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Letter of Comment No: 49

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September 7, 2004

Suzanne Q. Bielstein  
Director of Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, Connecticut 06856-5116  
VIA E-MAIL

Reference: **Exposure Draft of a Proposed Statement of Financial Accounting Standards, Fair Value Measurements (File Reference No. 1201-100).**

Dear Ms. Bielstein:

Freddie Mac is a publicly held company chartered by Congress in 1970 to increase the availability of funds for home ownership by developing and maintaining a secondary market for residential mortgages. We participate in the secondary mortgage market principally by providing our credit guarantee on the mortgage-related securities we issue, and investing in mortgages and mortgage-related securities. Freddie Mac owns or guarantees over \$1 trillion of mortgages and mortgage-related securities.

At December 31, 2003, Freddie Mac's assets totaled approximately \$803 billion, a substantial portion of which are carried at fair value. A significant majority of Freddie Mac's assets consist of mortgages and mortgage-related securities. Freddie Mac presents a fair value balance sheet, which displays fair value and describes the valuation methods and assumptions for each financial statement line item and complies with the disclosure requirements of SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. We believe fair value measures provide an important view of our business and risks and are useful for communicating results using a consistent basis of presentation for all assets and liabilities.

We appreciate the opportunity to comment on the Exposure Draft (the "ED") of the Proposed Statement, *Fair Value Measurements* and support the Board's efforts to provide further guidance about the measurement of fair value. However, we believe the existing ED could be improved significantly by addressing several matters summarized below for your consideration.

**I. Executive Summary of Recommendations**

- We request that the Board provide a definition of "availability" that considers the following operational concerns (among others) when selecting and applying a valuation methodology: timing, costs, and accessibility of data on a consistent and controlled basis. We also request that the Board expand on the concept that companies may balance the principles of reliability and availability when estimating fair value. We believe that

companies should be allowed to select a methodology in any level of the Fair Value Hierarchy, as long as that method produces a reasonably reliable estimate, balancing the need to accommodate operational constraints such as financial reporting timeliness, cost and consistent accessibility of data.

➤ As defined, the levels in the Fair Value Hierarchy leave room for significant interpretation and non-comparable application across companies. Therefore, the Board's goal of improving comparability among companies through Fair Value Hierarchy disclosures may not be met. In addition, as we understand the hierarchy definitions, there seems to be an overweighting to Level 3, which may not adequately facilitate the delineation of the many different fair value techniques that would likely end up in this category. Specifically:

- Regarding Level 1 of the Fair Value Hierarchy, we suggest that –
  - (a) the Board clarify the term “quoted prices” when used in the context of markets other than exchange markets, to promote comparable application of the Hierarchy across companies. Specifically, we suggest that the Board consider whether “quoted prices” must be provided by marketplace participants who are able to transact with the reporting entity; and
  - (b) the Board eliminate the prescriptive guidance on the bid/ask/mid convention to be used in applying dealer quotes. Application of the ED's prescribed approach without regard to individual facts and circumstances could result in estimates that might not be reliably representative of fair value, are not practicable to determine, or for which the application of the convention is inconsistent from company to company depending on interpretation. Instead, companies should select a convention that will be consistently applied across time periods.
- Regarding Level 2 of the Fair Value Hierarchy, we recommend removing the “objectively determinable” criterion. We suggest that the Board develop guidelines that permit judgmental adjustments to accommodate contractual or market differences. Any judgmental adjustments should incorporate market-based inputs to the extent available or practicable.
- Regarding Level 3 of the Fair Value Hierarchy, we recommend eliminating the “multiple valuation techniques” requirement. The application of each of the three approaches (market, income and cost) may not be relevant or practical for financial instruments. Also, the multiple valuation techniques requirement imposes a significant operational burden without an expectation of improved reliability of the valuation estimates.

➤ We request that the Board expand the discussion of changes in valuation techniques to permit changes in methodologies to accommodate operational constraints such as changes in data availability (including accessibility and cost) and changes in timelines for financial reporting, which are of significant current interest due to the accelerated filing requirements of most public companies.

