November 13, 2008

Securities and Exchange Commission (SEC)
Attention: Florence E. Harmon, Accounting Secretary
100 F Street, NE
Washington, DC 20549-1090
Reference File No. 4-573
Email: rule-comments@sec.gov

Subject: MBA's Comments for "SEC Study of Mark to Market Accounting", under the Emergency Economic Stabilization Act of 2008

Ladies and Gentlemen:

Mortgage Bankers Association[1] (MBA) welcomes the opportunity to comment on the proposed SEC study of the application of fair value accounting in the current, inactive credit market environment. The study was chartered under the Emergency Economic Stabilization Act of 2008 (the Act), which was enacted and signed by the President on October 3, 2008. The Act requires the SEC to conduct a study of "mark-to-market" accounting and submit a report to Congress within 90 days.

MBA applauds the SEC for studying the impact of "mark-to-market" accounting on financial institutions in the current inactive credit market environment. In addition, MBA applauds the SEC and the Financial Accounting Standards Board (FASB) for issuing their joint press release on September 30, 2008, which provided guidance for how management's internal assumptions should be considered when measuring fair value when relevant observable data does not exist.

1 The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 370,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

MBA has been a consistent supporter of the FASB's long-standing objective of migrating from accounting based upon amortized cost to standards where certain assets and liabilities are carried at fair value.

MBA notes that fair value accounting, as defined in various pronouncements over the years and updated in Statement of Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), was never "test driven" in an inactive or illiquid market environment. MBA believes that interpretations for the use of fair value in inactive markets have resulted in a pro-cyclical impact in the current credit market crisis. MBA submits the following comments and observations for the SEC's consideration in planning its study of mark-to-market accounting. MBA's members are not unanimously in support of all of the points in the following, but believe that the SEC should consider the observations below in its study. MBA's comments are organized in accordance with the six questions that the Act sets forth for the proposed study.

<u>SEC Study's Stated Focus</u>

(1) ***The effects of such accounting standards on a financial institution's balance sheet;***

MBA Response:

Some of the problems that MBA has observed that are inherent in fair value accounting as applied today by financial institutions are listed below. MBA encourages the SEC to examine these issues in its study.

- Fair value accounting focuses on the value that an enterprise could sell its assets today. It is often "blind" to management's ability and intent to hold certain assets longer term as investments. It also is "blind" to the duration matching of specified assets with specified liabilities.
- Fair value measurements are challenging for assets traded in less active markets and extremely challenging when markets become inactive or illiquid.
- Fair value as defined in FAS 157 and interpreted by various accountants and regulators has generally contributed to a higher volatility of reported earnings, especially in an inactive market situation.
- Fair value measures based upon the concept of "exit price" may be inappropriate if the enterprise's strategy is not to sell the asset in the near term. This is especially true in an inactive market.

(2) ***The impacts of such accounting on bank failures in 2008;***

MBA Response:

The pro-cyclical impact of FAS 157 has been described recently by many authors and speakers in different venues. These are summarized as:

- Initial markdowns (based upon estimates of real economic losses) lead to margin calls on debt or capital shortages
- The margin calls or capital shortages lead less capitalized entities to make sales into an inactive market or obtain capital from sources they may have otherwise not considered
- These sales provide “observable market evidence” further impairing values
- Leading to mark downs by all market participants holding that asset at “fair value”
- Leading to additional sales resulting from margin calls or capital shortages by the original list of troubled institutions, joined now by additional institutions experiencing margin calls on debt or capital shortages as a result of the mark to recent distressed sales
- These additional sales provide “observable market evidence” further impairing values
- Leading to mark downs by all market participants holding that asset at “fair value”
- On and on in a downward spiral

And, the disturbance in one market adversely affects other markets by:

