
Financial Accounting Standards (FAS) 157, 157-4, & Sub-Topic 820-10

A Practical Application of the New Mark-to-Market Guidelines

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Mark-to-Market Pricing & Transparency History

- Prior to the late 1990's, loan investors carried performing loans at par value and internally assigned valuations to defaulted loans
- In 1999, the LSTA and Loan Pricing Corporation formed the LSTA/LPC Mark-to-Market (MTM) Pricing Service, the first independent third-party provider of daily MTM prices
- In 2002, the LSTA provided an annual Trade Data Study, a transparent assessment of MTM price accuracy (comparing individual Trade to MTM prices)
- In 2006, the LSTA provided quarterly Trade Data Studies in order to not only assess MTM price accuracy, but also Trade Volume, Liquidity, and Settlement
- In 2010, the LSTA will provide monthly Trade Data Studies to further support the growing needs of its constituency

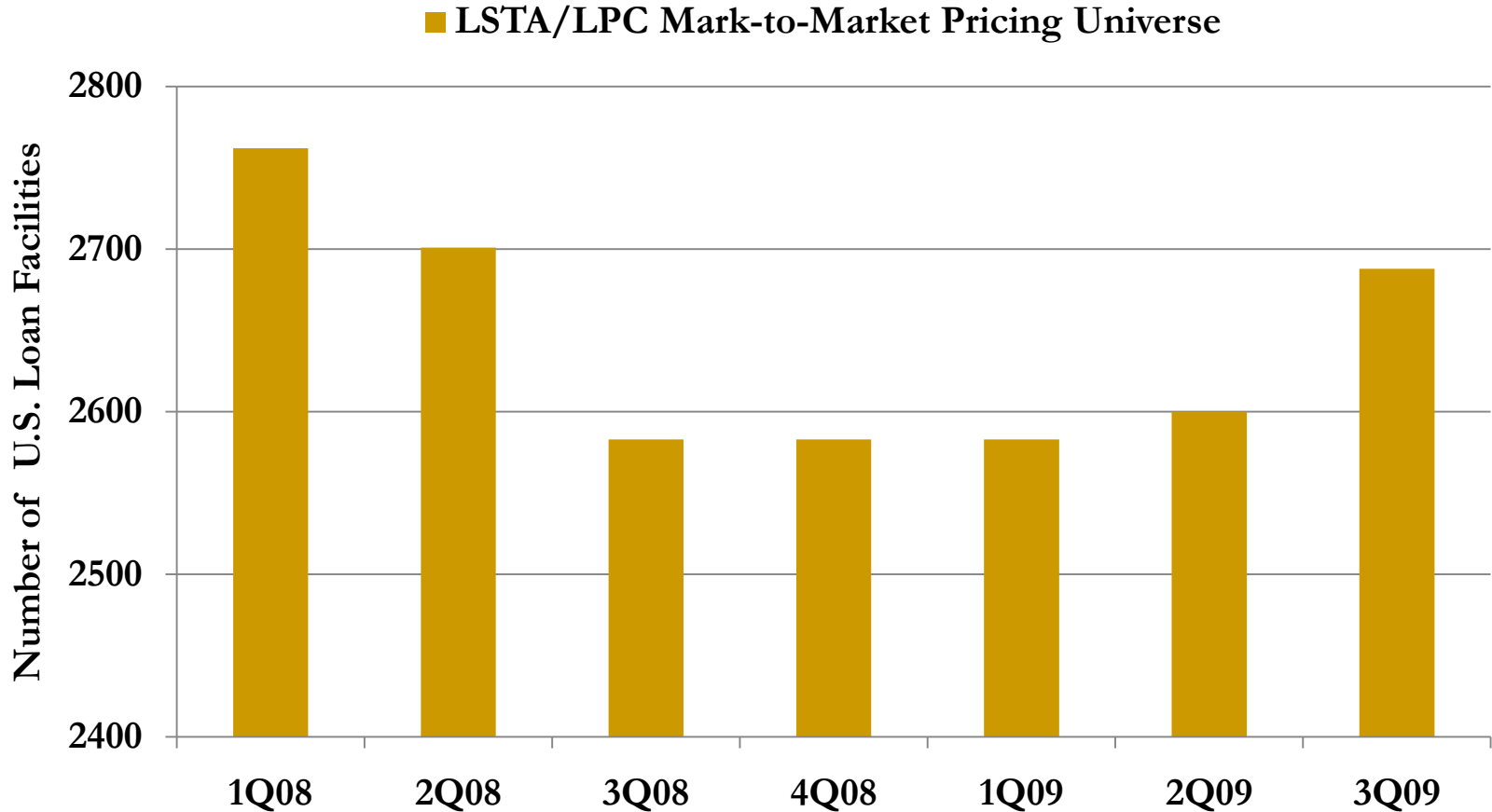
Regulatory History

- **The SEC issued an interpretive letter in the year 2000**
 - The SEC ordered funds to change their valuation methodology, mandating that bank loan fund managers use a mark-to-market price rather than a fair value price
 - Loans that trade or are available to trade in the secondary market would now need to be priced as they trade, or "marked to market," like stocks and corporate bonds
- **FAS 157 issued in 2006**
 - Establishes a single definition of fair value, a framework for measuring fair value, and expanded disclosures about fair value measurements
 - Level 1, 2, and 3 assets
- **FAS 157-4 issued in 2009**
 - 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
- **Fair Value Measurements and Disclosures (Topic 820-10)**
 - A proposed Accounting Standards Update; comment period ended 10/12/09
 - Aimed at improving disclosures about fair value measurements

