



March 26, 2009



LETTER OF COMMENT NO. 189

Financial Accounting Standards Board
c/o Technical Director
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 237

Re: Proposed FSP FAS 157-e
Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b

Members of the Board:

Redwood Trust, Inc. appreciates the opportunity to comment on the proposed FASB Staff Positions No. FAS 157-e, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed*, and No. FAS 115-a, FAS 124-a, and EITF 99-20-b, *Recognition and Presentation of Other-Than-Temporary Impairments*.

Responding Organization

Redwood Trust is a publicly traded real estate finance company that primarily invests in illiquid mortgage loans and mortgage-backed securities that are often characterized as "Level 3" assets. We are accustomed to valuing these assets in inactive and/or disorderly markets, and are constantly balancing the complexity of our valuation methodologies with the need for transparency from our investors. As an illustration, I have attached a copy of our Annual Report on Form 10-K for 2008 as well as a supplemental quarterly publication we issue called the *Redwood Review*. *The Redwood Review* is intended to provide additional transparency to the readers of our financial statements by helping to further explain our business, accounting, and results.

With respect to fair value accounting, we share the Board's belief that fair value measurement is a fundamentally sound accounting principle that allows companies to report amounts that are more relevant, timely, and comparable than amounts that would be reported under alternative accounting approaches, even during extreme market conditions. We also recognize the efforts of Congress to seek relief on behalf of banks and other financial institutions that have been affected by the perceived pro-cyclical effects of inflexible mark-to-market accounting standards. It is our belief that a balanced solution is needed that provides such accounting relief to market participants without sacrificing the transparency or integrity of financial reporting. This comment letter response has been written with this objective in mind.



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Our specific responses to each of the proposed FSPs are included below. While we have offered recommendations that we believe will help the FASB clarify and enhance the proposed FSPs, we maintain no specific grievances toward existing fair value accounting standards nor do we lobby for any preferential outcome.

Proposal Summary: Proposed FSP on Statement 157 (FSP FAS 157-e)

FSP FAS 157-e provides additional guidance on determining whether a market for a financial asset is not active and a transaction is not distressed when estimating fair value measurements under Statement 157. The FSP establishes a two-step process to determine whether a market is not active and a transaction is not distressed. Step 1 provides factors that indicate that a market is not active. These factors include, but are not limited to:

- a. few recent transactions;
- b. price quotations not based on current information;
- c. price quotations vary substantially either over time or among market makers;
- d. indexes that previously were highly correlated with the fair values of the asset are demonstrably uncorrelated with recent fair values;
- e. abnormal (or significant increases in) liquidity risk premiums or implied yields for quoted prices when compared with reasonable estimates (using realistic assumptions) of credit and other nonperformance risk for the asset class;
- f. abnormally wide bid-ask spread or significant increases in the bid-ask spread; and,
- g. little information is released publicly (for example, a principal-to-principal market).

If the reporting entity concludes in step 1 that the market for the asset is not active, then the reporting entity must presume that a quoted price is associated with a distressed transaction unless the reporting entity has evidence that (a) there was sufficient time before the measurement date to allow for usual and customary marketing activities for the asset and (b) there were multiple bidders for the asset. If the reporting entity has evidence that both factors are present for a given quoted price, then that quoted price is presumed not to be associated with a distressed transaction and may be a relevant observable input that should be considered in estimating fair value.

If the reporting entity does not have evidence that both factors in the above paragraph are present for a given quoted price, then the reporting entity shall consider that quoted price to be associated with a distressed transaction. When that is the case, the reporting entity must use a valuation technique other than one that uses that quoted price without significant adjustment.



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Comments: FSP FAS 157-e

In general, we agree that additional fair value accounting guidance is necessary and useful for practitioners. We find the two step approach proposed in the FSP to be an improvement over current accounting guidance for determining when a market is inactive or a transaction is distressed. However, the proposed guidance is still not explicit enough for us to conclude that the market for any of our securities is inactive, despite our belief that many of them are. Accordingly, many reporting entities as well as independent accountants may continue relying on observable market inputs without additional discretion, due to the risk of misinterpreting authoritative guidance and the significant effects that changes in fair value can have on a reporting entity's financial results, capital, and operations. The proposed FSP may therefore be applied inconsistently by reporting entities that participate in the same markets. Based upon these considerations, we believe that the proposed effective date of this FSP for interim and annual periods after March 15, 2009, would not be operational without more specific guidance.

