

LETTER OF COMMENT NO. 218

December 30, 2008

<u>Director@FASB.org</u> Via email

Re: FSP EITF 99-20-a

Dear FASB:

Performance Trust Capital Partners, LLC focuses on advising community financial institutions through strategic financial advisory services. Much of our focus is on teaching analytics and strategy for disciplined, responsible portfolio management in the fixed-income marketplace which include extensive modeling of structured financial instruments. We work with over 500 community financial institutions nationwide and have approximately 90 full-time employees. Our principal offices are in Chicago, Illinois.

FSP EITF 99-20-a ("FSP 99-20-a") asks whether similar debt instruments should be subject to the same impairment model and whether the SFAS 115 impairment model is operational for securities previously within the scope EITF 99-20. We believe impairment models should be subject to the same principles, but different debt structures in the market and/or differences in the credit quality of the securities at purchase may require different methods ("or models") to analyze whether a security is other-than-temporarily impaired ("OTTI").

The key principle in determining whether a security is OTTI from paragraph 16 of SFAS 115 states:

For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.

This principle is evident in all of the areas where OTTI is discussed in the accounting literature but the focus of the guidance differs slightly depending on the type of debt security or the credit quality of the security. It is important to note that the definition of SFAS 115 includes the phrase "not impaired at acquisition". This is left out of FSP 99-20-a and often left out by others in the industry when discussing impairment. Our concern is that many understand the 115 model to assess for OTTI based on the probability of receiving all contractual cash flows and therefore par. However, as credit concerns increase due to impairment of either the cash flows or collateral of the debt-security, the credit spreads widen and reduce the price of the security often below par. Thus, the current expected cash flows should be compared against the cost or expected cash flows at purchase for the purpose of evaluating a debt security for OTTI.

This concept or principle is in all other areas in the literature where OTTI is discussed. For example, the SEC's SAB 59, which was originally intended for equity securities and later





updated to include debt securities (seemingly bullet type structures), closes with the following (emphasis mine):

Unless evidence exists to support a realizable value equal to or greater than the **carrying value of the investment**, a write-down to fair value accounted for as a realized loss should be recorded.

The examples in the **Appendix A to FASB Staff Position Nos. FAS 115-1 and FAS 124-1** compare the expected cash flows to the amortized cost of the investment which would reflect any purchase discount from par due to credit concerns or other factors.

EITF 99-20 and SOP 03-3 were both written to provide guidance for asset-backed securities or pools of loan with credit quality issues. Both provide the most explicit OTTI guidance and are clear that the current cash flow estimates are to be compared to the cash flows expected at purchase (or the last time cash flow estimates were revised). In fact, SOP 03-3 interpretation of SFAS 115 is as follows:

An entity should apply the impairment of securities guidance in paragraph 16 of FASB Statement No. 115. For example, if it is probable, based on current information and events, that the investor is unable to collect all cash flows expected at acquisition. (emphasis mine):

Thus, the consistent theme or principle in the accounting literature to determine whether a debt-security is OTTI is whether it is probable that the investor will receive the cash flows expected at purchase to support its carrying value or amortized cost. Accordingly, the 115 model would be operational for securities previously under the scope of 99-20 as long as this principle is clearly defined. We strongly recommend that FSP 99-20 clarify that OTTI is measured by the probability of receiving expected cash flows and not contractual cash flows to take away any uncertainty in the literature.

To make the 115 model more operational for securities previously under 99-20, we suggest providing some examples on assessing credit sensitive CDOs for OTTI. One reason for the different models already in place is that different types of securities require different types of analysis. SAB 59 was intended to provide guidance for bullet-type corporate structures and uses macroeconomic indicators to assess for OTTI. The EITF 99-20 model was intended for lower rated CDOs with different debt structures that require dynamic cash flow modeling under various assumptions. The guidance also needs to incorporate the principles of OTTI given the wide range of uncertainty within the market today. During a discussion regarding residential asset-backed securities at the FASB Board meeting on December 15, one member commented on the massive degree of uncertainty among economic paths and how there was a wide range of opinions on what that means to the housing market. The member commented that you cannot prove either opinion was right or wrong but it is important, although difficult, to get the facts, analyze them objectively and stress test them under various economic scenarios. Thus, it would make sense to use probability weighted cash flows or to model a range of cash flow possibilities to assess whether a security is OTTI.