FASB Statement No. 157. Fair Value Measurements

- **Established a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value**
- The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements).
- The three levels of the fair value hierarchy under FAS 157 are the following:
 - **Level 1** Inputs that reflect unadjusted quoted prices in active markets for identical assets or liabilities that the Partnership has the ability to access at the measurement date
 - **Level 2** Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly, including inputs in markets that are not considered to be active
 - **Level 3** Inputs that are unobservable

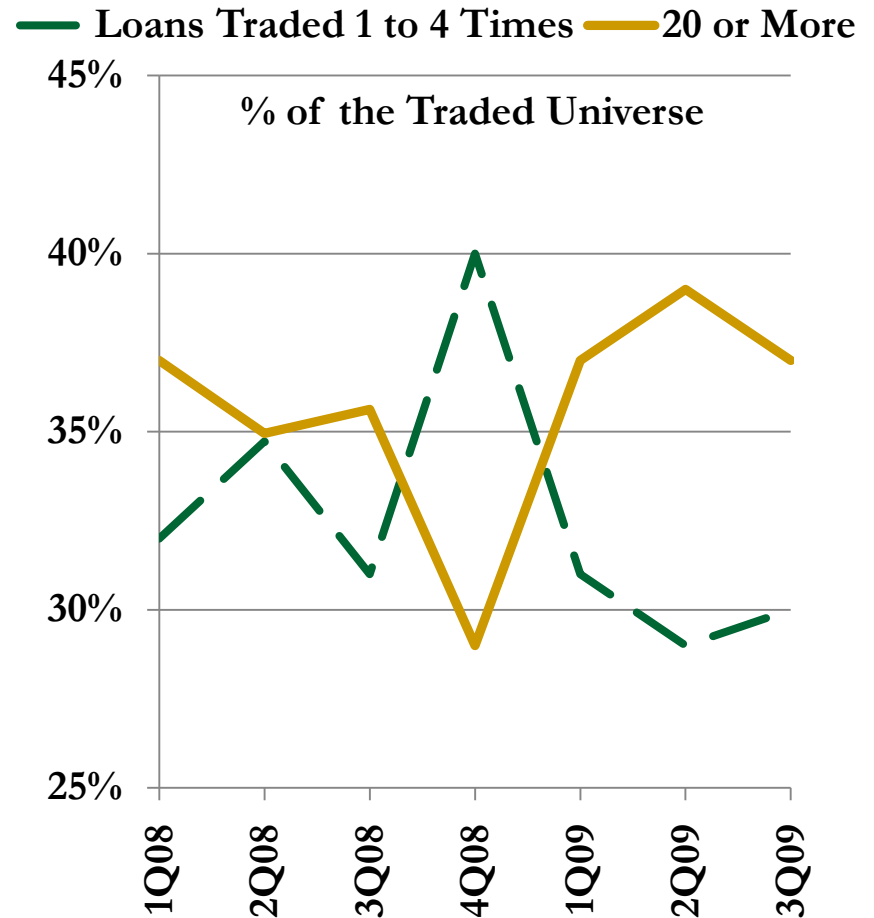
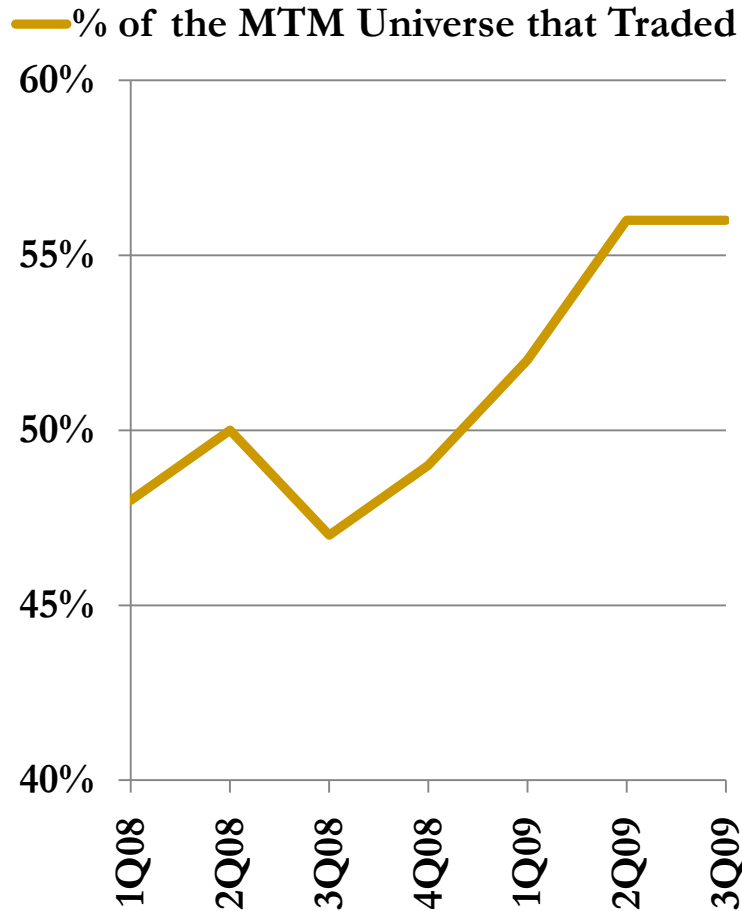
The LSTA/LPC MTM Loan Pricing Universe



