



LETTER OF COMMENT NO. 28

To: Adrian Mills; Diane Inzano; Joseph Vernuccio; Kevin Stoklosa; Kristofer Anderson; Mark Trench; Meghan Clark; Peter Proestakes; Russell Golden; Vita Martin; Wade Fanning

Subject: FW: File Reference: Proposed FSP FAS 157-e

Attachments: Response to Proposed FASB Staff Position No 157-e.doc; Response to Proposed FASB Staff Position No. FAS 157-e.xls

From: John Wall [mailto:john.wall@jmeglp.com]
Sent: Monday, March 23, 2009 4:55 PM
To: Director - FASB
Subject: File Reference: Proposed FSP FAS 157-e

Response to Board requests:

1. I believe proposed date is operational.
2. I believe that amendments to Statement 157 are necessary and will help determine whether a market is not active and a transaction is not distressed. However, I feel that modifications to the example of valuation under the discount rate adjustment technique are necessary:

I feel that the proposed approach to a discounted rate adjustment technique confuses the issue in that some risk factors are considered both in projecting cash flows and in determining the discount rate to be used. Hence the current application could cause duplicate discounts for identical risks with the result of improperly discounting values.

I feel that the proposed approach to the discount rate adjustment technique is confused in that it develops one rate for discounting all cash flows. In reality the discount rate used for instances where collateral values are less than the underlying note amount should be considerably higher than that used where the underlying notes are current in payment and the collateral is adequate. Because cash flow on the "good" mortgages is extended out much farther than the "bad", excessive discount could result.

I believe that the discount rate adjustment technique should place all elements relating to risk, including collateral value risk, default risk, and delinquency risk, in the cash flow consideration. The resulting cash flows can then be discounted using a single "market" rate as inferred in more current securitizations since the net cash flows are the expected cash flows after consideration of all risk factors.

I have included an excel spreadsheet that demonstrates a three part calculation of discounted expected cash flows.

3. I agree with the proposed two-step model for determining whether a market is not active and a transaction is not distressed except:

I feel that language should be added cautioning against the use of quoted prices of **similar assets or liabilities** when the asset under consideration is a mortgage backed security. I feel that each mortgage backed security is unique by its very nature and should be valued based upon its unique underlying mortgages rather than any comparison to other securities.

4. I believe that the factors in paragraph 11 are appropriate.

3/23/2009

I would be more than happy to discuss any of the above or attachments.

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Response to Proposed FASB Staff Position No. FAS 157-e.

I would like to make a four part response to the above FSP:

1. Comment re Paragraph A1. b. relative to mortgage backed securities.
2. Implied redundancy between Paragraph A32D and A32E.(5) when valuing mortgage backed securities.
3. Suggested Calculation of value of mortgage backed securities when the market for that security is not active at the measurement date and any quoted price for this security is associated with a distressed transaction.

General: I feel that it is preferable to consider all risk factors in coming up with estimated cash flows. Specifically, if risk factors are considered within the discount rate it would be necessary to have several distinct rates. It would not make sense to use the same rate in discounting cash flows on notes for which the value of the collateral is less than the note as in discounting cash flows on notes which are current and have adequate collateral. To do so would give an artificially low total value since the "bad" debt would be incurred early on while the "good" debt would be discounted over many years. If all risk factors are included in the cash flow, the current rate (market rate) can be used to calculate present value of all cash flows.

- a) Calculation of most likely cash flows (Also Exhibit)
- b) Discount rate to be used.

Attachment: Working Excel Exhibit to be used in calculating value using a present value technique.

1. Comment re Paragraph A1. b. relative to mortgage backed securities.

I believe that added language is warranted specifically cautioning against the use of quoted prices of ***similar** assets or liabilities* when the asset under consideration is a mortgage backed security. The respondent posits that the word “similar” can have a constructive meaning in relation to mortgage backed securities only in a situation where there is a high degree of comparability as to individual mortgages packaged in the security, their rates, location of underlying collateral, valuation of underlying collateral, and existence of default on payments. However, in such situations where all of this information is available it would seem more appropriate to use the discount rate adjustment technique (see later suggested revisions to this technique).

See also comments relative to other information used in paragraph A32E addressed in topic 3. a) below.

2. Implied redundancy between Paragraph A32D and A32E.(5).

Paragraph A32B states that “realistic assumptions about the performance of the underlying mortgage loans” should be used in determining an estimate of most likely cash flows from the collateralized debt obligation security.

