



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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October 4, 2004

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Fair Value Measurements Exposure Draft – File Reference No. 1201-100

Dear Mr. Herz:

We appreciate the opportunity to comment on the FASB's proposed Fair Value Measurements Statement, issued for public comment on June 23, 2004. The Federal Reserve has long advocated sound accounting policies and practices, and we continue to support improved transparency and enhanced financial disclosures.

The proposal was developed to provide a framework for fair value measurement objectives, and it is just the initial phase of a long-term fair value project. We recognize that this proposal is generally intended to apply to financial and nonfinancial assets and liabilities that are currently subject to fair value measurement and disclosure and not to expand the use of fair value measurements at the present time.

Federal Reserve Board staff has reviewed the Exposure Draft, and enclosed are specific comments. We believe the proposal is a good first step in enhancing fair value measurements guidance, and the attached comments identify a number of areas where further guidance is warranted.

We strongly encourage the FASB to conduct further research and testing to enhance reliability of fair value measurements before the use of fair value is significantly expanded in the primary financial statements. Accordingly, we recommend that FASB consider how best to facilitate an ongoing dialogue about the range of acceptable valuation and disclosure practices in a principles-based regime. In this regard, as the Federal Reserve and the Basel Committee have previously suggested, we recommend that the FASB utilize a multi-disciplinary working group comprised of experts from regulatory authorities and the private sector to explore valuation technique sound

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practices and develop specific valuation guidance on illiquid instruments such as bank loans. Furthermore, FASB will need to coordinate closely with the Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), American Institute of Certified Public Accountants (AICPA), Institute of Internal Auditors (IIA), and accounting firms to ensure robust guidance is developed that will improve the verifiability and auditability of fair value estimates. It is imperative that all of this guidance is developed and tested before dramatic moves to comprehensive fair value accounting are made.

We continue to support the FASB's efforts to develop fair value measurement guidance that increases consistency and reliability of this information. If you have any questions regarding our comment letter, please contact Gerald Edwards, Associate Director and Chief Accountant – Supervision, or Charles Holm, Deputy Associate Director, Division of Banking and Regulation, at (202) 452-2741 and (202) 452-3502, respectively.

Sincerely,



Susan Schmidt Bies

Enclosure

**Federal Reserve Board Staff
Comments on the FASB
Fair Value Measurements Proposal¹**

Overview

The proposed Fair Value Measurements Statement was developed to provide a framework for fair value measurement objectives, and it is just the initial phase of a long-term fair value project. We recognize that this initial phase is generally intended to apply to both financial and non-financial assets and liabilities that are currently subject to fair value measurement and disclosure and not to expand the use of fair value measurements at the present time.

The Federal Reserve has long advocated sound accounting policies and practices that improve the transparency of financial statements and disclosures. Such improved transparency promotes financial market discipline and allows for better understanding and decision making among the users of financial statements. Our current views, as addressed below, are consistent with the Federal Reserve's longstanding comments to the FASB and the International Accounting Standards Board (IASB) on the topic of fair value.² We also note that the Basel Committee on Banking Supervision (Basel Committee) has provided similar comments on IASB proposals related to fair value. In this regard, we continue to support enhanced disclosures in footnotes and Management's Discussion and Analysis (MD&A) of fair value-based information. Such information provides insight on the methodologies used to determine fair values and the associated risk exposures of financial organizations.

The conceptual and application guidance related to fair value measurements has been insufficient to date. Accordingly, Board staff supports the FASB's efforts to provide additional guidance related to fair value measurements, consistent with its objectives to increase consistency and comparability of this information. Nonetheless, there continue to be reliability and verifiability issues for fair value estimates. We have provided recommendations and comments that we hope will help contribute to the development over time of a more robust and reliable fair value measurement framework.

We also are concerned with possible management bias, either unintentional or intentional, in determining fair value measurements. As a result of the significant amount of management judgment in determining Level 3 and some Level 2 estimates,

¹ This document was prepared by the Federal Reserve Board staff. It is not intended to be a comprehensive report on accounting issues associated with fair value measurements, but rather a brief statement of key issues that should be considered for financial institutions.