Source: LSTA/LPC MTM Pricing



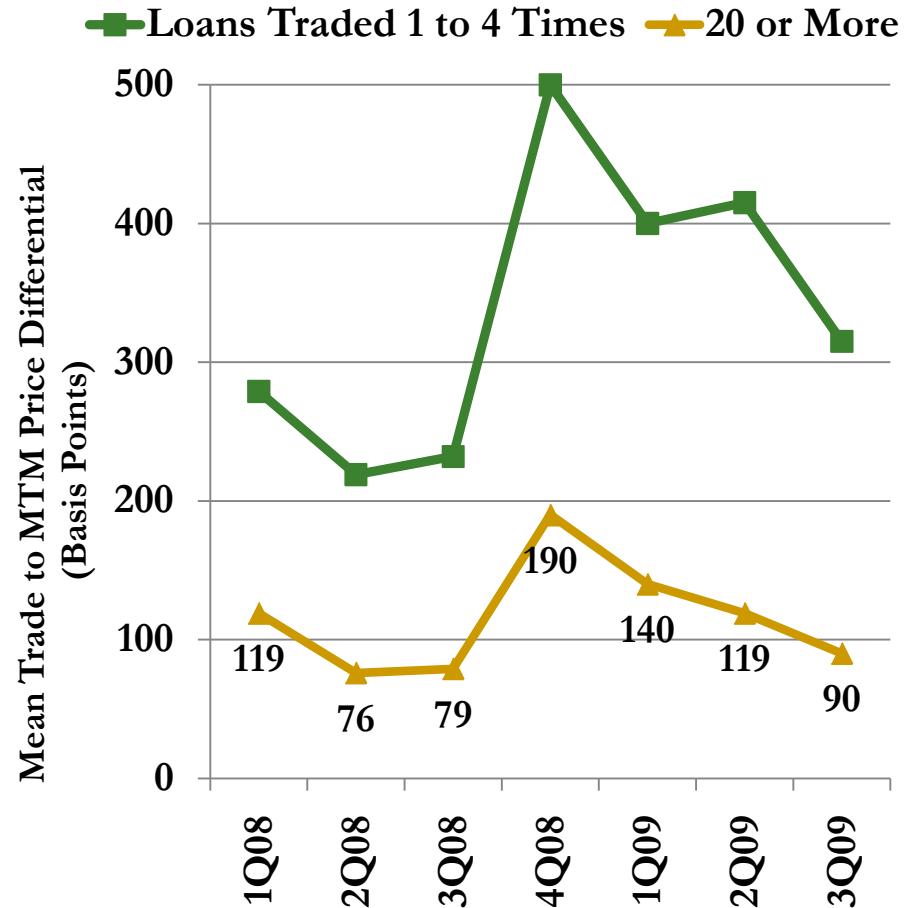
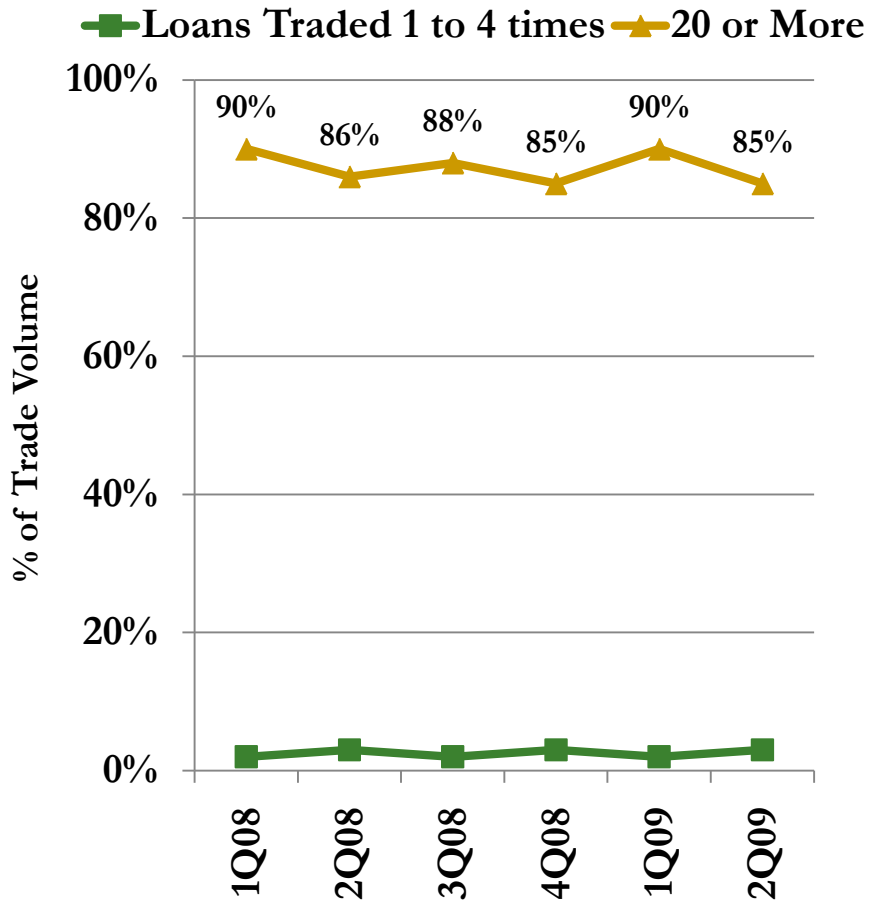
Secondary Trading Market Breadth & Depth



