April 7, 2006

Technical Director
Financial Accounting Standards Board
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Via Email to director@fasb.org

Letter of Comment No: 1250-001
File Reference: 1250-001

Re: File Reference No. 1250-001, Proposed Statement of Financial Accounting Standards,
The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115

Ladies and Gentlemen:

Fannie Mae appreciates the opportunity to comment on the exposure draft ("ED"), The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 (the "FVO"). We support the FASB's efforts to improve the usefulness of financial reporting and believe that fair value accounting can be beneficial for investors.

Overview

The ED states several objectives which include: (i) reducing volatility in earnings, (ii) avoiding the need for complex hedge transactions, (iii) providing simplicity in the application of accounting guidance, (iv) avoiding the documentation requirements of hedging relationships, (v) converging with international standards, and (vi) offering more relevant financial information. We would like to offer some observations related to these objectives that the FASB might want to consider as it continues deliberations on the ED. We have highlighted these observations below and elaborate on them further in the course of this letter.

- **Simplifying Accounting and Reducing Earnings Volatility** – Changes in the fair value of financial assets and liabilities result from numerous variables such as changes in interest rates, credit and market spreads. Most companies do not hedge all of the risks inherent in financial instruments. While the FVO may reduce or eliminate earnings volatility and eliminate the need for hedge accounting under FAS 133, Accounting for Derivative Instruments and Hedging Activities, the application of fair value to a financial asset or financial liability in its entirety (and not just the risks subject to hedging) is likely to introduce earnings volatility.

- **Consistency and Comparability** – Allowing companies to elect to apply fair value on a contract-by-contract basis provides an appropriate level of flexibility for companies to make practical decisions if or when to apply fair value. However, the effect is that
companies are unlikely to apply fair value consistently, which will result in financial statements that may not be comparable. To enhance comparability and provide investors with more relevant financial information, we suggest that the FASB consider requiring additional fair value disclosures.

- **Fair Value Measurement** – While fair value measures are readily available for many types of instruments, determining the fair value of financial instruments that are not exchange traded and have no quoted market prices requires subjective judgment and may involve complex financial modeling. We support the Board’s efforts to establish a consistent framework for what constitutes fair value and applying fair value measurements. We note the Board’s recent decision to delay the effective date of the proposed standard on Fair Value Measurement, and question whether a final FVO standard should be delayed until the Board finalizes that standard.

I. **Simplifying Accounting and Reducing Earnings Volatility**

We support the concept of a FVO. We believe that the FVO simplifies the accounting guidance and meets the Board’s objective to reduce earnings volatility in instances where entities hedge all or the majority of the risks causing fair value changes in the hedged instrument.

Companies typically use derivatives to hedge only a portion of the risk associated with a financial instrument. If a company qualifies for and elects to apply hedge accounting under FAS 133, earnings volatility is reduced because changes in the fair value of the derivative offsets changes in the fair value of the hedged risk. A company might not necessarily reduce earnings volatility if it records both the derivative and the financial instrument subject to the hedge at fair value rather than applying hedge accounting. In fact, the accounting may result in greater earnings volatility if the hedged risk is not the most significant driver of fair value changes in the financial instrument (i.e., if the risk hedged is a lesser portion of a financial instrument’s total risk). For example, spread risk is a significant driver of changes in the fair value of mortgage assets; however, many companies use derivatives to hedge only the interest rate risk component of mortgage assets. The earnings volatility attributable to interest rate risk that is not offset by derivatives used to hedge mortgage assets may be quite small relative to the spread risk that would be introduced into earnings if the entire mortgage asset were recorded at fair value.

In less complex instruments and arrangements, the FVO will allow entities to avoid the complexity of the hedge accounting requirements, while at the same time reduce earnings volatility that occurs when only one side of a hedging transaction is carried at fair value. However, we believe that in more complex scenarios, such as where the hedged risk is not the primary driver of fair value volatility in an arrangement or a portfolio, the FVO is not an alternative to hedge accounting.

