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*presents*

# FASB's ASU 2010-06: Expanded Requirements for Fair Value Disclosures

## Navigating New Guidance for Disclosing Valuation Techniques and Measurements

### A Live 110-Minute Teleconference/Webinar with Interactive Q&A


**Today's panel features:**
Kenneth Fick, Director, Forensic and Litigation Practice, **FTI Consulting Inc.**, Washington, D.C.
Chris Esposito, Partner, Securitization Advisory Services, **Deloitte & Touche**, New York
Craig Goodman, Partner, Financial Services Group, **Eisner LLP**, New York


**Tuesday, April 20, 2010**

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**1 pm Eastern**
**12 pm Central**
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# FASB's ASU 2010-06: Expanded Requirements for Fair Value Disclosures Webinar

**April 20, 2010**

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# Today's Program

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# Background On Other FASB Fair Value Initiatives

Craig Goodman, Eisner LLP

# Financial Accounting Standards Board Statement No. 157 - *Fair Value Measurements* (FASB ASC 820-10)

- SFAS 157 (FASB ASC 820-10) addresses how reporting entities should measure fair value for measurement or disclosure purposes under generally accepted accounting principles in the U.S. (U.S. GAAP).

# SFAS 157 – Scope

- Scope

  SFAS 157 applies under all other accounting pronouncements that require or permit fair value measurements, with limited exceptions as specified in the standard.

- Scope exceptions

  The statement does not apply under accounting pronouncements that address share-based payment transactions: FASB Statement No. 123 (revised 2004), share-based payment.

  The statement does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of the statement.

- SFAS 157, Appendix D, lists all Accounting Principles Board (APB) and FASB pronouncements that refer to fair value.

# Application Methodology

SFAS 157 provides a five-step application methodology as follows:

- One: Determine unit of account
- Two: Determine potential markets based on highest and best use
- Three: Determine markets for the basis of valuation
  - Principal
  - Advantageous
- Four: Apply the appropriate valuation technique(s)
  - Market approach
  - Income approach
  - Cost approach
- Five: Determine fair value

# Fair Value Hierarchy

The fair value hierarchy gives the highest priority to quoted prices in active markets and gives the lowest priority to unobservable inputs. Some of the key differentiating factors are:

***Level 1***
- Quoted prices for identical assets or liabilities in active markets

***Level 2***
- Observable
- Quoted; similar items in active markets
- Quoted; identical/similar items, no active market
- Must be observable for substantially the full term

***Level 3***
- Unobservable inputs (e.g., a company’s own data)
- Market perspective still required

**Remember – generally:**
Level 1 inputs should be used whenever available.
Level 3 inputs require significantly more disclosure.

# Classification

**Classification within the hierarchy**

**Level 1 inputs**

Generally, for a price or other input to qualify as a Level 1 input, reporting entities should be able to obtain the price from multiple sources in accessible markets. Level 1 inputs relate to items traded on an exchange or an active index/market location.

**Level 2 and Level 3 inputs**

In some cases, reporting entities may rely on pricing services or published prices that represent a consensus reporting of multiple brokers. It may not be clear if the prices provided can be transacted upon. In order to support an assertion that a broker quote or information obtained from a consensus pricing service represents a Level 2 input, the entity should typically perform due diligence to understand how the price was developed, including understanding the nature and observability of the inputs used to determine that price.

# Level 1 Inputs

**Level 1 inputs**

- Level 1 inputs are quoted prices (unadjusted) for identical assets or liabilities in active markets. A quoted price for an identical asset or liability in an active market (e.g., an equity security traded on the NYSE) generally provides the most reliable fair value measurement and, if available, should be used to measure fair value in that particular market.

- FSP 157-3 clarifies the application of Statement 157 in a market that is not active:

  "However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value. Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales."

# Level 2 Inputs

### Level 2 inputs

Level 2 inputs are inputs that are observable, either directly or indirectly, but do not qualify as Level 1 inputs. Level 2 inputs include the following:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)
- Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment rates, credit risks, and default rates)
- Inputs that are derived principally from or corroborated by observable market data through correlation or by other means (market-corroborated inputs)

Adjustments to Level 2 inputs should include factors such as the volume and level of activity in the markets within which the inputs are observed.

