



LETTER OF COMMENT NO. 4



File Reference: Proposed FSP EITF 99-20-a

Thank you for the opportunity to comment on the proposed FASB Staff Position (FSP) amendment to EITF Issue No. 99-20. Andrew Davidson & Co., Inc. is a leading provider of prepayment models, credit models and valuation tools to the mortgage investment community. The intersection of quantitative financial modeling and financial reporting is an area of great concern to us and our clients. In recent months issues of impairment and fair value have become increasingly important.

We support the proposed FSP as we believe it will bring greater clarity to the process of determining impairment. To our eye, a central issue in the computation of impairment is the choice of cash flow forecast used. Cash flow forecasts for mortgage-backed securities and other securitized assets are usually produced by first making assumptions about the performance of the underlying collateral and then inputting those assumptions into a system or program that computes the cash flows on the collateral and then the bonds. Generally we find that market participants use three types of cash flow forecasts for mortgage collateral:

- Pricing conventions
- Model forecasts
- Risk-neutral forecasts

Pricing conventions are used by market participants to compute yields and spreads of mortgage-backed instruments. There is generally consensus among market participants on these conventions. However, even though there is consensus on the convention, the pricing convention may not reflect the expected performance of the collateral. For example, a common convention for the pricing of hybrid mortgages is CPB. CPB is a pattern of prepayments that assumes a constant CPR (conditional prepayment rate) up until reset and then a balloon payment on the loans at the reset. Despite the general consensus on the pricing convention, market participants do not expect a full payoff of the loans at the reset date.

Model forecasts are used by a wide range of market participants. These models use loan characteristics and economic variables (such as interest rates and home prices) to project collateral performance (prepayments, delinquencies, defaults, severity). Because these models are often proprietary and because of their complexity, no two models will predict exactly the same cash flows, even under similar economic assumptions. Nevertheless by comparing the results of several models and looking at the historical performance of a model, it is possible to determine the reasonableness of a forecast.

Risk-neutral (or risk-adjusted) forecasts are model results (or possibly pricing conventions) that have been adjusted for the uncertainty in the underlying economic factors or the uncertainty in the model. The difference between model forecasts and risk-neutral forecasts is explained in Appendix B of FAS157:

B6. Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique uses a risk-adjusted discount rate and **contractual, promised, or most likely cash flows**; Method 1 of the expected present value technique uses a risk-free rate and **risk-adjusted expected cash flows**; and Method 2 of the

expected present value technique uses a risk-adjusted discount rate (which is different from the rate used in the discount rate adjustment technique) and *expected cash flows*.
(Emphasis added)

In practice it is often easier to determine market participants' consensus on pricing conventions and risk-neutral forecasts than model forecasts. Pricing conventions are generally available to anyone who trades and risk-neutral forecasts can be derived from market prices. Yet for purposes of computing impairment model forecasts are the most appropriate source of performance assumptions. Model forecasts help answer the question whether or not an investor will collect all amounts due according to the contractual terms of a security under a particular assumed economic environment.

Therefore we support the proposed FSP because it gives firms greater ability to utilize model forecasts to compute impairment and recognizes that there is a degree of management judgment in the determination of the reasonableness of the forecasts.

As an additional note, we believe that it would be useful to further clarify the definition of "probable" in the determination of impairment. It appears to us that there is almost always the possibility of loss on a security. This possibility may be reflected in pricing. In some cases there is the near certainty of some losses. For example if there is a large percentage of the collateral that is in foreclosure. While probable is closer to near certainty than mere possibility, the demarcation is not clear.

While we do not make determinations of impairment for our clients, we find that they have conflicting views on whether probable represents a probability just greater than 50% or a probability substantially greater than 50% (like 70%). Alternatively some might look at probable based on what they consider to be the most likely economic scenario. Another view is that assets which could be held to maturity should not be considered as other than temporarily impaired if there is even a small chance that the determination could be reversed at a later date. Clarification of the definition might improve the consistency of reporting.