² These comments were provided in the Federal Reserve's comment letters to the FASB on July 31, 1997 and May 26, 2000 and to the IASB on December 27, 2001.

management may select valuation inputs that result in the misstatement or management of earnings and the misstatement of equity. A more detailed framework and specific guidance may help to reduce this risk.

While the proposed Statement is a positive first step in the development of a fair value accounting and disclosure framework, we believe that reliability issues should be addressed more adequately in this proposal. Additionally, we are particularly concerned if the proposal is used as a basis for subsequently expanding fair value measurements in the primary financial statements for illiquid assets such as bank loans before reliability, verifiability, and auditability issues are adequately addressed. We firmly believe that more research, guidance, and testing is required before there is an expanded use of fair value measurements in the primary financial statements. Such an expansion would be premature at this time.

We recognize that FASB is responsible for setting accounting standards, not auditing standards, and that FASB desires moving to a more "principles-based" approach to standards setting. Accordingly, FASB will need to consider the extent that detailed guidance should be included in a formal standard versus what is included in "implementation guidance" from the FASB or FASB staff. In developing this guidance, FASB should take into account the new legal environment under Sarbanes-Oxley and PCAOB Standard No. 2, whereby firms and auditors desire specific implementation guidance in addition to broad principles.

In addition, FASB should consider how best to facilitate an ongoing dialogue about the range of acceptable valuation and disclosure practices in a principles-based regime. In this regard, as the Federal Reserve and the Basel Committee have previously suggested, we recommend that the FASB utilize a multi-disciplinary working group comprised of experts from regulatory authorities and the private sector to explore valuation technique sound practices and develop specific valuation guidance on illiquid instruments such as bank loans. Furthermore, FASB will need to coordinate closely with the SEC, PCAOB, AICPA, IIA, and accounting firms to ensure robust guidance is developed that will improve the verifiability and auditability of fair value estimates. It is imperative that all of this accounting and auditing guidance is developed and tested before dramatic moves to comprehensive fair value accounting are made.

Board staff's specific concerns related to the Exposure Draft are more fully described below. We recognize that the proposed Statement applies to various financial and nonfinancial assets and liabilities measured at fair value. However, because loans represent approximately 50% of total banking organization assets, and because the proposal will affect loan disclosures under FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and loan values in other areas, such as under FASB Statement No. 141, *Business Combinations* and for loans held for sale, we have focused our comments primarily on loans.

Reliability and Measurement Issues

In a perfect world with liquid and transparent markets for all assets and liabilities, fair value information would be very helpful to creditors and investors evaluating a company's financial condition and performance. However, active markets are not available for many assets and liabilities at the present time. Furthermore, as many assets and liabilities are not originated to be sold, active markets for such instruments are not likely to exist for the foreseeable future. The information and methods for calculating fair values of such assets and liabilities in the absence of liquid markets are highly imperfect. Accordingly, fair value estimates for such instruments may not be reliable, nor are they subject to rigorous validation.

In the case of banking organizations, active markets do not exist for the majority of their assets and liabilities, and accordingly, fair value estimates will be based primarily on Level 3 and Level 2 estimates. This will be the case for most bank loans, for example, which due to their varying and even unique characteristics, may be difficult to value accurately. Earlier Board staff research suggested fair value estimates for bank loans could vary widely based on the valuation inputs and methodology used.³ For example, observed market rates for corporate bonds and syndicated loans within lower-rated categories have varied within ranges of 200 to 500 basis points. These wide ranges even include interest rate differences between senior bonds and loans when obligors are matched. The reasons for these wide variations vary, but may reflect different terms and covenants, including maturity, seniority, collateral, ability to prepay, amortization, and interest rate (e.g., fixed or floating). Typical bank loans that are not sold and are highly illiquid could potentially be subject to as wide or wider rate variations.

The proposal suggests that concerns about reliability may be overcome to the extent that market inputs are used in valuation, whenever possible. However, in some cases market inputs may not significantly improve reliability, since management has significant discretion in selecting those inputs (including interest rates and credit spreads). Substantial judgment would be required in this selection when market prices are not available for instruments that are very similar to the illiquid assets or liabilities being valued.

