

DUFF & PHELPS



LETTER OF COMMENT NO.

64

October 9, 2008

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

**File Reference: Proposed FSP 157-d**

Duff & Phelps appreciates the opportunity to provide comments on the Proposed FSP No. FAS 157-d, *Determining the Fair value of a Financial Asset in a Market that is Not Active*. We would be pleased to further discuss our comments with the Board and staff. Please direct any questions to David L. Larsen at (415) 693-5330.

Sincerely,

A handwritten signature in black ink, appearing to read 'David L. Larsen'. The signature is written in a cursive, flowing style.

David L. Larsen  
Managing Director

**Proposed FSP No. FAS 157-d, *Determining the Fair value of a Financial Asset in a Market that is Not Active***

We interpret the proposed FSP as a clarification of FAS 157, rather than an amendment, as we believe that FAS 157, as issued, allows for the use of judgment and management's assumptions, where appropriate, with the objective of arriving at a measurement that is most representative of fair value in the circumstances. We also believe that the example included in proposed FSP FAS 157-d builds on this existing principle in FAS 157 and further clarifies its application in markets that are not active. We believe that the example will be useful to practice in that it underscores the importance to a fair value measurement in markets with little or no activity of a robustly developed model with robustly analyzed inputs, while also considering any available transaction information. While we understand that it is beyond the scope of the example to articulate the mechanics of the model, a solid model with supportable inputs is clearly required.

We would like to offer the following comments and observations on the proposed FSP:

**General Comments**

▪ **Emphasis on Consistency**

Paragraph 20 of FAS 157 articulates the principle of consistent application of valuation techniques to measure fair value, unless another technique yields an equally or more representative fair value measurement, which would warrant a change in the technique. We believe that the FASB staff should consider emphasizing this principle not only in the context of any particular instrument, but also within asset classes, where appropriate. That is, it should be clarified that the broad judgments made for all securities that are *similar in terms of illiquidity and asset class* should be governed by an overarching sense of consistency.

This point could be emphasized by adding a subparagraph "d" in Paragraph 9 (in the background discussion of FAS 157 principles)

▪ **Inactive Market v. Active Market**

Paragraph 11a. of the FSP (A32B) describes an "inactive market" as one with a "significant widening of the bid-ask spread", "few observable transactions", where "prices for transactions that have occurred are not current", and "observable prices...to the extent they exist... vary substantially either over time or among market makers". It may be useful if the FSP reiterates that there are no "bright lines" in the definition of inactive market (or active market), or if it reiterates the position stated in the FASB/SEC joint press release that "the determination of whether a market is active or not requires judgment".

Many preparers continue to struggle with the definition or meaning of "active market". Without the above clarification or additional guidance, some may interpret the FSP as allowing flexibility in measuring fair value in *thin markets* where trades may regularly occur. One philosophical issue in this situation is if the observed market price is a Level 1 or a Level 2 (the distinction being based on the level of activity of the market for that security). A loose interpretation of "inactive market" based on the FSP example could lead to the consideration of the market price (deemed a Level 2 input in this case) in conjunction with Level 3 input(s), even when the market price may have been more appropriately considered a Level 1 input.

### Comments on the Example

- Paragraph 11a (A32A) uses an example of a BBB-rated tranche as a starting point (on January 1, 2008). However, it may be more appropriate to use a tranche that was *originally* rated AAA as the starting point instead. Given current and expected default rates, it is highly likely that a tranche originally rated BBB (one of the lowest level tranches in a CDO hierarchy) would have significantly less, if any value in the current market because it may not receive any cash flows from underlying mortgages (they would accrue to the more senior tranches first). While a tranche that was originally rated AAA would not be worth par in the current environment, given that it is senior in its claims on underlying cash flows, it would still have value.
- Paragraph 11a (A32D, second bullet): Dealer quotes are normally expressed as prices (e.g. 50% of par) rather than a discount rate (e.g. 25% as used in the example). Therefore, the FASB staff may wish to consider modifying the language to emphasize price (for example, by providing a dollar amount as well) and then describe that the price is translated into a discount rate (e.g. 25%) for purposes of comparison with the discount rate determined using unobservable inputs (A32D, first bullet).

When discussing the discounted cash flows (A32D, first bullet), the focus is initially on the discount rate (20%), which is then translated into an implied price indication (a dollar amount also could be provided).

By providing discount rates and the related implied price indications, one could observe that sometimes the range of inputs may appear tighter than the resulting implied prices; this emphasizes the importance of well-supported judgment in arriving at the fair value conclusion.

- Additionally, the discount rates of 20% and 25% used in the example are conveniently close together and the conclusion (22%) is virtually the mid-point of the range. In practice, the spread is often much wider, at least for the more difficult to value securities. It may be appropriate to adapt the example to show a security for which the discount rate inputs vary, for example, from 20% to 35% (i.e., brokers are bidding very low). The example should then elaborate on the concluded discount rate

and fair value, and the rationale for, or factors considered in, making this conclusion under the market conditions the example is addressing.

- Finally, the FSP example should emphasize that a fair value measurement analysis requires a thorough understanding of the characteristics and manner of operation of the market for the financial asset measured at fair value, and a proper interpretation of the information embedded in any observed transaction prices, in light of the nature of such market.

In this regard, the market for structured products, including CDOs (focus of the FSP example) is inherently illiquid, or "less active". Very little trading occurs after origination, which is the point at which the bulk product is distributed to investors. The holders of such structured products invest for the long term and rarely dispose of any positions. Re-sales of these products in the ordinary course of business may be driven by one-off events such as a downgrade in the credit quality of the issuer or of the related credit enhancements, portfolio rebalancing, and new product introductions.

Given the above characteristics of the structured products market, there is additional "absorption risk" related to the average trading size in the market when compared to the position at hand. When liquidation sales occur and/or a large amount of product is released into the marketplace, this effect is magnified, increasing the pricing discount (widening the yield spread) significantly. Therefore, when considering any observed transactions in this market, supply and demand, and transaction size need to be considered and their effect on the observed price.

Examining the above in the context of the fair value hierarchy, which prioritizes the inputs to valuation techniques and gives priority to observable (Levels 1 & 2) over unobservable inputs (Level 3), one has to consider the quality and suitability of the observed transaction price (Level 2 input) in light of the position size it is related to, which may be substantially larger than that occurring normally in the market. Therefore the observed pricing metric may not hold for the financial asset subject to the fair value measurement, and may warrant the use of Level 3 inputs as part of a cash flow (model) analysis.

We also observe that there is a continuum of levels of activity/inactivity that exists between an "active market" and a "market that is not active". We are aware that currently there are no clear definitions of "active market" and "market that is not active", and that it might be challenging to draw a bright line around either. In this regard, we observe that the clarification proposed by the FSP may also apply to markets with lower levels of activity, when appropriate, which also requires the exercise of judgment and a solid understanding of the way the market for the subject financial asset works. (Also see our earlier comment on Inactive Market v. Active Market.)

**Other Comments (Consistency of Terminology)**

▪ **Use of the term “liquid market”**

Paragraph 9c of the proposed FSP uses the term “liquid market”. When describing the level of activity of a market, FAS 157 refers to an “active market” or “market that is not active”. We recommend not introducing yet another term (“liquid market”) in order to avoid confusion, unless a very specific meaning is ascribed to such term, and its meaning is clearly explained.

▪ **Use of the term “inactive market”**

The FSP uses the term “inactive market” throughout. However FAS 157 (and the proposed FSP’s title) refers to a “market that is not active”. It is not clear if there is any distinction between the two terms; if there is no distinction, we recommend using one or the other consistently.