- Impacting the level of confidence in credit rating agency ratings in other markets
- Forcing sale of other debt instruments to meet capital requirements and margin calls
- Use of Level 2 observations in one market to infer a value in other similar markets (for example use of Alt A MBS sale to infer a value for a subprime MBS in the absence of a recent subprime MBS sale)

MBA believes that fair value accounting is not the driving force causing bank failures. However, MBA believes that the narrow interpretations by some accountants and some regulators as to the application of fair value accounting in inactive markets have in fact magnified reported losses of banks, reducing reported regulatory capital. MBA believes that this pro-cyclical impact may have been a contributing factor to bank failures in 2008. MBA recommends that the SEC study, in consultation with the Board of Governors of the Federal Reserve, include a review of the largest bank and savings and loan failures during 2008 to determine the impact of fair value adjustments in inactive markets on the reported capital of those institutions, and the resulting impact on “run on the bank” or regulatory action taken to close or force a merger of subject banks. The

Board of Governors of the Federal Reserve may want to extend the study to other financial institutions that have not yet failed but are under significant regulatory scrutiny due to anemic capital ratios to determine the extent that the capital problems may relate to fair value measures in an inactive market.

(3) ***The impact of such standards on the quality of financial information available to investors;***

MBA Response:

Fair value as measured under FAS 157 is a calculation of liquidation value at the balance sheet based upon the last trades during the last hour of the last day of the quarter. This may be an appropriate measure for an investment fund like a mutual fund, but may be inappropriate for a bank or savings and loan association that has no intention to sell certain assets or repay specific liabilities in the near term. SEC and accounting standards setters should consider an alternative measure of management's performance, one based upon a longer term investment value. Liquidation value has its place under GAAP in measuring assets and liabilities in a situation where there is significant liquidity or going concern issues. However, it may be inappropriate for measuring the value and performance of healthy financial institutions.

(4) ***The process used by the Financial Accounting Standards Board in developing accounting standards;***

MBA Response:

MBA is a firm believer that accounting principles should be set by an independent body such as FASB.

Most of the recent controversy surrounding the FASB relates to fair value accounting in the current inactive market. MBA observes that the FASB's process around fully vetting FAS 157 and Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159) generally seemed to work. As indicated above, fair value accounting could not be "test driven" in the current market environment. Nonetheless, a test period wherein companies would work with live examples and share the results and complications of applying the standard with FASB would be preferable.

Generally, the FASB's protocol for developing and vetting accounting standards is adequately designed. However, MBA offers the following as areas that the SEC's study of the effectiveness of FASB's rulemaking process in practice should focus on:

- MBA observes that in the past, the accounting principles with the most implementation problems and inconsistencies often occur in reaction to a crisis. FIN 46 was rushed in reaction to the Enron crisis. It required almost immediate amendment and numerous staff interpretations. The current revisions to FIN 46(R) and FAS 140 are being rushed to the finish line in reaction to the current credit market crisis. If enacted as presently drafted, these principles would require an enterprise to recognize assets it does not control and liabilities that it does not have a present obligation. MBA believes that robust disclosure requirements could adequately bridge the gap of addressing the crisis while the standard is fully tested.

