

FAS Rule 157, Write Downs & Risk - Randomly Activated Hidden Contingencies (“RAhC”)

The finance, accounting and legal structure of the securitized mortgage system is riddled with randomly activated hidden contingencies (“RAhC”), the extent of which is still unknown. We must ask who was zooming who? Who’s responsible and why? Since the answer is everyone from Congress to Wall Street with Main Street in-between, let’s jump to the solutions. The same-old just doesn’t work anymore. We need new solutions and improved mortgage business models. It’s a new world out there, and we must take it back – together.

The fact that secondary market participants purport to rely upon mere contractual ‘put’ “representations and warranties”, “repurchase”, and “indemnification” obligations of the lending originator, must cause us to wonder whether this is a new level of legal, accounting and finance genius, malpractice or something more cynical. Did we really expect that a thinly capitalized originator made insolvent from indemnity claims and repurchase buyback demands could make good on such subprime or bad loans? Or was this just a hollow promise made with the intent to drive such lenders into insolvency (and/or bankruptcy) based upon a belief that bankruptcy remote assignee trusts could not be reached by creditors. What is this system called; the “fall-guy” system, or “it all rolls downhill” system?

The fact that we are still *debating* whether or not the banks must put these CDO (of ABS, etc.) assets back on their balance sheets and take (its) losses underscores the incestuous complicity inherent in our ‘system’. Is this what Enron taught us? Is this what we mean by transparency? On November 15, 2007 FAS Rule 157 was to mandate the reporting of such losses under a “Fair Value Measurements” method, instead the Board delayed the implementation date for one more year (www.marketdevaluation.com). These rules, to date, have allowed delayed or underreporting of losses on the balance sheet and income statement, adding to the “uncertainty” and problems in the industry. Estimates of losses range from \$100B to \$200B-\$450B. No one is sure what this means. Are these losses from marking to market, or marking to model, and how much of these are actual losses from sales? What would the losses really be if Rule 157 forced ‘fair value’ losses to be realized?

FAS Rule 159 (“The Fair Value Option for Financial Assets and Financial Liabilities”) is set to take effect on January 1, 2008. Will it be delayed also? Rule 159 will allow Credit Unions bring any balance sheet item in line with fair value measurements by adjusting cost basis to retained earnings capital, thereby circumventing the income statement. Rule 159 also requires use of Rule 157. This rule may afford opportunities for credit unions with ample capital (retained earnings) to increase margins and investment yields by lowering interest expense.

Fair Value will also and currently does touch the reporting of derivative and embedded derivative transactions under FAS Rule 133 and FAS Rule 155, as well as Stock Options (Rule 123R), and *Securitization (and Servicing Rights) under FAS Rule 156*.

How will these rules change the reporting and ‘losses’ estimated in the marketplace today? The argument for Fair Value includes the concept that the current “historical cost” balance sheet reporting does not accurately reflect a company’s current economic state. The counter arguments include the uncertainty of how to value assets and liabilities that have no current active market. Presently the markets are driven by “earnings” as reported in the income statement. The change to Fair Value will may shift focus from the income statement to the balance sheet. We may also see some more uncertainty in the pricing of mergers and acquisitions (“M&A”) as Fair Value acquisitions would require more balance-sheet reporting of present value of contingent payments based upon assumptions of the “likelihood of materializing” and lessen the expensing of after close payments.

Fair Value may require marking debt to market. This may affect financing growth with debt unless an offsetting hedge against same is also disclosed on its balance sheet. Interest (ownership) in other companies may allow for enhanced mark to market balance sheet reporting of same over historical cost.

FAS Rule 157 states in part:

Differences between This Statement and Current Practice

The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

The definition of fair value retains the exchange price notion in earlier definitions of fair value. This Statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

This Statement emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, this Statement establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity’s own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The notion of unobservable inputs is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In those situations, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity must not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

This Statement clarifies that market participant assumptions include assumptions about risk, for example, the risk inherent in a particular valuation technique used to

measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. A fair value measurement should include an adjustment for risk if market participants would include one in pricing the related asset or liability, even if the adjustment is difficult to determine. Therefore, a measurement (for example, a “mark-to-model” measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

This Statement clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. A fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset. That guidance applies for stock with restrictions on sale that terminate within one year that is measured at fair value under FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*.

This Statement clarifies that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity’s credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

This Statement affirms the requirement of other FASB Statements that the fair value of a position in a financial instrument (including a block) that trades in an active market should be measured as the product of the quoted price for the individual instrument times the quantity held (within Level 1 of the fair value hierarchy). The quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor). This Statement extends that requirement to broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

This Statement expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs (within Level 3 of the fair value hierarchy), the effect of the measurements on earnings (or changes in net assets) for the period. This Statement encourages entities to combine the fair value information disclosed under this Statement with the fair value information disclosed under other accounting pronouncements, including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, where practicable.

The guidance in this Statement applies for derivatives and other financial instruments measured at fair value under Statement 133 at initial recognition and in all subsequent periods. Therefore, this Statement nullifies the guidance in footnote 3 of EITF Issue No. 02-3, “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.” This Statement also amends Statement 133 to remove the similar guidance to that in Issue 02-3, which was added by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*.