

March 31, 2009

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



284

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:

I, and Brazos Valley Bank, appreciate 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. I believe it is critical to make immediate improvements to financial reporting – in this case, improvements to fair value accounting. I believe that fair value accounting or mark to market accounting currently provides misleading information to users of financial statements - the current market has clearly demonstrated this. Although SFAS 157 required no additional use of fair value, it resulted in a new definition of fair value that has not worked effectively.

Many questions arise in mark-to-market accounting, particularly in an economic situation as we currently find ourselves. For example:

- If a true "market value" does not exist, then how do we 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?

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 have contributed to what I believe to be overstatements of losses. Enormous amounts of time have been spent on substantiating and documenting mark-to-market estimates. My hope is that the FASB will bear in mind that the Proposed FSP needs to help improve the definition of fair value, but also streamline the work that is currently required. It is critical that the FASB, PCAOB, and preparers are in agreement about what is required and expected in the application of fair value guidance. I 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, 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. I 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 normal 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.

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. Long term investors, such as banks, will normally have lower risk premium requirements than other market participants. Banks are generally buy-andhold investors who are interested in cash flows over time, whereas dealers and traders often strive for shortterm profit. 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. Unless more guidance is provided, I believe 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. However, the fact 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. In a dislocated market, the risk premiums will vary significantly. The example will cause the same confusion as that caused by the example that is being deleted by the Proposed FSP. I 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 non-distressed transaction in a normally active and functioning market."

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 inactive (that is, it is the sort of security for which trades are infrequent under any market conditions) and one that is 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 dislocated markets, 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. 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 repeating 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 undergo Level 3 modeling. I would repeat that normally inactive markets operate very differently from dislocated markets. I recommend the following:

Revise proposed paragraph 29A

- 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. I 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.
- To permit reasoned judgment to determine, even in an inactive market, whether quoted prices are appropriate or not. I believe that, 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.

I support the Proposed FSP and believe it will help clarify what I believe the FASB intended to clarify with FSP 157-3. However, I also believe that the above clarifications are needed to avoid continued confusion.

Cordially,

W.L. Wantuck, CPA CIA Executive Vice President Chief Financial Officer Brazos Valley Bank, NA 4030 Hwy 6 South College Station, TX 77845