



HIDDEN GEMS

RECONCILING NEW LAWS, RULES & BEST PRACTICES GUIDANCE

SHOULD FAS 157 (FAIR VALUE MARK-TO-MARKET ACCOUNTING) BE SUSPENDED?
IS FAS 157 (FAIR VALUE ACCOUNTING) CREATING OR FEEDING THE
DOWNWARD FAIR VALUE SPIRAL?

CAN WE, OR SHOULD WE, IMPLEMENT PRINCIPAL FORGIVENESS MODIFICATIONS THAT
DO NOT REQUIRE SEVERE & IMMEDIATE LOSS WRITE-DOWNS OR
MODIFICATIONS THAT DO NOT REQUIRE PRINCIPAL FORGIVENESS BUT ENHANCE
BORROWER AFFORDABILITY?

SHOULD WE EMBRACE NEW MODIFICATION ENHANCEMENTS UNDER HR 1424?

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Overview Agenda

- 1) Overview of Current Problems or Issues
- 2) \$700 Billion Plus Rescue Law: HR 1424: “Emergency Economic Stabilization Act of 2008”
- 3) \$300 Billion Voluntary Short Payoff Refinance Law: HR 3221: Housing and Economic Recovery Act of 2008.
- 4) SEC & FAS Update re FAS 157 (Fair Value Mark-to-Market Accounting). Alternatives to Fair Value Severe Write-Downs!
- 5) Wilbur Ross: New Modifications & Solutions
- 6) New Principal Reduction or Forgiveness Solutions that Do Not Forgive or Write-Down Losses at Outset (QBieSam™)

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

Update of Recent Urgencies:

The latest emergencies that our government responded to are the frozen inter-bank and commercial paper relationships, and the implementation of its new authority to **invest** in financial institutions, and **insure** or **purchase** troubled mortgage assets.

This was/is all occurring upon the backdrop of screams from the banking industry to suspend Fair Value Accounting (FAS 157); to avoid additional (unwarranted) write-downs, and further capital and covenant impairments that would cause more going-concern failures. **The debate should now ask:** Has Fair Value Accounting caused excessive write-downs? Has Fair Value Accounting caused unwarranted loss of banking and lending entities? Has or Will Fair Value Accounting Create Unnecessary Damage to the Broader Economy; Feeding the Downward Fair Value Spiral?

1) Overview of Current Problems or Issues

Have we marked below Fair Value?

Item	Value Example	Detail
Mortgage Value	\$100	If 12% defaults with 50% loss (or 6%); the holder would lose \$6 of \$100 and get back \$94.
Approx. Price	\$75	If would trade at \$75
Treasury Potential Profit	\$25 Plus Bond Coupon Payments	If 75% subprime current and 25% default/foreclose; at 50 cents/dollar recovery rate; the bond is worth 87.5 cents Source: CNBC
		If marked to 22-25%, to 65; Fair Value is higher
Expected Receipt of Principal and Interest and Appreciation should also be factored into Fair Value (or Equivalent Fair Value ("EFV"))	Expected Cash Flow (discounted per GAAP) must also be factored in to raise Fair Value.	Factor: Expected Insurance or CDS Recovery if not wiped out in excessive write-downs

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

On October 10, 2008, the world waited for more specific guidance from the FASB on how to apply or not apply FAS 157 (Fair Value Accounting). October 10th, came and gone with little if any useful clarifications. The Chairman of FASB was quoted as saying that fair value accounting was not intended in times of illiquidity or disorderly markets (transactions), but could offer no alternative course of action.

The SEC has the power to suspend FAS 157, and that power was reaffirmed in the new law (HR 1424). The banking industry is calling for the suspension of FAS 157 and fair value accounting. The investors groups are opposing its suspension.

The last 2 weeks saw another example of the dire need for leadership. As the third quarter ending September is closed, and the 4th quarter close is fast approaching, the world looks to the US for guidance with no help in sight. We just keep breeding more damning uncertainty.

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

How Much More Financial Pain is in The System?

In the last 2 weeks we have seen the largest weekly decline in the stock market, in its 112 year history (1800 points or 18%; CNN).