## **II. Balancing Reliability with Operational Considerations (Timeliness, Cost, Consistent Data Access)**

We request that the Board provide a definition of “availability” that allows for consideration of the following operational concerns (among others) when selecting and applying a valuation methodology: timing, costs, and accessibility of data on a consistent and controlled basis. We also request that the Board expand on the concept that companies may balance the principles of reliability and availability when estimating fair value. We believe that companies should be allowed to select a methodology in any level of the Fair Value Hierarchy, as long as that method produces a reasonably reliable estimate, to accommodate operational constraints such as financial reporting timeliness, cost and consistent accessibility of data.

### **A. We request that the Board provide a definition of “availability” that contemplates timing, costs and consistent accessibility of data.**

From a theoretical standpoint, the concept of “availability” is acknowledged in several places (e.g., ¶15, ¶19, ¶21, ¶22, ¶24) in the ED. The Board also inserted a reference to timeliness in the ¶12 discussion of “market inputs.” The discussion of “active markets” in ¶10 refers to the accessibility of quoted prices as a measure of whether a market is “active.” However, the ED does not explain what “available” means or give examples of how to apply this concept in practice. We request that the Board provide a definition of “availability” and guidance as to its application in selecting valuation methodologies. We believe that application of the “availability” concept in practice should allow for consideration of the following factors: timing, costs, accessibility of data on a consistent and controlled basis, and other operational constraints such as the number of instruments for which fair value estimates must be obtained.

In looking to other GAAP guidance, we note that Statement of Financial Accounting Concepts No. 2 (“CON 2”) acknowledges the importance of balancing such availability concerns with reliability. For example, CON 2 states that timeliness is part of what makes information relevant: “It may sometimes be desirable ... to sacrifice precision for timeliness, for an approximation produced quickly is often more useful than precise information that takes longer to get out.”<sup>1</sup> Also, CON 2 acknowledges that the usefulness of information is subject to a cost-benefit constraint.<sup>2</sup>

### **B. We request that the Board explicitly acknowledge that companies may balance the principles of reliability and availability when estimating fair value.**

We agree that reliability, as defined in CON 2, is critical. In practice, companies also consider the principle of availability when selecting among valuation methodology alternatives. Selection of a method for estimating fair value involves consideration of practical constraints including the time and cost of the estimation process. Without considering the availability principle in selecting valuation methodologies, companies would be unable to achieve a timely, cost-effective financial reporting process. The concept that companies may balance the principles of reliability and availability when estimating fair value is consistent with generally accepted valuation practices for financial instruments.

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<sup>1</sup> Statement of Financial Accounting Concepts No. 2 (“CON 2”), *Qualitative Characteristics of Accounting Information*, ¶57.

<sup>2</sup> CON 2, ¶¶133-144.

For example, some firms may obtain price quotes for a matrix of representative securities with defined contractual characteristics. The single price estimate obtained for each representative security is then adjusted to obtain a price estimate for other similar individual securities in a matrix pricing relationship. For companies with significant numbers of securities to be priced each reporting period, this method reduces the number of instruments to be priced while still resulting in a reasonably reliable estimate of fair value for each individual security (as proved through internal controls such as sample-based price verification). Dealer quotes for each individual instrument (higher in reliability according to the Fair Value Hierarchy) could hypothetically be obtained, but not without significant cost in terms of time and dealer willingness to respond to the requests. Use of the matrix pricing method described involves small trade-offs in reliability to accommodate large operational constraints.

C. We also request that the Board allow selection of a method in any level of the Fair Value Hierarchy, to balance the goal of reliability with the practical constraints of data accessibility, timeliness, and cost.

As we understand the ED's Fair Value Hierarchy, a company is required to select a methodology in the highest possible level of the hierarchy. In contrast, we believe that, while the selected method must provide a reliable estimate of fair value, a company should not be required to select a method in the highest possible level of the hierarchy. This flexibility is consistent with the notion that there is a reasonable range of outcomes for a fair value estimate in practice. The ED acknowledges that fair value measurement by necessity requires estimation of a transaction price, "in the absence of an actual transaction."<sup>3</sup> The Board acknowledged the uncertainty inherent in the estimation process:

*"Like other estimates, a fair value estimate, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, the amount and timing of the cash flows will be uncertain. Even contractual amounts, like the payments on a loan, will be uncertain if there is risk of default."*<sup>4</sup>

Markets tell us that there are reasonable ranges of estimates of fair value, as evidenced by ranges of quoted dealer prices that may vary significantly based on the liquidity and characteristics of the instrument and the perspectives of the individual dealers. In practice, companies use various methodologies to achieve fair value estimates that are within the ranges of reasonableness. An estimate made using a methodology categorized in any level of the Fair Value Hierarchy can result in a reliable outcome. By selecting a method that might be categorized in any level of the Fair Value Hierarchy, a company would be permitted to balance reliability goals (within the reasonable range of pricing outcomes) with the practical constraints of availability. Communication about the relative reliability of the methodologies selected will be accomplished through the ED's required disclosures.

