

# THE FINANCIAL SERVICES ROUNDTABLE

*Impacting Policy. Impacting People.*



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## **VIA EMAIL**

Ms. Florence E. Harmon, Acting Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington DC 20549-1090

### **RE: File Number 4-560: SEC Roundtable on Fair Value Accounting Standards (July 9, 2008)**

Dear Ms. Harmon:

Despite the fact that FASB Statement no. 157, *Fair Value Measurements*, (“FAS 157”) is a fairly new standard, the debate as to what the definition of “fair value” is has existed for decades. Recent market conditions have further highlighted this debate. As a trade association representing 100 of the largest integrated financial services companies, the Financial Services Roundtable<sup>1</sup> (“Roundtable”) is submitting this letter to the record for the July 9<sup>th</sup> Roundtable on Fair Value Accounting Standards and to add to the current debate.

The Roundtable endorses the use of fair value when there is a readily identifiable value established in the market for a particular asset or liability. However, fair valuing assets held for long term, non-trading purposes should not be based on short term market fluctuations, and thus, companies should not be required to rely on an illiquid market to price such assets or to create an educated guess of such an asset’s value. Therefore, we *recommend* that the Securities and Exchange Commission (“Commission”) evaluate FAS 157 as it is applied in illiquid and at times, dysfunctional market conditions.

As we discuss in detail below, the Roundtable *urges* that in illiquid market conditions, rather than a blanket application of fair value exit pricing, investors should be able to use alternative definitions of fair value that focus on the value to the investor if the security does not require immediate liquidation.

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<sup>1</sup> The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for \$66.1 trillion in managed assets, \$1.1 trillion in revenue, and 2.5 million jobs.

## **Challenges with FAS 157**

FAS 157 requires companies to use “fair value” accounting to estimate the market value of all financial assets. The accounting guidance in FAS 157 defines “fair value” as the price to sell an asset or transfer a liability in an orderly transaction between market participants. In the absence of an orderly marketplace or in the case of thinly traded or illiquid markets, fair value exit price accounting causes unreasonably low and at times, potentially misleading valuations because of the high liquidity premium extracted in markets that are basically closed to trading. As a result, financial statements include values based on liquidation values, rather than “fair value”, often leading to less relevant and unreliable financial statements. Large paper losses due to the uncertain market pricing may cause investors and shareholders to lose confidence in a company and its financial statements. Thus, fair value accounting can potentially supply further uncertainty in an already weakened market.

Another major consequence of FAS 157 is the requirement that companies write down assets held as “trading” to the “exit price” fair value despite having no intention of selling these assets in the current market, thus causing companies to incur heavy paper losses and lose investor confidence. This is particularly exacerbated in a leveraged structure where the write down of asset values can result in margin or capital calls and thereby force an entity to sell under valued assets into a dysfunctional market, perpetuating the problem of marking the assets to an “observable” market price. In turn, this forces issuers to raise capital to cover these “losses” in an unfavorable capital market.

The Roundtable has also identified concerns with pro-cyclicality stemming from the industry’s attempt to fair value assets in a poor economic market. Accounting requirements to write-down securities to observable prices encourages some companies to sell sooner than they otherwise would; further depressing prices in an illiquid market. Problematic pro-cyclical effects have created further problems in the areas of purchase accounting, adjustment of loan loss reserves, and auction rate securities.

## **The Roundtable’s Proposed Solution**

### *Creation of Sub-Category within Fair Value Accounting*

Based on the challenges discussed above, the Roundtable *recommends* that the Commission evaluate FAS 157 in the context of dysfunctional markets and recognize that fair value accounting cannot be applied consistently in all market conditions. The Roundtable contends that one’s income statement should reflect the income that is based on a concept of what are certain financial assets worth not the latest fire sale price in an illiquid market. However, in the case of a dysfunctional market, the income reported by an entity includes “phantom” income and “phantom” losses which may never be realized if the entity’s intent is to hold particular assets for a longer period or even to maturity.

This essentially counters the underlying intent of FAS 157 to provide more transparency in the market regarding fair value.

