Tuesday, December 30, 2008

EITF99-20A

LETTER OF COMMENT NO. 226

Mr. Russell Golden
Technical Director
FASB
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PO Box 5116
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Re: File Reference: Proposed FSP EITF 99-20-a

Dear Mr. Golden:

Thank you for the opportunity to comment on the proposed FASB Staff Position. We appreciate that the FASB has chosen to attempt to resolve several difficult issues in time for year-end 2008 reporting. We also note that there are additional proposals on disclosures for year-end and will comment on them later.

The proposed FASB staff position is a step toward dealing with some of the issues. The clarification should help in upcoming year-end valuation conversations with auditors. In fact, GNAIE has commented several times that the current requirements in using the view of a "market participant" could skew the economic valuation of a balance sheet.

While we support the FASB staff position, we still would like to see the FASB take the action we recommended previously to account for assets in disorderly markets.

The fundamental problem with FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157") as it relates to certain illiquid securities (primarily mortgage-related securities – or "MRS") at the epicenter of the crisis is that it has been pushed beyond its limitations.

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We believe SFAS 157 does not produce reliable measurements representative of fair value when prices are determined in the absence of market observable data of a direct or indirect nature as a result of an absence of market activity, liquidity, or order).[1]

The described situation would occur when there is a significant decline in market observable transactions or data on or around the measurement date resulting in insufficient data points to support a reliable consensus price. In these situations, applying existing guidance in SFAS 157 results in fair value measurements that we believe represent liquidation values. These values are incompatible with financial statements presented on a going-concern basis.

The following observations are also relevant:

- How did we get here?
  - SFAS 157 replaced the notion of a "willing buyer/willing seller in an arm's length transaction other than a forced or liquidation sale" with "price received to sell asset or paid to transfer liability in orderly transaction at measurement date (i.e., exit value)". SFAS 157 asset sale or liability transfer is a hypothetical transaction, not an actual transaction at measurement date from perspective of market participant;
  - The SFAS 157 continuum is intentionally designed to be virtually infinite in that it produces a fair value measurement whenever one is required and is not burdened by "willing buyer/willing seller" requirements; just a requirement to simulate a hypothetical transaction with all available information;
  - SFAS 157 includes a notion of "orderly transaction" but refers specifically to hypothetical rather than actual transactions so there is no requirement for sustained, transparent, "market" activity to determine fair value; just the need to develop a market participant view of exit value;
  - In current environment, certain MRS' are out of favor with investors; this in part caused spreads to widen to historical levels. Despite severe decline in liquidity/market activity for affected MRSs, a market participant view of exit value can be developed because it's just a hypothetical transaction based on all available information – the question is not "can" a number be assigned to exit value, but rather is the number:
    - Relevant: i.e., if measurement represents a liquidation value; inconsistent with financial statements on a going concern basis;
    - Reliable: i.e., the market participant view is derived from limited market observable information; and thus would be difficult to validate;

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- Comparable: i.e., limited availability of market observable information means fewer data points, more variability, less consensus

- Proposed Solution – where markets are no longer active, liquid, or orderly and reliable fair values cannot be consistently derived on a direct or indirect basis, a "screen" should be added to SFAS 157 to redirect instruments from SFAS 157 to basic standards for affected instruments. This would provide more appropriate measurement alternatives other than fair value. Despite the move from fair value to an alternative measurement attribute, fair value could remain a footnote disclosure requirement and thus fair values could continue to be estimated (this could be for benefit of financial statement users who might wish to obtain such information regardless of the level of its reliability).

  - MRS' associated with markets that are not active, liquid, or orderly, should utilize same measurement framework applied to identical mortgage loans held in un-securitized (i.e., whole loan) form by originators.

    - Rationale;

      - Absence of active, liquid, orderly markets from which market observable information can be used to fair value instrument(s) should not qualify for fair value measurement;

      - Aligning measurement of securitized assets associated with inactive markets with the existing paradigm applied to identical assets held in non-securitized form would bring symmetry between accounting for originators that hold whole loans for investment (e.g., banks) and investors (e.g., insurance companies) with a similar philosophy;

      - Measurement attribute for this sub-category of instruments would be amortized cost. Loans would be reported net of reserves (i.e., valuation allowance) determined under FASB Statement No. 5, *Accounting for Contingencies* ("SFAS 5") and impairment determined under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* ("SFAS 114").