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<sup>3</sup> ED, ¶5.

<sup>4</sup> ED, ¶A4. We have also found the discussion in Statement on Auditing Standards No. 101, *Auditing Fair Value Measurements and Disclosures*, ¶¶5-6 to be helpful in interpreting the nature of fair value estimates, including the idea that there will be a range of reasonable outcomes when estimating fair value: "Fair value measurements for which observable market prices are not available are inherently imprecise. That is because, among other things, those fair value measurements may be based on assumptions about future conditions, transactions, or events whose outcome is uncertain and will therefore be subject to change over time ... Assumptions used in fair value measurement are similar in nature to those required when developing other accounting estimates."

### III. Fair Value Hierarchy

As defined, the levels in the Fair Value Hierarchy leave room for interpretation and non-comparable application across companies. Therefore, the Board's goal of improving comparability among companies through Fair Value Hierarchy disclosures may not be met.

Also, we believe that the restrictive definitions of Level 1 and Level 2 will result in the requirement to categorize many financial instrument valuation techniques in Level 3. This may be the case even for methodologies that maximize market-based inputs and result in highly reliable estimates, as may be demonstrated through price verification techniques such as comparison to dealer quotes. We do not think that lowest-level classification for methodologies that maximize market-based inputs and result in highly reliable estimates is consistent with the Board's goals in trying to communicate relative reliability. We also think that the required disclosures of such methodologies as Level 3 would be potentially misleading to financial statement readers or, at the least, have no utility in communicating the relative reliability of methodologies.

To begin to address these concerns, we would like to share the following observations and suggestions about each level of the Fair Value Hierarchy. Also, the Attachment to this letter presents several example financial instruments with illustrative valuation methodologies. For each financial instrument, we have analyzed how the valuation methodology may be categorized within the ED's Fair Value Hierarchy. We have also presented an alternative classification using a revised hierarchy that incorporates our suggestions described below.

#### A. Level 1

##### We request clarification of the term "quoted prices."

The ED does not define the phrase "quoted prices." The meaning of the term "quoted prices" is clear in the context of exchange markets such as the New York Stock Exchange. However, in dealer markets and other non-exchange markets, the phrase "quoted prices ... in active reference markets" may be interpreted in various ways. The possibility for different interpretations by different companies undermines the Board's intention for comparable application of the Fair Value Hierarchy across companies.<sup>5</sup>

Market inputs, including quoted prices, are defined as being "originated from sources independent of the entity,"<sup>6</sup> but the ED is silent as to whether these independent sources must be market participants who regularly transact with the reporting entity. In the context of dealer markets, some companies may interpret "quoted prices" as being prices provided by market participants with which the reporting company could transact. For example, a quote provided by a dealer with which the reporting company transacts is a "quoted price." Alternatively, some may interpret "quoted prices" as being prices provided by knowledgeable parties that are able to provide reasonable estimates of hypothetical transaction prices in the active reference market. For example, a quote provided by a pricing service<sup>7</sup> or an appraiser that is designed to represent

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<sup>5</sup> We believe that the Board values the CON 2 concept of comparability across companies as an important goal of issuing fair value measurement guidance. For example, as stated in ¶C2 of the ED, the Board intends that fair value estimates should be consistent across entities.

<sup>6</sup> ED, ¶12.

<sup>7</sup> A "pricing service" is an independent, third party company with significant knowledge about financial markets that provides price quotes in exchange for a fee. The pricing service intends to provide unbiased pricing information and may base its estimates on a variety of methods, including quotes

an estimate of fair value in the active reference market might be construed to be a “quoted price.” Note that these types of quotes, while provided by knowledgeable parties, are not provided by market participants who are able to transact.

These simple examples illustrate that the phrase “quoted prices” may be interpreted inconsistently by different companies, resulting in non-comparable Level 1 classifications. Therefore, we recommend that the Board clarify the definition of the term “quoted prices,” especially in the context of markets other than exchange markets.