Source: LSTA/LPC MTM Pricing and LSTA Trade Data Study



Higher Liquidity Leads to More Accurate MTM Prices



Source: LSTA Trade Data Study

FSP FAS 157-4

- FAS 157-4 is a response to the concern that the fair value hierarchy of FAS 157 may encourage undue weighting of a “last transaction price,” however FAS 157 still retains the “exit price” concept
 - Management’s intention to hold an asset is not relevant in estimating fair value. Rather, fair value should be based on a hypothetical transaction to sell the asset, considered from the perspective of willing market participants

- Provided further guidance in identifying:
 - Whether the volume and level of activity have significantly decreased, in relation to normal market activity,
 - Identifying transactions that are not orderly

- If there has been a “significant decrease in volume and level of activity” and the transaction is deemed “not orderly,” a single transaction or quoted price may not be determinative of fair value

FSP FAS 157-4

- **Making a significant adjustment to observable inputs when there has been a significant decrease in volume**
 - If there has been a significant decrease in the volume and level of activity for the asset, a change in valuation technique or the use of multiple valuation techniques may be appropriate
 - For example, indications of fair value developed from both a market approach and a present value technique may be used

- **Identifying transactions that are not orderly**
 - When management determines that there has been a significant decrease in the volume and level of activity, it is *not appropriate* to conclude that all transactions in the market are not orderly

FSP FAS 157-4

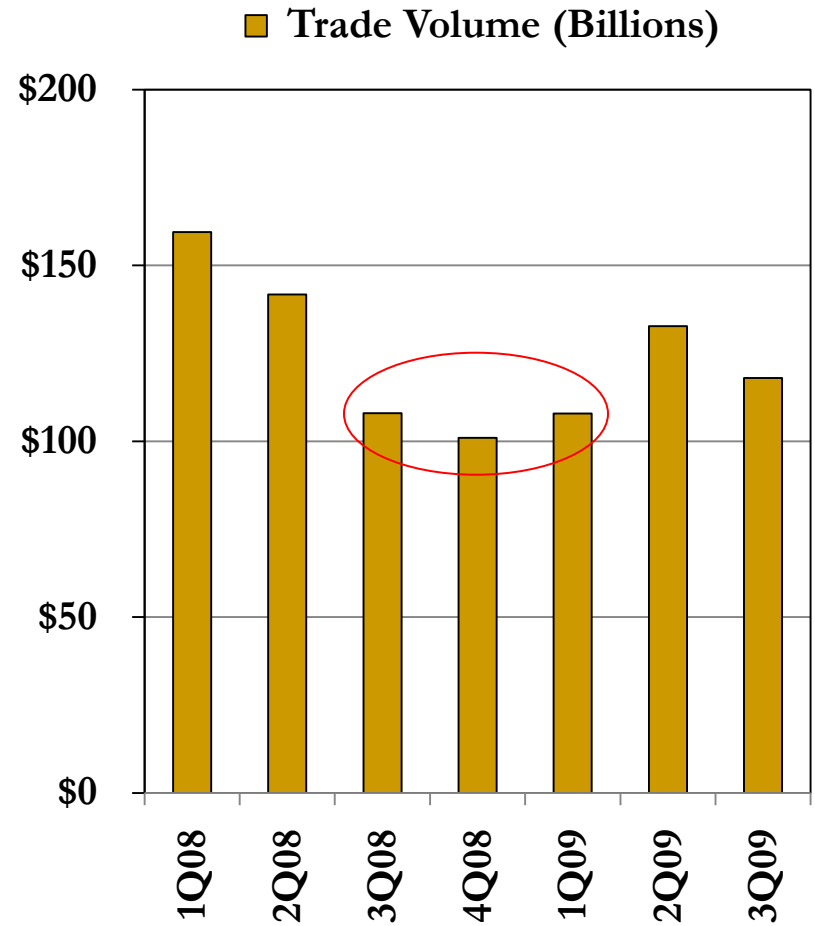
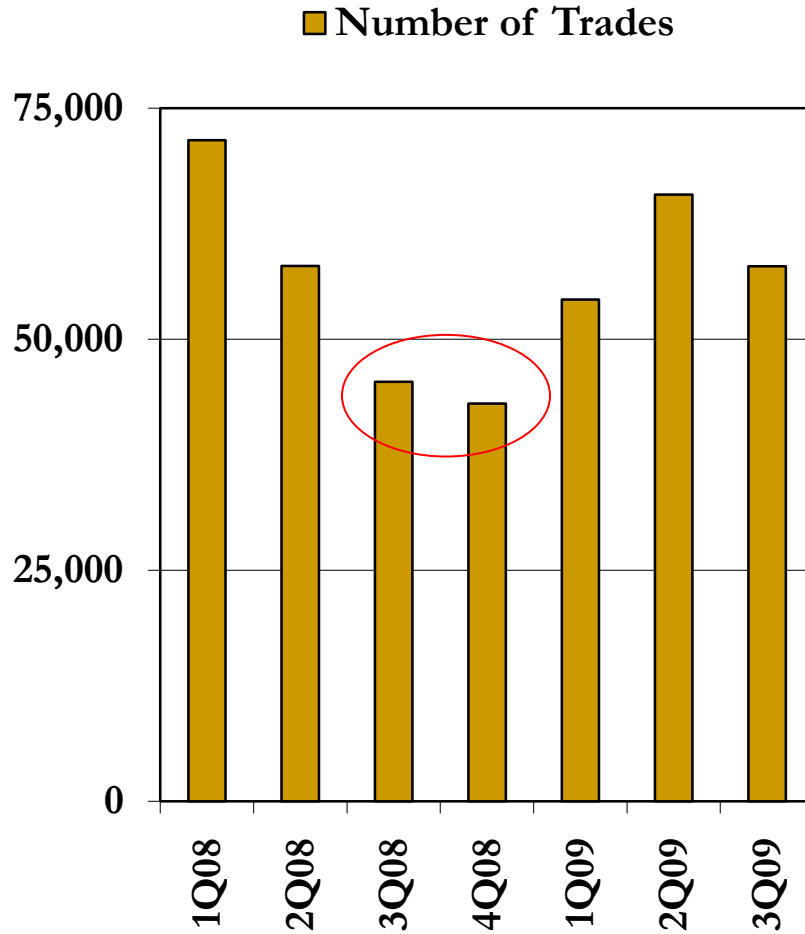
■ Evaluating observable transaction prices

