markit™

Level 5
2 More London Riverside
London
SE1 2AP

+44 20 7260 2000 Office
+44 20 7260 2001 Fax
www.markit.com

International Accounting Standards Board
First Floor
30 Cannon Street
London, EC4M 6XH
United Kingdom

Submitted via www.iasb.org

IASB Exposure Drafts *Financial Instruments: Classification and Measurement* and *Fair Value Measurement*

London, September 10th, 2009

Dear Sirs,

Markit welcomes the publication of the IASB Exposure Drafts *Financial Instruments: Classification and Measurement* and *Fair Value Measurement* and we appreciate the opportunity to provide you with our comments.

Markit is a financial information services company with over 1,200 employees in Europe, North America, and Asia Pacific. Over 1,500 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 instruments that 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. Totem Valuations collates market makers' best estimate of the mid-market price for all of the derivative instruments that they trade to then create a single composite price for each instrument and maturity that is covered by the service.

All of our prices are rigorously tested to ensure that they are appropriate given other pricing levels and market inputs. We have also been conducting continuous analysis and testing over the years and are of the view that for many products our consensus prices are more representative of fair value than those from any other single source, including inter-dealer broker and model-based prices, or some "official" closing prices of exchange-traded products. Today, all major banks, broker dealers, buy-side institutions, and commodities traders will 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.

All said we feel well positioned to comment on the issues related to fair value measurement and the relevance and reliability of different pricing sources. We hope you will find our comments useful and we would be very willing to voice our views at one of your public round table meetings.

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+44 20 7260 2001 Fax
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ED Financial Instruments: Classification and Measurement

Markit supports the IASB's initiatives to reduce the complexity of financial reporting and we agree that with only two measurement categories, one impairment test, and the elimination of tainting rules as well as of reclassifications the ED seems like a step in the right direction. However, we are of the view that simplification could be further increased by considering alternatives while the ED's proposals might risk reducing the usefulness of financial reporting and increasing measurement complexity.

Usefulness

While the ED proposes a seemingly simple approach to divide all financial products into just two categories we question the rationale that was used to justify this division. Specifically, we think that a number of products that are to be marked at amortized cost might actually have less predictable returns than those in the fair value bucket and the proposal therefore risks reducing the usefulness of financial reporting:

- The failure of financial institutions is often driven by losses that accumulate in portfolios of traditional loans[1], which are assumed to have more predictable cash flows. Particularly during the downturn of a credit cycle it therefore seems absolutely critical for investors to be able to monitor these losses. That said, we are of the view that accounting all "simple" loans at amortized cost will reduce the usefulness of financial reporting just where it is currently needed the most.

- For structured finance instruments the most senior tranches would qualify for amortized cost treatment, again based on the assumption that their returns are more predictable. However, this approach ignores the fact that the single biggest sources of losses during the financial crisis were exposures to exactly these most senior parts of the capital structure, e.g. super senior tranches of CDOs. Allowing amortized cost accounting for these products ignores recent lessons and reduces transparency and usefulness of the reported information where it is seems most needed.

Measurement Complexity

- One should be aware of the fact that your proposals are likely to increase measurement complexity by extending fair value especially to those products that are the hardest to value, such as non-quoted shares and junior tranches of structured finance deals. At the same time the ED would apply amortized cost accounting to simple bond and loan products that will not create any meaningful valuation challenges as many of them are actively traded.

- Also, while removing or reducing some of the current complexities the ED's proposals will introduce a number of new ones such as the definition of "loan like features" and "managing on a contractual yield basis". One point which might require further clarification in this context is the fact that instruments would not be accepted for amortized cost measurement if they trade at a significant discount, as it is considered to signal a higher variability in cash flows. We do not regard this as appropriate and would ask you to consider a common situation where two corporate bonds with similar maturities have been issued by the same company at different points in time while its credit quality has deteriorated. We find it difficult to understand why the seasoned issue with a lower coupon that might now trade at a significant discount carries a higher risk than the recently issued bond with a higher coupon that will trade close to par.

[1] See for example the SEC's *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*

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+44 20 7260 2001 Fax
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Alternatives

Based on our experience as a pricing and valuation provider we think that even in a challenging market environment with limited trading activity marking-to-market is feasible for most financial products. It will just require more time and effort than in the good times. While the application of fair value might indeed increase P&L volatility, it will be just because it reflects economic realities. We therefore do not regard this as a valid reason for accounting standard setters to reject the use of fair value. We are also of the opinion that if there ever was an ideal timing for a revolutionary change to financial reporting standards, it is now, at a time when most concepts related to financial products such as their regulation and their reporting are fundamentally revised.

All said, we do agree with the alternative view that only the application of fair value to all financial instruments can truly minimize complexity, while maximising transparency and usefulness of financial reporting, at the cost of only a limited further increase in measurement complexity compared to the ED's proposal. Additional discussions about the potential for introducing fair value measurement for all financial instruments should therefore be required before making any decisions.