To illustrate the need for additional clarity, we provide the following examples along with recommendations that would enable practitioners to more definitively conclude whether or not a market is inactive.

Example 1

Assume an entity acquired a \$20 million mortgage backed security at par five years ago and the security is still performing in line with the original expectations of the acquirer and the credit agencies that rated the security. The security has the following characteristics:

Security:	RMBS
Vintage:	2004
Collateral:	Prime Residential 1 st Lien Loans (Non-Agency)
Current Rating:	AAA
Original Principal Balance:	\$100 million
Purchased Principal Balance:	\$20 million
Original Credit Support:	500bps
Current Credit Support:	700bps
Delinquencies:	5 bps (90+ Days Delinquent)
Price at Issuance:	\$100.00
Recent Transacted Price:	\$65.00

Also assume that (i) significant portions of the \$100 million original principal balance were sold to various investors, including \$10 million to a CDO entity, (ii) this CDO entity recently experienced an event of default, (iii) the \$10 million security owned by the CDO entity has been offered for sale as part of a



liquidation auction, (iv) the marketing period is considered to be reasonable and sufficient, (v) the auction drew multiple bids from hedge funds and other opportunistic buyers, and (vi) the security ultimately transacted at a price \$65.00.

Bids for the security were widespread and within an acceptable range, but represented a completely different investor base compared to traditional buyers of AAA prime securities. The traditional buyers of AAA securities have targeted discount rates or yields that more closely approximate prime interest rates and generally include banks, insurance companies, pension funds, and other institutional investors. Such traditional buyers have exited the market over the past two years due to adverse macro-credit conditions and a lack of new origination activity.

Based upon this example, two possible conclusions could be drawn. Either 1) the market for the security could be characterized as an active market based upon Step 1 of the proposed FSP, thus requiring management to prioritize the observable transaction when estimating fair value; or 2) the market for the security could be characterized as an inactive market based upon Step 1 of the proposed FSP, but the transaction would still remain a relevant observable input under Step 2, since (a) there was sufficient time before the measurement date to allow for usual and customary marketing activities for the asset and (b) there were multiple bidders for the asset. Neither of these conclusions would enable the reporting entity and/or their independent auditor to revert to an alternative valuation technique to the extent that relevant market transactions are prioritized.

Recommendation

The FASB should consider clarifying the definition of a primary market to require that reporting entities consider the level of market activity of traditional buyers when determining whether the primary market for a security is active. Since these buyers are typically investors interested in generating long-term cash flows over time with the ability to hold a security and the intent not to sell the security (versus traders, brokers, or other acquirers interested in generating short-term cash flows from the active buying and selling of securities), the existence of new securitizations is objective evidence of whether the primary market is active. To the extent the primary market is not active (as evidenced by the lack of new issuance, or predominant participation by non-traditional market participants), management should not be required to prioritize non-primary transactions, such as CDO liquidations, when estimating fair values of securities classified as available for sale.

For securities where the reporting entity does not have the ability to hold or the intent not to sell the security (e.g., trading securities or securities financed with



short-term debt), management should continue prioritizing all observable market inputs assuming that a sale would occur in any existing market for the security.

Example 2

Assume that the market for the security in Scenario 1 is determined to be active despite the observation of historically wide bid/ask spreads in the primary market. Assume the bid/ask spread for the security is 10 points. That is, owners of the security are willing to sell at a price of \$65 or above, but buyers are only willing to buy at a price of \$55 or below. Under Standard 157, the exit price criteria would require a "Day 2" mark-to-market write down of \$10, or 15% of the buyers acquisition price despite the lack of any fundamental changes in the value or performance of the security. This can result in a pro-cyclical decline since bid/ask spread adjustments continue to increase as the market for a security becomes less active, discouraging non-distressed market participants.

Recommendation

The FASB should consider implementing a "down-tick" rule that allows practitioners with the ability to hold and the intent not to sell a security to maintain a market value at or above the transacted value or original "exit price" until there has been an adverse change in the underlying cash flows of the security, or the market price for the security has declined to a point that the practitioner no longer expects the fair value of the security to recover to the transacted value.

