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RE: File No. 4-573 - Comments about the application of SFAS 157

As an appraiser of non-exchange securities, I appreciate the effort to achieve more transparency in valuations. Unfortunately, SFAS 157 throws out methods that have often worked for non-exchange assets and substitutes with methods that are often confusing and illogical.

I am well aware of the challenges in obtaining market values for non-exchange assets. My background includes over 22 years as a licensed securities representative where I primarily helped people liquidate non-exchange assets. (I retired my securities licenses in 2003.) For the last 20 years I have also completed appraisals of non-exchange assets, primarily limited partnership positions and private bank stocks. My firm, Partnership Consultants, Inc. ("PCI") is one of the leading firms in partnership research and we maintain one of the largest partnership research libraries in the country. I was a director of the Partnership Secondary Market Association and I contributed non-exchange trade data to *The Partnership Spectrum* (formerly *The Perspective*), *Dow Jones Investment Advisor* (formerly *Investment Advisor, Stanger's Investment Advisor* and *Financial Product News*) magazines. My firm was also a regular contributor of trade data to the Wall Street Journal series on limited partnerships in the early 1990s.

The staff at PCI compiled a directory of public limited partnerships titled <u>Limited Partnership Locator</u>. This original directory was published in 1993 and revised editions were published in 1994, 1997, 1999, 2002 and 2005. PCI also published over 90 bi-monthly issues of The Partnership Alert ("Alert"). The Alert was considered to be the authority on the status of partnership tenders and it identified over 1,800 tenders during the mid-1990's. Each issue, of the Alert, compared Tender Prices to Partnership Secondary prices and General Partner buy-back prices. The objective was to identify the best market price available to potential fractional interest sellers.

In summary, my experience is in the area of data collection for non-exchange securities, obtaining best execution in various negotiated securities markets and producing appraisals for non-exchange securities.

SFAS 157 is referred to as "Mark-to-Market accounting standards" or "fair-value accounting standards". In many ways these terms are misnomers, unless they are referring to the exchange-traded securities held by financial institutions. The terms, “Mark-to-Market” and “fair value” sound nice but they misrepresent the actual applications required by SFAS 157.

We have had “Fair Value” accounting for some assets for a few years. (For an explanation of the existing general accounting framework for financial institutions – see the October 17, 2008 4-573 comments by Todd M. Adams, CFO of Members United.) Now the FASB and the SEC want “Fair Value” accounting for all assets and liabilities of financial institutions. (That should be read as financial institutions that are required to file with the SEC or who use GAAP. It is noted that many private entities do not file with the SEC or use GAAP.)

The proposed SFAS 157, including 157-1, 157-2 and SEC Notice 2008-234 have a number of confusing provisions and illogical requirements. For example:

1. In applying the new mark-to-market provisions to a company’s liabilities, a reduction in the company’s credit rating (say from AA to BBB) creates a lower market value of the Company’s own liabilities. According to SFAS 157, the difference adds to shareholder equity and the difference is also an income item. (The 10-21-08 WSJ Heard on the Street column mentions Citigroup and Morgan Stanley who each booked over $1 Billion of income from marking their own debt down to market.)

   Logic says that if a Company’s credit rating goes down, then the company is in worse shape than it was. SFAS 157 seems to imply that if the liabilities are now rated lower, then in theory, the Company could buy them back cheaper than if they are higher rated. SFAS 157 labels this difference as an income item and lower liabilities increases shareholder equity.

2. SFAS 157 prefers “market data obtained from sources independent of the reporting entity (observable inputs) over the reporting entity’s own assumptions …” (so-called unobservable inputs). SFAS establishes 3 levels of priority in developing fair values. Level 1 is the exit market price, (before transaction expenses) of shares of an identical security in an active market, which is also described as the most advantageous market for such security. Level 2 is the market price of similar securities and Level 3 is a price based upon inputs or calculations of the reporting entity.

   The financial institutions have used similar mark-to-market provisions for exchange-traded securities for a few years. The difference is that FASB wants the financial institutions to use SFAS 157 for all securities.

   a. Consider a local bank. If the bank negotiates with a borrower and writes a Jumbo Mortgage for $1,000,000 (This is a non-conforming mortgage since it is larger than Fannie Mae will accept.), then the bank wants to put that mortgage on its books as a $1,000,000 asset. The bank negotiated the rate and terms with the borrower and the bank considers $1,000,000 to be the current market value of the mortgage asset. Now, say the Lehman bankruptcy trustee sells a pool of similar jumbo mortgages for 60% of the remaining mortgage balances or Secretary Paulson does a reverse auction and buys similar assets at 60% of face. The subject bank's auditors could apply SFAS 157 to the $1,000,000 mortgage and record a $400,000 reduction as a "mark-to-market" adjustment. (The SEC's 9-30-08 Release 2008-234 could provide relief on this issue, but definitions and clarification are still needed.) The new guidance from SFAS 157 is that market data should be obtained from sources independent from the reporting entity. This seems backwards, since it would seem that the banker's negotiations established the highest and best market.

With SFAS 157 provisions controlling valuations, how many Jumbo Mortgages will a bank want to write? How many new sub-prime mortgages, or Alt-A mortgages can the bank afford? How many deductions can they sustain in their capital? So while SFAS 157 might have worked when markets were calm, or with exchange-traded assets, it could cause a real mess when the markets decline or with non-exchange-traded assets.

Where is the logic? The old rules instructed the bank to put the mortgage on the books at face and adjust the value later, if impaired. If the bank's negotiation with the borrower is not the market, then why would the bank take the risk of writing any non-conforming mortgage? Why risk an immediate accounting write-down? How does the application of SFAS 157 to this Jumbo Mortgage market help transparency?

