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LETTER OF COMMENT NO.

214

Mr. Russell Golden
Technical Director
Financial Accounting Standards Board
301 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via email: director@fasb.org

File Reference: Proposed FSP FAS 157-e, Determining Whether a Market Is Not Active and a Transaction Is Not Distressed

Dear Mr. Golden:

The American Bankers Association¹ (ABA) appreciates the opportunity to comment on Proposed FSP FAS 157-e, Determining Whether a Market Is Not Active and a Transaction Is Not Distressed (Proposed FSP). Certain current accounting guidance and practices are resulting in financial statements for banks that are not transparent and are misleading to users of financial statements. ABA unequivocally supports transparency in financial reporting, both as preparers of financial statements and users of others' financial statements. Therefore, we believe it is critical to make immediate improvements to financial reporting – in this case, improvements to fair value accounting. So, we commend the FASB's efforts to better address this key issue, considering that many, if not most, of the markets for mortgage-related and other securities are currently dysfunctional and/or illiquid.

ABA believes that fair value accounting (mark to market accounting, or MTM) for banking institutions often provides misleading information to users of the financial statements, and the current market has clearly demonstrated this. Although SFAS 157 required no additional use of fair values, it resulted in a new definition of fair value that has not worked effectively. Some believe the problem is the standard itself, while others point to a litigious environment that forces reliance on the lowest tangible quotes. In any case, we appreciate the FASB's efforts to make improvements to the guidance for estimating market values in illiquid markets.

¹ ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$12.7 trillion in assets and employ over 2 million men and women.

MTM is not as simple as it sounds – nor is it simple to apply. Many questions arise. For example:

- If a true "market value" does not exist, then how should one estimate market value?
- Does an estimate provide useful information? Is an estimate relevant and reliable?
- What is the proper framework for estimating market value among a range of possible market value estimates?
- How does one know when an active or dislocated market does or does not exist?
- Can entities whose business models are not based on MTM prepare their own financial statements, or must they buy programs or hire outside vendors to develop the information?

These questions, so vital to the basic financial accounting concepts of reliability and relevance, may also have been applicable under the former definitions of fair value in this current market. However, the use of "exit" price and the application of the three "levels" of inputs as a hierarchy have resulted in a significant increase in the debate and research relating to individual securities and have contributed to what we believe to be overstatements of losses. Enormous amounts of time have been spent on substantiating and documenting MTM estimates. Our hope is that the FASB will bear in mind that the Proposed FSP needs to not only help improve the definition of fair value, but also streamline the work that is currently required. To help ensure this, it is critical that the FASB, PCAOB, and preparers are in agreement about what is required and expected in the application of this and other fair value guidance.

We strongly support the Proposed FSP and encourage the FASB to finalize it during this week's Board meeting. It is a significant step in the right direction in helping preparers and their auditors understand the concepts for estimating fair value in illiquid markets. Even though the Proposed FSP should improve practice, we believe some confusion will remain and there may continue to be misapplication of SFAS 157. The following recommendations will help reduce that confusion:

- Guidance is needed on the use of discount rates and risk premiums. In this regard, we recommend that the description of an "orderly transaction" be modified to ensure that risk premiums used in Level 3 valuation techniques reflect those of a normally active and functioning market.
- Guidance is needed to clarify issues with "inactive markets".

 Differentiation between a normally inactive market and a dislocated market is essential in order to properly evaluate bid price quotes. In addition to helping evaluate the quality of the pricing data received, differentiation helps determine whether certain bid prices should be disregarded in a Level 3 valuation technique.
- Entities should use reasoned judgment as to whether reliance on Level 3 is more appropriate than Level 2. Additionally, entities should be

permitted to base this decision on whether the cost of estimating cash flows passes their internal cost/benefit analysis.

Guidance regarding the use of discount rates and risk premiums

The objectives of the various market participants in the debt securities markets are varied. Long term investors, such as commercial banks, will normally have lower risk premium requirements than other market participants. Banks are generally buyand-hold investors who are interested in the contractual cash flows over time, whereas dealers and traders often strive for short-term profit or price speculation. The amount of risk each assumes differs significantly because their objectives are different.

The FASB staff appears to recognize this, as the example in paragraph 32 details assumed discount rates that range from 7 percent to 15 percent. In other words, there is the recognition in the Proposed FSP that various market participants will have different required rates of return — one discount rate being more than twice the other discount rate in the example. With that in mind, unless more guidance is provided, we believe that there will continue to be confusion in setting discount rates based on an "orderly transaction". This is because the term "reasonable risk premium for bearing uncertainty that would be considered by market participants" (as noted in paragraph 29A) may be interpreted differently based on which kind of market participants are considered and the illiquidity in the market.