Experts estimate that we have some \$62 Trillion in notional exposure on credit default swaps (CDS); the insurance on default. We currently have no reconciliation or clearing house, or rules or laws, that govern the settlement of these CDS devices. There are efforts underway now to create a CDS trading and clearing house. Such efforts would require the US Government to guarantee the settlement of these CDS transactions. Although critical, is it too little too late? Last Friday some \$400 billion of CDS protection on Lehman were auctioned. The 3 month Libor was at 4.819 and the ted-spread was at 4.326. The pricing was at 9.75% which would require about \$360 billion. Sellers of CDS protection on Lehman may have to come up with 91 cents on the dollar. What are these CDS worth? They have already been written down per Mark-to-Market (Fair Value Accounting).

Moreover, the corporate markets may be worse off. Spreads continued to widen. Counterparty risk fear is at an all time high. Muni bonds traded at triple risk levels from just three months ago. High yield bonds traded at 1200 bps or 12% over swaps.

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

How Much More Financial Pain is in The System?

It is estimated that we have written-off some \$500 billion under Fair Value Accounting. If banks can lend \$10 for every \$1 of capital, \$500 billion of loss capital would result in \$5 trillion of lost lending capacity.

Some estimate that we have seen over \$1.1 trillion in asset destruction as a result thus far. Billionaire Wilbur Ross estimates that lenders have lost some \$13 trillion in lending capacity (if \$1 of equity supports \$12 of assets). Mr. Ross also estimates that home property values in the United States have fallen from its \$20 trillion peak (at least 10% if not 15% or more). For every 10% home price decline, \$2 trillion is lost in the personal net worth (wealth) of the American people (\$7/\$100). For each \$2 trillion of price decline, \$140 billion is lost in consumer spending (or 1% of the GDP of America).

Hidden GEM Observation: We need to consider an immediate central reconciliation clearing house (CDS Exchange) for CDS devices to establish counterparty risk and pricing. We also need a resolution system (regulations, authorities, funding facilities) to define how to deal with failing non banks and large financial institutions.

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

With gas, oil and product prices rising, consumers are strapped with credit card debt in amounts that cause homeowners to choose between paying their mortgage or their credit cards (and auto payments). As consumers support about 70% of the American GDP, and incomes have not kept pace with prices, consumers are on the brink of default and financial ruin. The delay to implement (en mass) sensible mortgage loan (or principal) modifications, and consumer credit card modifications that maintain FICO scores, may have caused another buildup of potential defaults, delinquencies, foreclosures or repossessions, especially as 1.7 million to 2.0 million ARMs are expected to reset to unaffordable monthly payments, in 2008-2009. We are in the midst of a very serious U.S. and world economic crisis in want of new (creative) solutions.

When free markets allow “5 million homeowners” (9/19/08 Paulson, Press Room) to incur delinquency, default, or foreclosure and potentially become homeless, and the broad economy is threatened with recession (or worse), and the money and capital flow freezes (worldwide), capitalism falls to its knees begging for refinement and new creative solutions that serve all market participants including the borrower.

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

Government Response:

Most recently, the Treasury has announced its intention to **invest in preferred non voting stock** of major financial institutions. Also, the Federal government has **guaranteed interbank transactions, and private entity commercial paper transactions.**

Until recently, the government has proposed new Treasury authority to purchase mortgage-related assets and establish a temporary guaranty program for the U.S. money market mutual fund industry, consolidated the regulators, granted authority to Investment Banks to use the Discount Window, created facility auction funds, lowered interest rates, caused an historic take-under, and used conservatorship to take-over the GSEs. Additionally, on July 28, 2008, Treasury Paulson, the FDIC, and four major banks, announced their support to create a “Covered Bond” market that would help create liquidity.

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

Government Response:

Covered bonds are mortgage debt that remains on the balance sheet of the issuer (bank or special purpose entity). Covered bonds should attract more investment monies as they provide the investor dual recourse from the “cover pool” and the “issuer.” Although the new U.S. covered bond device is a critical part of the overall solution, private label securitization and/or new credit enhancement products must return or be introduced into the market for the real estate market to recover. The U.S. Treasury reports that during the 2005 to 2007H1 private label securitization exceeded or was equal to funding by GSE (MBS). During such periods FHA remained fairly constant and insignificant. Balance Sheet Lending was about the same as the GSE (MBS) and private label securitization until 2007H2 and 2008Q1, where it decreased significantly. But private label securitization fell significantly in 2007H2 and almost ceased to exist by 2008Q1. This is the problem.