***An adjustment that is significant to the fair value measurement may place the measurement in Level 3 in the fair value hierarchy.***

# Observable Data

**Observable data is:**

- Not proprietary
- Readily available
- Regularly distributed
- From multiple independent sources
- Transparent
- Verifiable

# Characteristics Indicating That Data Is Observable

- **Not proprietary**

The data incorporated into an input of a valuation technique should come from sources other than within the reporting entity that is making the determination. In addition, the data should be distributed broadly and not limited in its distribution to only the entity that is making the determination or to a small group of users. The data should be available to and regularly used by participants in the relevant market/product sector as a basis for pricing transactions or verifying such prices (i.e., an assumption generated internally by a reporting entity should be comparable to the external data).

- **Readily available**

Market participants should be able to obtain access to the data, although the supplier of the information could impose a reasonable fee for access.

- **Regularly distributed**

The term “regular distribution” means that the data is made available in a manner that is timely enough to allow the data to be meaningful in pricing decisions. Further, there should be procedures in place to verify that changes between intervals have not occurred that would render the data meaningless. In addition, the distributed information should indicate its effective date to ensure that data received is not stale.

# Level 3 Inputs

**Level 3 inputs**

- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an **exit price** from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

# Market-Based Data

**Market-based data is:**

- Reliable
- Based on a consensus within reasonably narrow, observable ranges
- Provided by sources who are actively involved in the relevant market
- Supported by actual market transactions

# Additional Corroboration

**Additional corroboration**

- Applies to Level 2 and Level 3
- Discussions with pricing services, dealers or other entities to collect additional prices of identical or similar assets to corroborate the price
- Back-testing of prices to determine historical accuracy, and
- Comparisons to other external or internal valuation model outputs.

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# Additional Corroboration (Cont.)

**Additional corroboration (Cont.)**

- The level of due diligence performed is highly dependent on the facts and circumstances, such as the type and complexity of the asset or liability being measured, as well as its observability and liquidity in the marketplace.
- Determining the amount and type of due diligence to be performed is a matter of judgment, and reporting entities should clearly document the assessment performed in arriving at their conclusions.
- Without additional supporting information, prices obtained from a single broker or a pricing service are indicative values or proxy quotes. Such information generally represents Level 3 inputs.

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# Other Considerations

**Other considerations**

- It is management's responsibility to determine the appropriateness of its fair value measurements and their classification in the fair value hierarchy, including instances in which pricing services are used.

# Observable Vs. Unobservable Inputs

A determination of what constitutes “observable market data” will require ***significant judgment.***

Observable market data would comprise, in the following hierarchical order:

- Prices or quotes from exchange or listed markets (e.g., NYMEX, or New York Stock Exchange (NYSE)) in which there is sufficient liquidity and activity
- Proxy observable market data that is proven to be highly correlated and has a logical, economic relationship with the instrument that is being valued, and
- Other direct and indirect market inputs that are observable in the marketplace.

# Different Types Of Markets With Observable Inputs

- **Exchange market**
  In an active exchange market, closing prices are both readily available and representative of fair value (example: NYSE closing prices are both readily available and representative of fair value).

- **Dealer market**
  In a dealer market, dealers stand ready to trade for their own account, thereby providing liquidity by using their capital to hold an inventory of the items for which they make a market. Typically, bid prices and ask prices are more readily available than closing prices.

# Different Types Of Markets With Observable Inputs (Cont.)

- **Brokered market**

  In a brokered market, brokers attempt to match buyers with sellers, do not stand ready to trade for their own account and do not use their own capital to hold an inventory of the items for which they make a market. For a broker quote to be observable, a reporting entity will need transparency into the market data used to develop the quote and to make a judgment as to whether the market data is observable.

- **Principal-to-principal market**

  Principal-to-principal transactions (both originations and resales) are negotiated independently, with no intermediary. Often, very little information about these transactions is publicly available.

Entities need to consider the characteristics of the underlying markets in assessing whether a valuation input is observable.

# FASB Staff Position No. FAS 157-3 (FSP FAS 157-3): Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active

- The FASB staff position issued Oct. 10, 2008, clarifies the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. Key existing principles of Statement 157 illustrated in the example include:
  - “A fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. As discussed in Statement 157, in situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an exit price notion) that is not a forced liquidation or distressed sale at the measurement date.”