- **Transaction is not orderly** -- If the weight of the evidence indicates the transaction is not orderly, **an entity is required to place little, if any, weight (compared with other indications of fair value) on that observable transaction price when estimating fair value** or implied market risk premiums
- **Transaction is orderly** -- If the weight of the evidence indicates the transaction is orderly, **an entity is required to consider that observable transaction price when estimating fair value** or implied market risk premiums. The amount of weight placed on that transaction price (when compared with other indications of fair value) will depend on facts and circumstances, such as volume, comparability and proximity
- **Insufficient information to conclude** -- If there is not sufficient information to conclude that a transaction is orderly, **it is required to consider that transaction when estimating fair value**. In those circumstances, **that transaction price may not be determinative** (i.e., the sole or primary basis) **for estimating fair value** or implied market risk premiums. Less weight should be placed on transactions where an entity has insufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly

FSP FAS 157-4

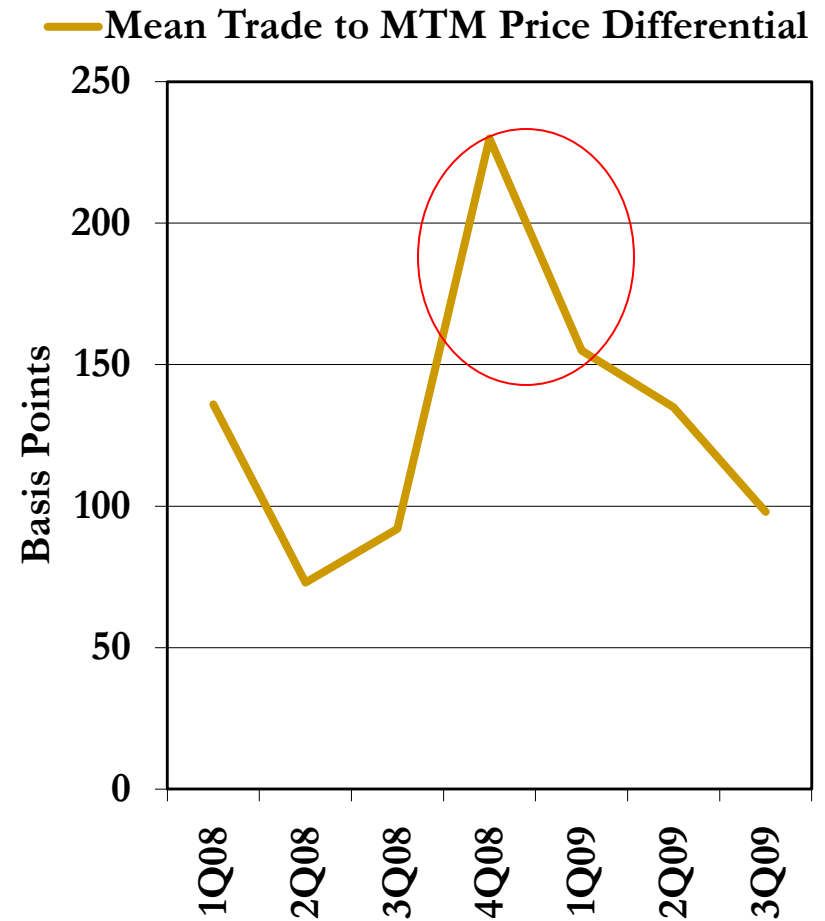
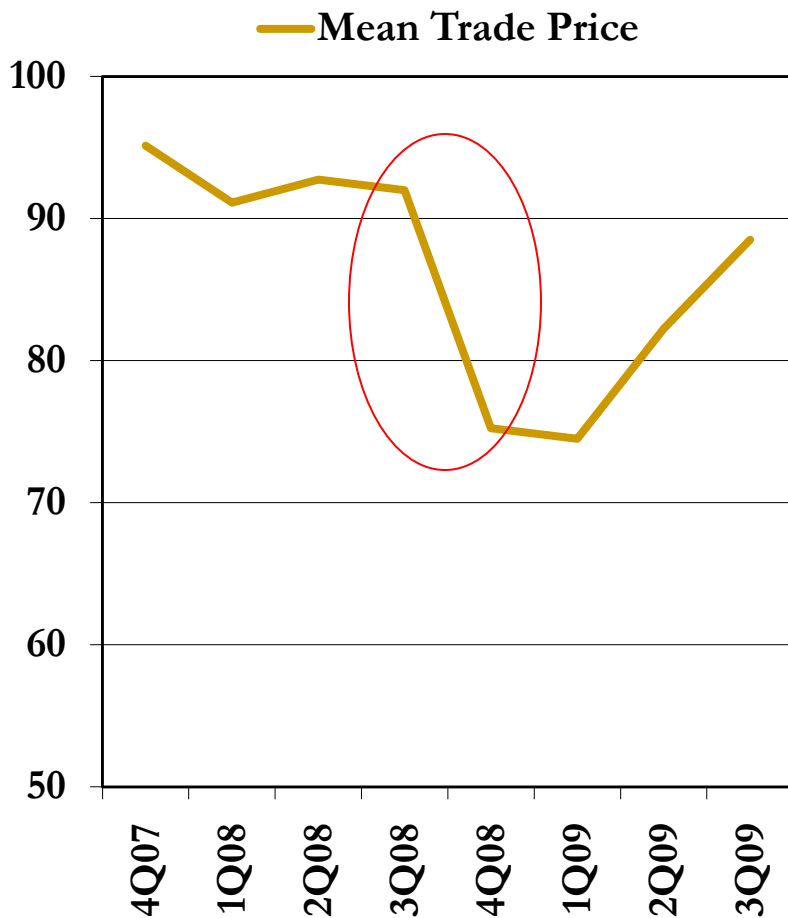
- **Factors to consider in determining whether there has been a significant decrease in volume**
 - ❑ Price quotations are not based on current information
 - ❑ Price quotations vary substantially (over time or among market makers)
 - ❑ There is a wide bid-ask spread or significant increases in the bid-ask spread
 - ❑ There is a significant decline or absence of a market for new issuances
 - ❑ Indices that previously were highly correlated with the fair values are demonstrably uncorrelated with recent indications
 - ❑ There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the entity's estimates of expected cash flows (considering all available market data about credit and other nonperformance risk for the asset or liability)
 - ❑ There is little information released publicly (e.g., a principal-to-principal market)