Private label securitization or the liquidity that it supplied the mortgage finance industry has all but dried up. Investors are not willing to put money into the securitization vehicles as it exists today for fear that they will lose their money with little or no recourse. During 2005, 2006, and 2007H1, private label securitization exceeded \$1 Trillion (\$1.2T). Now it is almost non-existent. For more information and the official Press Releases and Guidelines, visit www.ProCouncil.com and click on Covered Bonds (or www.USCoveredBondCouncil.com).

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

Most Recent Industry Position:

It has been reported that although the implementation date of October 1, 2008 for the new voluntary principal forgiveness modifications as authorized under HR 3221, has come and gone, many lenders and servicers are slow to enter the program, and otherwise **holding back** from processing mortgage “modifications”, as they wait for the Treasury to issue its new regulations, rules and letters necessary to purchase troubled mortgage assets under the **TARP program**. The holders (lenders, servicers, investors) desire to weigh its options between the short payoff refinance modification under 3221 and any potential changes that may be implemented by the TARP program modifications, even though it requires modifications pursuant to 3221. Since there is uncertainty as to the practical implementation, industry awaits more specific guidance.

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

Most Recent Congressional Position:

It has been reported that Senator Dodd and others will be seeking immediate legislation (before the Christmas Holiday) encompassing the following issues:

1. New Economic Stimulus Package for the People
2. Bankruptcy Modification Reforms
3. Moratoriums on Foreclosures
4. Guaranteed Modification Programs (Use of government (FHA) insurance or guarantees without the need for the government to purchase the troubled mortgage assets)
5. New Predatory Lending or Predatory Modification Laws
6. New Credit Card Reforms
7. Restrictions or Elimination of Broker Yield Spreads

1) OVERVIEW OF CURRENT PROBLEMS OR ISSUES

What to do?

If 90% (or 75%) of borrowers are paying their mortgage, has Fair Value Accounting written down below the true value of these assets. Since, FAS 157 was not intended to be a measure in illiquid or disorderly transactions or markets where “price” is not readily available, we must look to more realistic measurements. In simplest terms, we must consider **expected and actual cash flows, and new Modification devices**. Since credit default swaps are insurance policies on the MBS bonds, backed by home payments, shouldn't we look to the home payments as a measure? Shouldn't GAAP require us to use the best measurements that reflect the most accurate value of assets, especially in times of market destruction. Doesn't GAAP require us to look at the “**substance**” of the transaction or device we are measuring? FAS (financial accounting standards) require us to measure the extent of collateralization supporting the obligations, so we must ask: **Is there a Modification Device that can (en mass) increase the measure of collateralization to enhance value** to a more accurate Fair Value, or must we just throw our arms up and continue to apply non-reflective techniques in measuring Fair Value? **Or Should FAS 157 be suspended?**

2) New Solutions: HR 1424: The TARP program

Summary of the “Emergency Economic Stabilization Act of 2008”

Several weeks ago, the Paulson Plan grew from 3 pages to 110. Now we have a new law, HR 1424, commonly referred to as the **TARP Program**, which is 451 pages.

- **Stabilizing the Economy: Title I. Troubled Assets Relief Program.**
- **Section 101. Purchases of Troubled Assets.** Authorizes the Secretary to establish a Troubled Asset Relief Program (“TARP”) to purchase troubled assets from financial institutions. Establishes an Office of Financial Stability within the Treasury Department to implement the TARP in consultation with the Board of Governors of the Federal Reserve System, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision and the Secretary of Housing and Urban Development. Requires the Treasury Secretary to establish guidelines and policies to carry out the purposes of this Act. **Section 121 –** Establishes the Office of the Special Inspector General for TARP.
- **Section 115. Graduated Authorization to Purchase.** Authorizes the full \$700 billion as requested by the Treasury Secretary for implementation of TARP. Allows the Secretary to immediately use up to \$250 billion in authority under this Act. Upon a Presidential certification of need, the Secretary may access an additional \$100 billion. The final \$350 billion may be accessed if the President transmits a written report to Congress requesting such authority. The Secretary may use this additional authority unless within 15 days Congress passes a joint resolution of disapproval which may be considered on an expedited basis.

2) New Solutions: Will HR 1424: The TARP Program, Make Taxpayers Money?