# FASB Staff Position No. FAS 157-3 (FSP FAS 157-3): Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (Cont.)

- "In determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available."
- "Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In an active market, a broker quote should reflect market information from actual transactions. However, when markets are not active, brokers may rely more on models with inputs based on information available only to the broker. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence."

# **FASB Staff Position No. FAS 157-4 (FSP FAS 157-4)**: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

FASB Staff Position (FSP) No. FAS 157-4 provides additional guidance for (1) estimating fair value in accordance with SFAS No. 157 , Fair Value Measurements, (FASB ASC 820-10 ) when:

1. The volume and level of activity for an asset or liability have significantly decreased, and
2. Identifying circumstances indicating that a transaction is not an orderly one.

FSP No. FAS 157-4 was issued in response to concerns that SFAS No. 157 itself and FSP No. FAS 157-3 do not provide sufficient guidance on the manner in which a previously active market should be evaluated in determining whether it is no longer active and whether a transaction is not an orderly one.

- Concerns that the emphasis in SFAS No. 157 (FASB ASC 820-10 ) on the last transaction (or quoted) price as the sole or primary basis of estimating fair value even when a significant adjustment to such price may be required or when other valuation techniques should be considered
- Resulted in the misapplication of SFAS No. 157 (FASB ASC 820-10 ) under certain circumstances

FSP No. FAS 157-4 amends SFAS No. 157 and supersedes FSP No. FAS 157-3

# **FASB Staff Position No. FAS 157-4 (FSP FAS 157-4)**: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (Cont.)

**SFAS No. 157 (FASB ASC 820-10 ) does not prescribe a specific methodology for making significant adjustments to transactions or quoted market prices**

- If there has been a significant decrease in volume and level of activity for an asset or liability, it may be necessary to apply multiple valuation techniques or a valuation technique that does not take into account quoted prices without significant adjustment.
- The reasonableness of the range of fair value estimates produced must be considered to determine the point within the range that is most representative under current market conditions. The existence of a wide range of fair values could be indicative that yet further analysis is required.
- Even when there has been a significant decrease in the volume and level of activity, the objective of a fair value measurement remains the same.
- Fair value is a market-based measurement rather than an entity-specific one, and thus the entity's intention to hold the asset or liability is not a relevant factor in estimating fair value.

# **FASB Staff Position No. FAS 157-4 (FSP FAS 157-4)**: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (Cont.)

**Decline in volume and activity level**

The following factors (which are not all-inclusive) should be evaluated in determining whether there has been a significant decrease in the volume and level of activity for a particular asset or liability:

- There have been few recent transactions.
- Price quotations are not based on current information.
- Price quotations have varied substantially either over time or among market makers.
- Indexes that were previously highly correlated with the asset's fair value are now demonstrably uncorrelated with recent indications of fair value.
- There has been a significant increase in liquidity risk premiums, yields, or performance indicators.
- There is a wide bid-ask spread.
- There has been a significant decline in or there is an absence of a market for new issuances for the particular asset or liability or for similar assets and liabilities.
- Little information is released publicly.

# **FASB Staff Position No. FAS 157-4 (FSP FAS 157-4)**: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (Cont.)

**Orderly transactions**

A significant decrease in the volume and level of activity does not, of itself, necessarily mean that all transactions for the asset or liability are not orderly.

- There has not been adequate exposure to the market for the period before the measurement date to allow for usual and customary marketing activities.
- There has been the usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- The seller is in (or near) bankruptcy or receivership (indicating a distressed transaction) or the seller was required to sell the asset or liability to meet regulatory or legal requirements (indicating a forced transaction).
- The transaction price is an outlier amount when compared with other recent transactions for the same or similar asset or liability.

# **FASB Staff Position No. FAS 157-4 (FSP FAS 157-4)**: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (Cont.)

**Orderly transactions**

Depending on the entity's conclusion regarding whether a transaction is or is not orderly, the following guidance should be applied:

- If the weight of evidence points to a transaction that is not an orderly one, then little weight should be given to the transaction when estimating fair value.
- If the weight of evidence points to a transaction that is an orderly one, then the transaction price should be taken into account in estimating fair value.
- If, however, there is insufficient information to conclude that the transaction is either orderly or not orderly, then the transaction price should be taken into account (but less weight placed on it) when estimating fair value.

# Disclosure Requirements

- FAS 157 (FASB ASC 820-10) requires use of a tabular format to present the required quantitative disclosures. In addition, qualitative disclosures about the valuation techniques used to measure fair value are required in all annual periods.