*We recommend elimination of the prescriptive guidance on the bid/ask/midpoint convention.*

Use of the convention defined in ¶17 of the ED (bid prices for assets, asked prices for liabilities and mid-market prices for offsetting positions) might result in certain cases in fair value estimates that are not reliable. This rules-based approach does not fit all facts and circumstances, and could result in unintended consequences such as fair value estimates that do not represent levels at which an entity would transact or non-comparable application across companies. The following are a few examples of problems with the ED’s prescribed conventions.

- *The ED’s prescribed convention may differ from levels at which the reporting entity generally transacts.* The reporting entity may be able to prove, through transaction history, that it executes transactions at prices other than the dealers’ bid or ask levels. If that entity were required to follow the ED’s convention of marking long positions (assets) to dealers’ bid levels, the resulting fair value estimates would not be representative of current hypothetical transaction prices for the reporting entity. Immediate gains and losses could be recorded from immediately marking to the bid level (from non-bid level transaction prices).
- *Information about the dealer’s spread may not be available.* For example, an institution issuing debt may only have access to dealers’ bid-level quotes, and these bid-level quotes may represent where the reporting entity would expect to transact when issuing debt. Dealers may not provide ask-level quotes to the institution. Therefore, application of the prescribed convention of marking to dealers’ ask levels for liabilities is not feasible and also would not represent levels at which the reporting entity would generally transact.
- *The lack of definition of the term “offsetting positions” would likely result in non-comparable application among reporting entities. Also, application of this approach may not be relevant or practicable for all business models.* The term “offsetting positions” is not defined and could be interpreted differently by companies. How should the notion of “offsetting positions” be applied with consistent results by companies that manage risk on a portfolio basis, rather than by necessarily matching the risk characteristics on a contract-by-contract basis?

We request that the Board eliminate prescriptive guidance on the bid/ask/mid convention to be used in applying dealer quotes. In our opinion, the prescriptive rules-based bid/ask/mid convention defined in ¶17 does not apply well to all fact patterns. Application of the ED’s convention without regard to individual facts and circumstances could result in estimates that (a) might not be reliably representative of fair value, (b) are not practicable to determine, or (c) for which the application of the convention is inconsistent from company to company depending on interpretation.

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from market participants and modeled prices using varying degrees of market-based or proprietary inputs.

Instead, we recommend that the Board require that the chosen pricing convention should generally be applied consistently across time periods.

### **B. Level 2**

**We suggest removing the “objectively determinable” criterion.**

The guidance in ¶¶19-20 and ¶C55 is narrow, restricting Level 2 classification to methodologies using quoted prices for similar instruments, with adjustments for which the price effects of differences are “objectively determinable.” The ED does not specifically define “objectively determinable,” but we would interpret this phrase to mean a high threshold. That is, we would expect that “objectively determinable” price impacts are not subject to variation and do not involve management judgment in estimating the price effects of contractual or market differences.

The narrow definition of Level 2 would effectively eliminate its use in practice for many financial instrument valuation techniques. The basic premise of Level 2 (use of prices for similar instruments, adjusted as necessary to reflect market or contractual differences) is applied frequently in practice. In practice, though, the price adjustments are not strictly “objectively determinable” and usually involve management judgment. Companies apply judgment, often involving the use of modeling techniques, to estimate price adjustments for similar instruments. Companies are able to prove (through price verification and other validation controls) that the adjusted prices are reliable estimates of fair value.

We recommend eliminating the “objectively determinable” criterion from the Level 2 definition. We believe that the Level 2 category should contain methodologies that produce fair value estimates primarily based on quoted prices (or other quoted inputs). Any judgmental adjustments to accommodate contractual or market differences should incorporate market-based inputs to the extent available or practicable. We expect that this alternative approach would result in Level 2 classification for many common financial instrument valuation techniques for which a quoted price for a similar instrument is the major driver of fair value. This seems reasonable given the Board’s intentions stated in the Basis for Conclusions:

*“In general, the more market inputs, the more reliable the estimate. Accordingly, the Fair Value Hierarchy gives the highest priority to market inputs that reflect quoted prices in active markets and the lowest priority to entity inputs that reflect an entity’s own internal estimates and assumptions.”<sup>8</sup>*

An implication of this approach is that modeling to some limited extent (with appropriate incorporation of market-based inputs) would be permitted in estimating the price adjustment.

