Letter of Comment No: 3 | File Reference: 1201-100 Date Received:

File Reference No. 1201-100

Comments on the Exposure Draft of Proposed Statement of Financial Accounting Standards – Fair Value Measurements

**Dear Sirs** 

I am responding to your request for comments on the exposure draft of the Proposed Statement of Financial Accounting Standards – Fair Value Measurements.

I am the founder and CEO of Totem Market Valuations Limited, a wholly owned subsidiary of Mark-it Partners.

Totem was established in early 1997 to establish "Fair Value" market levels in over-the-counter derivatives markets. Today Totem's services are used by all the major investment banks, broker dealers and commodities traders to determine whether or not their trading books are being marked-to-market/fair value. A large number of US and international banks incorporate Totem's independent and high quality price information in the preparation of their financial accounts.

Over the last 7 years Totem has accumulated a significant amount of knowledge and data on the derivatives markets and I feel that we are well placed to comment on the issues surrounding "Fair Value Measurements".

Below I shall address each of the substantive issues that the FASB are asking for comment on but would like to summarize our comments first.

## **EXISTING BEST PRACTICE**

I would like to start by commending the FASB for taking this initiative and for providing guidance which is largely compatible with existing best practice in the financial markets. Our objectives are clearly very closely aligned with the FASB's. The independent collection and validation of market inputs in the pursuit of consistency and comparability in determining fair value is the very reason for Totem's existence and worldwide use today.

## DISCLOSURE OF ADJUSTMENTS TO FAIR VALUE

The FASB's goal of achieving comparability and consistency would be met if entities used the definition of Fair Value, which appears to be indistinguishable from that of mid-market price, as it is written in Paragraphs 4 and 5. However, the guidance then introduces the hierarchy approach, which for Level 1 inputs requires accounting at bid or asked price, and other adjustments which all move the valuation away from the defined Fair Value.

We believe that a more appropriate approach would be for all entities to account for all assets and liabilities using the precise Fair Value definition. This would ensure that, whether long or short, held as inventory in a bank's market-making book or as part of a

longer term strategy, whether "in-use" or "in-exchange" any assets and liabilities would have the same base value across entities.

This would lead in all cases to a "mid-market" level valuation. I believe it is the adjustments away from this Fair Value towards an expected Realizable Value that is most subjective and that requires disclosure, rather than the proposed split of the gross values of assets and liabilities. The disclosure of such adjustments would enable direct comparison between different entities' financial statements. It would give readers a better measure of possibly unrealizable Fair Value.

## **EVALUATING ALL TYPES OF PRICE EVIDENCE**

Although in theory the hierarchy of inputs should give consistency, Paragraph 23 of the Exposure Draft highlights to a great extent the issues that will arise from the use of the hierarchical approach. Any Level 1 input that has a timestamp that differs from the time of closing of the books of record shall have to be adjusted and thus become a Level 3 input automatically. Level 1 price inputs in different markets have different "shelf lives" and the determination as to whether or not each input is stale requires significant work and a great deal of subjectivity.

Often Level 3 inputs are more appropriate than Level 1. For example the closing prices of any exchange traded instrument can be heavily influenced by a single dealer and would thus not be representative of the market as a whole. The emphasis on Level 1 inputs opens the whole concept of fair value to abuse, it will encourage the publication of trades to create a level and there is a risk that auditors will not look further into all the available evidence.

We believe that the most appropriate method is to combine all available information sources and to weigh up the validity of each source. We recommend that the FASB drop the concept of the hierarchy and allow entities to use a single, appropriate valuation technique that incorporates all the available evidence. For a wide range of assets and liabilities, including all derivatives portfolios, an entity would use Level 3 techniques and inputs that are thoroughly tested against Level 1 and Level 2 inputs.

## Regarding the Issues on which the FASB has asked for comments:

Issue 1 – The definition of Fair Value is one that we completely agree with. We have been polling banks on this basis for 7 years. U.S. and international investment banks have been preparing mark-to-market accounts for their trading books on this basis for many years.

It is important to note that, even if the guidance is applied consistently, different entities have different levels of knowledge which by definition will lead to different fair values.

Issue 3 – Exchanges and brokers, even if in an active market, are not the only, nor necessarily the best sources of market inputs. In derivatives markets it is often the difference in price between two assets/liabilities that has the greatest influence on profit

and loss. If two sides of a spread or two parts of a curve are priced at different moments in time even using market inputs from active markets then the errors can be substantial.

Thus while the guidance seems appropriate for single positions in isolation, when applied to derivatives in a portfolio it will not work well. Using the most appropriate valuation technique, the output of which is tested using all available Level 1 and Level 2 inputs, entities will arrive at a more consistent and comparable fair value than they would by applying the guidance as currently drafted.

Issue 4—Does the FASB intend that the guidance concerning valuation premise should be applied to financial assets?

If this is the case then an end-user would apply an in-use valuation equivalent to the market offer whereas a dealer would value the same asset as inventory.

Issue 5 – The availability of a Level 1 input should not cause an entity to disregard any alternative information. It is the provenance, independence and level of scrutiny that the input has been subjected to that is important.

We believe that, rather than using the hierarchy approach, entities should consider the various techniques and apply the most appropriate. The FASB clearly appreciates in its definition of Level 3 inputs, and we agree, that it is beneficial to consider more than one valuation technique.

Issue 6 – The use of the most advantageous market is appropriate and it will give consistency between similar entities. There will however be differences between entities where one has no immediate access to the more advantageous market. Will an entity who has access to "wholesale" and "retail" markets, and buys a financial instrument in the wholesale and sells a similar instrument in the retail market be able to account for the long position at the higher retail market mid price and the short position at the wholesale mid?

Issue 7 – We believe that for fair value to be applied consistently mid prices ought to be used wherever possible. If, as stated in paragraph 50 of Appendix C, dealers can buy at bid and sell at offer they would report half the profit on inception and the other half at the close of the position. The explanation in Paragraph C50 is incorrect.

Issue 9 – For financial instruments we would not expect entities to gain any benefit from using multiple valuation techniques as defined in the guidance for Level 3 inputs. In practice entities should apply industry best practice to ensure that the valuation technique used is the most appropriate for the market and instrument type concerned.

Issue 11 – We are in favor of transparency but the approach shown in the example is not helpful as the table fails to quantify the uncertainty of valuations. The hierarchy approach implies a Level 1 price is superior to a Level 3 price. There are many situations where this is not true e.g. USD100m of NASDAQ stock is not necessarily better

priced/less risky than the equivalent "Fair Value Amount" of liquid over-the-counter derivatives priced using industry recognised models with independently validated inputs.

I hope that the Board finds our perspective on the issues interesting and the above comments useful.

Please do not hesitate to contact me directly if you would like me to expand on any of the points raised.

Yours faithfully

Tim Barker CEO Totem Market Valuations Limited

www.totemvaluations.com