- FAS 157's (FASB ASC 820-10) disclosure requirements vary depending on whether the asset or liability is measured on a recurring or non-recurring basis and the classification of the fair value measurement in its entirety within the fair value hierarchy.

# Disclosure Requirements (Cont.)

For assets and liabilities that are measured at fair value on a recurring basis, the following information is required:

- The fair value measurements at the reporting date
- The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using:
  - Quoted prices in active markets (Level 1)
  - Significant other observable inputs (Level 2), and
  - Significant unobservable inputs (Level 3)

# Disclosure Requirements (Cont.)

- For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period from each of the following:
  - Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets) and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities);
  - Purchases, sales, issuances and settlements; and
  - Transfers in and (or) out of Level 3.

- The amount of the total gains or losses for the period included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities).

- In annual periods only, the valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques, if any, that have occurred during the period.

# Disclosure Requirements (Cont.)

For assets and liabilities that are measured at fair value on a non-recurring basis in periods subsequent to initial recognition disclose the following for each interim and annual period by major category of assets and liabilities:

- The fair value measurements recorded during the period and the reasons for the measurements
- The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)
- For fair value measurement using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs
- In annual periods only, the valuation technique(s) used to measure fair value and a discussion of any change in the valuation technique(s) used to measure similar assets and (or) liabilities in prior periods.

The quantitative disclosures required by Statement 157 are required to be presented using a tabular format.

# Material Aspects Of ASU 2010-06

Chris Esposito, Deloitte & Touche

Kenneth Fick, FTI Consulting

# Material Aspects Of ASU 2010-06

| Topic | Current Disclosure Under ASC 820 | ASU 2010-06 New or Amended Disclosure |
|---|---|---|
| Transfers into and out of Levels 1, 2 & 3 | Only required to disclose activity in Level 3 on a net basis | Significant transfers between Levels 1 & 2<br>AND<br>Significant transfers into and out of Level 3<br>AND<br>Reasons for those transfers |
| Level 3 reconciliation | Not required to break-out gains and losses reported in other comprehensive income<br>Purchases, sales, issuances and settlement of assets are netted<br>Transfers in and/or out of Level 3 by major category | Separately present gains and losses presented in earnings and comprehensive income<br>Purchases, sales, issuances and settlement of assets presented separately<br>Transfers in and/or out of Level 3 (separately when significant) |
| Level of disaggregation | Disclosure by each “Major Category” of assets and liabilities | Disclosure by each “Class” of assets and liabilities |
| Valuation technique and inputs | Disclosure of the inputs and valuation techniques used and discussion of changes in valuation techniques and inputs, if any | For Levels 2 & 3: Description of valuation technique and inputs of each class of assets or liabilities<br>If valuation technique has changed, then disclose that change and the reasons for the change |

**NOTE: For Recurring Fair Value Measurements Only**

# Transfers Between Levels 1 And 2 And Into Or Out Of Level 3

1. **Separately disclose <u>significant</u> transfers between Levels 1 and 2**
2. **Separately disclose <u>significant</u> transfers into or out of Level 3**

**BUT, what is significant?**

- Significance is determined based upon an analysis with respect to an entity's:
    1. Earnings and total assets or total liabilities, or
    2. When changes in fair value are recognized in other comprehensive income, then with respect to total equity

**Must include the reasons for the transfers**

- For example: Transferred from Level 2 to Level 3 due to lack of observable market data caused by a decrease in market activity

# Transfers Between Levels 1 And 2 And Into Or Out Of Level 3 (Cont.)

**An entity must disclose and consistently follow its policy for determining when transfers between levels are recognized**

- The policy related to timing of when to recognize transfers should be the same for transfers in and out of a particular level. Examples:

  1. The actual date of the event or change in circumstances that caused the transfer
  2. The beginning of the reporting period
  3. The end of the reporting period

# Level 3 Reconciliation Table

- Must break out gains and losses included in earnings between those included in comprehensive income
- Include separate line items for each type: Purchases, Issuances, Sales and Settlements
- Break out significant transfers into and out of Level 3, include disclosure as to reason for the transfer

