



LETTER OF COMMENT NO. 322

Thank you for the opportunity to comment on the proposed FASB Staff Position (FSP) amendment to FAS Statement 157, Fair Value Measurements. 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. The following analysis presents a conceptual discussion of Fair Value accounting and a proposed modification of 157-e.

The Fair Value Dilemma

Fair Value accounting is built upon the ideas of efficient markets theory that prices reflect all available information about a security. Thus the value of a security is reflected in its price. In that framework, market price is the best measure of Fair Value.

FASB now faces the unfortunate circumstance where market prices do not seem to reflect the economic value of some securities. Market prices have dropped more for some securities than appears justified by loss expectations.

Accounting statements should provide stakeholders, and possibly others such as regulators, with the ability to assess the ongoing prospects of the subject firm. Changes in the expected performance of assets will alter those prospects. Normally, market prices would be the ideal measure to assess changes in expected performance of assets. Now however, the linkage between price and performance is not so clear, as market prices appear to reflect other factors. It seems that if firms use market prices to determine fair values, they falsely state the prospects of the firm. On the other hand, if firms use cash flow based values then they falsely state the values of their assets. And so FASB faces a dilemma.

In the current environment declines in market values reflect two factors. First, there has been a substantial deterioration in the likely cash flows of many financial instruments. Second, there has been a disproportional increase in the discount rate applied to those cash flows, as the discount rate also reflects the on-going deleveraging of the financial system.

For a firm that is forced to liquidate its assets the current “distressed” market prices reflect its true economics. Even firms which may not liquidate but offer investors the opportunity to invest or sell at Net Asset Value, market prices are the best measure of value. Use of any other price would create inappropriate incentives.

For firms that have the ability and intent to retain assets that they acquired earlier, and can maintain financial leverage, the situation is more complex. The use of market prices might indicate that the firm has insufficient assets to meet its liabilities. Yet, a cash flow analysis

would indicate that the firm has excess capital. Use of market prices creates the illusion that the firm has failed, while use of a cash flow based price, using historical discount rates, ignores the changing dynamics of the market and opportunity cost the firm faces.

A Liability Based Solution

One solution to the dilemma is to focus on the liability side of the balance sheet. If assets are deeply depressed in value because of higher discount rates, the value of the firm's debt obligations are also likely depressed. Legacy liabilities at low interest rates create tremendous value on the balance sheet. This solution creates the odd situation that a firm's liabilities are reduced in value well below the actual obligation. A liability based solution also creates issues when the source of value is a government guarantee that will allow the firm to continue borrowing at rates otherwise well below market in the future.

For example, suppose a bank issues a 12 month CD at 2.5%. Without government support the rate on that CD might be 10% or more. The bank could discount its liability by about 7% to reflect its funding advantage. Suppose the bank owns a three year asset with a coupon of 5% which is funded with the CD. Suppose the market rate on that asset is now 12%. The firm would need to mark the asset at a price of about 80 to reflect its market value. The firm would still show a mark to market loss of 13% on the net position. To fully reflect the value of the liability, the firm would need to show an additional reduction in liability costs of about 13% to reflect *future* liabilities that would benefit from the government guaranty.

An Asset Based Solution

As an alternative, it may make sense to allow the firm to value assets based upon its own cost of capital reflecting its liability mix and leverage. This is especially true if the institution has existing liabilities at below market rates or the access to borrowing because of government guarantees or other preferred access to debt markets. In such a case the firm would value its assets at discount rates reflective of its cost structure, rather than the cost structure of the marginal buyers of assets.

In such a world, each firm (or set of firms with similar circumstances) would have its own asset value. While this contradicts the idea of mark-to-market and it makes determination of value subjective, it does reflect the economic reality in the current environment. Implementation of these ideas will require linking assets and liabilities and require a reconsideration of current approaches to Fair Value accounting.

A Short Term Solution

In the interim, the following is a possible approach:

Limit the application of FSP FAS 157-e to assets where management can demonstrate that:

1. It does not have the intent to sell the security,
2. It is more likely than not that it will not have to sell the security,

3. It has access to liabilities to fund the asset at a lower rate than the discount rate used to value the security after adjusting for expected losses and imbedded option costs.

This approach should be limited to held to maturity and available for sale securities. It should not be available to entities which are subject to redemption or investment at Net Asset Value.

One benefit of this approach is that it provides greater guidance as to the appropriate discount rates to use to value securities in distressed markets. Another benefit is that this approach ties the use of cash flow based pricing to the analysis of other than temporary impairment (OTTI) and requires a positive statement as to the source of the value of the asset.

Fair Value accounting carries the promise of clearer presentation of the prospects of a firm. While at times market values provide the best indications of Fair Value, in the current environment market values may distort a true picture of a firm's viability. A complete analysis of the value of assets and liabilities in combination could resolve the dilemma of mark to market accounting. Such an analysis would need to take into account the value a firm's existing liabilities and access to *future* liabilities at better than market rates. In the interim, allowing firms with access to preferred financing terms to value their assets based on liability costs may provide a method to resolve the current inconsistencies between fair value analysis and cash flow analysis.

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