

September 22, 2005

Linda MacDonald  
Project Manager  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856

Dear Ms. MacDonald:

In conjunction with the expected issuance of FASB's Statement of Financial Accounting Standards, *Fair Value Measurements*, (the "Fair Value Measurements Statement") and a proposed FASB Staff Position ("FSP") regarding "Measuring Fair Value of Certain Derivative Contracts Under Statement 133" (the "Proposed FSP"), the International Swaps and Derivatives Association ("ISDA"), The American Securitization Forum ("ASF") and the Securities Industry Association ("SIA") would like to take this opportunity to provide brief comments relating to the expected accounting guidance and propose some drafting clarifications. In light of the Board's directive to the staff at the September 14, 2005 Board meeting and the significance of the issue, we would like to provide you with our current observations and comments that may be useful in your analysis of the issues being discussed.

The comments that follow were developed and are being presented jointly by a working group (the "Joint Working Group") composed of representatives of the respective accounting policy committees of ISDA, ASF and SIA.<sup>1</sup> The Joint Working Group previously submitted comments to the FASB on the topic of fair value in its letter dated September 2, 2004 in connection with the formal comment period on the Fair Value Measurements Statement and our representatives have followed the redeliberation process with great interest.

### **OBSERVATIONS**

The first observation below ("Observation 1") focuses on the developments arising from the FASB's September 14, 2005 Board meeting, at which the Board discussed and directed the staff to further research what is meant by a "principal value driver." The other observations below arise from discussions of the Joint Working Group after review of the project summaries on the FASB website, informal discussions with the staff and attendance at FASB Board meetings and education sessions.

#### **Fair Value Hierarchy:**

*Observation 1:* In response to the Board's directive regarding the definition of "principal value driver" we wish to express our view that such determination should be based on the significance of an input to the valuation estimate, and should not be based on which input has the largest possible distribution of values. We believe that inputs could vary widely or be driven by an entity's own input and still not impact the value of an instrument

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<sup>1</sup> A description of our organizations is contained in Attachment I.

significantly. Inputs that do not impact the value of an instrument significantly should not be a key driver in determining the classification of that instrument in the fair value hierarchy. We acknowledge that the significance of an input relative to the valuation may sometimes be a matter of judgment. We believe that the significance of inputs should be incorporated into the definition of each fair value hierarchy level.

Further, in differentiating between Level 4 and Level 5 of the hierarchy, we agree with the Board's approach of using both the concepts of "corroborated" and "derived principally" in describing Level 4 estimates. We believe that each concept may be relevant depending on the significance or immateriality of specific inputs and the availability of corroborating market data. We believe the concept of "derived principally" incorporates consideration of the significance of market data when determining the fair value of an instrument. The concept of corroborated data further incorporates market data that are observable based upon a preponderance of the evidence but does not prescribe a formulaic sensitivity analysis of the market data in order to assign an instrument to Level 4 in the hierarchy. Furthermore, using both of these concepts more clearly delineates Level 4 estimates that are derived principally from market based inputs from Level 5 estimates that are derived principally from entity-specific inputs.

We recommend the descriptions of the hierarchy in the two documents include both concepts. Accordingly, we suggest the following wording for Level 4 estimates:

*Inputs which are significant to the overall valuation that are derived principally from, or corroborated by, market data that relates indirectly to the asset or liability, including correlated, interpolated or extrapolated measures.*

Observation 2: The Board Handout from the June 29, 2005 Fair Value Measurements Statement meeting defines Level 3 of the fair value hierarchy as: "Market inputs that relate directly to the asset or liability and are observable over the full term of the asset or liability (direct market inputs)..." This language could be read to imply that normal interpolation between observable market input points that are directly related to the asset or liability would not be included in Level 3.

Market participants consider the entire USD Libor swap curve to be observable as any desired point on the curve can be interpolated using commonly accepted calculations; however, direct market inputs would be available only for certain points along the curve (for example, four-year, five-year, etc.). In applying the current definition of Level 3, we believe that a 5-year plain vanilla USD interest rate swap would be grouped in Level 3 on day one because there are direct market inputs for the swap, and then in the next quarter when it becomes a 4 year 9 month swap, it could be grouped in Level 4 because the data must be interpolated. We believe that the Board's intent with respect to interpolation in Levels 4 and 3 was to differentiate interpolation of inputs between similar assets as opposed to interpolation within inputs directly related to the asset being priced.

