

FASB Rules Bring Clarity to Fair Market Value, Says Clayton

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The return on private-label residential mortgage-backed security (RMBS) investments during the last several years resulted in a “constant stream of disappointment,” **Clayton Independent Pricing Service** (IPS) said in a recent review of ongoing valuation problems and accounting policy responses. IPS provides third-party, fair market pricing of mortgage- and asset-backed securities for fixed-income managers and investors.

In an effort to help security owners and investors better understand the real value of these assets in the midst of disappointing returns, the **Financial Accounting Standards Board** (FASB) established Financial Accounting Standard (FAS) 157, which as of early 2008 requires institutions that report to the **Securities and Exchange Commission** (SEC) to clarify statements about fair market value of each investment security they own.

“What has exacerbated the difficulty of applying the new accounting rules is the lack of observable liquidity (read: active trading of the securities) in the marketplace,” the IPS report reads. “The number of dealers who historically traded residential mortgage bonds and thereby directly supported the market has shrunk from as many as twenty active participants to a small handful of names that are less willing to commit capital to the sector than they had in past.”

The report adds: “If RMBS were trading freely between deals and investor portfolios, finding the current ‘fair market value’ of a security would be relatively easy and the related credit pricing spreads would be apparent.”

FASB then clarified the practical use of valuations. With the formation of FAS 115, FASB requires an investor to categorize the assets they purchase into one of three categories: trading, available-for-sale or held-to-maturity (held-for-investment).

Within the trading portfolio, assets must realize any increase or decrease in value as the individual securities are either marked up or down with fair market value changes.

Under the available-for-sale portfolio, assets are typically securities the institution does not wish to trade right away or hold until the assets mature. The valuation marks on these investments are unrealized gains or losses that go against equity at the point of realization.

The held-to-maturity portfolio contains assets the institution intends to hold until maturation. The assets are measured on the investor's books at amortized cost and all unrealized marks are recorded as "other comprehensive income" and merely show the theoretical price decline that would occur if the security instruments were liquidated at the current price.

"What complicates the simple application of the valuations of both available-for-sale and held-to-maturity assets is the accounting concept of 'other than temporary impairment', which is also covered under FAS 115," IPS said.

If an impairment is other than temporary, the cost basis of the security must be written down to fair value, and the amount of the write-down must be put in the earnings as realized loss. Following this write-down, any recovery of fair value for both an available-for-sale or held-to-maturity security cannot be recognized in earnings until the security is sold or until it matures.

These clarifications, along with other revisions that came along in response to the ensuing price erosion — when poor collateral performance kept RMBS buyers away, which pressured prices and led to further write-downs — have brought a sense of clarity to the issue of fair market value.

According to IPS: "The combination of these revisions ensure that the intended purpose of fair value transparency is still in place, but now the results bring greater accuracy about an asset's true worth in terms of how an investor intends to manage and own its portfolio holdings."