ISDA®

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Mr. Russell G. Golden
Director, TA&I
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference: Proposed FASB Staff Position FAS 157-d, *Determining the Fair Value of a Financial Asset in a Market That Is Not Active*

Dear Mr. Golden:

The International Swaps and Derivatives Association ("ISDA") appreciates the opportunity to comment on the proposed FASB Staff Position FAS 157-d, *Determining the Fair Value of a Financial Asset in a Market That Is Not Active* (the "Proposed FSP"). ISDA members represent leading participants in the privately negotiated derivatives industry. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments.

In summary, ISDA commends the Financial Accounting Standards Board ("FASB") for its efforts to provide guidance that illustrates application of SFAS 157, *Fair Value Measurements'* ("SFAS 157"), principles to the fair value measurement of a financial asset when the market for such assets is inactive. We acknowledge that the Proposed FSP should be considered by preparers and auditors in conjunction with the press release issued jointly by the Office of the Chief Accountant of the U.S. Securities and Exchange Commission ("SEC") and the FASB staff on September 30, 2008 (the "Joint Press Release") in order to understand the level of judgment necessary to determine the relevance of potential inputs to fair value measurements in inactive and distressed markets, and how to use those inputs that market participants would consider relevant. However, in order to more clearly align the example to the concepts in the Joint Press release, we suggest certain modifications to the Proposed FSP to illustrate how an entity would exercise judgment in weighing the relevant inputs to the fair value measurement.

In the paragraphs that follow, we have provided several recommendations consistent with SFAS 157's principles and the Joint Press Release for enhancing the Proposed FSP's usefulness to financial statement preparers and auditors. We hope the FASB finds these recommendations informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned.

Sincerely,

Laurin Smith
J.P. Morgan Chase & Co.
Chair, N.A. Accounting Policy Committee
International Swaps and Derivatives Association

1. <u>Example 11 – Determining Fair Value in a Market that Is Not Active</u>

ISDA understands that the FASB's objectives in issuing the Proposed FSP are to clarify the application of SFAS 157 in an inactive market by providing an example that illustrates how the fair value of a financial asset is determined when the market for that financial asset is not active, and to amplify the guidance contained in the Joint Press Release.

In order to ensure consistent interpretation with, and amplify the guidance in the Joint Press Release, ISDA recommends that the example included in the Proposed FSP be enhanced to illustrate how Entity A exercised judgment in weighing the relevant inputs to the fair value measurement. We believe such modification is necessary to assist preparers and auditors in interpreting the level of judgment to be exercised in the determination of the relevance and the weight of inputs to a fair value measurement, and in the classification of the measurement within the fair value hierarchy.

While the calculation of credit risk and liquidity risk inputs discussed in paragraph A32D inherently require judgments, especially in current markets, we believe that the implied use of judgment in this paragraph is too subtle for preparers and auditors to apply consistently and comparably. As currently drafted, the "determination" of these inputs appears to be a Level 2 observation. ISDA recommends that the FASB incorporate the following changes into paragraph A32D of the Proposed FSP (inserted text is <u>underlined</u>).

> A32D. Entity A determines that the appropriate discount rate (footnote omitted) used to discount the contractual cash flows of its collateralized debt obligation security is 22 percent after considering the following:
>
> - The implied rate of return at the last date on which the market was considered active for the collateralized debt obligation security was 15 percent. Based on an analysis of available market data for mortgage-related debt securities, Entity A determines that market rates of return generally have increased in the marketplace since the last date on which the market was considered active for the collateralized debt obligation security. Entity A determines that credit spreads have widened (100 bps) and liquidity risk premiums have increased ~~during that period~~ (400 bps) <u>during that period</u>. <u>In order to derive these inputs, Entity A makes relevant adjustments to market data based on what it believes a market participant would assume given the same level of information.</u> Other risks (for example, interest rate risk) have not changed. Thus, Entity A estimates that an appropriate rate of return is 20 percent. In <u>arriving at that estimate</u> ~~making that determination~~, Entity A considered all available market information that could be obtained without undue cost and effort<u>, and weighted the inputs depending on the extent to which they provide information about the value of the asset</u>. For this collateralized debt obligation security, the available market information used in assessing the risks in the security (including nonperformance risk [for example, default risk and collateral value risk] and

liquidity risk) included (a) quoted prices that are not current that represent orderly transactions for the same or similar collateralized debt obligation securities, (b) relevant reports issued by analysts and ratings agencies, (c) any directional movements in relevant indexes, for example, interest rate and credit risk indexes, and (d) other relevant market data.

- Indicative quotes (that is, nonbinding quotes) for the collateralized debt obligation security from brokers or independent pricing services based on proprietary pricing models (that is, Level 3 inputs) imply a rate of return of 25 percent.

ISDA believes that the above recommendations also clarify the reference to "significant adjustments" in paragraph A32B, which we believe is otherwise unclear as drafted. However, while the above modifications would clarify the inherent application of judgment in measuring fair value, ISDA also believes that the judgment inherent in classifying a measurement within the fair value hierarchy should also be present in the example. Paragraph A32B does not discuss the specific factors that led Entity A to conclude that the instrument should be classified within Level 3 of SFAS 157's fair value hierarchy (other than via the reference made to the "significant adjustments" in this paragraph). ISDA recommends that the FASB incorporate the following changes into the last sentence of paragraph A32B of the Proposed FSP.

> Consequently, while Entity A appropriately considers those observable inputs, ~~ultimately,~~ Entity A~~'s~~ concludes that the observable inputs are not determinative and therefore require adjustments to those inputs to determine fair value at the measurement date. Since Entity A further concludes that the adjustments are significant and based on unobservable inputs, Entity A will classify the collateralized debt obligation security ~~will be classified~~ within Level 3 of the fair value hierarchy ~~because significant adjustments are required to determine fair value at the measurement date~~.

ISDA's recommended modifications to paragraph A32E of the Proposed FSP below are consistent with the above and are intended to amplify the judgment inherent in calculating and classifying a fair value measurement (inserted text is underlined).

> A32E. Because Entity A has two indications of the appropriate rate of return that it ~~determines~~ judges market participants would consider relevant in estimating fair value, it evaluates and weighs, as appropriate, the respective indications of the appropriate rate of return, considering the reasonableness of the range indicated by the results. Entity A concludes that 22 percent is the point within the range of relevant inputs that is most representative of fair value in the circumstances. Entity A's conclusion is based in part on the fact that the relative indications of the appropriate rate of return are reasonable in relation to each other given the nature of the asset and current market conditions.