### **C. Level 3**

**We suggest that the Board eliminate the “multiple valuation techniques” requirement.**

As stated previously, we believe that the restrictive definitions of Level 1 and Level 2 will result in the requirement to categorize many financial instrument valuation techniques in Level 3. The Level 3 requirement to use “multiple valuation techniques consistent with the market approach, income approach and cost approach”<sup>9</sup> may not be practical or relevant for financial instruments, and would potentially impose significant operational burden without an expectation of improved

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<sup>8</sup> ED, ¶C43.

<sup>9</sup> ED, ¶21.

reliability of the estimates of fair value of financial instruments. We ask the Board to eliminate the “multiple valuation techniques” requirement.

We understand that the Board is concerned about the reliability of fair value estimates that are not based on quoted prices. As stated in ¶C56-C57, this “multiple valuation techniques approach” is an attempt to ensure improved reliability. The Board “concluded that because different valuation techniques tend to provide independent indications of fair value, an estimate based on the results of multiple valuation techniques is likely to be more reliable than an estimate based on the results of a single valuation technique.”<sup>10</sup> We think the desire for increased reliability that is at the heart of this requirement can be accomplished more effectively and efficiently through practices currently in use for financial instrument valuation.

The ED’s requirement to use multiple valuation techniques differs from how companies ensure reliable estimates in practice. In practice, companies provide assurance about the reliability of fair value estimates through internal controls such as validation and verification functions, risk oversight and governance controls. Financial institutions commonly devote considerable time and effort to ensure that valuation methodologies, models, and results are appropriate and well-documented, and they dedicate significant resources to price verification as a key component of the control environment. As described in the 2003 Group of Thirty report, common practices designed to ensure reliability of valuation estimates include the following, among others:<sup>11</sup>

- A documented governance structure including reporting lines to senior management and the Board of Directors;
- Defined responsibilities and segregation of duties among the following groups: front office (the “risk-taking business”); control functions; financial reporting function; risk oversight function; and internal and external audit functions;
- Valuation and control policies and procedures, with appropriate senior management oversight;
- Price verification and model verification functions that are independent of the risk-taking units;
- Control procedures such as monitored risk limits (market and credit) and new product approval; and
- Financial statement disclosures consistent with the ways that risk is measured and managed.

The price verification function includes an element of reperformance, such as independent gathering of pricing information including quotes from third parties. This verification function is performed using sampling techniques. However, note that the controls and procedures described above do not require multiple valuation techniques to be used to price each instrument, and do not mandate that the market, income, and cost approach must each be employed. Companies use judgment about both the primary valuation methodology selected and the most appropriate methods for performing price verification.

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<sup>10</sup> ED, ¶C57.

<sup>11</sup> Group of Thirty report, *Enhancing Public Confidence in Financial Reporting* (2003), chapter 2.

In our view, the ED's Level 3 approach has several significant drawbacks:

- *As described above, the use of more than one valuation technique does not necessarily result in an improvement in reliability.* In our view, the important factors to consider in evaluating the reliability of Level 3 estimates should be the extent to which the technique incorporates market-based information and the extent to which the valuation outcome is verifiable, or able to be substantially duplicated by independent measurers using the same measurement methods.<sup>12</sup>
- *The concept of using each of the "market approach," "income approach," and "cost approach" may not be practical or relevant to apply in valuing financial instruments.* The "market approach" and the "income approach" may not have discrete identities. Many valuation methods may be viewed as either or a combination of the two (e.g., a discounted cash flow model using market-based inputs for the discount rate; a quoted price converted into an option-adjusted spread using a model and application of the option-adjusted spread in pricing similar securities). Also, in many cases, one or more of the three approaches is not relevant to the asset or liability being valued (e.g., the "cost approach" might not be applicable for valuing financial instruments).
- *The ED is not clear about how frequently the "multiple valuation techniques" must be applied (i.e., each reporting period, once at inception, other periodic basis).* To apply multiple techniques to the many thousands of financial instruments held by many large financial institutions each reporting period would be prohibitively time-consuming and costly.
- *The ED's approach in Level 3 does not adequately distinguish the levels of judgment that may be involved in the many varieties of techniques that will be captured under Level 3.* As we stated previously, we believe that the restrictive nature of Level 1 and Level 2 will result in many financial instrument valuation techniques being classified in Level 3. Techniques that companies will have to categorize as Level 3 may vary tremendously as to the following factors: (a) the liquidity of the markets for the asset or liability, (b) the complexity of the valuation techniques, (c) the verifiability of the valuation outcomes, (d) the extent to which market-based inputs are available as compared to the extent to which they have been incorporated, and (e) other factors. The ED's proposed hierarchy levels and proposed disclosures do not communicate about these factors and the consequent use of management judgment in estimating fair value. As a result, the Fair Value Hierarchy will have no utility in communicating about relative reliability of pricing methodologies used by various financial institutions.