A corollary to the above example is what if the terms of the mortgage required more capital from the borrower every time the house went down in value? Say the mortgage had its own mark-to-market provision with the borrower. So if neighborhood home prices declined, the bank could request additional principal from the borrower. (I can't imagine any borrower voluntarily agreeing to such terms.)

b. How do financial institutions, such as regional banks, gather the trade data on non-exchange assets to determine Level 1 or Level 2 prices? Where is this data published? For example, for over 20 years, *The Direct Investment Spectrum* magazine has collected and published data on trades of non-exchange, limited partnership fractional interests. I'd estimate that the Spectrum gathers data on 10% to 30% of the limited partnership trades. (It does not cover mini-tenders or general partner buy-backs or trades through the major broker/dealers. Contribution of trade information is voluntary.) Is there a similar published source for trades of CDOs, CMOs, Alt-A mortgage funds, jumbo mortgage funds, credit-default-swaps etc.? How are the assets from reported trades similar or different from assets held by a specific financial institution? What discounts or premiums are appropriate? Where is the guidance?

c. Banks and other financial institutions are used to dealing with credit risk. It appears that SFAS 157 adds market risk to the valuation equation. While this might be appropriate for trading assets, it seems inappropriate for assets that are to be held to maturity.

d. SFAS 157 requires prices from an "active market" but doesn't specify how many trades it takes to determine such a market. (This "active market" issue has been litigated for years in connection with IRC 2031 and IRS Revenue Ruling 59-60. The court decisions are very diverse on this issue.) How many exchange trades does SFAS 157 want in order to determine an "active market"? For example, what if data was available for one similar security sale one quarter and 15 similar trades the next quarter? Is the first quarter a "Level 3" and the second quarter a "Level 2" under SFAS 157?

e. How do the financial institutions know if reported trades are "disorderly transactions"? Who determines if any impairment is temporary? (SEC Notice 2008-234)

f. At financial institutions, declines in asset values can lead to inadequate capital ratios and the need to raise capital when prices are low. Then if the asset values go back up in a subsequent quarter, the financial institutions are still saddled with diluted ownership. For example, if a bank holds a portfolio of municipal bonds yielding 5% and the market goes to 10% on similar bonds, then SFAS 157 specifies that the bank must take huge write-downs, even if the intent was to hold the municipal bonds to maturity, unless the bank can somehow determine that the 10% trades were disorderly or that the impairments are temporary. Then later when the municipal prices improve or when the bank's municipal holdings mature, the capital ratios suddenly get healthy. It is illogical to apply SFAS 157 to such assets when the intent is to hold them to maturity.

g. SFAS 157 puts additional strain on public companies, which further burdens them in competing against private financial companies, such as various hedge funds. Hiring appraisers is expensive and the "Mark-to-Market" information is subject to rapid change.

h. It would seem that if a bank owns a mortgage pool with a 20% delinquency, then logic says the current market value should be at least 80% of the face value. (Or to put it another way, the performing loans are carried at cost and the non-performing loans are carried at an impaired value.) Currently the bank could expect to receive approximately 80% of the original principal plus interest plus something from the foreclosure of the delinquent 20%. Under the old rules, if the bank CEO or CFO felt they were carrying the asset at too high of a value, they would report an estimated impairment and move on. Under SFAS 157 life gets complicated. What similar pools have sold? When did they sell? How were the pools similar or different? What were the sale prices? What is an appropriate valuation premium or discount to the reported trades? Were any of the reported sales distressed or disorderly?

In addition, the SEC 2008-234 Release asks the holders to determine "whether impairment is other than temporary". The SEC directs the holder to consult "SAB Topic 5M", in case things are unclear in the 100+ pages of SFAS 157 or the amendments 157-1 and 157-2 or the SEC's Release.

In addition to the above, the situation could easily get much worse. For example, Treasury Secretary Paulson is supposedly going to try to re-start various markets. His proposed actions could cause massive problems with SFAS 157 write-downs.

The news media has suggested that Secretary Paulson might try reverse auctions to re-start various markets. However, under SFAS 157 the trades from Paulson's reverse auctions (or other purchases by Paulson) could establish market values at artificially low prices. This would present quite a dilemma for the financial institutions. Financial Institutions could sell to Paulson or mark their mortgage pools, CDOs, CMOs, auction-rate municipals or other assets down to the prices from Paulson's auctions. (For example, if the financial institutions are carrying the assets at 80% of face and Paulson's highest reverse-auction price for similar assets is 40% of face, the institutions who don't sell have a big problem.) **Either way, the public Banks' (and public brokerage firms') capital is reduced, earnings suffer by the SFAS 157 type adjustments to asset values and loan ratios suffer. Rather than stabilizing or restarting the markets, we could easily see a continuation of the current snowballing and freezing up, since financial institutions are hesitant to add assets that could be marked down by forced compliance with SFAS 157.**

In summary, SFAS 157 might be fine for determining a market value for trading assets with active markets on various exchanges, but it can cause wide valuation swings when applied to long-term assets or non-exchange assets or assets that are being held to maturity. When dealing with such assets, the SFAS 157 provisions cause confusion rather than adding transparency and SFAS 157's use of terms such as "Mark-to-Market" and "fair-value accounting" are misnomers that ignore how the non-exchange markets really work. The SEC needs to throw out SFAS 157 for non-exchange assets and allow the public financial institutions to apply the rules that they have used in the past.

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