We recommend the Board clarify the definition of Level 3 to include interpolated market inputs to be considered as direct market inputs, and suggest the following wording for Level 3:

*Inputs which are significant to the overall valuation that are derived from market data which is observable at the commonly quoted intervals over the full term of the asset or liability and that relates directly to the asset or liability.*

**Disclosure:**

Observation 3: The project summary of the Fair Value Measurements Statement lists one of the required disclosures as:

Unrealized gains or losses related to those assets and liabilities still held at the reporting date should be separately disclosed for each disclosure level below Level 3.

Consistent with our views expressed in our comment letter dated September 2, 2004, we support the general concept behind the required disclosures. It is our understanding from recent FASB Education Sessions that this particular disclosure requirement is only applicable to Level 5 disclosures. In addition, we understand that the requirement applies only to income statement amounts, not balance sheet amounts. We question whether a requirement to disclose the change in unrealized gain or loss in isolation provides useful information to users of financial statements. Consider the example of a derivative contract in a net unrealized gain position at the beginning of a period which reports zero change in value in the income statement for the period. This revenue of zero could be composed of a realized gain due to the receipt of contractual cash flows during the period, and the related reversal of a portion of the initial unrealized gain. The reversal of the unrealized gain would be reported as an unrealized loss under the disclosure requirements of the Fair Value Measurements Statement and we question how the disclosure of this change in unrealized gain or loss due to the realization of cash improves financial reporting., Note that this disclosure will require significant systems and operational process changes, as the change in unrealized gain or loss is not consistent with the manner in which most firms evaluate profitability, which is on a total gain or loss basis.

While we question the usefulness and cost of the income statement disclosure as written, we believe that a requirement to disclose the balance sheet amount for Level 5 alone may not provide useful information to financial statement users. This is particularly true given that most derivatives have an initial cost of zero. Therefore, the unrealized gain or loss on a derivative is the same as the fair value amount disclosure requirement for each major category of assets and liabilities.

Further, while we understand from the recent FASB Education Session that the disclosure refers to income statement amounts, we note that it is unclear as written as to whether the unrealized disclosure requirements refer to the unrealized gain or loss at the balance sheet

date (a balance sheet amount) or to the change in unrealized gain or loss during the reporting period (an income statement amount).

We recommend the staff clarify the intent and the application of the disclosure requirements, particularly for derivative instruments.

*Observation 4:* The project summaries for the Fair Value Measurements Statement and the Proposed FSP require similar disclosures, however, the disclosure requirements are inconsistent. We recommend the disclosure requirements for the Proposed FSP do not overlap the disclosure requirements in the Fair Value Measurements Statement (i.e., the disclosure requirements should not be duplicative). We also recommend the disclosure requirements for the Proposed FSP focus solely on the disclosure of day one dealer profit/(loss) and a rollforward of the deferred gain or loss required by EITF 02-3 and should reference or rely on the guidance in the Fair Value Measurements Statement to meet other disclosure needs. If the staff does not agree with our recommendations, we recommend that, at a minimum, the disclosure requirements be consistent between the projects.

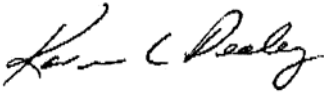
*Observation 5:* The project summary for the Proposed FSP requires that an entity should disclose “The fair value of *the derivative instrument*, indicating whether the transaction price or the model value is used to estimate that amount” [emphasis added]. This disclosure requirement appears to refer to singular derivatives and not a tabular presentation of all derivatives within the level/category as required under the Fair Value Measurements Statement. This could be interpreted to require a listing of all individual derivatives and each individual specific input which we do not believe is the staff’s intention.

In addition, we assume that the disclosure requirements regarding “the inputs to a model used to estimate the fair value amount” in the Proposed FSP are qualitative disclosures that describe the nature of the types of inputs and not quantitative disclosures. We recommend clarification if this is not the case. Quantitative disclosure of the specific inputs with respect to all of the inputs and terms of a portfolio of derivative contracts would not be practicable.

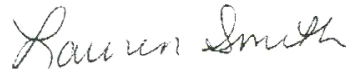
## **CONCLUSION**

The Joint Working Group appreciates the opportunity to provide the unsolicited foregoing comments. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact any of the undersigned at the telephone numbers provided, or Robert Pickel, Director and CEO of ISDA at 212.901.6020, George Miller, Executive Director of the ASF at 646.637.9216 or Jerry Quinn, Vice President and Associate General Counsel of SIA at 212.618.0507.

Sincerely,



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## **Attachment I**

**The American Securitization Forum** is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. More information about the ASF and their respective members and activities may be found at the ASF's internet website, located at [www.americansecuritization.com](http://www.americansecuritization.com).

**ISDA** is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

**The Securities Industry Association**, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 790,600 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated \$213 billion in domestic revenue and an estimated \$283 billion in global revenues. (More information about SIA is available on its home page: [www.sia.com](http://www.sia.com).)