# FHLB Chicago

Federal Home Loan Bank of Chicago



LETTER OF COMMENT NO.

130

March 27, 2009

Mr. Russell G. 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 Home Loan Bank of Chicago ("FHLBC") appreciates the opportunity to comment on the proposed FASB Staff Position FAS 157-e, "Determining Whether a Market is Not Active and a Transaction is Not Distressed," (hereinafter referred to as the "proposed FSP"). Our specific comments to the questions raised in the Proposed FSP are attached. Our general comments and our responses to the specific questions posed by the Board are presented below.

# **General Comments:**

The proposed FSP is a step in the right direction. The proposed FSP appropriately shifts the burden of proof to using quoted market prices only if evidence exists that such quotes were not distressed in an inactive market. The existing guidance in FSP FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset is not Active," (hereinafter referred to as "FSP FAS 157-3") placed the burden of proof on entities to support that quoted market prices were distressed or the result of forced sales in order to use a valuation model approach such as the income approach. This means that entities would have to know the circumstances to trades to which they were not a party to in order to know which trades were with willing or forced participants. Such a standard is not operational. However, as currently written, the proposed two step approach is not operational either. We believe further clarification and guidance is required to make the proposed two step approach operational. Our comments on the two step approach are discussed in our responses to the specific questions posed by the Board. In our general comments, we will offer two possible alternatives to using the two step process.

Our preferred alternative to the two step process involves adopting the approach cited in ASR No. 118 Accounting for Investment Securities by Registered Investment Companies" ("ASR 118") into the final FSP. In short, the inability to value a security because a quoted market price is not readily available is not new. The only difference between the issue this proposed FSP is

attempting to address and ASR 118 is the reason that a quoted market price is not readily available. Under ASR 118, the issue is thinly traded markets while here the issue is both inactive markets and the nature of the trades that do occur – that is, the trades are distressed transactions. Under ASR 118, entities are provided more discretion and allowed to rely on management judgment to determine when an alternative method of valuation is required. Specifically, ASR 118 indicates the following:

"If sales have been infrequent or there is a thin market in the security, further consideration should be given to whether "market quotations are readily available." If it is decided that they are not readily available, the alternative method of valuation prescribed by Section 2(a)(41)"fair value as determined in good faith by the board of directors" should be used."

We believe an approach that provides more discretion and reliance on management judgment would be preferable to the proposed two step approach which may or may not be operational. Further, since the ASR 118 approach has withstood the test of time, it is clearly operational.

The good faith estimate concept also provides the necessary flexibility and safe harbor for both preparers and their external auditors when valuing financial assets. In particular, it is essential that such a concept exist with respect to determining assumptions between willing buyers and sellers. In particular, the good faith estimate concept allows for a principle based approach to selecting a valuation approach. Specifically, ASR 118 states the following:

"No single standard for determining "fair value . . . in good faith" can be laid down, since fair value depends upon the circumstances of each individual case. As a general principle, the current "fair value" of an issue of securities being valued by the board of directors would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale...."

Our second alternative approach to the two step process involves incorporating the concept in Statement 157, paragraph 29. Specifically, we believe that, if an adjustment is needed that is significant enough to cause the security to be downgraded from Level 2 to Level 3 in the fair value hierarchy, then prima facie evidence exists that the market is inactive and that the quoted market price represents a distressed transaction. In such cases, an alternative valuation model should be permitted.

Additionally, we believe the proposed FSP lacks detailed and practical guidance to determine fair value based on appropriate market-based discount rates as of the measurement date in an orderly market. It may be difficult for independent public accountants and regulators to consistently apply this guidance without additional practical and specific guidance. In this regard, we recommend that the final FSP add guidance in selecting an appropriate discount rate.

The current guidance in the proposed FSP indicates the following:

"Reasonable assumptions regarding liquidity and nonperformance (for example, default risk and collateral value risk) risks that willing buyers and willing sellers would consider in pricing the asset in an orderly transaction based on current market conditions." [Emphasis added].

The above guidance appears to be inconsistent with the presumption of an inactive market and distressed trades. We believe the language should be revised to indicate that the assumptions should not be based on current market conditions but rather hypothetical market conditions that would exist if the market were active and trades were between willing buyers and sellers. Further, it may be useful to clarify that the discount rate used to determine the amount of the credit component impairment is not the same discount rate used to determine fair value.

We believe the proposed FSP is operational for interim and annual periods ending after March 15, 2009 <u>provided</u> our alternative approaches to the two step approach are incorporated into the final FSP or alternatively, additional guidance is provided to make the two step process operational. Otherwise, we recommend that the effective date be deferred to interim and annual periods ending after June 15, 2009.