Paragraph A32E. (5) states that “Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates.” Should be used in estimating the appropriate rate of return.

My objection is that the securities in question are being devalued twice for an identical risk factor. If the anticipated cash flows already include assumptions about performance of the mortgage loans, and to be of any relevancy they would have to, then to adjust the *discount rate for an identical risk serves only to drive the value of the asset further* without merit.

3. Suggested Calculation of value of mortgage backed securities when the market for that security is not active at the measurement date and any quoted price for this security is associated with a distressed transaction. I feel that this should be approached by first estimating future cash flows incorporating all relevant risk factors.

- a) Determining most likely cash flow.

I feel that the determination of cash flow should entail at least three distinct considerations:

- i. **Collateral Value Risk.** If the value of collateral is less than the face value of a portion of the loans in the securitization, this should be a specific step in determining total cash flow. The portion of loans subject to such risk must be estimated; the anticipated cash price that could be obtained by sale of the collateral must be estimated, and the approximate time needed to execute such a sale must be estimated.

The present value would then be determined by the formula in the Exhibit.

- ii. **Default and/or Delinquency Risk.** If there are mortgages in arrears on which the collateral held equals or exceeds the face value of the notes the effect of the delinquency and default must be considered. Since the servicing agent will adjust total interest charged for delinquency, the most damaging outcome would come from actual default on these notes. The portion of the loans subject to such risk must be estimated; the anticipated cash price that could be obtained by sale of the collateral must be estimated, and the approximate time needed to execute such a sale must be estimated.

The present value would then be determined by a formula similar to i. above and as shown in the Exhibit.

- iii. The cash flow from remaining notes can then be estimated based upon monthly payments and the number of months remaining on the notes. See Exhibit.

3 b) **Determining Discount Rate.** Since all relevant risk factors are considered within the cash flow calculations, the discount rate used should be the “market” rate implicit in current securitizations.

See also the Excel Attachment containing a spread sheet for calculating value using a present value technique.

FSP FAS 157-e
Calculation of Fair Value Using a Discount Rate Adjustment Technique

Exhibit:

_____ = Independent Variables

a. Remaining book value of notes underlying securitization.	10,000,000,000
b. Percentage of book value of notes where underlying collateral is less than remaining book value	40.0%
c. Anticipated sale price of collateral in b. above as percent of remaining book value	40.0%
d. Anticipated collection on collateral in b. above in years	2
e. Percentage of book value of notes on which payments are in arrears (Not to duplicate any of notes in a. above).	10.0%
g. Percent of delinquencies anticipated to be foreclosed upon	5.0%
h. Monthly payments on loans which are current.	33,774,812
i. Average number of payments remaining	300
j. Average rate on underlying loans	5.5%
k. Discount rate used for present value calculation (See separate discussion following cash flow).	5.0%

	Present Value @ (k.) %	% of Total Securitization
i. Collateral Risk: Determine value of portion of loans where value of underlying collateral is less than remaining amortization of note.		
Total book value of securitization (a.)	10,000,000,000	
Times percentage with undervalued collateral (b)	40.0%	40.0%
Times anticipated sale price as percent (c.)	40.0%	
Anticipated collection amount	1,600,000,000	
Anticipated collection on loans with undervalued collateral in years	2	
Present value	1,451,247,166	
ii. Default and/or Delinquency Risk: Determine value of portion of loans on which payments are in arrears.		
Total book value of securitization (a.)	10,000,000,000	
Percentage of dollar amount of loans on which payments are in arrears (e.)	10.0%	
Percentage anticipated to be foreclosed upon (g.)	5.0%	5.0%
Remaining percent to be included in calculation iii. below	5.0%	
Anticipated sale price as percent as percent of (c.)	40.0%	
Anticipated collection amount	200,000,000	
Anticipated collection on loans with undervalued collateral in years (d.)	2	
Present value	181,405,896	
iii. Value of loans with sufficient collateral and currently current in payments.		
Percent of loans with sufficient collateral and current	55.0%	55.0%
Total monthly payments in dollars on loans with sufficient collateral and current (h.)	33,774,812	
Average term of loans in months (i.)	300	
Present value	5,777,520,942	

FSP FAS 157-e
Calculation of Fair Value Using a Discount Rate Adjustment Technique

Present Value of Cash Flows

<u>7,410,174,004</u>	<u>100.0%</u>
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