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Financial Accounting Standards Board Via email to director@fasb.org



LETTER OF COMMENT NO. 87

London, October 9, 2008

Proposed FASB Staff Position on FAS 157-d

Dear Sirs.

Markit welcomes the publication of the proposed FASB Staff Position on FAS 157-d and appreciates the opportunity to comment on it.

Markit is a financial information services company with over 1,000 employees in The United States, Europe, and Asia-Pacific. Over 1,000 financial institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements. Over the past years Markit has accumulated a significant amount of expertise in the pricing and valuation of financial products and we feel that we are therefore well placed to comment on the issues surrounding Fair Value Measurement for all kinds of financial products. Please find below a summary of our comments on the proposed FASB Staff Position on FAS 157-d which we hope you will find helpful.

General comments

Markit welcomes the ongoing discussions about Fair Value and the additional guidance provided by standard setters and regulators alike on how to determine fair value for instruments that no longer trade. Whilst we recognise that some further investigation into the potential pro-cyclical effects of fair value accounting and possible regulatory measures to smooth its impact might be needed, we are of the opinion that the actual measurement of fair value should not be impacted by these discussions. The rigorous measurement and disclosure of fair value represents the ultimate means of restoring transparency and investor confidence in the marketplace, as well as creating comparability between different entities. It should hence not be compromised by political pressure or the need to support specific institutions.

The definition of "inactive"

Paragraph A32B states that an entity is required to determine whether a product has become "inactive" to be allowed to determine the fair value of this product on the basis of internal assumptions. To decide whether an instrument has become inactive, the entity would analyse



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the bid/offer spread and the traded volume of the product, and if bid/offer spreads had widened and volumes had fallen significantly the product could be regarded as inactive.

We are of the view that there are a couple of issues related to the procedure of defining "inactive" and also of using it to allow for the use of internal assumptions:

- Firstly, it is not clear why the decision to move to a valuation based on internal assumptions should be based primarily on reduced market activity, instead of referencing a lack of observable data as the key driver for this decision. In our view, only the lack of observable data that represents fair value can justify the use of a model-based approach.
- Secondly, while the measurement of activity will always have a certain vagueness attached to it and there is no "bright-line" between active and inactive products, we are of the view that the described definition would allow entities to apply the description of "inactive" in far too many instances. In the current market environment, sharply reduced volumes and wider bid/offer spreads can be observed for most, if not all financial products.
- Finally, in your proposals, you do not seem to take into account the many situations where financial instruments that rarely or never trade will have reliable coverage from consensus pricing services on a daily basis backed by mark-to-market prices from dealers. In European Asset Backed Securities for example, while bid/offers have widened and probably less than 100 bonds trade every week, consensus prices are available for more than 4,500 bonds every single day based on contributions from dealers. Similarly, in the area of exotic derivatives, while only a limited number of transactions can be observed in longer maturities or far out-of-the-money strikes, the Markit TOTEM service provides observable prices for the whole range of all tradable products at the end of every month. In interest rate derivatives alone, the service delivers more than 100,000 price points.

The nature and use of consensus prices

In section A32D, you refer to "indicative quotes" from "independent pricing services based on proprietary pricing models". Obviously, we are not in a position to speak for the entire range of available pricing services that might use a variety of different approaches. However, we thought it might be helpful to clarify the characteristics of Markit's pricing services, as they do not seem to coincide with the understanding of pricing services in the FASB Staff Position.

Some of our pricing services, such as TOTEM Valuations, have been operating for more than 10 years providing fair value levels in over-the-counter derivatives to the market. TOTEM Valuations collates market makers' best estimate of the mid-market price for all of the derivative instruments that they trade across all asset classes. Using these contributions, we then create a single composite price for each instrument and maturity that is covered by the service. All prices are rigorously tested to ensure that they are appropriate given other pricing levels and market inputs. In response to your remarks, we feel it is essential to clarify that there is not a single stage in the process of creating consensus prices where we employ any sort of "model" to compute, derive, or extrapolate a price. In most cases, consensus prices are simply the average of the price contributions that were accepted after cleansing the original data.

