Letter of Comment No: 48
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Deutsche Bank

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September 7, 2004

Ms. Suzanne Q. Bielstein
Director – Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut, 06856-5116

Re: File Reference No. 1201-100, Proposed Statement of Financial Accounting Standards, *Fair Value Measurements*

Dear Ms. Bielstein:

Deutsche Bank appreciates the opportunity to provide comments on the Exposure Draft (ED) of the Proposed Statement of Financial Accounting Standards – Fair Value Measurements.

While we are supportive of the Board's effort to consolidate the fair value guidance in one comprehensive standard, we are concerned that certain provisions of the ED would result in a significant change in current valuation practices, at a substantial cost. We also believe that certain additional fair value guidance should be included in this standard. Further, in the interest of harmonization, we support the Board's continued effort to work with the IASB on convergence with respect to fair value measurement and other projects.

We have responded to most of the specific issues that the Board requested constituents to comment upon in the pages to follow. We are also interested in sending a representative to the Round Table Meeting scheduled for September 21, 2004. If you have any questions regarding this letter, please call me (212-250-2660) or Melanie Pinto (212-250-1174) or send an electronic message to accounting.policygroup@db.com.

Very truly yours,

Peggy H. Capomaggi
Managing Director – Accounting Policy
Deutsche Bank

cc: Anthony Dilorio – Group Controller

Pricing in Active Dealer Markets

We agree with the requirement in the proposed standard that for financial instruments traded in active dealer markets i.e., Level 1 estimates, mid-market prices should be used for the matched portion of offsetting positions and bid and asked prices should be used for the net open position, as appropriate. However, we think that clarification is needed for assets and liabilities classified in Levels 2 and 3 of the proposed hierarchy. For these levels, we suggest, based upon the conclusion in Appendix C52, that other methods within the bid-asked spread should be considered when determining fair value, which includes mid-market pricing for offsetting positions.

When an entity has locked in its cash flows from the assets and liabilities and potentially could sell the matched position without incurring the bid-ask spread, using the mid-market price is appropriate because this price represents the best estimate of fair value. Pricing to mid-market ensures that the valuation for packaged products or individual products with the same risk profile would be equivalently estimated, eliminating any arbitrage opportunities that will otherwise exist. Therefore, we ask the Board to clarify that when an entity has offsetting risk positions, using the mid-market price is appropriate regardless of which level the assets or liabilities are in the hierarchy.

We find the Footnote 8 reference to other pronouncements that specify whether and, if so, when offsetting is appropriate, confusing. We believe that the Board intended "offsetting" to refer to risk positions based on the discussion in Appendix C53 and did not intend to limit mid-market pricing to transactions that are netted under other guidance. Rather, the footnote is merely indicating that existing guidance for balance sheet presentation is not being changed by the valuation guidance for offsetting positions in this standard. We suggest that the Board remove Footnote 8 to avoid confusion regarding offsetting for valuation and balance sheet presentation purposes.

Valuation Techniques

The ED proposes to incorporate the guidance in FASB Concept Statement 7 (Con 7), *Using Cash Flow Information and Present Value in Accounting Measurements*, into the fair value measurement standard. We are concerned about the requirement in Con 7 to include changes in credit standing in the measurement of liabilities and believe that this guidance needs further clarification. We think that entities should consider including changes in credit standing in the measurement of liabilities, which are required to be measured at fair value, only if the entity has the ability to realize such gains or losses. Considering the Board's belief that fair value measurement is the most relevant measure for all financial instruments, we are concerned about the potential recognition of gains and losses based on credit standing that will not be realizable. For example, while currently an issuer's own debt is carried at amortized cost, if eventually an entity's own debt could be carried at fair value, this requirement would result in an entity recognizing gains in its income statement when its credit is deteriorating. In this situation, the debt issuer is unlikely to realize gains from changes in the decline of its own credit standing until they are in bankruptcy. We find this concept contrary to the underlying assumption that financial statements of a going concern are prepared on the assumption that the entity will continue in business.

Level 3 Estimates

The ED proposes that in the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value should be estimated using multiple valuation techniques consistent with the market, income and cost approaches, whenever the information necessary to apply these techniques is available without undue cost and effort. We would like the Board to clarify that this requirement is not applicable to financial assets and liabilities where fair value is measured using valuation models and suggest that an example illustrating the valuation of a financial asset or liability be included in Appendix B - Implementation Guidance.

For instance, suppose a bank enters into a credit default swap purchasing credit protection of EUR 1 million on a specific reference entity's obligations and pays 35 basis points for this protection; if the reference entity defaults, the bank can settle the contract by delivering the obligation of the reference entity that is the cheapest to deliver to the swap counterparty. To value this contract, the bank uses the "income approach" in the form of a financial model in which the present value of the 35 basis point leg is calculated and the present value of the credit protection leg of the contract is calculated using market inputs to the model, including default probabilities, recovery rates, stock/debt ratio, stock price volatility and prevailing market prices of highly correlated instruments. Before the model is used for determining financial statements' valuations it is fully validated. This process involves a thorough independent assessment of the model's assumptions by validation against market practice and academic integrity, which includes validation of the appropriateness of the model's inputs with respect to form and source. The fair value estimate calculated by the model and update of inputs to the model are analyzed and verified independently of the front office. The bank may use a "market approach" to validate its model, if an exact or similar transaction is observable in the market or by referencing data available from pricing service providers, such as KMV Credit Monitor, Totem or inter-dealer brokers. Additionally, the model is calibrated to minimize differences between the model valuation and any available observable market prices. However, it is unlikely that the bank would ever use a "cost approach" to determine the fair value of a financial asset or liability. Given the rigorous process that firms employ to approve and validate financial models used for Level 3 estimates, we suggest that the Board clarify that in the valuation of financial assets and liabilities the use of multiple valuation techniques is not required.