- The vetting process for complex accounting principles should include robust field-testing by various enterprises using real transactions. The results of the field testing should be shared with and considered by FASB.
- The transition rules should allow sufficient time for enterprises to design and fully test controls around the new accounting processes.
- Frequently the exposure periods for proposed pronouncements are too short, and the period becomes even shorter when "roundtable discussions" are accelerated.
- MBA observes that FASB often makes few substantive changes between an exposure draft and the pronouncement ultimately issued--- even when the comment letters and roundtable discussions are consistent in pointing to potentially serious flaws in the proposed guidance. FASB explains some of its reasoning for rejecting such proposed changes in its "basis for conclusions" appendix to pronouncements. However, that process needs to be more robust. At a minimum, FASB should specifically reconcile the most frequent comments received for an exposed document with the issued document, highlighting the reasons the guidance in the comment letters was not incorporated and the issued guidance preferred.
- MBA believes that proposed accounting standards that will introduce accounting principles and models that are dramatically different from existing principles or standards or that could result in a material impact on markets or the economics of transactions should require more study. For example, MBA commented to the FASB on its most recent proposed amendments to FAS 140 and FIN 46(R) that the FASB should undertake a study of the proposed standards with the following objectives:
    - To determine whether constituents would be better served by allocating resources to advancing the joint FASB/IASB convergence.
    - To include an assessment of the cost/benefits associated with switching from existing standard to the proposed standards and then again switching to a GAAP/IASB standard in a relatively short period of time.
    - To determine whether the newly consolidated financial information under the proposed statements would provide users with more useful information than would be provided through enhanced disclosures.
    - To study the extent to which the proposed statements would discourage securitization transactions, thereby reducing the availability of credit and increasing interest rates.
- In the absence of a thorough FASB study of new standards, perhaps the SEC should study all new standards prior to issuance.

- FASB tends to rush the decision process on standards without fully testing the standards with real life examples. Frequently the examples used in the statements themselves are clear-cut examples that do not fully test the clarity and functionality of the statement.
- Further, in the absence of clarity in the statement and examples, accountants and regulators frequently come up with their own, often draconian, interpretations. MBA believes that this occurred with respect to the application of FAS 157 in today's inactive market. In various speeches and publications, the FASB staff, SEC staff, large accounting firms, and bank regulators have expressed views about the use of fair value accounting in an inactive market environment. These views required the use of Level 2 measures from the few transactions that do take place as long as there were 1) multiple bidders in the sale or 2) the asset sold was exposed to the market for a customary time. In order to ignore a transaction, the FASB itself has set the hurdle high. In an appearance at an American Enterprise Institute conference on fair value accounting on April 8, 2008, Leslie Seidman from the FASB stated, "…a distressed sale would be a very unusual occurrence in the marketplace. One transaction that I've heard of that people seem to readily agree is a distressed sale is the price of Bear Stearns, for example, two dollars in a weekend agreement…" Leslie further commented, "…when you look at other situations where people are having to sell assets to meet collateral calls, et cetera, et cetera, you need to ask a lot more questions….Are there many willing buyers of those assets? That might suggest that that is not a distressed sale even though the seller is in distress."[2]

(5) ***The advisability and feasibility of modifications to such standards.***

MBA Response:

MBA believes that the guidance that the SEC and FASB provided in the joint press release on September 30 and that FASB provided in its subsequent FSP FAS 157-3—*Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP) were a good starting point to guide enterprises on how management's internal assumptions should be considered when measuring fair value when relevant observable data does not exist. In its comment letter on the exposure draft of the FSP, MBA observed that in the current market, additional conditions may arise requiring further clarification by the FASB and FASB staff. MBA believes that the SEC study should include a survey of publicly-held financial institutions to specifically identify

[2] Leslie Seidman, Transcript from presentation at April 8, 2008 symposium, *What is Fair Value and Why are People Concerned About It?,* pages 11 and 12.

practice issues that remain after the press release and FSP guidance. In addition, MBA believes that the SEC should:

- Determine if the characteristics that are currently considered to determine if the market for a particular security is inactive are significantly robust.

- Study the impact of FASB's example in the FSP that appears to require the use of a liquidity risk factor based upon recent sales in an inactive market. This appears to be having a "circular" impact. On the one hand, FASB is guiding toward use of future cash flow models in an inactive market but, on the other hand, requiring the use of a liquidity factor from infrequent, observable sales that may be distressed. The results of such cash flow models are similar to using the distressed sale results themselves. MBA believes that this will further the pro-cyclicality impact.