Will the taxpayers profit from HR 1424? Pursuant to Bill Gross, Chair of PIMCO, says the Treasury will earn some \$25B per year on \$700B earning the spread between the Cost/Treasury Yield of (3-5%) and the Gross Treasury Yield (10-15%). Analysis (See Chart)

Item	Value Example	Detail
Mortgage Value	\$100	65 Cents on the Dollar; Foreclosure Rate of 20%; Recovery Value of 40%; Treasury earns 10-15%; Treasury owns equity return
Approx. Price	\$65	
Treasury Gross Yield	10-15%	
Cost Treasury Yield	3-5%	
Treasury Potential Profit	7-8%	

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- ▣ **Section 102. Insurance of Troubled Assets.** If the Secretary establishes the TARP program, the Secretary is **required to establish a program to guarantee** troubled assets of financial institutions. The Secretary is required to establish risk-based premiums for such guarantees sufficient to cover anticipated claims. The Secretary must report to Congress on the establishment of the guarantee program. It requires the Secretary, if TARP is established, to establish also a program to guarantee troubled assets **originated or issued before March 14, 2008, including mortgage-backed securities.**
- ▣ Establishes the **Troubled Assets Insurance Financing Fund for deposit of premiums collected** from participating financial institutions in order to fund such guarantee program. (GovTrack)
- ▣ **HIDDEN GEM:** The Guarantee Program may prove key in creating market certainty, as well as alternatives to fair value loss severity in the form of new loan guarantees and credit enhancements; and new Principal Forgiveness or Reduction Modifications. See Wilbur Ross Solutions, and QBieSam.

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- ▣ **Section 109. Foreclosure Mitigation Efforts.** For mortgages and mortgage-backed securities acquired through TARP, the Secretary **must implement a plan to mitigate foreclosures and to encourage servicers of mortgages to modify loans through Hope for Homeowners and other programs.**
- ▣ Directs the Secretary, to the extent that he or she acquires mortgages, mortgage backed securities, and other assets secured by residential real estate, and the Federal Housing Finance Agency, as conservator of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), to implement a plan to maximize assistance for homeowners and encourage the servicers of the underlying mortgages to take advantage of the HOPE for Homeowners Program under the National Housing Act or other available programs to minimize foreclosures. **Authorizes the Secretary to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.** (GovTrack))
- ▣ **HIDDEN GEM:** Modifications as Alternatives to Foreclosure: Congress may expect that Loan Modifications be guaranteed or insured, and that such guarantees will act as credit enhancements; which will lessen fair value loss severity. This section builds on the (voluntary) mandate to effectuate Principal Forgiveness Modifications pursuant to HR 3221.

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- **Section 110. Assistance to Homeowners.** Requires federal entities that hold mortgages and mortgage-backed securities, including the Federal Housing Finance Agency, the FDIC, and the Federal Reserve to develop plans to minimize foreclosures. Requires federal entities to work with servicers to encourage loan modifications, **considering net present value to the taxpayer.** **(b) HOMEOWNER ASSISTANCE BY AGENCIES.**
- **(1) IN GENERAL.**—To the extent that the Federal property manager holds, owns, or controls mortgages, mortgage backed securities, and other assets secured by residential real estate, including multifamily housing, the Federal property manager shall implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and **considering net present value to the taxpayer**, to take advantage of the **HOPE for Homeowners Program under section 257** of the National Housing Act or **other available programs to minimize foreclosures.** **(2) MODIFICATIONS.**—In the case of a residential mortgage loan, modifications made under paragraph (1) may include—**1 (A) reduction in interest rates;****2 (B) reduction of loan principal;** and **3 (C) other similar modifications.**
- **HIDDEN GEM:** Modifications as Alternatives to Foreclosure: This section builds on the (voluntary) mandate to effectuate Principal Forgiveness Modifications pursuant to HR 3221, and adds the duty to consider the net present value to the taxpayer (not just investors). Read with the Fiduciary Duty language in 3221, are duties owed lessened to certain investor (lower) tranches?

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- ▣ **Section 110. (c) ACTIONS WITH RESPECT TO SERVICERS.**—In any case in which a Federal property manager is not the owner of a residential mortgage loan, but holds an interest in obligations or pools of obligations secured by residential mortgage loans, the Federal property manager shall—**(1) encourage implementation by the loan servicers of loan modifications** developed under subsection (b); and **(2) assist in facilitating any such modifications**, to the extent possible. (d) LIMITATION.—The requirements of this section shall not supersede any other duty or requirement imposed on the Federal property managers under otherwise applicable law.
- ▣ **HIDDEN GEM:** Expressly Brings Servicers into the Modification Duty Loop: This section builds on the (voluntary) mandate to effectuate Principal Forgiveness Modifications pursuant to HR 3221, and adds the duty to “SERVICERS” to encourage and assist the process. Does the servicer have a duty to consider the net present value to the taxpayer (not just investors) if it performs the modification? When read with the Fiduciary Duty language of 3221 does it lessen the duty owed to a particular investor party, and provide protection from investor lawsuits for modification decisions that also benefit the taxpayer to the disfavor of certain investors?