Since current valuation standards only require that an appraiser *consider* using all three valuation methodologies, we object to the Board requiring that multiple valuation methodologies be used for Level 3 estimates. The appropriate valuation techniques should be determined by appraisers and valuation specialists who are required to adhere to the standards and industry practices of their own profession.

Level 1 Reference Market

Under the proposed standard, the Level 1 reference market is the active market to which an entity has immediate access, or if the entity has immediate access to multiple active markets, the most advantageous market. While we agree with including a concept, which recognizes that banks and broker-dealers realize profits because they have access to both retail and wholesale markets, we disagree that the most advantageous price should be used to fair value a contract, if that market is one in which the entity would not transact. As written, the ED implies that we would have to implement procedures to override a process that is currently automated. For example, as a global organization, we may enter into a EURO$ 3 months future in London, which would be priced on the London International Financial Futures and Option Exchange (LIFFE), every day, at the same time. To require that the traders and independent price verification personnel look at other markets in which EURO$ 3 months futures trade i.e., in the different time zones between LIFFE and Chicago Mercantile Exchange (CME), every day, to determine where the best price can be obtained, is not practical. Another example is a 1 month Euro OverNight Index Average (EONIA) future that is traded in Frankfurt on the Frankfurt Eurex, a European derivatives exchange, but is also quoted on the LIFFE. Because the two exchanges are not cooperative and the future is not very liquid, prices will differ between the two exchanges. Not only could this result in the "most advantageous market" changing from one day to the next, it could result in the recognition of profit that will never be realized, if the Frankfurt trader would not transact on the LIFFE. We suggest that the most advantageous market be defined as one to which an entity has immediate access and in which the entity would typically execute transactions.

The Board should also clarify whether transportation costs are considered transaction costs because Level 3 estimates allow for adjustments for differences in location i.e., transportation costs, but Level 1 does not allow for the inclusion of transaction costs. This difference could result in inconsistent valuation methodologies across levels, e.g., the fair value methodology for commodities contracts could vary depending upon whether the commodity is traded in an active market or not.

For Level 1 estimates, the ED states that entities should establish and consistently apply written policies on how to reflect significant events, if any, after the close of business, but before the reporting period ends. We think that an entity's policies regarding significant subsequent events should apply to all levels in the hierarchy.

Fair Value Disclosures

We find that the Board's suggested disclosure stratifying the balance sheet by fair value measurement methodology is not particularly meaningful and could be confusing to financial statement users. For example, the fair value of derivatives on the balance sheet could vary significantly from one point in time to another, which may lead users of the financial statements to conclude that the bank is experiencing volatility in earnings when, in fact, gains or losses on derivatives in Level 3 are offset by losses or gains on securities in Level 1.

We also find that the disclosure of aggregate unrealized gains and losses proposed in the ED is not meaningful because the financial statement user can not determine which valuation methodology was applied, i.e., those amounts that are determined based on active market quotes vs. those that are least observable. We suggest a disclosure that stratifies the balance sheet based upon the actual price testing performed, e.g., by assets and liabilities that are independently priced, independently verified, and measured using alternative procedures, including a description of the price verification process. The disclosure we are proposing would represent the price testing methodology and risk management practices currently used by market participants.

Effective Date

If the Board decides to finalize the standard as proposed, we think that the effective date should be delayed to allow the Board time for field testing and constituents time to implement the necessary system changes.

Other Issues

We are supportive of the FASB's addition of the fair value option project to its agenda. However, because of the importance of the fair value option and in the interest of convergence, we believe that the option should be considered as part of this standard, rather than delayed for consideration. When the Board addresses the fair value option, we believe that it should not result in a dual standard for valuation based on "verifiability" similar to IAS 39 ED proposed amendment.

We also encourage the Board to address the EITF No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* (EITF 02-3), under this fair value standard rather than as part of the broad revenue recognition project. We are concerned about the potential conceptual flaw in hierarchy because derivatives may not be recorded at the fair value estimate determined by financial models and strongly believe that revenue recognition can not be separated from valuation practices. Additionally, the application of the EITF 02-3 results in financial statement presentation that is not representative of the risk management practices of the bank, which is important information to financial statement users. Because of the importance of this issue, we believe any proposed guidance that is incorporated into this standard should be exposed for public comment.

We also note that the IASB is considering re-exposing their fair value hierarchy in light of the FASB's proposal and are supportive of these convergence efforts. Without convergence of the hierarchies, entities may be required to fair value their portfolios multiple times, i.e., for risk management, for US GAAP and for IAS reporting purposes.

Public Round Table Meeting

Deutsche Bank is interested in sending a representative to the Round Table Meeting scheduled for September 21, 2004.

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