RESPONSE TO FASB STAFF POSITION AMENDMENT TO FASB STATEMENT NO. 157—FAIR VALUE MEASUREMENTS

Thank you for the opportunity to comment on the Staff Position Amendment to FASB Statement No. 157. Andrew Davidson & Co., Inc. is a leading provider of prepayment models, credit models, and valuation tools to the mortgage investment community. In recent months, many of our clients have sought assistance in determining the value and risk of their private label mortgage securities holdings. In the example below, we provide a methodology to derive the value of an asset when the market for that asset is inactive. This bond is indicative of the assets that many of our clients are seeking to assess. Our methodology is based upon Credit OAS pricing, which incorporates both voluntary prepayments and defaults based on a joint simulation of housing prices and interest rates. These defaults may result in collateral losses and asset principal write-downs.

BACKGROUND

AD&Co’s LoanDynamics\textsuperscript{TM} Model (LDM) is a proprietary transition-based model that evaluates the credit risk of each individual loan in the collateral pool. LDM has four possible states for each loan at each point in time: current, delinquent, seriously delinquent, and terminated. It uses loan, borrower, and property characteristics as inputs. Given a term structure model and a housing price model, we can use a stochastic process for both interest rates and home prices (Monte Carlo simulations) to derive asset prices, adjusted for the embedded credit risk of each loan. For structured transactions, the cash-flows generated by LDM are passed to Intex so that the correct principal, interest, and loss distributions are made to each of the tranches in the transaction.

A key element of our proposed methodology is the determination of the CrOAS spread to use for pricing. This spread does not incorporate loss expectations. In our judgment, a large “liquidity” spread is inconsistent with the concept of a “normal” market. By definition wide bid/ask spreads are characteristics of distressed markets. If the purpose of this “fair value” procedure is to determine value in the context of a normal, functioning market, we believe that the CrOAS spread should be a function of the leverage and ROE of an institution on a hold-to-maturity basis. In other words, pricing should provide a sufficient risk adjusted return to the institution given its ability to fund and hold the asset. This spread is independent of current inactive/distressed market spreads based upon perceived credit spreads and risk premiums from dealers or other participants.
EXAMPLE

SASC 2006-BC4 A5: subprime, Libor + 31 bps, settled 11/30/06

Original Ratings S/M/F: AAA/Aaa/AAA; Current Ratings: BBB-(*)/A2/A(*)

This security is indicative of what is going on in the subprime market and embodies what the fair value issue is all about. The A5 tranche was structured as the last cash-flow AAA security, and it has now been downgraded to marginal investment grade by one rating agency and is on credit-watch negative by two rating agencies. The current credit performance of the underlying collateral is consistent with this collateral vintage. The weighted average FICO and LTV were 674 and 78.6 at origination, respectively. Loans in CA and FL comprised almost 50% of the pool at origination.

Credit Enhancement - 18.7% original; 24% current

60+ Delinquency - 35.2%

Foreclosure = 14.3%

REO = 11.2%

Cumulative Collateral Losses to Date = 3.9%

In our base case housing price scenario, which assumes that housing prices will decline approximately 16% from now to the trough, collateral defaults are 66.3%, and collateral losses are expected to reach 35% of outstanding loans. Under this scenario the bond does not take any losses. However, there are many scenarios in the OAS analysis where the bond does have significant losses. The distribution of losses in accounted for in the valuation results below.

We have provided pricing/value comparisons between distressed “Market Estimates,” “Normal Market” with CrOAS = 50 bps, and “Reduced Leverage” with CrOAS = 200 bps.

<table>
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<th></th>
<th>PRICE</th>
<th>Z-Spread</th>
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<tbody>
<tr>
<td>MARKET (IDC/ABX)</td>
<td>48</td>
<td>996 BPS</td>
</tr>
<tr>
<td>CrOAS @ 200</td>
<td>76.5</td>
<td>372 BPS</td>
</tr>
<tr>
<td>CrOAS @ 50</td>
<td>85</td>
<td>237 BPS</td>
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</tbody>
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The Z-Spread represents the yield spread of the bond over the LIBOR curve. It is higher than the assumed OAS due to the expected credit losses of the bond.
It is clear that current distressed market prices produce expected risk adjusted returns that reflect the marginal bid in the market—the unlevered hedge fund bid. Virtually the only selling in the current market is due to forced liquidations.

In contrast, the CrOAS approach provides more reasonable estimates of fair value. By historical standards, the CrOAS @ 50 price/Z-spread is consistent with the experience of marginal investment grade securities. Given model risk and housing market uncertainty, perhaps a wider spread is appropriate in the current environment. However, it is clear that the CrOAS methodology provides a consistent valuation that incorporates credit risk in a stochastic framework. The CrOAS spread should reflect funding and institutional return requirements, rather than being determined from a discount rate inferred from market pricing by participants who have varying and obscure objectives.

**COMMENTARY**

Some might object to this approach saying that if there is a distressed market, those values should be incorporated into the analysis. Our thought process is explained by the following example.

Andrew Davidson & Co., Inc purchased $100,000 worth of furniture. We record it on our books at cost and then amortize that cost over the useful life. If we applied fair value accounting to that asset we would need to mark it down to $30,000 or so. There is a market for used furniture, which is essentially an illiquid distressed market. Our new furniture is now an impaired asset.

I think we would all agree that this approach is wrong. Why then would we apply the same standard to financial instruments? An illiquid distressed market should not be the source of “fair value.”