

Financial Accounting Standards Board
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Submitted via email to director@fasb.org

Proposed FASB Staff Position FAS 157-e: *Determining Whether a Market Is Not Active and a Transaction Is not Distressed*

London, April 1st, 2009

Dear Sirs,

Markit appreciates the opportunity to comment on the proposed FASB Staff Position 157-e: *Determining Whether a Market Is Not Active and a Transaction Is not Distressed*.

Markit is a financial information services company with over 1,100 employees in Europe, North America, and Asia Pacific. Over 1,500 financial institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements. Markit provides pricing services for financial products across all asset classes including many products that are illiquid and do not actively trade. Some of our pricing services, such as Totem Valuations, have been operating for more than 10 years providing the market with fair value levels in over-the-counter derivatives across all asset classes. Totem Valuations collates market makers' best estimate of the mid-market price for all of the derivative instruments that they trade. Using these contributions, we create a single composite price for each instrument and maturity that is covered by the service. All prices are rigorously tested to ensure that they are appropriate given other pricing levels and market inputs. We have conducted continuous analysis and testing over the years and are of the view that the resulting prices are more representative of "fair value" than those from any other source, including inter-dealer broker prices, model based prices, or some "official" closing prices of exchange-traded products.

Today, all major banks, broker dealers, buy-side institutions, and commodities traders use Markit's services to assist them in the process of determining the fair value of their positions and in the preparation of their financial accounts. We therefore feel well positioned to comment on issues relating to fair value and the inputs that market participants will use to determine it.

General Comments

In our view most market participants are in a position to determine fair value, even for products that do not trade, without requiring additional guidance, as the findings of the IASB Expert Advisory Panel demonstrated last year. Whilst we understand that the publication of additional formal guidance related to fair value might be beneficial to some users, we suspect that the real cause of FSP 157-e, the politically driven push against fair value, only really aims at providing more leeway to users to value their positions higher than they would have otherwise. However, any changes to accounting standards or additional guidance that are forced upon us by political pressure will only reduce transparency and comparability, threaten the independence of accounting standard setters, and prolong the duration of the financial crisis.

We are of the opinion that the additional “guidance” provided in this FSP is seriously flawed and will only confuse matters. Even once the drafting issues have been resolved we would strongly object to the essence of this FSP which actively encourages users to disregard even relevant and reliable observable price information, in line with other recent FAS 157 related guidance.

The Applicability of Fair Value

In the current discussions about fair value, it is often argued that the concept of fair value, while potentially a good idea, is not really appropriate in the current market environment, and that it should therefore be suspended or amended through the issuance of additional guidance. Markit has for many years assisted clients in determining the fair value of financial products with a particular focus on those instruments that are illiquid or that do not actively trade. We are of the view that most of the arguments put forward against fair value do not reflect reality:

- Some argue that the use of fair value made sense before the start of the crisis - when most financial products traded actively - but no longer does now that most of these products do not trade anymore. In reality, most of today's valuation issues relate to products such as CDOs, ABS, or exotic derivatives that never actively traded. One simply has to accept the fact that even in a "normal" environment only a very small fraction of all credit and OTC derivatives products that need to be valued actually trade on a regular basis.
- Claims that observable data which can serve as input for an accurate valuation is not available at times when markets are inactive are not founded. Despite the much reduced trading activity, the coverage of pricing services for credit products today is largely the same as it was two years ago. This is because consensus pricing services which are based on end-of-day book-of-record contributions require dealers to submit their marks for all of their positions at the end of every day, no matter whether there was active trading or no trading at all.
- Some market participants find it impossible to come up with a reliable valuation for many financial instruments in today's environment, and therefore demand additional guidance from standard setters. In reality though many other users can still determine credible fair values even in today's markets. It just requires them more work to gather data from different sources, look through the data to evaluate its relevance and reliability, and finally use their judgment to determine the appropriate fair value on that basis. Simply relying on month end marks from the original counterparty or any other single data source won't suffice anymore, and should have never been regarded as acceptable in the first place. We are of the view that the IASB's Expert Advisory Panel publication (*IASB Expert Advisory Panel - Measuring and disclosing the fair value of financial instruments in markets that are no longer active*) provides all the necessary information on how to determine fair value even in difficult circumstances.