Therefore, the Roundtable proposes the following solution for addressing this issue of determining fair value when there is not a properly functioning market. If the market is functioning properly, the Roundtable recommends that the current FAS 157 accounting guidance apply.<sup>2</sup>

One possible solution under existing accounting standards is the creation of a sub-category within the fair value hierarchy for illiquid or dysfunctional market conditions. Financial instruments that meet certain criteria would continue to follow the appropriate balance sheet and income statement classifications with enhanced disclosures. However, a refined valuation methodology would be based upon the financial instrument's expected future cash flows discounted at the instrument's original effective interest rate.

Instruments eligible for such proposed measurement would need to meet clearly defined criteria, especially with respect to the determination that dislocated or inactive markets exist and an entity has the ability and intent to hold to maturity or recovery. As a result, those entities that have no intention or financial motivation of exiting a position would not be obligated to recognize a write-down based on infrequent or no transactions occurring in a highly dislocated market. Additionally, for assets in this sub-category, registrants should be able to rely on internally developed cash-flow based models to account for credit risk and interest rates, rather than relying on exit prices. Such a change would minimize unintended consequences with respect to the safety and soundness of companies and more accurately reflect an entity's intent to hold for the longer term or to maturity.

The Roundtable also *recommends* qualitative disclosure for the recommended sub-category. Such disclosure would include the amount of securities in the sub-category, why the market is dislocated or inactive, and a discussion of the effect of selling such securities in this market, including selling the security at a market price significantly below the carrying value of the security.

This proposed approach serves several purposes. It provides investors with valuations that consider both the market's short term pricing vagaries and the fundamental risk the firm is exposed to in holding these financial instruments for a longer period of time. At the same time, this approach will also create confidence in the market by improving liquidity and eliminating diversity in practice among companies applying fair value. Additionally, this proposed solution will continue to support the underlying intent of FAS 157 to provide transparency in a company's accounting valuation process and

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<sup>2</sup> "Properly functioning market" should be defined as a market in which there are multiple parties that would buy and sell a security, loan or other financial instrument and as such, multiple trades occur.

consequently, emphasize the importance of disclosures in a company's financial statements.

*Permit Sale of Securities without "Tainting" the Portfolio*

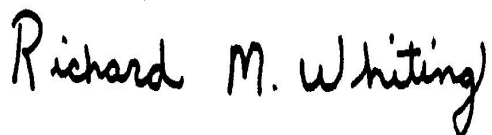
Additionally, the Roundtable *recommends* that fair value accounting be amended to allow the sale of securities that are available for sale and held to maturity for more than 30 days after the balance sheet date without tainting the remainder of the portfolio. Some institutions adjust their interest rate management outlook which tends to imply that some of the securities should be sold or in some instances, indicates securities which have unrealized losses would meet the criteria for sale. Unfortunately, under current "tainting" rules, investors are prevented from selling securities in these instances for fear that this would jeopardize the accounting for the rest of the portfolio. By permitting the sale of such securities, investors will regain confidence in the market.

*Continuous Evaluation of "Fair Value"*

The Roundtable further *recommends* that the Commission continue to evaluate the use of "fair value" accounting in non-contractual financial liabilities, areas in which such application would cause unintended consequences. In particular, the Roundtable *strongly opposes* assigning "fair value" to all pending litigation.<sup>3</sup>

Thank you again for the opportunity to share our views with you on this subject. The Roundtable staff will be in touch with the Commission shortly to schedule a meeting to discuss this issue and our proposed solution in more detail. In the meantime, if you have any questions, please feel free to contact me or Melissa Netram at 202-289-4322.

Sincerely,



Richard M. Whiting  
Executive Director and General Counsel

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<sup>3</sup> The Financial Accounting Standards Board ("FASB") recently proposed changes to FASB Statement No. 5, *Accounting for Contingencies*, which would require companies to disclose a substantial amount of information regarding their litigation loss contingencies. Although the proposal does not require "fair value" accounting to be used in these instances, the Roundtable *urges* the Commission to acknowledge that fair value accounting is not necessary to account for such liabilities. The underlying intent behind FASB's proposal of enhancing disclosures is greatly outweighed by the unintended consequences of the proposal, such as imposing upon the Attorney-Client privilege and Work Product Doctrine.