Addicted to FAS 157-e

By Brett Cooper

The Financial Accounting Standards Board (FASB) has been busy trying to respond to the turmoil roiling our markets. One particular change that has been well-received was issued in April and is intended to provide additional application guidance regarding fair value measurements and impairments of securities. Proposed staff position FSP FAS 157-e, Determining Whether a Market Is Not Active and a Transaction Is Not Distressed, provides guidelines for making fair value measurements more consistent with the principles presented in FASB Statement No. 157, Fair Value Measurements. Before you rush to take advantage of these changes, however, call your doctor and discuss if the prescription will address your symptoms.

FSP FAS (April 9, 2009) in part states:

The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows.

You may be tempted to look for a quick fix and contact your sales broker to have them run a model with new "stressed" assumptions (e.g., home price depreciation of 10 percent, interest-rate increase of 2 percent, prepay reductions and high default rates for loans in California, with high LTV, and equity take out). This is in hopes of demonstrating to your auditor and examiner your ability to hold to maturity and push back credit losses, while placing the income statement in safe custody of Other Comprehensive Income, assumptions and a cash-flow model. Problem solved. Pain alleviated.

Although this author believes the new accounting FASB 157-e and revision of FASB 115 provide essential immediate relief for those banks capable of holding illiquid, toxic assets, to maturity — using the presumed relief to simply revise assumptions for old cash-flow models — will certainly lead to more surprises for banks once real credit losses mount. Blindly ignoring the underlying assets and their warning signs for the potential realization of and subsequent timing of future credit losses will create another painful shock.

Those that seek an appropriate prescription, however, will take a proactive stance to manage the positions, just as any other distressed product under management. Actively taking a role in appraising, evaluating and predicting credit losses by understanding the reality of each position will allow the proper prescription to bring the financial institution back to health.

Let us take a closer look into the cause of this current malaise. First, all parties in the pooled debt system were motivated by one aim: to produce better numbers. For all structured products, better credit numbers resulted in diversity (a presumed panacea); and the brokers, bankers, sellers, raters and investors all benefited from the supposed diversity. As long as the numbers demonstrated diversity, pooled risk could be sold cheaply under the illusion of strong credit fundamentals.

Second, models were built to structure and sell bonds to investors, which belied the faulty underlying fundamentals. Investors relied heavily on those models, unaware of the illusion the data created. Some models are less transparent than others, but they all rely on the fundamental fact the data must be correct, and the loans/securities must comply with the assumptions. Many investors did not understand the models they were using or being told to use.

Third, structured products were cleverly marketed and branded. RMBS transactions have a similar shelf name such as CWALT, RALI or MANA, to name a few. Trust Preferred Securities were sold most commonly under the PRETZL moniker. The average private-label securitization prospectus is about 350 pages, with hundreds of additional pages filled with supplemental information. Most investors never opened them even though that information is critical to deal performance. These bonds were built as brands, and the brand names became commodities. As a trusted commodity, investors did not read documents, audit the models, or review the data and trustee reports. The ratings furthered the belief that these commodities were similar, despite the fact they were not.

Fourth, an AAA rating became commoditized and lost its intrinsic value. The agencies established credit enhancement in the form of a percentage of an entire pool acting as protection for senior bondholders. For AAA-rated RMBS bonds, a 6 percent credit enhancement was not uncommon. Once losses totaling 6 percent of the total transaction balance occur, AAA bondholders incur a loss (i.e., 94 percent of the issuance was AAA rated). As a result, no credit-rating opinion distinguished characteristics of bonds that sat above the established credit enhancement, and the entire bond was considered the highest rating. AAA classes of the same RMBS bond, however, often have substantially different credit characteristics and vary widely in terms of recovery prospects. One major distinguishing credit characteristic between AAA classholders within the same RMBS issuance is the loan groups.