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- **Section 124.** Hope for Homeowners Amendments. Strengthens the Hope for Homeowners program to increase eligibility and improve the tools available to prevent foreclosures. Amends the National Housing Act, with respect to extinguishment of subordinate liens for refinanced mortgages, to authorize the Secretary to make payments, which shall be accepted as payment in full of all indebtedness to any holder of an existing subordinate mortgage in lieu of certain future appreciation payments.
- **HIDDEN GEM:** Subordinate Lien holders Motivation to Participate in Loss Modifications as Alternatives to Foreclosure: This section builds on the (voluntary) mandate to effectuate Principal Forgiveness Modifications pursuant to HR 3221 (Section 257 (e)(4)(A)) authorizing the Secretary **to facilitate coordination and agreement between the lien holders**, by creating the ability for subordinate lien holders to obtain some payment (to the extent of insurance proceeds) on its liens.

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- **SEC. 113. MINIMIZATION OF LONG-TERM COSTS AND MAXIMIZATION OF BENEFITS FOR TAXPAYERS.** (a) LONG-TERM COSTS AND BENEFITS.—
- (1) MINIMIZING NEGATIVE IMPACT.—The Secretary shall use the authority under this Act in a manner that will minimize any potential long-term negative impact on the taxpayer, taking into account the direct outlays, potential long-term returns on assets purchased, and the overall economic benefits of the program, including economic benefits due to improvements in economic activity and the availability of credit, the impact on the savings and pensions of individuals, and reductions in losses to the Federal Government. (2) AUTHORITY.—In carrying out paragraph 1 (1), the Secretary shall—**(A) hold the assets to maturity or for resale** for and until such time as the Secretary determines that the market is optimal for selling such assets, in order to **maximize the value for taxpayers**; and **(B) sell such assets at a price that the Secretary determines, based on available financial analysis, will maximize return on investment for the Federal Government.**
- **HIDDEN GEM:** Allows the Secretary to hold-to-maturity or sell at anytime to maximize returns to the Federal government (and taxpayer). This section may build on the (voluntary) mandate to effectuate Principal Forgiveness Modifications pursuant to HR 3221, or other programs, especially if the modification can enhance value to the assets purchased with guarantees, insurance and credit enhancements. See QBieSam™ – a Hold-To-Maturity pricing equivalent (and In-Substance Collateral Defeasance Enhancement) that can be insured and guaranteed, that adds value to the loan, adds obligors, on the loan or portfolio, and allows for sales before maturity with shared appreciation benefits at first sale or “determinable dates” or future events.

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- ▣ **SEC. 113. MINIMIZATION OF LONG-TERM COSTS AND MAXIMIZATION OF BENEFITS FOR TAXPAYERS.** (a) LONG-TERM COSTS AND BENEFITS.—
- ▣ (3) PRIVATE SECTOR PARTICIPATION.—**The Secretary shall encourage the private sector to participate in purchases of troubled assets, and to invest in financial institutions**, consistent with the provisions of this section.
(b) USE OF MARKET MECHANISMS.—In making purchases under this Act, the Secretary shall—(1) make such purchases at the lowest price that the Secretary determines to be consistent with the purposes of this Act; and (2) maximize the efficiency of the use of taxpayer resources by using market mechanisms, including auctions or reverse auctions, where appropriate. (c) DIRECT PURCHASES.—If the Secretary determines that use of a market mechanism under subsection (b) is not feasible or appropriate, and the purposes of the Act are best met through direct purchases from an individual financial institution, the Secretary shall pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset.
- ▣ **HIDDEN GEM:** This section and others (102, 109, 110), may allow the Secretary to create private-public purchase or insurance guarantee programs. Wilbur Ross has indicated that he might be willing to infuse \$1 billion into an insurance guarantee program.