With respect to the relevance and usefulness of fair value as the primary basis of accounting, as pointed out in the ED, some drivers of changes in fair value will provide counterintuitive earnings results, such as when an entity’s credit quality decreases and causes the fair value (and recorded value) of its debt to decline, resulting in an increase in earnings. Although consistent with an overall presentation of fair value, users may not understand that deteriorating credit quality (which is a negative event) will actually increase the earnings and reported equity of a company. Similarly, it may not be apparent to financial statement users that an improvement in
a company's credit risk (which is a positive event) would lead to an increase in the recorded fair value of its debt and a corresponding decrease in earnings and equity. To enhance transparency and investor understanding, the Board may want to consider requiring disclosures specific to these types of changes in fair value.

II. Consistency and Comparability

We understand the concepts that have led to the proposed elective nature of this standard and appreciate the simplicity and flexibility it is intended to provide. The Board has recognized that this flexibility may lead to different presentations of information between companies that have consistent businesses and are otherwise relatively comparable. We believe that the benefits of greater transparency into the value of financial assets and liabilities will depend on whether the users of financial statements are able to evaluate the results of similar entities that have taken different approaches to applying the FVO.

Regulated companies will need to be prepared for potential fluctuations in reported values of assets and liabilities that may affect their regulatory capital requirements. In conjunction with a transition to a fair value model, users of such financial information will need to understand the implications of fair value relative to historic accounting models, and be aware of the potential lack of consistency and comparability of information.

To enhance the usefulness and comparability of information for financial statement users, the Board may wish to consider requiring certain disclosures. Specifically, we believe if fair value disclosures for all financial assets and liabilities were required quarterly, whether or not the FVO has been elected, financial statement users would be able to evaluate similar enterprises on a fair value basis.

III. Fair Value Measurement

As suggested in the Fair Value Measurement exposure draft, the measurement of fair value can be straightforward — as is the case for exchange traded equity securities — or very judgmental, such as when no market inputs are available. For example, where quoted market prices are not readily available, companies may have to rely on third party pricing services or internally developed models to estimate fair value. As more entities adopt fair value measures and apply the FVO, the Board should provide further clarity around appropriate techniques and approaches to determining fair value. We noted that the Board recently decided to defer the effective date of the Fair Value Measurement exposure draft until 2008. We suggest the Board may want to consider aligning the effective dates of the final standards on the FVO and Fair Value Measurement.

IV. Implementation and Effective Dates

We believe that companies will need time to enhance systems and internal control procedures to support fair value reporting, an effort that may be difficult and time consuming for many companies. We also observe that the timeliness of obtaining fair value quotes from third parties may become increasingly challenging as the number and frequency of fair value marks grows. Because companies will need to address (i) the shortening of financial reporting requirements, (ii) the time required to complete the necessary validation steps of third party sources as required for appropriate internal control and reporting requirements of Sarbanes Oxley, and (iii)
the potential for delays in delivery of fair value data from third parties, the increased use of fair value measures will put pressure on the timeliness and accuracy of financial reporting. Given these perceived challenges, the Board may want to consider delaying the effective date until January 1, 2008. Early adoption should continue to be a transition option.

Lastly, we believe that companies should be permitted to apply the FVO retroactively. Retroactive application would provide useful historical comparative information of a company electing fair value. Retroactive application, however, should be limited to those instances where a company elects to apply fair value to all financial assets and liabilities.

V. Recommendations

We recommend that the Board consider the following enhancements to the ED:

1) Require quarterly disclosure of the fair value of all financial instruments, including a separate disclosure of the beginning and ending fair value balances of financial instruments.

2) Align the effective dates of the FVO and Fair Value Measurement standards.

3) Permit two adoption choices:
   - Delay the implementation date to January 1, 2008 (with early adoption permitted) given that enhancements to systems and internal control procedures to support fair value reporting may be difficult for many companies; or,
   - Allow the retroactive application of the FVO if a company carries all financial assets and liabilities at fair value. Retroactive application would provide useful historical comparative information should a company elect fair value.

We would like to continue to participate in the public discussions of this issue, and would be pleased to discuss any aspect of our positions with the FASB and provide further assistance in your deliberations on the ED. Thank you for considering our views.

Sincerely,

R. Scott Blackley
Senior Vice President – Accounting Policy

cc: Robert T. Blakely, Executive Vice President and Chief Financial Officer