ED Fair Value Measurement

We are generally supportive of the IASB's efforts to clarify the definition of fair value and create a single source of guidance while enhancing the disclosure about the inputs that are used to determine it. However, whilst we appreciate the guidance that the ED provides on the use of mid market prices and on pricing services, we do have serious objections to the factors that are proposed in the Application Guidance to determine whether a product is not active. We would therefore strongly recommend removing them and to refer to the publication of the IASB Expert Advisory Panel[2] instead for additional guidance.

1. The use of mid market prices

We welcome the recommendations related to the use of bid/offers and mid market prices respectively. Specifically we are of the view that when aiming at using the price within the bid/ask spread that is most representative of fair value one should not preclude the use of mid-market pricing as a practical expedient. This approach not only mirrors common market practice but is also consistent with not taking transaction costs into account when determining fair value, as bid/offer spreads represent the cost that is incurred when executing a transaction.

Needless to say that the acceptance of mid market levels will also maximise comparability, as different users will otherwise account for the same position at a whole range of different levels depending not only on whether it is a long or a short position, but also on the size of the position as well as their level of market access. That said, it is worth pointing out that users reporting under US GAAP seem to move into the opposite direction, reflected in an increased interest from those clients in the provision of bid/offer information for valuation purposes, be it actual or modelled, to reflect the actual exit price for the financial instruments that they hold.

2. Quoted prices by third parties

We generally welcome additional guidance related to the use of pricing services and we do support the view that users need to be able to look through the data that they receive from brokers or pricing services. It is worth pointing out that we provide users of our pricing services with information such as the number of accepted contributors as well as the range and standard

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[2] IASB Expert Advisory Panel, Measuring and disclosing the fair value of financial instruments in markets that are no longer active

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2 More London Riverside
London
SE1 2AP

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+44 20 7260 2001 Fax
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deviation of the accepted contributions in addition to the actual consensus prices, to allow them to develop their own view on the relevance and reliability of the data. That said we are of the view that third party pricing providers in general should be required to be as transparent as possible about sources and inputs into their pricing procedures as well as their modelling techniques.

As part of our pricing services we will also clearly identify whether prices are based on firm bid/offers, best estimates of mid market, end-of-day book-of-record contributions, or transactions. That said, we question the notion that more weight should always be given to prices that are based on transactions. As we have found repeatedly when comparing transaction prices to other sources, a significant portion of them will diverge from what market participants would regard as fair value, be it because of timing differences or of the characteristics specific to the individual transactions such as unwinds or switches. We are therefore of the opinion that while transactional data, where available, does represent an important input into the determination of fair value, it should by no means be regarded as the dominating one.

All said we are of the view that the ability of users to look through all of the data regardless of its source and the use of judgement are crucial to decide which source of pricing information is the most relevant and reliable one depending on the specific situation.

3. How to decide whether markets are not active and transactions are not orderly

We do understand that in a challenging market environment where activity for many financial products is reduced and forced transactions occur more frequently some users might appreciate additional guidance on how to determine fair value.

However, as we have stated in previous responses, we are of the opinion that the factors to identify non-active markets that were included in FAS 157-4 and in the Application Guidance of the IASB's ED seem counterproductive and run the risk of causing unintended consequences as they provide users with leeway to disregard even the most relevant and reliable observable data. We would therefore recommend removing them and emphasizing the need for users to apply their judgement based on the individual circumstances when deciding on the reliability of prices instead, consistent with the recommendations of the IASB Expert Advisory Panel.

The notion of "activity"

While for hard-to-value products in particular one must determine whether a specific observable price can be regarded as relevant and reliable we are of the view that it is neither practical nor appropriate to use "activity" for this purpose:

- There simply is no bright line between active and inactive markets, and even if there was one it will change over time. One therefore has to accept that for less active products simply more effort has to go into determining fair value.

- As a provider of pricing services, we often come across products that are quoted by dozens of market makers that all agree on the price but are not active as there simply is no interest in trading them at the moment. As there are numerous examples of inactive products for which reliable observable prices are available, we are of the view that users should not necessarily be required to apply significant adjustments or to rely on alternative valuation methods even if the product is not active.

All said, we are of the view that as general principle users should always try to take all available data sources into account to start with and apply their judgement when deciding which of those are relevant and reliable for each specific case, no matter whether the market is "active" or "not active".

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Factors that signal that a market is not active

The "factors that signal that a market is not active" seem like remains from a hastily drafted FSP reflecting arguments that only make sense within the context of the recent financial crisis. It therefore does not come as a surprise that at best they are just confusing; at worst they measure the exact opposite of what they are supposed to. We were therefore somewhat surprised to find these factors not only in FAS 157-4 but even in the IASB ED, a document that aims at fundamentally improving financial reporting for the decades to come.