Also, we think the description of "indicative" which you only seem to attach to prices received from pricing services and brokers, requires some comment. Ideally entities would want to use current tradable quotes from dealers to determine at what price an orderly transaction could take place at that time. However, while desirable, this is not feasible in practice. Strictly speaking none of the price sources that are used in practice represents tradable prices:

Transaction prices only reflect where the last transaction has taken place in the past. Any market maker would agree that if a product has traded at a certain price in the past, this by



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itself provides a strong reason why the next trade will most likely NOT occur at the same price.

Broker quotes and prices on dealer runs are supposed to be close to tradable prices.
However, in reality, these prices will always be indicative only.

Prices provided by our pricing services are based on the best estimate of mid market or the book-of-record prices respectively, i.e. the best estimate of the current price determined by market makers based on a variety of factors, and reflecting where the dealer expects that product to trade in an orderly transaction at that point in time. This seems very much in line with the FAS 157 requirements asking for a hypothetical transaction, considered from the perspective of a market participant, where the fair value shall be determined based on the assumptions that market participants would use in pricing an asset or a liability.

That said we would also like to comment on your statement that broker prices are "not necessarily determinative if an active market does not exist", assuming that your statement shall also apply to pricing services. The book-of-record prices that we receive from our contributors are the prices at which dealers mark their positions at close of business. To determine the fair value of their positions market makers will use their expert knowledge of the market, they will take into account transactions that they have observed in identical or similar assets as well as movements of relevant indices, and any other factors that they regard as relevant. While book-of-record prices do not represent firm bids or offers, they certainly should count as an observable price, and will often provide the best reflection of where an orderly transaction in this asset would occur. In this respect we would also like to refer to the view voiced by the IASB Expert Advisory Panel on Measuring fair value of financial instruments in markets that are no longer active that "for some markets, such as for exotic derivatives, consensus pricing services might constitute the best available data."

We have conducted continuous analysis and testing over the years and are of the view that our consensus prices are more representative of fair value than those from any other source, including inter-dealer broker prices, model based prices, or some closing prices of exchange-traded products. Today, all major banks, broker dealers and commodities traders use Markit's services to assist them in the process of determining the fair value of their positions. Also, a large number of banks will incorporate Markit's independent price information for products across asset classes in the preparation of their financial accounts.

To summarise, taking all the above clarification on "pricing services" into account, it does not seem justified to only call prices provided by pricing services "indicative", neither does it seem appropriate to not accept them as potentially "determinative" in the search for fair value, as this would be in stark contrast to both market practice and views from other standard setters.

Other comments

Regarding your recommendation that entities should only use "quoted prices from orderly transactions" we would like to point out that your definition of orderly transactions would probably exclude the majority of transactions that are conducted in the current market environment. This would be very much in contrast to observations recently voiced by the *IASB Expert Advisory Panel* which stated that transaction prices cannot be disregarded and that "forced" transactions are rare.

We do understand that in your Staff Position an example was mainly used for illustrative purposes. Nevertheless, it would be helpful to clarify how the entity in this example managed to come up with a "fair value" rate of return of 22 percent, given that the interim steps had produced a 20 percent rate based on its own assumptions, and a 25 percent rate based on a broker quote. Also, again related to this example, it would be worth quantifying the impact of the choice of using internal assumptions on the "fair value" cash price of the instrument. Would



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it be fair to say that, assuming a duration of 5 years for the CDO tranche in question, a 300bp rate of return differential between the broker/pricing service quote and the "fair value" based on internal assumptions would amount to a difference of approximately 15 points in terms of price?

Finally it seems as if, in the approach based on internal assumptions, no provision has been made for the impact of bid/offer spreads. We not only think that this is acceptable for a model-based valuation but would strongly support using this approach also for valuations that are based on observable or traded prices. The general use of "mid" levels as a as a practical expedient for fair value measurements within the bid-ask spread could significantly reduce the operational burden for users and would improve comparability between different entities.

We hope that our comments are of value for you. Please do not hesitate to contact us if you require further information or if you want to discuss any of our comments in more detail.

Kind regards.

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