# Material Aspects Of ASU 2010-06

## Level 3 Reconciliation Table: Example

| Roll Forward<br>($ in millions) | Fair Value Measurements Using Significant Unobservable Inputs (Level 3) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Available-for-sale Debt and Equity Securities | | | | | Other Investments | | |
| | Mortgage-Backed Securities-Residential | Mortgage-Backed Securities-Commercial | Obligations of U.S. states and municipalities | Corporate debt securities | Equity securities | Loans | Mortgage servicing rights | Private Equity |
| Beginning Balance | XXX | | | | | | | |
| Transfers into Level 3 | XX (a) (b) | | | | | | | |
| Transfers out of Level 3 | | | | | | | | |
| Total gains or (losses) | | | | | | | | |
| Included in earnings | X | | | | | | | |
| Included in other comprehensive income | (X) | | | | | | | |
| Purchases, issuances, sales and settlements | | | | | | | | |
| Purchases | | | | | | | | |
| Issuances | | | | | | | | |
| Sales | (X) | | | | | | | |
| Settlements | | | | | | | | |
| Ending Balance | XXX | | | | | | | |

(a) All transfers into and/or out of level 3 are assumed to occur at the beginning of the reporting period.

(b) Transferred from Level 2 to Level 3 due to lack of observable market data caused by a decrease in market activity.

# Level Of Disaggregation

Depends on:

- Nature and risks of the assets/liabilities
- Consider the level of disaggregation required under other topics
- Classification in the fair value hierarchy (Level 1,2,3)
    - Current market (active vs. inactive)
    - “Observability” of significant inputs
    - Valuation technique

Example: The number of classes might need to be greater for fair value measurements using significant unobservable inputs (Level 3) in order to achieve the disclosure objectives, because Level 3 measurements have a greater degree of uncertainty and objectivity.

# Level Of Disaggregation – Example

Trading securities
- Equity securities – real estate industry
- Equity securities – oil and gas industry
- Equity securities – other

Available-for-sale debt securities
- Residential-mortgage-backed securities
- Commercial-mortgage-backed securities
- Collateralized debt obligations
- U.S. Treasury securities
- Corporate bonds

Available for-sale equity securities
- Financial services industry
- Healthcare industry
- Other

Hedge fund investments
- Equity long/short
- Global opportunities
- Distressed debt

Private equity investments

Venture capital investments

Derivatives
- Interest rate contracts
- Foreign exchange contracts
- Credit contracts
- Commodity futures contracts
- Commodity forward contracts

Any of these categories may require further disaggregation

# Level Of Disaggregation (Cont.)

Consider the level of disaggregation required under other topics

Example:

- Under Topic 815, disclosures about derivative contracts are presented separately by “type of contract”
- “Types of contracts” under Topic 815 include interest rate, foreign exchange, equity, commodity and credit
- “Classes” for Topic 820 Tabular disclosures may differ from “type of contract” under Topic 815

# Level Of Disaggregation - Example

An entity established to earn returns based on U.S. commodity trading strategies uses common derivatives to execute its strategies

The entity:

- Trades in energy (oil and electricity), metals (precious metals), and to a lesser extent agricultural commodities
- Records all derivatives in “Derivative Assets” and “Derivative Liabilities” on the statement of financial condition
- Determined contracts are “Commodity Contracts” for Topic 815 tabular
- For Topic 815 qualitative and volume disclosures, uses more granular level
- Exchange traded contracts are Level 1
- Long-duration electricity derivative contracts are Level 3 (unobservable forward price curves)
- Remaining derivatives are Level 2

# Level Of Disaggregation – Example (Cont.)

The entity considers:

- Valuation techniques
- Valuation inputs
- Derivative classification in the fair value hierarchy
- Level of disaggregation in the statement of financial condition
- Level of disaggregation for Topic 815 tabular disclosures
- Level of disaggregation for Topic 815 qualitative and volume (Q&V) disclosures

And then establishes the following “Classes”:

| | |
|---|---|
| Commodity exchange-traded | Level 1 |
| Oil | Level 2, Consistent w Topic 815 Q&V disclosures |
| Electricity short-duration | Level 2, Consistent w Topic 815 Q&V disclosures |
| Electricity long-duration | Level 3 |
| Precious metals | Level 2, Consistent w Topic 815 Q&V disclosures |
| Other commodity contracts | Level 2, materiality |

# Valuation Technique And Inputs

Example disclosures

- Quantitative information about inputs
  - Prepayment rates
  - Default rates and loss severities
  - LIBOR
  - Volatilities
- Characteristics of the item being measured and its underlying collateral
  - Types of underlying loans
  - Guarantees/credit enhancement
  - Seniority level
  - Vintage
  - Underlying loan characteristics including weighted averages and concentrations
  - Rating data

# Valuation Technique And Inputs (Cont.)

Example disclosures (Cont.)