Example

A senior \$1 million CDO backed by non-conforming mortgages was purchased in January of 2008. Although the security was rated Triple A at purchase, high delinquencies and the



deteriorating real estate market caused the credit spreads to widen reducing the price of the security below par and increasing the expected yield to the investor. The investor's initial modeling of the cash flows utilized a range of default and severity scenarios of the underlying collateral (and credit support) considered most likely. The purchase estimate ranged from receiving virtually all contractual principal and interest to receiving a lesser amount that would still equate to an acceptable yield when compared to the alternatives available in the market place. The initial estimate along with some of the key assumptions was summarized as follows:

nitial Range		* P .		
	Low	Midpoint	High	
Defaults	45.00%	40.00%	35.00%	
Severity	27.78%	25.00%	21.29%	
Credit Enhancement	5.00%	5.00%	5.00%	
Yield	5.51%	6.01%	6.50%	
Principal	925,000	950,000	975,000	

As the real estate crisis worsened, buyers of these securities left the market and the remaining buyers were able to demand higher spreads to compensate for the liquidity and credit risk causing the market price of the CDO declined by 15%. As a result, the investor updated its cash flow expectations of the loans collateralizing the security which considered the performance to date and projected performance given current market conditions. The results are summarized as follows:

Initial Range				
		Low	Midpoint	High
Yield		5.51%	6.01%	6.50%
Principal		925,000	950,000	975,000
Revised Range				*
	Low	Midpoint	High	
Yield	5.00		6.01%	
Principal	900,0	925,000	950,000	

As the projected cash flows and yield are well within the range established at purchase, it is most likely that the performance of the security will be as expected at purchase. Therefore, the security is not OTTI as it is NOT probable the investor will be unable to receive the expected cash flows (even though they may not receive all contractual cash flows). This conclusion assumes the investor has the ability and intent to hold the security until maturity or recovery of amortized cost.

It should be noted to the extent the initial cash flow estimate indicated a probability, that if the investor would not get 100% of their contractual cash flows, the security would fall under

the scope of SOP 03-3. Determining if a security is OTTI is not different for SOP 03-3 securities as indicated above. However, the accounting for SOP 03-3 securities that are determined to be OTTI subsequent to purchase is significantly different. The OTTI charge is based on the present value of the revised cash flow estimate discounted at its purchase yield and NOT its fair value. This is consistent with the international accounting guidance and the accounting for loans but is dramatically different than for other securities. The implementation guidance is clearly demonstrated in Appendix A of SOP 03-03. Many CDOs backed by residential real estate purchased during the credit crisis could fall under SOP 03-3 and therefore require different accounting treatment.

This distinction is significant as FASB begins a review of the financial instrument accounting model and is works towards convergence with the international accounting standards. The fact that US GAAP already has a similar impairment model for at least some securities to the international rules would seem to make a transition easier. Further, it makes more sense for the accounting for financial instruments to match the investor's holding intent. Banks and credit unions, unlike hedge funds and investment banks, rely on core deposits for most of their funding and manage their assets accordingly. The assets are generally managed on a longer term basis to earn a positive spread on their funding costs given their respected maturities and cash flows. Thus, a major issue with the impairment model and fair value accounting guidance in place today is that even if securities are performing and earning a positive spread over their over their funding, financial institutions could be forced to mark down those securities to liquidation prices. Meanwhile, the accounting guidance prohibits writing up (or down) most of the core deposits used to fund the purchases. This write-down reduces their regulatory capital putting their core deposits at risk. Compounding the issue is that accounting rules do not allow impaired securities to be written up if fair value recovers. This could result in marked-down securities that were earning a 7% yield to jump to 15% to 20%. This does not seem to follow one of the core principles of accounting that require the matching of revenues and expenses. Fair value provides significant information to financial statement users and to preparers to help understand the risk of financial instruments, and this information should continue to be disclosed in the financial statements. However, it may not be the most effective way to recognize income for many financial institutions. We certainly recognize that this is not within the scope of FSP 99-20-a, but as the Board considers major revisions to the accounting for financial instruments model, these issues need to be considered.

We appreciate the opportunity to comment on FSP 99-20-a.

Regards,

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Chief Financial Officer

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