A Significant Decrease in Trading Volume



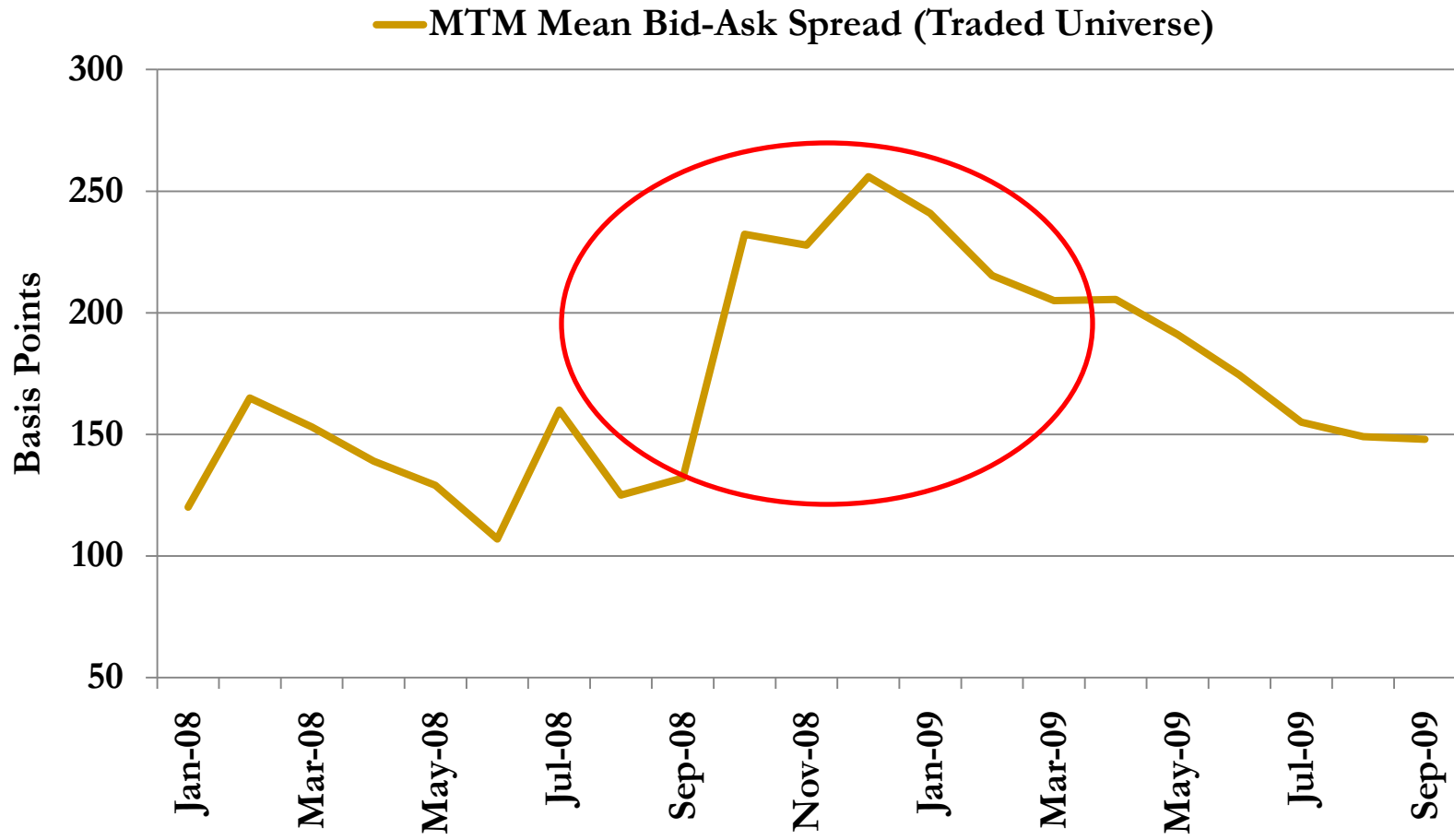
Source: LSTA Trade Data Study

Price Quotations Vary Substantially Over Time and Are Not Based on Current Information



