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Submitted via email to [iasb@iasb.org](mailto:iasb@iasb.org)

**IASB Request for Views on FASB Staff Positions FAS 157-4 and FAS 115-2 dealing with guidance on fair value measurement and impairments of financial instruments**

London, April 18<sup>th</sup>, 2009

Dear Sirs,

Markit appreciates the opportunity to provide you with our views on the final versions of FASB Staff Positions FAS 157-4 and FAS 115-2 as published on April 9<sup>th</sup> and dealing with guidance on fair value measurement and impairments of financial instruments.

Markit is a financial information services company with over 1,200 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 trade actively. 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 been conducting 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

Most market participants are in a position to determine fair value without requiring additional guidance, even for products that do not trade actively, as has been demonstrated by the findings of the IASB Expert Advisory Panel on *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. Whilst we understand that additional formal guidance related to fair value might be beneficial to some users, we suspect that the real cause of the FSPs on Fair Value and Impairments was the politically driven push against marking to market, which only really seems to aim 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, lead the public to question 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 the final versions of FSP 157-4 and 115-2 will only confuse matters and delay the necessary recognition of losses. Despite the fact that some major drafting issues that were contained in the initial proposals have been resolved, we do object to portions of both FSPs, particularly those that provide users with leeway to disregard relevant and reliable observable price information in order to avoid recognising the true extent of their losses, at least for now.

## The Applicability of Mark-to-market

In the current discussions about fair value, it is often argued that the concept of marking to market, 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 trade actively. We are of the view that most of the arguments put forward against mark-to-market do not reflect reality:

- Some argue that the use of mark-to-market 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 traded actively. One simply has to accept the fact that only a very small fraction of all credit and OTC derivatives products that need to be valued actually trade on a regular basis, even in a "normal" environment.
- 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 services that provide observable prices for financial 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, 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 never have been regarded as acceptable in the first place. We are of the view that the IASB Expert Advisory Panel's publication on *Measuring*

*and disclosing the fair value of financial instruments in markets that are no longer active provides all the necessary “educational guidance” on how to determine fair value even in challenging circumstances.*

- Another argument put forward is 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.HE 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 fair value, but rather the price at which the asset would trade in an orderly transaction between two willing counterparties. Allowing or even encouraging the use of own assumptions will almost certainly lead to inflated prices being used in financial accounts. 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. Upon closer inspection it becomes obvious that this statement would not even hold true for lenders of last resort such as governments or central banks.

We do not think that there is sufficient credence in the politically driven demands for changes to mark-to-market nor in the calls for the issuance of additional guidance. They only seem to aim at the relaxation of fair value requirements which would reduce the level of transparency and confidence in financial markets further and lead the public to question the independence of accounting standard setters.

#### **Comments related to FSP FAS 157-4**

We do understand that in a challenging market environment where activity for many financial products is very much reduced 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 some of the guidance that is provided in this FSP is either confusing or misses the point. Whilst we appreciate that FASB drafted and approved this FSP in a hurry under intense political pressure, we cannot ignore the fact that it fails to reflect the mechanics of financial markets.

We do appreciate that the final version of this FSP contains some significant changes compared to the initial draft. We do support the view that, even if a market is less active, users should take into account all available data sources and use their judgement to determine which ones they regard as relevant and reliable, without necessarily being obliged to either apply significant adjustments or rely on alternative valuation methods.

We also welcome the addition of a paragraph providing guidance on the use of pricing services to this FSP, and support the recommendation that users need to be able to look through the data in order to understand the background of the prices that they received from brokers or pricing

services. As a matter of fact, we do provide the users of our pricing services with as much information as possible to enable them to form their own informed view on the relevance and reliability of our data, e.g. based on the number of accepted contributions, the range of contributions, and whether the prices are based on firm bid/offers, best estimates of mid market or end-of-day book-of-record contributions.

### **Determining whether there has been a significant decrease in the volume and level of activity**

We applaud the decision to not use the concept of “active/inactive” in the final version of this FSP and replace it with “volume and level of activity”. We are of the view that one has to accept the fact that there is no bright line between active and inactive markets, and that for less active products simply more effort has to go into determining fair value.