- Often the argument is used that current market prices are artificially depressed and therefore not reflective of fair value. While it is true that market prices can indeed deviate from the value that reflects current fundamentals, both to the upside and to the downside, it is often just because they price in the expected future fundamentals. One should note that the above argument was often used in late 2007 when the price of ABX.HE, the benchmark tradable index for subprime assets, started dropping. The ABX junior tranches have now been trading in the single digits for many months, and it is broadly accepted that this does indeed reflect their fundamental value.
- Another argument is that, given the current "dislocated" markets, the concept of fundamental value or discounted cash flow should be used instead of mark to market prices. However, this is not what should be used to reflect an accurate picture of the current value, but rather the price at which the asset would trade between two willing counterparties. Allowing or even encouraging the use of own assumptions will almost certainly lead to inflated prices and investors being misled. Also one might wonder why this argument was never used at times when asset prices were elevated.
- Some users claim that a buy to hold investor should be allowed to value assets at their long term value, instead of marking them at their current market price. While this sounds like a sensible argument in principle, one has to wonder whether anyone can really be regarded as a true long term investor, i.e. an investor who is definitely able to hold the asset to maturity and will never be in a situation where he is forced to sell. At closer inspection it becomes obvious that this statement would not even hold true for lenders of last resort such as governments or central banks.

All said we do not think that there is sufficient credence in the politically driven demands for changes to fair value nor in the calls for the issuance of additional guidance. In reality both seem to aim at the relaxation of fair value requirements which will only reduce the level of transparency and confidence in the market further and create serious damage to the independence of the accounting standard setters and the overall economy.

Specific Comments related to FSP 157-e

We do understand that, in a challenging market environment where many financial products have become inactive and forced transactions occur more frequently, some users might require additional guidance on how to determine the fair value for financial products. However we are of the opinion that the actual guidance that is provided in this FSP is either confusing, misses the point, or is plainly wrong. Whilst we appreciate that the FASB staff had to draft this FSP in a hurry under intense political pressure, we cannot ignore that it fails to reflect the mechanics of actual financial markets and probably needs some serious re-drafting.

Also, if taken literally, FSP 157-e as it is currently drafted will cause a number of unintended consequences. Firstly, as you oblige the user to prove that the market is active and not distressed, you will create significant information gathering costs across all market participants. Furthermore, it will be impossible to provide sufficient proof in many cases, and users would therefore be forced to disregard observable data that they judged as sufficiently reliable and relevant. We would therefore strongly urge you to change the wording in order to allow users to use their judgement in deciding whether a market is inactive or distressed. Even if a market is inactive, users should not be obliged to either apply significant adjustments or rely on an alternative valuation method but should be allowed to use their judgement and rely on observable data that they regard as relevant and reliable.

Identifying Inactive Markets

In our view the whole concept of “active/inactive” is not really appropriate for its original purpose, which is to determine whether specific observed prices can be regarded as reliable and relevant. Firstly, as evidenced throughout this FSP, there simply is no bright line between active and inactive markets, and one should accept that for less active products more effort has to go into determining fair value. Also, based on our experience of providing fair value prices for many years, the “activity” level of a financial product is not necessarily strongly linked to its pricing certainty. We provide prices for many financial products that are quoted by dozens of market makers that all agree on the price, which are very liquid with reliable observable prices being provided on an ongoing basis, but which simply don’t trade as there is no interest in them at the moment. That said there will be numerous examples of inactive products with highly reliable observable prices.

That said we still feel compelled to comment on the factors that you suggested as indicators of whether a market should be regarded as “inactive” as the FSP left us with the impression that it will simply provide users with the opportunity to regard almost any financial product as inactive and distressed.

Factor a: A market is inactive if few recent transactions based on volume and level of activity have been observed, and thus, there is not sufficient frequency and volume to provide pricing information on an ongoing basis.

- As mentioned before, for most financial products a lack of transactions is not equivalent to a lack of relevant and reliable observable data. Whilst there is very little trading activity in European ABS for example, daily observable consensus prices are available for 80-85% of the asset class. Similarly, in OTC derivatives markets, reliable pricing is provided constantly across all available strikes and maturities, while only a small subset of all the relevant strikes and maturities actually trades.
- Furthermore, it would be worth clarifying whether it is the frequency or the volume of transactions that constitutes the focus of this rule. One might wonder whether a product can really be regarded as inactive if a notional of USD 1bn has traded in a single trade, or whether it can be called inactive if there were 100 single trades which add up to a total notional of only USD 1mm.