Source: LSTA Trade Data Study

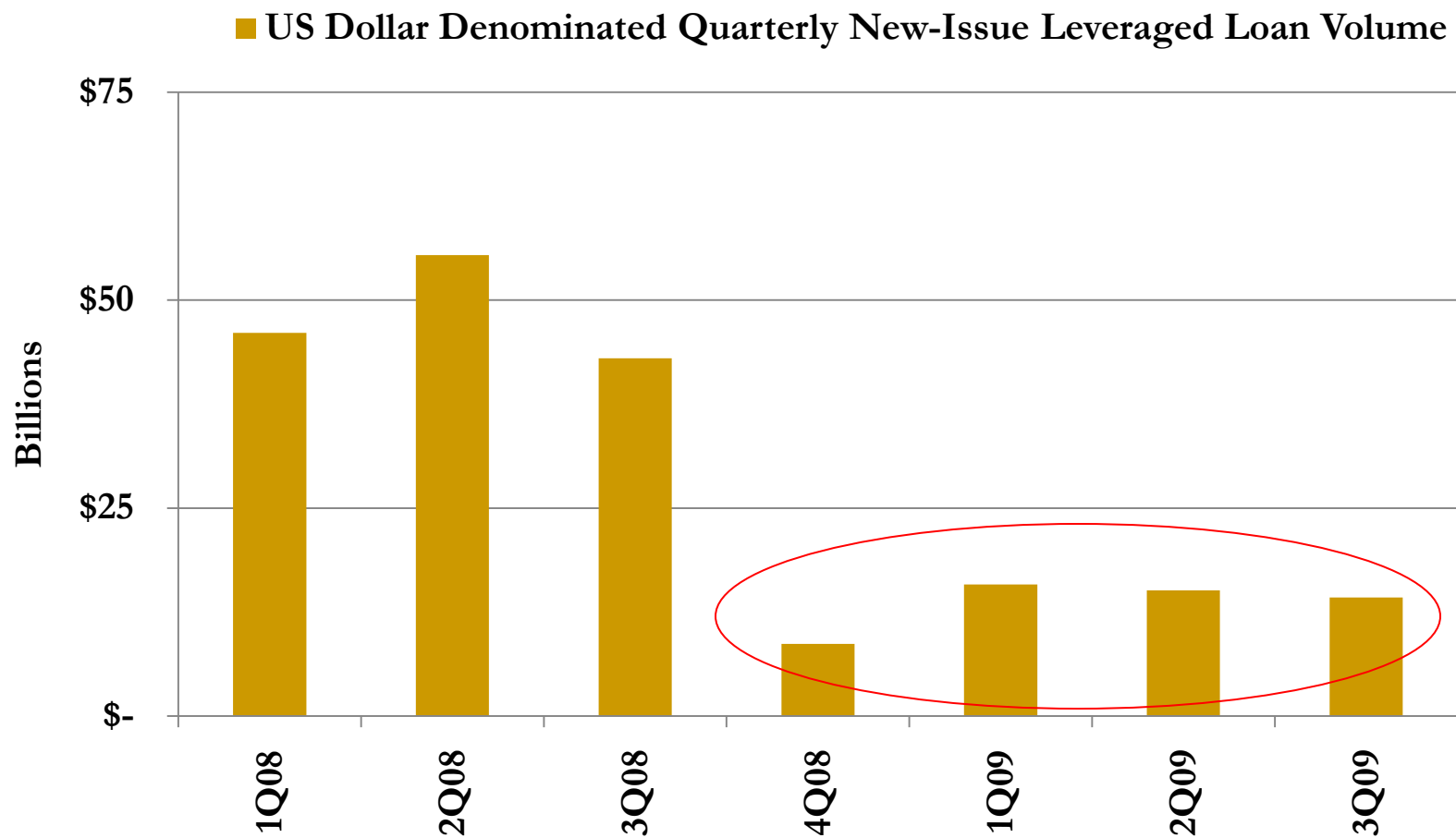
There is a Wide Bid-Ask Spread or Significant Increases in the Bid-Ask Spread



