

Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

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

**File Reference No. 1710-100: Exposure Draft *Improving Disclosures about Fair Value Measurements***

London, October 12<sup>th</sup>, 2009

Dear Sirs,

Markit welcomes the publication of the FASB Exposure Draft *Improving Disclosures about Fair Value Measurements* and we appreciate the opportunity to provide you with our comments.

Markit is a leading, global financial information services company with over 1,300 employees in North America, Europe, and Asia Pacific. Over 1,500 institutions use our independent services to value financial instruments, manage risk, improve operational efficiency or meet regulatory requirements. Markit provides pricing services for financial products across all asset classes including many products that do not actively trade. Some of our pricing services, such as Markit Totem, have been operating for more than 10 years providing the market with fair value levels for over-the-counter derivatives across all asset classes. Markit Totem 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 consensus prices are more representative of fair value than those from any other source, including inter-dealer broker and model based prices, or some official closing prices of exchange-traded products. We are also a major provider of valuations for OTC derivative positions across asset classes and of pricing and modelling services for structured finance products.

Today, all major banks, broker dealers, buy-side institutions, and commodities traders use Markit's pricing and valuation 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 the issues relating to inherent uncertainty of valuations and the use of alternative unobservable inputs.

## General Comments

We are of the view that the way in which existing accounting standards attempt to capture valuation uncertainty, e.g. through classification into Levels 1, 2, and 3 or by distinguishing between active and inactive, is not satisfactory. Not only are fair values crudely classified into a very small number of different reliability buckets, but these categories are based on the flawed notion that a specific level of reliability can be attached to a pricing source or to an activity level. Whilst for example we share the view that prices of actively traded exchange traded products are generally reliable, official exchange prices are often also published for products that do not actively trade. When operating our pricing services, we therefore frequently experience situations where the pricing of an OTC derivative is much more reflective of fair value than its exchange traded look-alike, particularly beyond a certain maturity and away from at-the-money strikes, where trades only really occur in the OTC format.

That said we strongly welcome the initiatives of the accounting standard setters to measure and disclose the inherent uncertainty of fair values in a more granular and accurate fashion, a need that was highlighted by the increased valuation uncertainties experienced during the financial crisis.

## Existing measures of valuation risk

As a provider of pricing and valuation services for financial products across asset classes we are very much aware of the inherent uncertainty of valuations and we therefore aim to maximize the transparency around the fair values that we provide. As part of our pricing services we will not only publish the consensus price, but also the number and the range of accepted contributions, often the actual accepted contributions and the standard deviation, skewness, and kurtosis of the distribution. Equipped with this additional information users should be in a position to decide whether to simply use the consensus price that they received, for example if it was based on a large number of contributions within a tight range, or whether they need to get hold of prices from additional sources to determine the fair value of the asset.

## Reasonably possible alternative inputs

We are of the view that some aspects of your Exposure Draft might require further clarification while others would be somewhat challenging and costly to implement:

- In our opinion no matter whether one deals with the valuation of a structured finance product, a complex OTC derivative, or a simple cash instrument the fair value that is chosen by the user has to be regarded as the most representative point within a range of possible values. That said, when asking users to determine reasonably possible alternative inputs you should clarify that they produce not just one, but rather two values, i.e. one above and one below the fair value that was used.
- Furthermore, users will have to choose these two values from a whole range of alternatives around the fair value with different likelihoods attached to them. That said we would find it difficult to decide what represents a reasonably possible alternative within this range, as it will very much depend on the probability that one equates with "reasonable". Needless to say that this probability will also differ between users, hereby reducing comparability.
- For valuations that are provided by third parties it should be clarified whose responsibility it is to choose the reasonably possible alternative inputs, as this might have a significant impact on the feasibility and the costs of implementation. Leaving the choice of alternative inputs with each individual user will not only reduce comparability but will also create significant costs: For example for one and the same position which is held by 20 different

clients a valuation provider would typically perform any necessary computation just once based on one set of inputs and provide the same fair value to all clients, hereby allowing for economies of scale. However, to re-value these same positions based on alternative inputs that are determined by clients individually the valuation provider would have to perform at least 20, if not 40 or more, additional calculations, hereby creating incremental costs that might surpass those of providing the original valuation. That said we realize that the alternative of leaving the choice of determining reasonably possible alternative inputs with the valuation provider is probably not acceptable either.