The proposal also suggests that concerns about reliability of Level 3 estimates will be mitigated by requiring entities to use multiple approaches (i.e., market, income, and cost) in determining fair value, if feasible. However, this argument is weak on several grounds. First, the valuer chooses the one approach that is deemed the most reliable. Under this procedure, the number of approaches adds little to reliability if one approach cannot be determined to be more reliable than another and if the approaches are not independent of each other. For financial instruments such as loans, the three estimates are unlikely to be independent because they are likely to be based on the same

³ The study, "Commercial Loan Fair Values: The Use of Market Prices and Loan Valuation Models," James O'Brien and Frank Zhang, May 2000, was provided with the Federal Reserve's comment letter to the FASB on May 26, 2000.

information about the instrument's income or payment streams. Second, since each estimate is based on the institution's own evaluation, this approach does not resolve incentive problems in reporting unbiased estimates versus estimates that best serve the valuer's own interests (as discussed more fully later in this document).

As bank supervisors, we evaluate risk management systems, including the use of significant models that utilize fair value estimates. As a result of our financial institution examinations, we have observed the substantial impacts resulting from minor changes among a number of assumptions of a pricing model. While in general we have a sufficient level of comfort with the processes for generating fair value estimates for liquid trading instruments that banks have long experience in fair valuing, we believe it will be some time before reliable fair value estimates are available for less liquid banking assets and liabilities.

Management Bias

Potential for management bias compounds our concerns regarding the lack of reliable fair value estimates. We have significant supervisory concerns that potential management bias may result in inappropriate fair value estimates, earnings misstatements and management, and misstatements of equity capital. Furthermore, inconsistencies from period to period in valuation estimates and the assumptions underlying them raise even greater concerns. As noted above, fair value estimates are based on various degrees of estimation by management. Management may, either unintentionally or intentionally, select inputs that are biased toward fair value estimates that are the most advantageous. While under the current accounting regime there are opportunities for management judgments to bias reported financial results, we believe the potential for such bias is significantly greater in a comprehensive fair value accounting regime, absent reliable fair value estimates.

Management's bias has been evident in the overvaluation of residual (subordinated) tranches in securitizations, where there is no market for these assets. In some cases, these valuations were significantly overstated. In recent years, we have seen a number of finance company and bank problems and failures that resulted from significant write downs of such overstated asset valuations. And, of course, we have seen similar problems resulting from overvaluations in nonbank trading portfolios and the related overstatements of income and equity that occurred. While in some cases fraud may have been the "root cause" of the problem, the lack of specific valuation guidance created an environment that made it easier for these misstatements to happen.

Verification

Independent verification of fair value estimates must be an integral part of fair value measurement. This is becoming increasingly important, with the increased use of fair value in the financial statements and the growing variety/complexity of instruments. However, independent verification by auditors and examiners of fair value estimates that are not based on observable market prices is very challenging. Auditors may not be fully

equipped to review and verify fair value methods and resulting measurements. Furthermore, as an appropriate fair value estimate will typically fall within a range of estimates, auditors may have great difficulty in drawing the line between what is an acceptable fair valuation within that range versus what is an inappropriate fair value estimate.

Additional fair value audit guidance, coupled with appropriate education and training, is required for third-party verification. This guidance would be necessary before dramatic expansions of fair value measurements are made in the primary financial statements.

Level of Knowledge

In defining fair value, the proposal indicates that the estimated market price is based on both parties to the transaction having a common level of understanding of factors relevant to the instrument. However, the proposed Statement does not explicitly address the applicability of a "common level of understanding" for instruments where the holder has private information. For most loans, i.e., those held to maturity, banks are likely to have information on their credit quality that is not available to the market. Fair values using a Level 3 estimate based on a bank's private information versus using the market's public information will be different.

It might be most reasonable for the bank to value its loans based on its internal information, implicitly assuming that a potential buyer would be provided access to private information through due diligence reviews. However, this assumption may not fully address the issue. For example, when banks sell or securitize pools of loans, they typically provide significant credit enhancements in order to maximize value. These credit enhancements are provided in part due to differences in information on the quality of the loans that are available to the seller and the buyer. Clarification in the standard is warranted on what level of knowledge a buyer would be presumed to have.