(6) ***Alternative accounting standards to those provided in Statement Number 157.***

MBA Response:

MBA recommends that the SEC explore the following alternative standards to those provided in FAS 157:

- FAS 157 articulates a fair value standard that attempts to measure the price that financial assets and liabilities could be sold for at the balance sheet date. This appears to provide information that investors desire. However, most banks and savings and loans are not managed as a trading portfolio. Rather, most assets will not be sold in the near term, but will be realized upon maturity, prepayment by the obligor, or, in some cases, future sales. It is for this reason that many managers of financial institutions complain that fair market value accounting does not present fairly the results of operations. Rather, operating results are based upon where the market lands at quarter end. The concept of using of an "exit price" as a fair value measure appears inconsistent with an asset that will not be sold in the near term.
- FAS 157 provides for a hierarchy of fair value whereby Level 1 inputs (quoted market prices in an active market) are preferable to Levels 2 inputs (inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly) which are preferable to Level 3 inputs (unobservable inputs for the asset or liability). MBA believes that, after observing fair value measurements in the current economic environment, in certain cases using a model value is preferable to using a measurement from a sale in an inactive market. Alternative hierarchy guidance should be considered. Normally in an efficient market, fair value and the value that is derived from the present value of future cash flows (intrinsic value) are pretty much aligned. However, fair value in an inactive market, as evidenced by the most recent trade, and intrinsic

value often diverge. Perhaps one of the triggering events for the consideration for use of mark-to-model should be the point when Level 2 inputs and intrinsic values significantly diverge.

- If an enterprise has the ability and intention to hold a financial asset until its investment is realized, it may not be appropriate to use the liquidity risk discount inherent in recent trades in an inactive market.

Looking Beyond the 90-Day Study

Although Congress only allotted 90 days for the SEC's study of "mark-to-market" accounting, MBA believes that perhaps the SEC and accounting setters should initiate a broader analysis after the initial study that would assess where we are on the fair value project and determine strategically where we go from here. There is a growing conflict of opinion on the usefulness of fair value accounting as now envisioned in the accounting rules. Investors favor the measurement of the values of assets and liabilities were they to be liquidated at the balance sheet date. Management increasingly believes that such accounting in certain cases is short-sighted and does not take into account the way management runs the business – which is a longer term view of managing the duration risks and credit risks of assets and liabilities to optimize cash flows on a longer term basis. MBA believes that it is time for accounting setters to think "outside the box" to find a financial presentation model that will capture the business strategies related to financial asset/liability management while still providing investors with a liquidation value that they are intent on having.

One idea that should be considered in such a strategic study is whether the end game of fair value accounting should accommodate the enterprise's desire for the balance sheet valuations to be consistent with the enterprise's intention for the financial asset or liability. Assets and liabilities in the first column of this model would use the level of measurement in FAS 157 that best captures the enterprise's intent to hold the asset or liability. For example, trading accounts would be measured based on the existing hierarchy while assets available for sale or held to maturity would be measured perhaps based upon the present value of future cash flows. The second column on the face of the balance sheet or a disclosure in the notes to financial statements would capture what investors want to see – the value of financial assets and liabilities if they were to be liquidated at the balance sheet date.

Concluding Remarks

MBA continues to support the FASB's long-term objective of migrating to a fair value accounting model. MBA believes that accounting standard setters need to step back and take a hard look at what they desire to accomplish with the long-term fair value project to see if an accounting model can be designed to satisfy the sometimes conflicting information needs of management, debtors, and investors.

Likewise, additional specific guidance is needed to prevent further pro-cyclical impacts of fair value measurements in today's illiquid credit markets.

MBA believes that accounting principles should continue to be promulgated by an independent body like the FASB. However, MBA believes the SEC's study should address specific concerns expressed in MBA's response to (4) above.

MBA appreciates the opportunity to share its observations and recommendations as to the role of fair value accounting in the current market crisis. We would be happy to meet with the Commission to discuss our comments and observations. Any questions about MBA's comments should be directed to Jim Gross, Associate Vice President and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Most sincerely,

John A. Courson

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