

October 8, 2008

Director@FASB.org
Via email

Re: FSP FAS 157-d



LETTER OF COMMENT NO.

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Dear FASB,

Performance Trust Capital Partners focuses on helping community financial institutions become top performers through strategic financial advisory and investment banking services. We work with 500+ community financial institutions nationwide and have approximately 90 full-time employees. Our principal offices are in Chicago, Illinois.

In our opinion, FSP FAS 157-d could place significant additional stress on an already precarious banking system and needs significant modification. We encourage the FASB to carefully consider the implications of this change and use good leadership to provide a productive salve to the current financial crisis, rather than another potential irritant.

While we recognize that the Board has responded to the significant concerns from the industry and is working to resolve those concerns, we still believe that the guidance on the application of SFAS 157 has conceptual flaws. In particular, it is inconsistent with its own fair value definition in that it both includes a requirement that fair value be based on orderly transactions that are not distressed or forced sales, but goes on to require the use of a market liquidity premium that essentially reflects a disorderly market.

In our work with depository institutions we observe the following general situation: Loan performance is worsening and non-performing assets are increasing. In loan participations and the secondary market this is reflected in loan prices. At the same time, most of the private label mortgage-backed securities purchased by these same institutions are still performing and are expected to continue to perform. Because of liquidity and economic concerns in the marketplace, however, many of these securities are trading at significant discounts to their long-term economic value. **A significant danger in the current situation** is that a well-intentioned, but misguided auditor attempts to impose an other-than-temporary impairment (OTTI) adjustment on performing, but illiquid securities, and that this adjustment causes depository institutions—already stressed for capital because of non-performing loans—to fail. The irony is that the non-performing asset is not marked-to-market while the performing asset would be OTTI.

As worded, your proposed staff position does not, in our opinion, adequately mitigate this danger because it does not address real performance problems, but only provides a problematic illustration of how to determine the fair value of a security in an inactive market.

The example calculates fair value based on the implied rate of return of a similar security when the market was last active and then adds the effects of the changes in interest rates, credit spreads and liquidity in the current “inactive market.” We see the following problems with this methodology:

1. How does one determine whether a market is “active” or “inactive?” Without specific guidance, this could create a minefield of debate and contention during an audit.
2. How does one determine when a market was last active? Who has the final word on this?

3. Even if there were some way to achieve consensus about an “inactive market” security and what “active market” rate to apply, adding the effect of a “liquidity premium” to the inactive market discount rate is simply stating that fair value is equal to what the market will pay at the measurement date. The “liquidity premium” is the entire reason many fully collateralized, performing securities have market values in the 70s and 80s. As worded, this circular logic is at best confusing, and at worst eliminates the benefit of pricing a security as of the most recent active market.

There appears to be no distinction between how fair value is determined in an active or distressed market; this is contrary to the guidance of paragraphs of 5 and 7 of SFAS 157 which bases fair value on orderly transactions and not distressed or forced sales.

For investors who are not forced to sell, and have the intent and ability to hold a security for the foreseeable future, a more appropriate estimate of fair value would be based on the principles set forth in Appendix B of SFAS 157. The investor should calculate the net present value of the security by using cashflow estimates that a current market participant would use. These cashflows would be adjusted based on modeled defaults and severities, and discounted based on current credit spreads (not liquidity spreads) of similar types of assets to the risk-free rate as of the measurement date.

This is the type of performance analysis used by the rating agencies and all responsible third-party valuation experts. It is also the type of analysis depository institutions already perform on loans, and in the current environment of crisis, it would ensure that all performing and non-performing assets, whether loans or securities, are treated equally.

Why does this matter for depository institutions? Fair value is viewed by many auditors as a leading indicator in determining whether a security is other than temporarily impaired (“OTTI”). If a security is determined to be OTTI, depository institutions must write down to its fair value through earnings, causing a decrease in regulatory capital. The primary accounting guidance for determining OTTI—such as SFAS 115, EITF 99-20, FAS 115-1 and SOP 03-3—clearly show that an OTTI assessment is based on the probability of an investor receiving expected cashflows, not on the fair value. The concern, however, is this: A security backed by performing loans and generating cash flow and interest income could face an OTTI charge if auditors ignore these cash flows, and instead rely on “fair value” as defined by FSP FAS 157-d . In the current environment, the effect of these charges could be significant.

The uncertainty as to 1) how accountants interpret fair value in the current market and; 2) how they will evaluate securities for OTTI has caused many investors to stay on the sidelines, further exacerbating the credit crisis. In our view, this uncertainty could be addressed without rewriting the accounting principles by simply clarifying or affirming the following principles already laid out in the accounting literature:

1. Fair value: If the investor has the ability and intent to hold the security for the foreseeable future, fair value determinations should be based on market based cash flow estimates and market based credit risk spreads for the types of collateral supporting the security. Wide liquidity spreads resulting from inactive and distressed markets should be excluded from a fair value measurement. All assumptions used should be clearly disclosed as part of the financial reporting process. *If* the investor intends to sell the security or cannot hold the security, fair value must reflect the liquidity risk of the distressed market.
2. OTTI: OTTI assessments are based on the probability of the investor getting the cash flows expected at purchase. Fair values would not cause an OTTI charge if the investor has the intent and ability to hold the security and market based cash flow projections indicate the investor will receive the cash flows expected at purchase.
3. Distressed asset purchases: Distressed asset purchases of securities whose credit has deteriorated since

origination, but prior to purchase, fall under the scope of SOP 03-3. For securities under SOP 03-3, income and impairment are assessed differently. For depository institutions, this may include many securities purchased in the last year. Income recognition is based on expected rather than contractual cash flows. OTTI charges occur if cash flow estimates are revised downward; the charge to earnings, however, is based not on fair value, but on the net present value of the revised cash flows discounted at the purchase yield.

Clarifying and/or affirming these principles on these three issues will go a long way toward easing the accounting fears of institutional investors, allowing them to actively enter the market place. More importantly, there need be no significant amendments or revisions to existing accounting literature, as we believe these concepts are consistent with the principles already in place.

In the current economic environment, we believe the FASB must demonstrate good leadership and sound judgment in providing guidance to the marketplace and the world. It was clearly not the intent of the FASB or financial market participants to encourage or promote a valuation paradigm that could lead to significant OTTI charges on **performing assets** that could worsen the current banking and financial crisis.

Richard S. Berg
Chief Executive Officer
Performance Trust Capital Partners, LLC