Example 3

Assume that the market for the security in Scenario 1 is determined to be inactive and any observable inputs are deemed as distressed transactions. According to the proposed FSP, "the reporting entity could alternatively use an income approach, such as a present value technique to estimate fair value. The inputs to the present value technique should reflect an orderly transaction between market participants at the measurement date. An orderly transaction would reflect all risks inherent in the asset, including a reasonable risk premium for bearing uncertainty that would be considered by willing buyers and willing sellers in pricing the asset in a non-distressed transaction at the measurement date."

Recommendation

The FASB should consider issuing more specific guidance for determining the inputs used to apply the present value technique for a debt security such as the security specified in Example 1. For Level 3 securities, the reporting entity should use a discount rate that incorporates a current risk free/benchmark rate, a historically based liquidity premium that approximates an active market, and a



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credit risk premium derived from changes in the expected future cash flows of the security. Since significant management judgment must be applied using the income method, the FASB should consider further clarification to the extent that

this approach becomes widely adopted by practitioners. Relevant disclosures of the valuation assumptions used by management to apply the income method should be included in the reporting entity's footnotes to the financial statements.

Proposal Summary: Proposed FSP on Statement 115, Statement 124, and EITF Issue 99-20

FAS 115-a, FAS 124-a, and EITF 99-20-b amends the other-than-temporary impairment guidance in U.S. GAAP to make the guidance more operational and to improve the presentation of other than temporary impairments in the financial statements.

The FSP modifies the current indicator that, to avoid considering an impairment to be other than temporary, management must assert it has both the intent and the ability to hold an impaired security for a period of time sufficient to allow for any anticipated recovery in fair value. The Board believes it is more operational for management to assert that (a) it does not have the intent to sell the security and (b) it is more likely than not that it will not have to sell the security before its recovery.

The FSP changes the total amount recognized in earnings when there are credit losses associated with an impaired debt security for which management asserts that it does not have the intent to sell the security and it is more likely than not that it will not have to sell the security before recovery of its cost basis. In those situations, the impairment should be separated into the following:

- a. the amount of the total impairment related to credit losses; and,
- b. the amount of the total impairment related to all other factors.

The amount of the total impairment related to credit losses should be included in earnings. The amount of the total impairment related to all other factors should be included in other comprehensive income. A reporting entity is required to present separately the total amount of the impairment in the statement of earnings and the amount recognized in other comprehensive income as a deduction from the total impairment.

Comments: FAS 115-a, FAS 124-a, and EITF 99-20-b

We support the FASB's proposal to require that entities separate an impairment of a debt security into two components (the credit component and the noncredit component) when there are credit losses associated with an impaired debt



security for which management asserts that it does not have the intent to sell the security and it is more likely than not that it will not have to sell the security before recovery of its cost basis. This approach will mitigate the unintended negative consequence to businesses that are currently forced to imbed volatile discount rates implied by the market, or lack of market, into reported capital and profits each quarter. However, we believe that the proposed effective date of this FSP for interim and annual periods after March 15, 2009, would not be operational without additional guidance specifying how reporting entities should calculate the credit component of impairment.

Recommendation

The proposed FSP would require that the credit component of the impairment of a debt security be determined by the reporting entity using its best estimate of the amount of the impairment that relates to an increase in the credit risk associated with the specific instrument. However, we believe that the FSP should include more specific measurement guidance to preserve the comparability and transparency associated with the existing other-than-temporary impairment methodology, which is based upon the fair value of the security. Additional guidance should specify the metrics that a reporting entity should hold constant in determining the credit component that is recorded to earnings. For example, holding the discount rate assumption of a debt security constant (e.g., using the prior period rate or the entity's cost of capital) as well as the prepayment rate assumption (e.g., the prior period rate), in order to compute the change in net present value of a security due to adverse changes in credit would be one method that could be consistently applied. Relevant disclosures of the impairment assumptions used should be included in the reporting entity's footnotes to the financial statements.



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We appreciate the invitation to comment on such significant issues. If you, other Board members, or your staff has any questions about our comments or wishes to discuss any of the matters addressed herein, please contact me at 415-380-3455.

Sincerely,

Martin S. Hughes
President and Chief Financial Officer
Redwood Trust, Inc.