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

- **SEC. 123. CREDIT REFORM.** (a) IN GENERAL.—Subject to subsection (b), the costs of purchases of troubled assets made under section 101(a) and guarantees of troubled assets under section 102, and any cash flows associated with the activities authorized in section 102 and subsections (a), (b), and (c) of section 106 shall be determined as provided under the Federal Credit Reform Act of 1990 (2 U.S.C. 661 et. seq.), as applicable. (b) COSTS.—For the purposes of section 502(5) of the Federal Credit Reform Act of 1990 (2 U.S.C.661a(5))—(1) the cost of troubled assets and guarantees of troubled assets shall be calculated by adjusting the discount rate in section 502(5)(E) (2 U.S.C. 661a(5)(E)) for market risks; and (2) the cost of a modification of a troubled asset or guarantee of a troubled asset shall be the difference between the current estimate consistent with paragraph (1) under the terms of the troubled asset or guarantee of the troubled asset and the current estimate consistent with paragraph (1) under the terms of the troubled asset or guarantee of the troubled asset, as modified.
- **HIDDEN GEM:** This section allows the cost of troubled assets and guarantees to factor in an estimate based upon the “modified” terms. Use of a new and creative modifications that build-in contractual and external enhancements may add value and lessen costs. See QBieSam™ with use of guarantees.

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

Exclusions from Taxable Discharge:

- Section 303. Extension of Exclusion of Income From Discharge of Qualified Principal Residence Indebtedness. Extends current law tax forgiveness on the cancellation of mortgage debt.

No Windfalls for Executives

- In order to participate in this program, companies will lose certain tax benefits and, in some cases, must limit executive pay. In addition, the bill limits “golden parachutes” and requires that unearned bonuses be returned.
- **Section 111. Executive Compensation and Corporate Governance.** Provides that Treasury will promulgate executive compensation rules governing financial institutions that sell it troubled assets. Where Treasury buys assets directly, the institution must observe standards limiting incentives, allowing clawback and prohibiting golden parachutes. When Treasury buys assets at auction, an institution that has sold more than \$300 million in assets is subject to additional taxes, including a 20% excise tax on golden parachute payments triggered by events other than retirement, and tax deduction limits for compensation limits above \$500,000.
- **Section 302. Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program.** Applies limits on executive compensation and golden parachutes for certain executives of employers who participate in the auction program.

2) New Solutions: HR 1424: The TARP program Hidden Gems of the Emergency Economic Stabilization Act of 2008”

Key Summary of the “Emergency Economic Stabilization Act of 2008”

FAS 157 FAIR VALUE ACCOUNTING & WRITE-DOWNS

- **Section 132.** Authority to Suspend Mark-to-Market Accounting. Restates the Securities and Exchange Commission’s authority to suspend the application of Statement Number 157 of the Financial Accounting Standards Board if the SEC determines that it is in the public interest and protects investors.
- **Section 133.** Study on Mark-to-Market Accounting. Requires the SEC, in consultation with the Federal Reserve and the Treasury, to conduct a study on mark-to-market accounting standards as provided in FAS 157, including its effects on balance sheets, impact on the quality of financial information, and other matters, and to report to Congress within 90 days on its findings.
- **HIDDEN GEM: FAS 157 Fair Value Accounting was not intended for application in disorderly, illiquid markets without price availability.** Astute changes must be made to guidance, or the SEC may have to suspend Fair Value Accounting, until the market stabilizes. See below SEC & FASB NEW GUIDANCE: FAS 157 FAIR VALUE

3) \$300 Billion Voluntary Solution: HR 3221: Housing and Economic Recovery Act of 2008

- ▣ **The new law**, known as the HOPE Program (Housing and Economic Recovery Act of 2008) was signed by President Bush on July 30, 2008 making \$300 billion in FHA loan insurance guarantees available for distressed borrowers to refinance into lower-cost, fixed rate, government-insured mortgages. In return lenders would have to reduce the loan principal, and homeowners would share with the government any profit when the house is sold. The program is voluntary (Section 257(e)(4)(c)) requiring Note Holders to accept principal forgiveness, including an FHA insurance fee. This is expected to greatly lower monthly payments for borrowers in trouble, It allows the borrower and government to share the risk of gain or upside appreciation or “claw-back” on the eventual sale, transfer or refinance. The Plan was set to be implemented on October 1, 2008. Also, eligibility requires a verified reasonable ability to pay, on a maximum loan amount of 90% of the current appraisal. However, many lenders are objecting to the voluntary program as lacking incentives and protections for the lender (holder and servicer), in part because of the costs to the holder, and the lack of holder clawback as the borrower and government share in the future appreciation. The law fails to clarify or protect the lender from reimbursement claims from HUD and FHA, typically from insurance claims on bad loans.
- ▣ **Hidden GEM Observation** Congress should consider amendments and changes to the law to include mutual incentives that trigger immediate, effective or en mass modifications, and provide a safe-harbor to auditors, holders and servicers. This may also require Federal preemption for opt-in shared appreciation modifications over States that have opted-out of the Alternative Mortgage Transactions Parity Act.