# Responses to Questions Posed by the Board

#### **Question 1:**

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

# **Response to Question 1:**

We believe the proposed FSP is operational for interim and annual periods ending after March 15, 2009 <u>provided</u> our alternative approaches to the two step approach are incorporated into the final FSP or alternatively, additional guidance is provided to make the two step process operational. Otherwise, we recommend that the effective date be deferred to interim and annual periods ending after June 15, 2009.

## Question 2:

Will this proposed FSP meet the project's objective 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?

# **Response to Question 2:**

We believe amendments related to our general comments in the letter above would improve financial reporting. We do not believe the current requirements in Statement 157 should be retained.

#### **Question 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? If not, please suggest alternative ways of identifying inactive markets and distressed transactions.

## **Response to Question 3:**

The proposed two step approach is more operational than FSP FAS 157-3; however, we believe that further enhancements are necessary to make it operational for all entities. Outlined below are our comments on the two step approach.

- The final FSP should explicitly address the use of pricing services and provide examples of evidence that could be obtained from pricing services or other sources to show that it meets the requirements of the guidance provided in the proposed FSP.
- The final FSP would be more operational if it contained more explicit examples of both Step 1 and Step 2. In particular, for Step 1, it would be useful to have a detailed example highlighting when an active market exists and another example highlighting when it does not exist. For Step 2, it would be useful to have a detailed example highlighting when a quoted market price should be used and when a model should be used. Further, the concept of significance could be more clearly defined and utilized to apply Step 1 and Step 2. We also request additional Step 2 guidance should be included in the final FSP to address how to assess and document whether multiple bid scenarios represent non-distressed transactions. Given the current market environment, we do not believe that just the existence of multiple bids is a strong indicator that a transaction is not distressed. Outlined below is a suggested example.

ABC Company determined that they should use an internal pricing model for their private label mortgage backed securities rather than the fair value provided through a quoted market price or by a pricing service at March 31, 2XXX. The rationale for their decision is as follows:

Step 1: The current market for private label mortgage backed securities is inactive. This is because of the ongoing credit deterioration in the mortgage market, in combination with the large price variability between third party pricing services across prime interest-first, subprime and Alt-A sectors, a widening of bid-ask spreads, low volume and evidence of distressed sales.

Step 2: ABC Company presumes that the quoted market price relates to distressed sales. ABC Company believes that there was sufficient time before the measurement date to allow for usual and customary marketing activities for their private label mortgage backed securities. However, ABC Company does not believe there is evidence of multiple bidders. Specifically, a low volume of trades exists in the current market relative to the volume that existed when the market was considered active. There also is evidence that distressed sales have occurred, which highlights that bids being made in the current market are not between willing buyers and sellers. As a result, adjusting the current market volume by this factor further reduces the number of multiple bidders.

We are concerned that Step 2 of the proposed FSP may be applied more broadly than the FASB intended and result in unintended consequences. For example, in the present economic environment, application of paragraphs 13 and 15, may have the unintended consequences of requiring pricing information to be discarded even if the preparer considers those inputs to be relevant to the fair value measurement. Therefore, we recommend that the FASB allow preparers to exercise judgment when evaluating whether a financial asset's price is associated with a distressed transaction rather than creating a presumption that is practicably impossible to overcome. As an alternative, the final guidance could be modified such that the two conditions in paragraph 13 of the proposed FSP represent factors that are considered when determining whether a price is distressed and also permit judgment to be applied in arriving at a final conclusion.

## **Question 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.

#### **Response to Question 4:**

We believe the factors are appropriate; however, we believe detailed examples on how to apply these factors should be included in the final FSP. In particular, for Step 1, it would be useful to have a detailed example highlighting when an active market exists and another example highlighting when it does not exist. Further, the concept of significance could be more clearly defined and utilized to apply Step 1.

# **Question 5:**

What costs do you expect to incur if the Board were to issue this proposed FSP in its current form as a final FSP? How could the Board further reduce the costs of applying the requirements of the FSP without reducing the benefits?

# **Response to Question 5:**

We strongly recommend that the proposed FSP include guidance as to what effort will be required of an entity in terms of gathering evidence with respect to applying the two step process. Such guidance is necessary to reduce the costs of implementing the final FSP and to facilitate financial statement preparation between an entity and its auditors and regulators. In this regard, we recommend that the final FSP explicitly reference Statement 157, paragraph 30 as applying to the two step process. Specifically, an explicit reference should be made to the following provision in paragraph 30:

"Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions."

We thank the Board for its consideration of the FHLBC's views. We welcome the opportunity to discuss this matter with the Board and its staff. Please do not hesitate to contact me at (312) 565-5714.

Sincerely,

cc:

Roger D. Lundstrom Chief Financial Officer

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**Executive Vice President** 

Robert H. Herz, Chairman, Financial Accounting Standards Board