 3 and 4 because Level 3 requires that inputs be observable "over the full term of an instrument. Examples include interest rates, yield curves, volatilities, and default rates." In contrast Level 4 (as elaborated on in paragraph C95) includes "market corroborated inputs" including those that are "derived using extrapolation or interpolation."

We cannot reconcile these two notions. For example, an interest rate yield curve is generally interpolated from readily observable data – there is no "instrument" for every given day that could possibly occur. That said, the interpolation required is not particularly complex; and we believe that parties would generally reach the same – or essentially the same – outcome. Instruments valued using this simple yield curve appear to be within Level 4. We believe that few, if any, items will truly end up in Level 3, since most simple inputs require some amount of extrapolation or interpolation. We suggest that the Board consider including interpolation (a relatively simple and uniform mathematical process) in Level 3 and reserve extrapolations



for Level 4. In contrast, we are not finding it particularly difficult to distinguish Level 1 from Level 2 and would be able to distinguish Level 3 from Level 4 with the modification we suggest above. Finally, while the boundary requires judgment, Level 5 is also reasonably distinct to us.

The Board should add a sentence or two on the use of models in pricing. That is, while the ED focuses on market-corroborated prices or inputs, it is silent on the use of models and their acceptance. Although the inputs are certainly critical, we believe that it is critical that the model itself be well-constructed and should also be corroborated by the market (used by other market participants and/or accepted in academic circles, validated through back testing, etc.) for an overall measurement to be considered Level 4 or higher. As currently drafted it is possible for a reader to conclude that a valuation is a Level 3 item, even though it was produced by a model that is not founded on economic rationality but whose inputs can be corroborated. We do not believe this is the Board's intent and we urge its clarification.

#### Transition

In general, we understand and support the transition proposed in the ED for disclosures as "stocks" or balance sheet positions for year-end 2006. These disclosures are required by paragraph 35 of the ED. However, several of the disclosure requirements (paragraph 36 of the ED) are "flow" in nature —they relate to income statement items that are generated through the entire year. The Board's current transition proposal would require that most enterprises be able to capture this information beginning on January 1, 2006 — essentially immediately upon issuance.

The disclosures required by paragraph 36(b) will be particularly difficult and costly to comply with, primarily because this measure is not currently tracked for derivatives. To ease the transition burden, we urge the Board to only require the disclosures in paragraph 35 – the balance sheet valuations – for year-end 2006.

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We would be pleased to further discuss our comments you at your earliest convenience.

Sincerely,

Robert Traficanti

Vice President and Deputy Controller

<sup>&</sup>lt;sup>4</sup> Refer to the JWG letter on paragraph 36(b). The reason this number is not tracked is because most market participants do not believe the information is particularly relevant.