We suggest the following potential improvements to the Level 3 category.

- Eliminate the "multiple valuation techniques" requirement.
- Consider refining the levels (or disclosures) to contemplate the judgment factors listed above. Consideration of these factors will result in improved communication about the reliability of fair value estimates to readers of the financial statements.

#### **IV. Consistency and Changes in Valuation Methodologies**

ED ¶8 states, "Valuation techniques used to estimate fair value shall be consistently applied. A change in the valuation technique(s) used is appropriate only if the change results in a more

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<sup>12</sup> CON 2, ¶¶81-89

reliable estimate of fair value, for example, as new markets develop or as new and improved valuation techniques become available.”<sup>13</sup>

We request that the Board expand this discussion to permit changes in valuation techniques to accommodate operational constraints such as changes in data availability (including consistent accessibility and cost) and changes in timelines for financial reporting. For example, a company may need to change to a valuation technique that can be performed more quickly to accommodate accelerated financial reporting deadlines (such as the SEC’s recent regulations requiring accelerated timelines for periodic filings). A company may also need to change a valuation technique to accommodate changes in data accessibility from third-party providers, or in an attempt to streamline operations.

Changes in techniques to accommodate these and other types of availability constraints should be permitted, provided that the company can establish that the revised methodology produces reasonably reliable estimates. A consequence of this approach would be that a company might change to a methodology that is categorized in a lower level of the Fair Value Hierarchy (provided that it provides reasonably reliable estimates) to accommodate availability considerations.

The Board might consider providing guidance on what constitutes a disclosable change in methodology and what disclosures are required. Currently, APB Opinion No. 20 provides limited guidance about disclosure requirements related to valuation-related changes in estimate.<sup>14</sup>

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We appreciate the opportunity to participate in the Board’s due process on this issue. If the Board or its staff would like to discuss any of the issues raised in this letter, please feel free to call me at (571) 382-3900; Ken Evola at (703) 714-4900; or Melissa Ballenger at (571) 382-3325. We would also be happy to meet with you at your convenience or participate in a working group to further explore these issues. We would like to participate in the September 21, 2004 roundtable meeting.

Sincerely,

John F. Woods  
Senior Vice President  
Principal Accounting Officer

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<sup>13</sup> ED, ¶8.

<sup>14</sup> The SEC’s market risk disclosure rules in S-K Item 305 also require certain disclosures related to methodology changes.

**Attachment**

The following are illustrative examples of valuation techniques commonly applied to estimate fair values of financial instruments.

Instrument	Description of Illustrative Valuation Technique	Fair Value Hierarchy Level		
		Our interpretation of the Exposure Draft	Freddie Mac Proposal	Notes
<p><b><u>Mortgage Passthrough Security</u></b> - A security backed by a pool of mortgage loans or securities.</p> <p>Mortgage passthroughs contain prepayment options driven by the mortgage borrower's ability to prepay the underlying mortgage loan. The uncertainty as to timing and amounts of cash flows on prepayable securities leads to complexity in estimating fair value.</p>	<p>Mortgage passthroughs tend to be very liquid. Passthroughs are traded in the TBA (to be announced) market where, at the trade date, only generic characteristics of the pool are known but the individual CUSIPs to be delivered in satisfaction of the trade have not yet been identified.</p> <p><i>Illustrative valuation technique for settled passthroughs:</i> Dealer TBA quote for representative security, as defined based on product (e.g., 30 yr or 15 yr mortgages), coupon and collateral characteristics. The TBA quotes are used to value similar securities, with adjustments for variations in contractual characteristics and other factors.</p>	Level 3	Level 2	<ul style="list-style-type: none"> <li>♦ The dealer quotes for TBA prices are the most significant driver of fair value. The pricing adjustments described at left are not "objectively determinable" in that some management judgment is involved. Accordingly, we believe this pricing method may be categorized as Level 3 under the ED's Fair Value Hierarchy.</li> <li>♦ However, this methodology produces results that are driven by market-based inputs, both through the dealer TBA quotes and the pricing adjustments that are based on market-based inputs. Market-based inputs are maximized.</li> <li>♦ In our view, Level 2 classification is a more reasonable depiction of the relative reliability of this methodology. Our proposal in this letter would accommodate this classification.</li> </ul>