Our general objection remains that the whole notion of activity is not really appropriate for its original purpose, which is to determine whether a specific observed price can be regarded as reliable and relevant. Based on our experience as a pricing service, we are aware of a whole range of financial products that are quoted by dozens of market makers that all agree on the price, are very liquid with reliable observable prices being provided on an ongoing basis, but do not trade as there is no interest in them at the moment. There will therefore be numerous examples of inactive products with highly reliable observable prices.

### **Factors that signal a significant decrease in the volume and level of activity**

We were quite surprised that no changes had been made to the factors used to measure activity in the final version compared to the proposed FSP. As explained in more detail below we are of the opinion that most of these factors cannot be used to measure activity effectively. We would recommend not using any of these factors and leaving it to the users to make their decisions based on all relevant input and using their expert judgment.

**Factor a:** There are few recent transactions.

- In our opinion a “decrease in the level of activity” and “few recent transactions” is one and the same. We therefore fail to understand how the fact that few recent transactions have taken place can be described as a signal that activity is very much reduced.
- More importantly, 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, we provide daily observable consensus prices for 80-85% of this asset class. Similarly, in OTC derivatives markets, while only a small subset of all the relevant strikes and maturities actually trades, reliable pricing is provided constantly across all available strikes and maturities by the dealers.
- 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:** Price quotations are not based on current information.

- This factor seems quite confusing and might require further explanation. If we assume that it refers to a bid/offer quote from a market maker, it is worth asking why it would ever not be based on current information. 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, we wonder who will decide whether the price quotation is actually based on current information and how this decision will be made. Will it be as easy as simply stating: “I think the price should be higher” to determine that the current price clearly does not incorporate the current information?

- Furthermore this factor will hold true for all traded 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 the drop in ABX.HE prices was irrational and not based on the “current information” at the time. However in retrospect these price moves 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 activity for a product as reduced based on their view that the current market pricing is too low.
- It might well be that this factor should refer to a “stale” price, i.e. a price that has not been updated by the market maker. If that was the case one 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 determinative anyway and it is therefore not clear why additional guidance in this situation would be beneficial.

**Factor c:** Price quotations vary substantially, either over time or among market makers, for example, some brokered markets.

- We do strongly object to the “variation over time” part of this factor as it will not only apply to most financial products but, even worse, would tend to identify in particular those products as less active that trade most actively. As you know, the market price of any traded financial product will fluctuate over time, and often elevated price volatility will actually 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 and their prices tended to be quite volatile as they traded very often. In contrast corporate bond prices showed a much lower level of volatility as they simply did not trade. “Variation over time” does not seem to be an appropriate factor to identify inactive products, and in most cases it would achieve the exact opposite.
- Whilst “variation among market makers” can be regarded as a more appropriate measure of the inherent pricing uncertainty of a product, we fail to understand what “some brokered markets” refers to. Does it refer to markets where interdealer brokers are active or to markets where market makers quote prices? In any case this remark does seem misplaced and not relevant in this context.

**Factor d:** Indexes that were highly correlated with the fair values of the asset are now demonstrably uncorrelated with recent indications of fair value.

- Unfortunately this is just another factor that 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 mostly not related to the activity in the asset. 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. Needless to say that the same can apply to the correlation between individual assets and a related index.

- 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:** There is a significant increase in implied liquidity risk premiums, yields or performance indicators for observable prices when compared with the entity’s estimate of expected cash flows.

- Firstly, it is quite obvious that after many years during which liquidity was available in abundance, we have entered a period where the cost of liquidity has increased. This factor can therefore easily be applied to all financial products and it is unclear why a significant increase in their liquidity risk premiums should imply that observable prices should not be reliable or relevant. Also, significant increases in the yields of credit products are neither related to the activity of the product nor to the reliability of observable prices as the market is just pricing in a sharply rising number of defaults in the coming years.
- Furthermore, this factor is highly subjective and we suspect that the decision of what should be regarded as “significant” will rest entirely with the individual user. The factor will offer just another opportunity for users to disregard observable prices that are relevant and reliable.

**Factor f:** There is a wide bid-ask spread or a significant increase 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, while there is no clear link to the level of activity of the product or to the reliability of their pricing.
- 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 in absolute terms. On the other hand there is no clear link between bid/offer spreads and the activity of these products or 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.
- Finally, one has to wonder how the decision about the meaning of “wide” or “significant” will be made, assuming that it will just depend on the subjective view of the user.