### **Issues related to multiple unobservable inputs**

For complex financial instruments such as OTC derivatives or structured finance products, there will be not just one, but a multitude of unobservable inputs into the valuation. When considering reasonably possible alternative inputs for these products it will therefore be necessary to define whether to use an alternative input just for one of these variables or for all of them, with the latter option creating an infinite number of input vectors. For highly structured products it will thus already be quite time consuming and costly just to define the reasonably possible alternative inputs and combinations thereof.

The fair value of RMBS tranches for example will be typically derived by entering several variables into a cash flow model that was built for the specific transaction. Whilst the cost of running additional scenarios for structured finance products might be limited, the effort required to generate ranges of alternative inputs can be significant. The relevant inputs will often be vectors of pre-payment rates, defaults, loss severity, and delinquencies, which will vary over time and are based both on observed and on expected behavior of the underlying loan pools. A variety of methods such as analysis of historical data or stochastic models can be used to forecast the different possible alternative inputs and hence the shape of these vectors. That said, given the multitude of inputs into the pricing of RMBS it is unclear whether as reasonably possible alternative inputs users should move all the variables by a specified percentage, use a combination of changes that are of different magnitude for the respective variables, or compute and disclose the effect of individual changes on valuations for each of the variables. Valuation providers could assist users by generating these ranges either based on a dedicated research function or through polling the relevant market participants to derive a consensus. Whilst the research based approach is more difficult to implement and would be subject to much debate the consensus approach seems more feasible from an implementation perspective.

Despite these challenges we are of the view that measuring and disclosing the degree of confidence around fair values of structured finance products is a worthy endeavor and should be pursued, particularly given that many complex structured finance securities exhibit a rather volatile return profile.

### **An alternative proposal**

Based on our experience as a pricing and valuations provider we are of the view that one simply cannot approach valuation as just a one-dimensional exercise and accounting standards should aim to reveal three or even four dimensions of fair values: In addition to the fair value of the product itself (1<sup>st</sup> dimension) one would want users to disclose a range of possible values around it (2<sup>nd</sup> dimension), as well as the uncertainty that is attached to this range (3<sup>rd</sup> dimension). Also, the liquidity of the position (4<sup>th</sup> dimension) should be taken into account as it will determine the actual exit price.

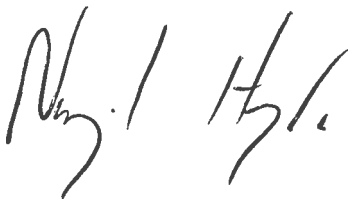
Given the difficulties of capturing all of these dimensions individually on the one hand, but also those of using reasonably possible alternative inputs as described above, we would urge you to consider the following alternative to capture both uncertainty and sensitivity of fair values:

- For all positions, independent of their pricing source, level of activity, or classification, users should disclose their confidence in the fair value that they used, for example on a scale from 1 to 10.
- In addition users should apply a sensitivity analysis that is somewhat standardized for those valuations that are based on unobservable inputs:
  - Moving the relevant unobservable inputs by a certain, pre-specified percentage seems to be an easy solution. However, it would not reflect the confidence one may have in the parameter estimation as, depending on the scale that was used to define it, a 10% change for a parameter can be a tiny shift or it may equate to a move outside the permitted parameter range. A time series based estimation of parameter uncertainty, possibly along the lines of historical Value-at-Risk, would thus appear to be a more sensible approach.
  - Alternatively, one could consider creating a consensus for possible alternative inputs based on polling of the relevant market participants. However, the use of an industry consensus for parameters relies on the assumption that the models used for valuation were accepted by the entire industry while in reality proprietary models are used. This challenge could be addressed by allowing parameter ranges that are “comparable” to the consensus when using proprietary models.

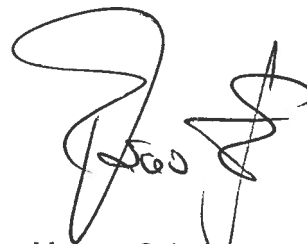
These alternative approaches will allow users to quantify both the inherent uncertainty of the valuation and its sensitivity to changes in unobservable inputs, while they seem easier and less costly to implement and would not cause any reduction in comparability.

We hope that our comments are of value to you. 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,



Nigel Hyde  
Managing Director  
Head of Totem  
[nigel.hyde@markit.com](mailto:nigel.hyde@markit.com)



Marcus Schuler  
Managing Director  
Regulatory Affairs  
[marcus.schueler@markit.com](mailto:marcus.schueler@markit.com)