Valuation Adjustments

We recognize that the FASB has elected to defer the issue of blockage discounts to a later date. The proposed Statement allows the continued use of block measurements by broker dealers and certain investment companies as permitted currently under the AICPA Audit and Accounting Guides for those industries. However, the AICPA Audit Guide for Depository and Lending Institutions does not address the use of blockage factors. Therefore, we are concerned about potential competitive inequities, which may provide institutional advantages and affect comparability. We encourage the FASB to develop a more consistent treatment of blockage factors across industries.

We note that in valuing instruments such as derivatives in trading accounts, it is common for major commercial and investment banks to make valuation adjustments in estimating fair values for such factors as credit quality, liquidity, and administrative costs. However, little guidance has been provided on how these adjustments should be

measured. For example, should such costs be based on firm-specific factors, or should they reflect market estimates? Further accounting guidance on such valuation adjustments would enhance the reliability of fair value estimates.

Moreover, most firms do not provide quantitative disclosures about these valuation adjustments. Accordingly, we recommend that the final standard include a requirement for disclosure of valuation adjustments and their impact on earnings.

Applicability to Financial Instruments

The applicability of the proposal's fair value measurement criteria to financial instruments is not always clear and most examples, such as in appendix B, refer only to physical assets. One area of ambiguity is the use of the cost approach in a Level 3 estimate for financial instruments. For physical assets, such as machines, replacement cost normally refers to production cost, which is clearly distinguishable from an income or present value measure. For financial derivatives (with positive value), the replacement cost is the market price of an instrument (or instruments) that would provide an equivalent cash flow. For loans, we presume that a firm would consider how much it would cost to purchase loans with the same cash flow.

How a replacement cost for financial instruments such as loans is distinguishable from an income (present value) or market approach is not clear. In this regard, the same types of assumptions would likely be relevant in valuation under all three approaches.

Along the same lines, the three-level hierarchy is not as effective as it could be in determining the relative reliability of valuations. For example, some level 3 valuations may be relatively reliable, while others will not be.

Board staff recommends that the FASB include better examples in the final standard that address fair value measurement and disclosure issues associated with financial instruments. This could have the additional benefit of addressing what some may view as a conceptual flaw in the proposal, namely that it sheds no light on how the guidance in EITF 02-3 relates to the valuation hierarchy set forth in the proposal.

"Compound" Values and Revenue Recognition Issues

In some cases, the value of a financial instrument is coupled with an intangible asset value. For example, servicing assets can be considered to reflect two values: 1) a financial instrument that is similar to an IO strip, and 2) an intangible value based on the contractual right to perform services over time with customers in exchange for a fee. Other bank assets and liabilities may also have compound values based on financial and nonfinancial components.

Under the current accounting paradigm, financial and nonfinancial components are often treated differently for accounting and disclosure purposes. However, the proposal does not provide adequate guidance in determining these separate valuations.

This lack of guidance may in some cases result in questionable and/or inappropriate practices, such as including projected income from cross-selling and marketing activities in the valuation of financial instruments. Furthermore, the relationship of fair value accounting with longstanding revenue recognition principles needs further consideration, to ensure that revenue that is not yet earned is not “up-fronted” through a fair value regime.

Disclosures

Disclosing measures of reliability of fair value estimates could enhance the information content of reported fair values. While the proposal takes a step in this direction, we believe the proposal could go further. For example, we recommend that FASB consider requiring that fair value estimates be disclosed separately for each level (Level 1, 2, and 3). Furthermore, Level 3 estimates could be broken down between estimates that are based primarily on market inputs and those based mostly on entity inputs.

As a cautionary note, however, it is important to emphasize that Level 2 and Level 3 estimates based primarily on market inputs will not necessarily result in reliable fair value measurements. Accordingly, FASB should consider whether additional disclosures would be necessary to provide users an understanding on the relative reliability of fair value estimates. For example, such disclosures might include key drivers affecting valuation, fair value range estimates, and confidence levels.