**Factor g:** A significant decline or absence of a market for new issuances.

- In our view this is another factor which applies to a whole range of financial products while it has no real relevance for the availability of pricing, neither is it necessarily linked to the activity in the secondary markets.

**Factor h:** Little information is released publicly (for example, a principal-to-principal market).

- Finally a factor that we do not disagree with as we simply fail to understand its meaning. Unfortunately it is unclear to us who should release what kind of information and what “principal-to-principal market” might refer to. It would probably be useful if some additional guidance for this guidance was provided.

Overall we were quite surprised by the lack of clarity provided by what is supposed to be “additional guidance” in this FSP. We disagree with most of the individual factors that were identified to determine whether a product has experienced a reduction in volume or activity. We would therefore recommend simply deleting all factors a-h in paragraph 12 as they simply do not

add any value. In the end it should be up to the user, after evaluating all relevant factors and considering the significance and relevance of each factor, to use its judgment to determine whether the market is active and observable prices are sufficiently reliable.

### Identifying transactions that are not orderly

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 larger number of trades as distressed and therefore disregard useful observable data. Whilst the FSP's guidance on how to identify transactions that are not orderly 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 whilst the “time used for marketing” argument is valid, it actually demonstrates that many of the recent transactions in structured credit products that some might want to describe as distressed do actually satisfy this requirement and should hence be regarded as orderly, as most of them are announced days, if not weeks, before the actual liquidation takes place.
- One bidder
  - We do have 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 not orderly.
  - Given their bespoke nature many structured credit products are only traded by a small number of banks and a significant number of them only by one single dealer, which is particularly relevant for structured finance products in North America. Also, market makers will often not even want to show their bid if they know that they will not win: If you know that another dealer will bid 20 for the product, is there any real need for you to show your bid at 10?
  - Finally, we would question the whole basis of the argument that the existence of only a single bidder implies that a trade is not orderly. 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 strongly support the approach summarised by the IASB Expert Advisory Panel of determining fair value for products that do not actively trade, which consists of 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. We are also of the view that with the exception of the factors listed in paragraph 12 FASB, FSP 157-4 should generally be consistent with the recommendations of the IASB Expert Advisory Panel, and we therefore do not see any real need for the IASB to issue any additional guidance in this respect.

**Comments related to FSP FAS 115-2**

The fact that FSP FAS 115-2 was only approved with the narrowest possible majority demonstrates how much it must have been against the conviction of a number of the FASB board members. We do support the arguments voiced by the dissenters and agree that the amended impairment rules are a result of political pressure aiming at providing users with temporary relief, as they can avoid revealing the true extent of their mark-to-market write downs. However, as long as loss recognition is postponed and transparency for investors is reduced further, the flow of credit to the real economy cannot be restored, increasing the risk of a “lost decade” such as the one experienced by Japan in the 1990s.

We also share the view that it is almost impossible to separate “credit losses” from “other losses” and we would like to refer again to the ABX.HE-related example that we used earlier to illustrate this view. Research studies conducted on ABX.HE price moves have shown that the initial drop in their prices in late 2007 could not be explained by fundamentals at the time, but only by so-called “market” factors such as risk aversion. However, just one year later, it became obvious that market prices at the time had correctly anticipated the future fundamental situation. Instead of behaving irrationally and moving away from fundamentals, the market had correctly anticipated future fundamentals. Any ability of the users to judge by themselves what the likely credit losses will be can only lead to an underestimation of the real future loss. One can wonder how many users would have predicted two years ago, based on “their best estimate of the present value of the cash flows to be collected” from an ABX.HE junior tranche investment, how little they would be worth today.

We hope that our comments are of value to you and encourage you to defend your independence against political influence. Accounting standard setting should not end up to be a race to the bottom, where a relaxation in standards forced upon one standard setter is regarded as competitive advantage by politicians and therefore enforced on others. It is in the interest of all market participants and of the public that standard setters continue to pursue their long term goal of creating a single set of high quality global accounting standards with a sensible and comprehensive application of fair value. This is the only way to maximise transparency and comparability for investors, rebuild market confidence, and restore the flow of credit to the real economy.

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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