Factor b: A product can be regarded as inactive if its “price quotations are not based on current information”.

- This description seems quite confusing and might require further explanation. If we assume that you are referring to a bid/offer quote from a market maker, it is worth asking why it would ever not be based on current information, as a market maker will typically be well-informed and will incorporate all of the available information into his price quotations. Also it is worth asking whether “current information” refers to the information that is available to everyone in the market, or just to the specific dealer. Furthermore, who will decide whether the price quotation is actually based on current information and how will this decision be made? Will it be as easy as simply stating “I think the price should be higher” to imply that it clearly does not incorporate the current information?
- Furthermore this factor will actually apply to almost all financial products as market prices are mostly based on expectations instead of current information. As described above, many market participants claimed in late 2007 that ABX.HE prices were irrational as they were not based on the “current information” at the time. However in retrospect they proved to be a pretty accurate reflection of market expectations. One can only assume that, like other recent guidance, this factor simply encourages users to describe a market as inactive based on their belief that the current market pricing is too low.

- It might well be that you wanted this factor to refer to a “stale” price, i.e. a price that has not been updated by the market maker. If that was the case you should consider changing the wording to “a price which is stale and has not been updated to reflect recent market information”. However it should be reasonable to expect that a user who had looked through the price would not regard it as relevant anyway and it is therefore not clear why additional guidance in this situation would be beneficial.

Factor c: In an inactive market “price quotations vary substantially, either over time or among market makers, for example, some brokered markets”.

- This statement seems to completely miss the point, as it will not only apply to most financial products, but it would also tend to identify in particular those products as inactive which are traded most actively.
- Firstly, it is the nature of any traded product that its market price will fluctuate over time, and often elevated price volatility will be one of the key characteristics of the most liquid products. Credit Default Swaps (CDS) for example were one of the few credit products that maintained liquidity throughout the crisis; their prices tended to be quite volatile as they traded very often. In contrast bond prices showed a much lower level of volatility as they simply did not trade. That said, “variation over time” does not seem to be an appropriate factor to identify inactive products, and in most cases the opposite is actually true.
- Whilst “variation among market makers” can be regarded as a more appropriate measure of the pricing uncertainty of a product, we fail to understand what “some brokered markets” refers to. Were you thinking of markets where interdealer brokers are active or of markets where market makers quote prices? In any case this remark does seem misplaced and not relevant in this context.

Factor d: A product might be inactive if “the indexes that were highly correlated with the fair values of the asset are now demonstrably uncorrelated with recent fair value.”

- This factor can potentially apply to any financial product and it is not clear to us why it should have any relevance: If the price of an asset used to be strongly correlated with the price of another asset (or index), but this correlation breaks down at some point in time, it is generally not related to the activity in the asset at all. For example, at times, equity and credit markets move in the same direction, at other times they are negatively correlated, and sometimes there is no correlation at all. However, it is quite obvious that the relationship between these two asset classes is in no way related to the level of their activity or the reliability of observable data.
- Also one must wonder what “demonstrably uncorrelated” actually means, how anyone would measure it in practice, and whether a negative correlation would also count as “uncorrelated” in this context.

Factor e: An inactive product might display “abnormal (or significant increases in) liquidity, risk premiums or implied yields for quoted prices when compared with reasonable estimates (using realistic assumptions) of credit and other non-performance risk for the asset class”.

- Firstly, it is quite obvious that after many years during which liquidity was available in abundance, we have now entered a period where the cost of liquidity has increased. That said, this factor can be applied to all credit products and it is unclear why a significant increase in the liquidity risk premium should imply that the product is not active. Also, significant increases in yields on the back of the market now pricing in sharply rising defaults are in no way related to the activity of the product neither to the reliability of observable prices.

- Furthermore, this factor is highly subjective and we suspect that the decision of what should be regarded as “abnormal”, “significant”, “reasonable”, and “realistic” will rest entirely with the individual user. That said the factor will offer another opportunity for users to regard a product as inactive even if observable prices that are relevant and reliable are available, herewith reducing transparency and comparability.