Source: LSTA/LPC MTM Pricing and LSTA Trade Data Study



There is a Significant Decline or Absence of a Market for new Issuances



Source: S&P LCD

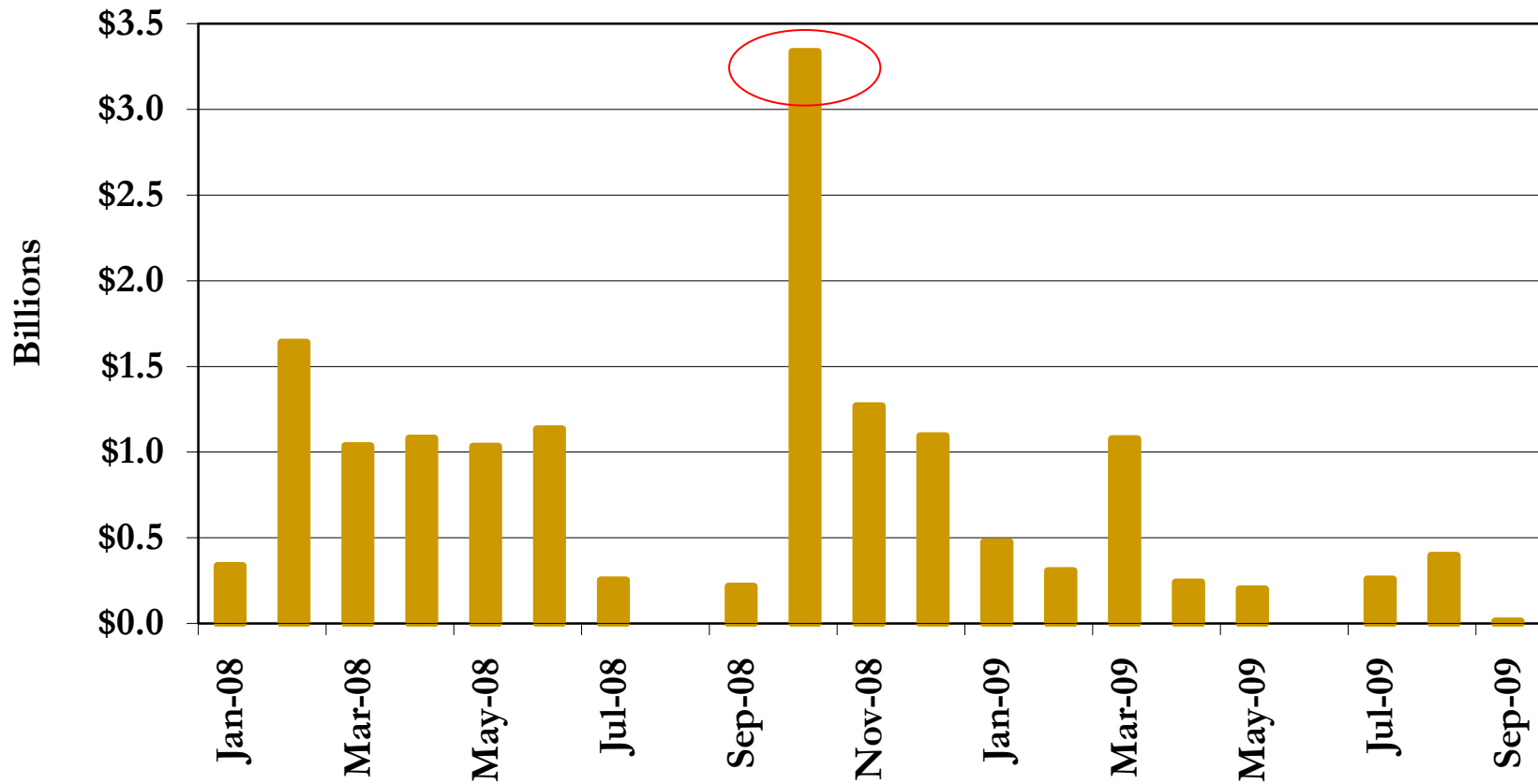


FSP FAS 157-4

- **Circumstances that may indicate that a transaction is not orderly include the following:**
 - The seller is in or near bankruptcy or receivership (i.e., distressed) or the seller was required to sell to meet regulatory or legal requirements (i.e., forced)
 - There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such an asset
 - There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant
 - The transaction price is an outlier when compared with other recent transactions for the same (or similar) asset

Identifying Transactions That are Not Orderly

■ Bids Wanted in Competition (BWIC) Volume



Source: S&P LCD

FSP FAS 157-4

■ Final Observation

- When there has been a **significant decrease in the volume or level of activity** for the asset or liability, an entity will **need to perform additional work to evaluate observable inputs**, such as quoted prices or broker quotes, to determine whether observable inputs reflect orderly transactions or a valuation technique reflects market participant assumptions.
- Entities **may still use prices obtained when markets are not active**, including from pricing services and broker quotes, provided they determine that those prices reflect orderly transactions.
- Furthermore, the FSP **does not preclude entities from concluding that the inputs are Level 2 in the fair value hierarchy** on the basis that a market is not active.

FASB Statement No. 157. Subtopic 820-10

– Proposed Update that Requires New Disclosures

- Why Is the FASB Issuing This Proposed Accounting Standards Update?
 - To improve U.S. generally accepted accounting principles (GAAP) disclosure requirements related to Fair Value Measurements and Disclosures
 - Provide improved disclosures and increased transparency in financial reporting
 - The new disclosures would be effective for interim and annual reporting periods ending after 12/15/2009, except for the sensitivity disclosures about Level 3 - ending after 03/15/10

- This proposed Update would require new disclosures as follows:
 - **Effect of reasonably possible alternative Level 3 inputs**

If changing one or more of those inputs does alter the fair value measurement significantly (sensitivity disclosures), then the reporting entity would state that fact and disclose the total effect(s) of the changes on the fair value measurement
 - **Transfers in and/or out of Levels 1 and 2**

The reporting entity would disclose the amounts of significant transfers in and/or out of Level 1 and Level 2 fair value measurements and the reasons for the transfers
 - **Activity in Level 3 fair value measurements**

Information about purchases, sales, issuances, and settlements would be required on a gross basis rather than as one net number

A Look to the Future

- **Portfolio Liquidity Reporting (on the Asset Level)**
 - Assess Level 1, 2, 3 loan assets by developing Liquidity “Ratings” using Trade and MTM Price Data
 - Loans Traded (trade prices), Available to Trade (sales-run prices) , Non-Traded (MTM prices)
 - Assess Trade Volume and Depth of Trading
 - Review bid-ask spreads, MTM quote counts, and facility sizes
 - Determine acceptable MTM Price Accuracy thresholds
 - Validate MTM price accuracy on loans that trade frequently
 - Create Comps on loans that don’t trade frequently in order to assess their MTM accuracy