FEDERAL HOUSING FINANCE AGENCY
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Office of the Chief Accountant

April 1, 2008

* F S P F A S 1 5 7 E *
LETTER OF COMMENT NO. 304

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

File Reference: *Proposed FSP FAS 157-e*

Dear Mr. Golden:

The Federal Housing Finance Agency (FHFA) is pleased to comment on FASB's proposed FSP on Statement No. 157, *Fair Value Measurement* (FSP 157-e). As the supervisor of the Federal Home Loan Bank system and the supervisor and conservator of Fannie Mae and Freddie Mac (collectively the Housing GSEs), we are deeply interested in transparency and disclosure in financial reporting as a means of fostering market discipline for both GSEs and financial institutions more generally.

We support the FASB's efforts to provide additional guidance on determining fair value when markets are not active. We are concerned, however, that the proposed FSP could diminish the use of objective, market-based inputs. There appears to be a presumption that price quotes in an inactive market are "distressed" and therefore should not be considered indicative of fair value without significant adjustment. We believe that presuming all quotes in an inactive market reflect distressed transactions does not achieve the balance FASB intends to achieve by expanding guidance on applying judgment when determining fair value in distressed markets. These changes could reduce investor confidence in financial reporting.

We also believe that FASB should clarify the definition of a "market" for the purposes of this FSP. For instance, in the private label mortgage-backed securities (PLS) market, could a preparer make a determination that the market for all PLS is inactive or should the determination be made on a more granular level (i.e., by PLS collateral type, credit rating, issuer, size, etc.)?

The definition of fair value from FAS 157 is "... the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The FSP creates a presumption that any price quote from an inactive market is not evidence of an orderly transaction, and is therefore irrelevant unless proven otherwise. This invites preparers to ignore observable inputs on the grounds that they cannot overcome a presumption of distress. Further, this FSP demotes the use of what were previously considered level 2 inputs (i.e., quoted prices for identical or similar assets or liabilities in markets that are not active)[1] and requires preparers to adjust those inputs, which would render them level 3 inputs. This presumption appears inconsistent with the current guidance from Paragraph 21 of FAS 157 that requires preparers to maximize the use of observable inputs and minimize the use of unobservable inputs. An alternative approach would be to identify factors that should be considered in the assessment of whether a quote is distressed, but require judgment to be exercised in the final determination of whether a quote reflects distress.

A proximate driver for this FSP as well as the FSP addressing OTTI is that certain regulatory capital frameworks are based on GAAP, including those of the Housing GSEs, and that entities have recognized losses under GAAP in excess of what they ultimately expect to realize in contractual cash flow shortfalls. Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, *Recognition and Presentation of Other-Than-Temporary Impairments* addresses this issue by removing estimated non-credit-related losses from earnings—which will remove them from most required regulatory capital calculations. If proposed FSP FAS 115-a moves forward, FSP 157-e should be considered only to the extent that it improves the information available to financial statement users.

The balance of this letter is devoted to our specific responses to selected questions in the FSP.

1. *Is the proposed effective date of interim and annual periods ending after March 15, 2009 operational?*

   No. In many cases, given the changes that may be required to implement a final FSP, there does not appear to be enough time to implement the proposed changes in a safe, sound, and controlled manner. Comments on FSP FAS 107-b *Interim Disclosures about Fair Values of Financial Instruments* indicated operational concerns with its possible implementation—especially on short notice, and its impact would have been less significant than this FSP. We suggest that the effective date be extended by one quarter, with early adoption permitted.

2. *Will this proposed FSP meet the project's objectives to improve financial reporting by addressing fair value measurement application issues identified by constituents related to determining whether a market is not active and a transaction is not distressed? Do you believe the amendments to Statement 157 in this proposed FSP are necessary, or do you believe the current requirements in Statement 157 should be retained?*

   We do not believe the proposed FSP meets the objectives for financial reporting. In our view, the amendments to FAS 157 should clarify guidance on fair values for financial instruments that require significant unobservable inputs and should not create a presumption that all transactions in inactive markets are distressed.

   In our view, illiquidity of financial instruments is a condition that should be reflected objectively in financial reports and is consistent with the notion of exit value. The proposed

[1] FAS No. 157, *Fair Value Measurements*, paragraph 28(b).

guidance, however, invites preparers to judge whether observed liquidity premiums or implied yields are "reasonable" given the preparer's assumptions about credit and non-performance risk for financial instruments. This suggests that credit and nonperformance factors have a higher order of significance in determining fair value than the liquidity of the financial instrument.

The example in the proposed FSP describes management identifying reasonable assumptions regarding liquidity and non-performance risk. It concludes with management inferring required yields from hypothetical bid and ask prices of the transaction. In the example, the preparer uses the midpoint to establish the discount rate, without an explicit attempt to identify a best estimate. While paragraph 31of FAS 157 provides that the use of mid-market is permitted as a practical expedient, FASB should provide more guidance on making this key judgment, and should explicitly address management's best estimate based on all available facts and circumstances, particularly given the range in the example.

The guidance in this proposed FSP will diminish the incorporation of objective, market-based evidence in reporting fair value in financial reports. For example, many entities rely at least in part on external pricing sources or broker/dealer quotes for valuing securities. It is our understanding that at least some pricing services seek to identify distressed transactions and adjust prices accordingly. As the inputs to these pricing sources may not be fully transparent, the guidance should consider and address their use in the valuation process. FASB should clarify whether a firm using pricing vendor quotes to establish fair value should use an alternative approach if the market is considered inactive.

3. *Do you believe the proposed two step model for determining whether a market is not active and a transaction is not distressed is understandable and operational?*

The approach to identifying an inactive market appears understandable and operational. However, creating a presumption that any quote price in an inactive market is distressed unless proven otherwise is problematic. It is not clear if the information needed to rebut the presumption of distress is readily available or if a company would even need to take the step of looking for it. In effect, the guidance would require preparers to make significant adjustments to quoted prices in an inactive market. Nonetheless, we acknowledge that the last available quoted price may not be a relevant input if it stems from a distressed trade.

4. *Are the factors listed in paragraph 11 of the FSP that indicate that a market is not active appropriate? Please provide any other factors that indicate that a market is not active.*

Relying on preparers' assessments of whether liquidity premiums and expected yields are "reasonable" does not provide sufficient guidance and will lead to inconsistent results with great potential for manipulation.

According to paragraph 11(c) an indication of an inactive market is "Price quotations vary substantially either over time..." Prices in active markets vary substantially over time; therefore, we do not believe this is an appropriate factor.

Similarly, 11(g) indicates that a "principal-to-principal market" is an example of where the lack of publicly released information might be a factor that would lead a preparer to deem a market inactive. While we fully support greater price transparency and greater public availability of trade data, we are skeptical if the mere fact that a market is a principal-to-principal market is an indication that the market is not active and therefore all quotes are distressed.

Thank you for the opportunity to provide our views. If you have any questions or comments regarding this letter, please do not hesitate to contact me.

Sincerely,

Wanda I DeLeo

Wanda I. DeLeo
Senior Associate Director and Chief Accountant