In an active market, banks often sell to banks or other institutions with similar investment objectives and risk premiums (with dealers passing through the security). However, the fact is that transactions are primarily made through broker/dealers who also trade for profit and often increase their risk premium because of their intent to sell in the short term. So, in this dislocated market, the risk premiums will vary significantly. Absent further guidance, the example will cause the same confusion as that caused by the example that is being deleted by the Proposed FSP.

Recommendation

We recommend that the description in paragraph 29A of an "orderly transaction" be modified as follows:

"An orderly transaction would reflect all risks inherent in the asset, including a reasonable risk premium for bearing uncertainty that would be considered by market participants (that is, willing buyers and willing sellers) in pricing the asset in a nondistressed transaction *in a normally active and functioning market*." (Inserted words are italicized)

Inserting such wording will reduce the confusion that arises during a dislocated market because of risk premiums required by certain market participants.

Guidance regarding "inactive markets"

Quotes received in dislocated markets should often be disregarded

The Proposed FSP introduces a two-step process to determine: (1) whether the market is inactive, and (2) whether the quoted price is related with a distressed transaction. Seven factors are listed that should be evaluated under step 1, three of which are new to SFAS 157 and are indicative not of a market that is necessarily inactive, but of a market that is dislocated.

There is a difference between a market for a security that is **normally inactive** (that is, it is the sort of security for which trades are infrequent under any market conditions) and one that is **abnormally inactive** or **dislocated**, and there is a difference on how broker quotes would be used in these markets for the purposes of estimating fair values. In many normally inactive markets (such as during the infant stages of a new derivative product), broker quotes may have large bid-ask spreads. However, those bid prices would likely be appropriately used as a point of reference when using a modeled valuation technique.

In abnormally inactive or dislocated markets, however, those bid prices generally have no relation to the economic value to a market participant who is a long-term holder of the security. They make sense only for dealers who are trading for quick profit. Within Step 2, in determining whether a transaction was "distressed", there is the requirement to determine whether multiple bidders were responsible for the price. In many cases in a dislocated market, bids do not necessarily represent prices that a company is actually intending to execute, but often may represent a starting point in negotiation. Therefore, the quality of the quotes must be evaluated.

These kinds of quotes should also be disregarded when using modeled valuation techniques. However, the example provided in the Proposed FSP to assist preparers in using valuation techniques (paragraph A32A-G), even after noting that quoted prices cannot be used as inputs, uses the inherent yield of bid prices as a basis to calculate a midpoint discount rate. This creates the mistaken impression that bid prices should automatically be considered in the valuation model, virtually replicating the same confusion caused by FSP 157-3.

Entities should use reasoned judgment as to whether reliance on Level 3 is more appropriate than Level 2

With the specific criteria provided in paragraph 29A, most debt markets today will be considered inactive, even though there may be some that are operating relatively effectively. Because of the relative difficulty in obtaining information regarding specific transactions that form broker/pricing service quotes, the two-step process might require the majority of debt securities to now needlessly undergo Level 3 modeling. There are also situations which, because of managerial preference, market preference, or lack of modeling capability, the entity may favor reliance on Level 2 inputs. In such cases, requiring Level 3 calculations could result in an administrative burden that most companies (banks, brokers, trust and investment companies, and

pricing firms, to name a few) will be unable to bear. In these cases, Level 3 inputs may be both unnecessary and burdensome.

Recommendations

We reiterate that normally inactive markets operate very differently from abnormally inactive or dislocated markets. With that in mind, we recommend the following:

- Revise proposed paragraph 29A
 - o To differentiate between normally inactive markets and dislocated markets. As long as the two are left together, inappropriate reliance on, or consideration of, unreasonable broker quotes may continue. We believe that transactions in a dislocated market need no test to determine whether the transaction is distressed.
 - To allow for evaluation of quotes to determine whether they are "reliable" in determining whether they are distressed transactions. This would include multiple bids from multiple types of market participants that are willing to transact at the bid prices.
 - O To permit reasoned judgment to determine, even in an inactive market, whether quoted prices are appropriate or not. We believe that, without further differentiation, in practice, securities in non-dislocated markets will unnecessarily require Level 3 inputs and such processes will be required even though an entity deems Level 2 inputs to be acceptable.
- Revise the example in paragraph A32F to exclude consideration of "bid-level yields", since this can be interpreted to use bid prices as a legitimate starting point in the modeling process within a dislocated market.

Summary

To summarize, we support the Proposed FSP and believe it will help clarify what we believe the FASB intended to clarify with FSP 157-3. However, we also believe that the above clarifications are needed to avoid continued confusion that is occurring in today's environment.

Thank you for your attention to these matters and for considering our views. Please feel free to contact Mike Gullette, ABA's VP of Accounting and Financial Management (mgullette@aba.com; 202-663-4986) or me if you would like to discuss our recommendations.

Sincerely,

Donne J Fisher

Donna Fisher