- How third-party data information was considered in measuring fair value
  - Broker quotes
  - Pricing services
  - NAVs
  - Relevant market data

# Valuation Technique And Inputs (Cont.)

Example disclosures (Cont.)

- Sources of information
  - Pricing services
  - Investment bank research reports
  - Rating agency research reports and pre-sale reports
  - Trustee or servicer reports
  - Calculations based on the actual collateral pool
  - Original offering document

*Tip:* Do your best to document where your assumptions are coming from and maximize the use of observable relevant inputs. Many research reports and industry publications are published regularly and can be integrated into a well-documented valuation process.

# Valuation Technique And Inputs – RMBS Example

- FV of AFS as of Dec. 31, 20X1
- The securities (currently below investment grade): Senior tranches in a securitization trust
  - The weighted average coupon rate
  - The weighted average life
- The underlying loans: Residential subprime mortgages originated in California in 2006
  - The weighted average coupon rate
  - The weighted average life
- In estimating FV, the entity used:
  - Industry standard valuation model, based on
  - Income approach

## Valuation Technique And Inputs – RMBS Example (Cont.)

- Significant **inputs** for the valuation model include the weighted average:
  - Yield: XX percent
  - Probability of default: XX percent constant default rate
  - Loss severity: XX percent
  - Prepayment: XX percent constant prepayment rate

# Valuation Technique And Inputs – Credit Card Example

- Significant **inputs** for the valuation model include the weighted average:
  - Portfolio yield
  - Charge-off rate
  - Principal repayment rate
  - Discount rate

# Valuation Technique And Inputs – Discount Rate

- How do I establish the appropriate discount rate?
  - Example found in ASC 820-10-55-59F previously referred to as FASB Staff Position 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*

- Paragraphs A32A through A32G describe a methodology for arriving at a discount rate for a downgraded (AAA to A) Alt-A security that has seen a decline in trading activity
- The decline in trading activity should be documented and should reflect a significant decrease
- Little trading activity for securities that previously traded in a brokered market, decline in primary issuance

## Valuation Technique And Inputs – Discount Rate (Cont.)

Estimates of a market discount rate are dependent upon the following factors:

- Risk-free rate on Treasuries with the same WAL
- Adjustments based on available market data
    - ❑ Credit spread implied at deal inception
    - ❑ Changes in observable credit spreads from deal issuance to measurement date
    - ❑ Tranche or deal specific characteristics that market participants would weigh in pricing (asset performance benchmarked to original expectations)
    - ❑ Rating agency or other relevant analyst reports
    - ❑ Quoted prices from third parties

## Valuation Technique And Inputs – Discount Rate (Cont.)

Example

- Alt A security issued January 20x8 to be valued on March 31, 20x9
- Estimate is 12% (1200bp) determined as follows:
  - Risk-free rate at March 31, 20x9 is 300bp
  - Add 250bp for security's credit spread over risk free at inception
  - Add 700bp for the change in the observable credit spreads from January 20x8 and March 20x9 for the most comparable index
  - Subtract 50bp net for the difference between the index and the security
    - Subtract 350 bp by comparing the implied yield from the most recent transactions for the security (which occurred in June 20x8) with the implied yield of the index as of the date of the most recent transactions
    - Add 300 bp because the index is more liquid derived by considering liquidity risk premiums implied in recent cash transactions for a range of similar securities

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# Likely Disclosure Questions


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# Related Disclosure Questions

- Will Level 3 sensitivity analysis eventually be required?
- Does the increased disclosure only apply to the fair value measurements of recurring assets and liabilities, or does it apply to nonrecurring as well?
- Is the clarification change from “major category “ to “class” affecting any other standards?

# Related Disclosure Questions (Cont.)

- Am I required to make quantitative disclosures about valuation inputs?
- I currently measure transfers into Level 3 at the beginning of the period and transfers out of Level 3 at the end of the period. Can I still do that? If I need to change my policy to something new, how do I disclose the change?