As an example, many senior investors do not realize they actually invest in a group or subgroup of loans within the senior class of bonds they purchased. This is because loan-group distinctions typically don't become relevant until the credit enhancement provided for AAA bondholders is breached, which was never supposed to happen. Prior to a breach, these groups share in losses. In short, investors may own a bond backed by a loan group outperforming other loan groups or one performing weaker than its peers within the same branded AAA bond. This sharing benefit or drawback occurs only while AAA Credit Enhancement exists.

Further complicating matters, loan groups can also share individual loans with other groups. An example found in a common prospectus stated "for loans with coupons between 6.00 percent and 6.25 percent, the net difference of the coupon within this range will be shared between loan groups III and IV. Each loan group will share in the principal losses and prepayments of these individual loans." Sometimes loan groups were created for beneficial reasons, such as allocating loans to a group with different prepayment speed expectations. Other sinister reasons involve creating worse loan groups for the unsuspecting investor, while still achieving an AAA rating over that loan group.

Path to recovery — Use the prescription wisely

To determine the likelihood, and timing, of credit loss, a bank has to dig deeply to find the real truth that lies within the details of the transaction structure, models, data and ratings. It is a meticulous and time-consuming process that requires a specialized acumen.

Step 1: Clean the data

Unfortunately, the underlying data at the loan, loan group and bond levels have a lot of errors. Pools were constructed with such haste that much of the loan-level data feeds established to the trustees were incorrectly set up at the outset. Sometimes trustees match investors with a loan group that differs from the one they purchased in the prospectus — a purely clerical error. Getting the correct information is the first order to determine what is owned and where the risks lie. Isolating data problems must occur before any

meaningful analytical exercise commences. Sometimes, data mistakes may actually benefit the investor — as long as no one else points out or solves the problem.

Step 2: Simplify the approach

Keep it simple. Unfortunately, all modeling solutions have inherent mistakes in how they interpret the documents. Rarely does a firm audit the models. Simple, straightforward controls allow a bank to better anticipate credit losses and triage its portfolio. Furthermore, complex models tend to create an average result when, in reality, the results may be outliers, depending upon the class owned by the investor.

Step 3: Understand the ratings

Ratings of CCC or Caa2 do not opine on recovery or timing of credit losses, which are central to the new methodology. They simply state that, in the view of the rating agencies, the bonds no longer have enough credit support to ultimately recover full principal. A bond that will recover 95 percent principal can have the same CCC rating as a bond that will recover 5 percent.

Step 4: Understand the Transaction

Many bonds aren't as bad as they appear. Reported credit metrics may be showing disaster (e.g., 50 percent + 60 days past due), yet the bonds continue to be paid as agreed. This is because investors may own a loan group, or a portfolio within the pool, that is structured to outperform the broader bonds. Conversely, some investors may be viewing a report indicating exceptional performance (2 percent 60 days past due, etc.), yet are receiving interest shortfalls.

Step 5: Get Regular Checkups

Performance is evolving on a daily basis. New regulations, increased defaults, recovery rates and time are all critical to the well being of your investment. Each transaction is a living and breathing entity, and the bank must treat them as such by closely monitoring their health and getting regular checkups.

In short, use the time afforded by the new proposed accounting standards to understand the health of your portfolio and the symptoms at hand. Although the rules help ease the pain, certainly in the near term, be diligent to apply the proper prescription and manage your positions actively to be certain the credit losses don't come sooner, or more severely, than you expect. IB

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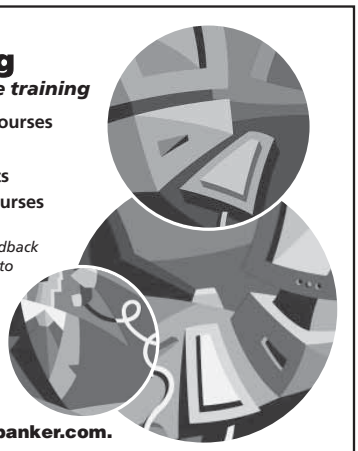

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