Factors a and b: *There has been a significant decrease in the volume and level of activity. There are few recent transactions.*

- In our opinion a "decrease in the level of activity", "few recent transactions", and "not active" are one and the same. We therefore fail to understand how the fact that few recent transactions have taken place can be helpful in identifying reduced activity if most market participants do not have access to this type of information anyway.
- More importantly, for most financial products, a lack of transactions is not equivalent to a lack of relevant and reliable observable data. Whilst for example there is very little trading activity in European ABS, daily observable consensus prices based on dealers' books of record are available for the majority of the bonds. Similarly, in OTC derivatives markets, while only a small fraction of all relevant maturities and strikes trades on a regular basis, reliable pricing is provided by market makers constantly across most product variations.

Factor c: *Price quotations are not based on current information.*

- This factor might require further explanation: If 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 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, we wonder who will decide whether the price quotation is based on current information and how this decision will be made.
- As a general principle market prices will always incorporate expectations of market participants instead of being based just on the current information. In late 2007 many market participants claimed that the drop in ABX.HE prices was irrational and not justified by the "current information" at the time while in retrospect these price moves proved to be a fairly accurate reflection of market expectations.
- If this factor refers to a stale price which has not been updated by the market maker, one should consider changing the wording to "a price which is stale and has not been updated to reflect recent market information". However, a user who had looked through the price would not regard it as determinative anyway, and it is therefore not obvious what value this additional guidance will add.

Factor d: *Price quotations vary substantially over time or among market makers (eg. some brokered markets)*

- While market prices of all traded financial products will fluctuate over time, it is often the most liquid products that display elevated price volatility. 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 more volatile compared to those of corporate bonds that simply did not trade. We therefore object to the argument that "variation over time" will signal reduced activity as it would often identify those products as not active that trade most actively.

- "Variation among market makers" seems a more appropriate measure of the inherent pricing uncertainty of a product and we therefore provide the users of our pricing services with information about the range of accepted contributions. However, we fail to understand what "some brokered markets" refers to, are they markets where interdealer brokers are active or where dealers quote prices?

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

- This is another factor that can potentially apply to any financial product and it is not clear why it should have any relevance for the measurement of activity. For example 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 rarely related to the activity in the asset. 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, the nature of the relationship between these two asset classes is linked neither to the level of their activity nor to the reliability of observable data.

- Also one must wonder what "demonstrably uncorrelated" actually means, how it would be measured in practice, and whether a negative correlation would count as "uncorrelated" in this context.

Factor f: *There is a significant increase in implied liquidity risk premiums, yields or performance indicators for observed transactions when compared with the entity's estimate of expected cash flows.*

- After many years during which liquidity was available in abundance its cost has recently increased, while rising yields of credit products reflect the expectation of more defaults in the coming years. The factor can therefore easily be applied to all financial products while it is neither related to the activity of the product nor to the reliability of observable prices.

- Furthermore, this factor is highly subjective and we suspect that the decision of what should be regarded as "significant" will rest entirely with individual users, who might be encouraged to disregard observable prices even if they are relevant and reliable.

Factor g: *There is a wide bid-ask spread or 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.

- Price information that we capture as part of our Markit Quotes services demonstrates that rising volatility or risk of a product will often cause its bid/offer spread to widen. However, there is no clear link between bid/offer spreads and the activity of these products or the reliability of their pricing. In contrast, a rise in the bid/offer spread might often be accompanied by an increase in activity, for example when a tight spread credit that never traded because no one cared becomes active based on concerns about its credit quality.

Factor h: *A significant decline or absence of a market for new issues.*

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

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+44 20 7260 2001 Fax
www.markit.com

Factor i: *Little information is released publicly (eg a principal-to-principal market).*

- Unfortunately it is unclear who should release what kind of information and what "principal-to-principal market" refers to. It would be useful if some additional guidance was provided related to this guidance.

All said, we are of the view that the individual factors that are used to determine whether a product is not active are not helpful, and we would therefore recommend removing them. Ultimately it must be up to the users, after evaluating the relevance and reliability of each input, to apply their judgment to determine what role a specific observable price should play when determining fair value.

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 additional guidance in this area runs the risk of encouraging users to identify trades as distressed even if relevant and reliable observable data was available. Whilst the 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.

- We are of the view that whilst the arguments related to adequate exposure to the market and marketing activities are valid, it notably implies that many of the recent transactions in structured credit products should be regarded as orderly as they were often announced days, if not weeks, before the actual liquidation takes place.

- While it will be difficult to measure whether a product was marketed only to a "single market participant" to start with, we do not think that the existence of only one bidder should necessarily imply that the transaction is not orderly. One has to accept that it is the nature of some markets, particularly for bespoke products such as structured credit, that there might only be one potential buyer or dealer.

- The "near bankruptcy" and the "outlier" arguments seem useful to identify non-orderly transactions. However we are of the view that any diligent user who follows the recommendations of the IASB Expert Advisory Panel would identify data outliers anyway.

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

Marcus Schüler
Managing Director
Regulatory Affairs
marcus.schueler@markit.com