Factor f: Another sign of an inactive product is the “abnormally wide bid-ask spread or significant increases in the bid-ask spread”.

- This factor can easily be applied to all financial products as bid/offer spreads in general have increased significantly over the last two years.
- As part of our Markit Quotes parsing services, we have captured bid/offer spreads for financial products for many years and it is quite obvious to us that rising volatility or risk of an asset will cause its bid/offer spread to widen. On the other hand bid/offer spreads are neither related to the activity of these products nor to the reliability of their pricing. Often the opposite will actually be true: a credit that has been quoted at a tight spread and never traded because no one cared might suddenly become very active once concerns about its credit quality rise, and bid/offer spreads have widened.
- Also, again one has to wonder who will actually decide what “abnormal” means, and whether it is just up to the user to make that decision.

Factor g: In inactive markets “little information is released publicly (for example, a principal-to-principal market)”.

- Unfortunately it is completely unclear to us what this statement is supposed to describe and what “principal-to-principal market” might refer to. It would probably be useful if you provided some additional guidance.

We assume that our above comments made it quite obvious that while we question the whole purpose of the “active/inactive” distinction to start with, we also disagree with all of the individual factors that you regard as relevant to determine whether a market is inactive. Overall we were quite surprised by the lack of clarity provided by what is supposed to be “additional guidance” in this FSP. However, we would like to emphasise that we do actually agree with the general principle that, after evaluating all the relevant factors and considering the significance and relevance of each factor, the reporting entity shall use its judgment to determine whether the market is active.

The concept of “active/inactive” was introduced to determine whether the available observable pricing is reasonably reliable, while in the market reality the two factors are not necessarily strongly linked. We are of the view that the approach of determining fair value for inactive products in particular should be based on the findings summarised by the IASB expert advisory panel, i.e. collecting data from all sources, looking through the data to judge its relevance and reliability, and finally the use of judgement to determine the appropriate fair value on the basis of this data.

Identifying distressed transactions

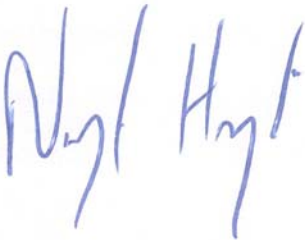
We do generally support the view that a distressed or forced transaction will often not be reflective of fair value. However we are also of the opinion that in reality the number of forced transactions is rather small and we suspect that additional guidance in this area will only encourage users to regard a trade as distressed and disregard useful observable data. Whilst the FSP’s guidance on how to identify distressed transactions overall seems reasonable, it should also include additional clarification to avoid the extensive use of these factors.

- Time used for marketing
 - We are of the view that the “time used for marketing” argument is valid. However, it demonstrates that many of the recent transactions in structured credit products that some might want to describe as distressed actually satisfy this requirement, as most of them are announced days, if not weeks, before the actual liquidation takes place.
- One bidder
 - In contrast we have our doubts about the “one bidder” requirement, as we do not believe that the fact that there is only one bidder can actually be properly measured, neither do we believe that the existence of only one bidder necessarily implies that the transaction is distressed.
 - Firstly, many structured credit products in particular are only traded by a small number of banks and a significant portion only by one, particularly in the US structured finance market. Also, judging from conversations with market makers we know that they often would not even want to show their bids if they knew they will not win. If you know that another dealer will bid 20 for the product, is there any real need to show your bid at 10?
 - Finally, we need to question the whole basis of the argument that a single bidder implies that the traded price is distressed. There are numerous asset classes where only one bidder shows up at a time and bids for the item without this transaction being regarded as distressed.

We are of the view that FSP 157-e in its current form can not be regarded as helpful guidance and it would need to be developed further in order to be useful. We actually think that the whole purpose of this FSP is flawed, and would recommend being honest about the politically determined goals of this guidance, and maybe simply propose that users can value their positions wherever they like regardless of reliable and relevant observable data, with all the detrimental impact on transparency, market confidence, and the economy at large that this would have.

We hope that our comments are of value to you and will encourage you to revise FSP 157-e fundamentally. Please do not hesitate to contact us if you require further information or if you want to discuss any of our comments in more detail.

Kind regards,



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