      - Proposal would require amendment of SFAS 157, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS 115") and other relevant standards to redirect securities associated with markets no longer active, liquid, or orderly back to their basic measurement standard;

      - If re-directed instruments held in certificated form, investor should be required to provide positive assertion as to intent and ability to hold for foreseeable future to provide comfort that non-recognition of unrealized losses is appropriate;

- Transfer from SFAS 115 available-for-sale designation to an amortized cost paradigm outside SFAS 115 would be accounted for at fair value and difference between fair value and amortized cost recognized as yield adjustment over remaining life of security;
- Securities would be redirected back to SFAS 115 and 157 if liquidity, activity, and order return to the market. This is consistent with the GNAIE support of the use of fair value as a measurement basis when markets are active, liquid, and orderly;
- A transfer back to available-for-sale from amortized cost would be at the then existing fair value and amortization of amounts in Other Comprehensive Income would cease and available-for-sale mechanics would resume.

GNAIE does not view this proposal as a compromise or concession but rather; it represents application of the appropriate measurement attribute in situations where fair value cannot be reliably measured;

We do not believe this degrades or otherwise affects the stature of fair value as a fundamental measurement attribute for financial instruments and we continue to believe that fair value is the most appropriate measurement attribute for financial instruments where FV can be obtained on a continuous basis from markets that are active, liquid, and orderly,

We believe our proposal would bring consistency between FASB and IASB Standards as it relates particularly to MRSs that (a) fall within the scope of SFAS 115 as they are held in certificated form and (b) are now associated with markets that are not active, liquid, or orderly, which have been at the heart of the fair value measurement debate, in that:

- Accounting framework for whole loans could be applied to this subset of MRSs and bring consistency with accounting by originators who originate mortgages to hold for investment;
- Income recognition (exclusive of difference between fair value and amortized cost at transfer date) consistent with accounting by originators who originate mortgages to hold for investment;
- Impairment and reserving consistent with accounting by originators who originate mortgages to hold for investment; and
- No requirement to add Loan & Receivable category to SFAS 115 and change intent and impairment guidelines.

Other Considerations

We are aware of proposals that attempt to decompose market value changes into basic interest, credit, and liquidity components and have only the credit component recognized in the income statement with the other components affecting only OCI to the extent the reporting entity has the intent and ability to hold affected securities to full recovery or maturity. We believe that attempts to reliably separate the periodic changes in fair value associated with credit and liquidity would be severely challenged and do not believe that any separation would be reliable or comparable between reporting entities;

The Global Financial Crisis has proven that capital markets are in fact global and thus solutions should be globally consistent; we believe our proposal achieves that objective;

There is always a concern when modifications are made to accounting standards in the midst of a crisis that the modifications are conceptually sound and durable; we believe our proposal achieves these objectives;

We believe the existing fair value paradigm pro-cyclicality when markets are both weak and strong. In weak markets as presently exist the effects would be muted we discontinued applying FV measurements to instruments associated with markets that are inactive, illiquid, or otherwise not orderly;

FSP FAS 157-3 did not address the existing issues with FV measurements. As a result, it is imperative that regulators, accounting standard setters, accounting firms, and the PCAOB need to be aligned as the objectives of any solution and the implementation of the solution should have the desired results;

The desires of investors, regulators, preparers and the investment community should be addressed with any solution; we believe our proposal achieves this objective;

The solution should be sustainable in the long-term; we believe our proposal achieves that objective;

Another topic that may come up relates to the basic purpose of financial reporting. We believe the primary objective of financial reporting is to provide relevant, reliable, comparable, and understandable information to financial statement users to allow them to make rational economic decisions about the reporting entity. Accordingly, we believe financial statement users should be provided financial statements that have predictive value in terms of providing a sound basis for decision making, which is fundamentally different from adopting an objective of supplying financial statement users with financial statements that are themselves built upon predictions (which is where we believe the IASB and FASB have headed in certain instances).

Conclusion:

Given the severity of the existing economic environment we believe it is essential that regulators and standard setters work together and attempt to identify and implement solutions that are effective as of December 31, 2008.

Sincerely,

Kevin Spataro

Kevin Spataro
Chairman
Accounting Convergence Committee

KS:dwb