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Instrument	Description of Illustrative Valuation Technique	Fair Value Hierarchy Level		
		Our interpretation of the Exposure Draft	Freddie Mac Proposal	Notes
<p><u><i>Collateralized Mortgage Obligations ("CMOs")</i></u> – A mortgage-backed security with separate tranches representing differing rights (including payment priority and credit and interest-rate risk) to cash flows from the underlying collateral.</p> <p>Examples of CMOs include structured securities including Interest-Only and Principal-Only classes, or senior and subordinated classes.</p> <p>CMOs may be difficult to value due to varying market liquidity and complexity of the structures.</p>	<p><i>Illustrative valuation technique:</i> Price quotes from independent pricing services. These pricing services may derive prices via dealer quotes or models. The reporting entity receives the price quote for each instrument but generally does not have access to detailed information about how each individual CUSIP was valued by the pricing service.</p>	<p>Unclear; companies may classify as Level 1 or Level 3</p>	<p>Either Level 1 or Level 3 (to be clarified by revised FASB guidance)</p>	<ul style="list-style-type: none"> <li>♦ The quotes provided by the pricing services represent "quoted prices for identical assets . . . in active reference markets," and so might be characterized in Level 1 by some companies. Other companies may classify this methodology in Level 3.</li> <li>♦ As described in our letter, we think that the definition of "quoted prices" should be clarified.</li> <li>♦ Pricing services are not transacting parties (although they may have affiliates that are market participants). Therefore, we believe that there is a need to clarify whether pricing service prices (quotes by non-transacting parties) are more appropriately characterized as Level 1 or Level 3 estimates.</li> </ul>

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Instrument	Description of Illustrative Valuation Technique	Fair Value Hierarchy Level		
		Our interpretation of the Exposure Draft	Freddie Mac Proposal	Notes
<p><b><i>Interest Rate Swaps</i></b> – A derivative instrument representing an exchange of cash flows, e.g., a series of fixed interest payments for a series of floating interest payments.</p> <p>The markets for these instruments are generally liquid.</p>	<p><b><i>Illustrative Valuation Technique:</i></b> Discounted cash flows. A common industry approach is to use a model incorporating market-based yield curves to project expected cash flows.</p>	Unclear	Level 2	<ul style="list-style-type: none"> <li>• We think it is likely that companies would classify this methodology in Level 3. However, some companies may categorize this methodology as Level 1 or Level 2 because the primary input (interest rates) is based on market quotes (although the measurement of fair value involves the use of a model to convert inputs to prices). Companies may interpret the requirements differently, leading to non-comparable application across companies.</li> <li>• This valuation methodology is consistent with industry standards. The fair value estimate is driven by market-based inputs and is highly reliable. We think that classification as Level 2 is appropriate.</li> </ul>
<p><b><i>Swaption</i></b> – an option to enter into an interest rate swap.</p>	<p><b><i>Illustrative Valuation Technique:</i></b> Option-pricing model. The option-pricing model accommodates inputs including market-implied volatilities and distinct contractual terms.</p>	Unclear	Level 2	<ul style="list-style-type: none"> <li>• We think it is likely that companies would classify this methodology in Level 3. However, some companies may categorize this methodology as Level 1 or Level 2 because the primary input (volatility) is based on market quotes (although the measurement of fair value involves the use of a model to convert inputs to</li> </ul>

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The following are illustrative examples of valuation techniques commonly applied to estimate fair values of financial instruments.

Instrument	Description of Illustrative Valuation Technique	Fair Value Hierarchy Level		
		Our interpretation of the Exposure Draft	Freddie Mac Proposal	Notes
				<p>prices). Companies may interpret the requirements differently, leading to non-comparable application across companies.</p> <ul style="list-style-type: none"> <li>• This valuation methodology is consistent with industry standards. The fair value estimate is driven by market-based inputs and is highly reliable. We think that classification as Level 2 is appropriate.</li> </ul>