3) \$300 Billion Voluntary Solution: HR 3221: Housing and Economic Recovery Act of 2008

- ▣ **In addition to the industry objections** to the new law, there is still the uncertainty as to whether a Servicer/Lender has requisite authority or protections, to implement such (voluntary principal forgiveness) modifications in type, amount or number under its Pooling & Servicing Agreements (P&S), Revenue Procedure 2008-28, REMIC rules under IRC 860 et. seq., Financial Accounting Standards Board Statement 140 (plus 114, 118, 155, 156, 157, 159, 133, 134, 147, 149, 115, 107), etc., ASF Guidelines, Hope Now Guidelines, Income Tax Regulations §1.671-5(m), and other authorities or best practices which are not yet comprehensively consistent.
- ▣ **The new laws (HR 1424 and HR 3221) only add to the uncertainty** as 1424 infuses a duty or test based on the net present value to the taxpayer, and 3221 sets out to lessen the conflicting duty burdens on servicers by attempting to lessen the inherent investor tranche conflicts with a supplement or explanation of the duty owed to any particular investor, with a duty to all investors.

3) \$300 Billion Voluntary Solution: HR 3221: Housing and Economic Recovery Act of 2008

The new laws (HR 1424 and HR 3221) only add to the uncertainty as 1424 infuses a duty or interpretation based on the **net present value to the taxpayer** (Section 110), and 3221 sets out to limit the conflicting duty burdens on servicers by attempting to lessen the inherent investor tranche conflicts with a supplement or explanation (or Federal interpretation) of the duty owed to any particular investor, with a duty to all investors (129A).

- ▣ **SEC. 1403. FIDUCIARY DUTY OF SERVICERS OF POOLED RESIDENTIAL**
- ▣ **MORTGAGE LOANS.** The Truth in Lending Act (15 U.S.C. 1601 et seq.) is amended by inserting after section 129 the following new section: “**SEC. 129A. FIDUCIARY DUTY OF SERVICERS OF POOLED RESIDENTIAL MORTGAGES.**“(a) IN GENERAL.—Except as may be established in any investment contract between a servicer of pooled residential mortgages and an investor, a servicer of pooled residential mortgages— “(1) owes any duty to maximize the net present value of the pooled mortgages in an investment to all investors and parties having a direct or indirect interest in such investment, not to any individual party or group of parties; and “(2) shall be deemed to act in the best interests of all such investors and parties if the servicer agrees to or implements a modification or workout plan, including any modification or refinancing undertaken pursuant to the HOPE for Homeowners Act of 2008, for a residential mortgage or a class of residential mortgages that constitute a part or all of the pooled mortgages in such investment, provided that any mortgage so modified meets the following criteria: “(A) Default on the payment of such mortgage has occurred or is reasonably foreseeable. “(B) The property securing such mortgage is occupied by the mortgagor of such mortgage. “(C) The anticipated recovery on the principal outstanding obligation of the mortgage under the modification or workout plan exceeds, on a net present value basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure. “(b) **DEFINITION.—**As used in this section, the term ‘servicer’ means the person responsible for servicing of a loan (including the person who makes or holds a loan if such person also services the loan).”

3) \$300 Billion Voluntary Solution: HR 3221: Housing and Economic Recovery Act of 2008

- ▣ **“SEC. 129A. FIDUCIARY DUTY OF SERVICERS OF POOLED RESIDENTIAL MORTGAGES**
- ▣ **Hidden Gem: Or More Uncertainty**
- ▣ **Unfavorable Write-Downs:** Voluntary participation in the 3221 FHA refinance program will require lender or holders to take write-downs and losses when it “forgives” debt by entering into the principal reduction modification. This is not a favorable event for the industry, or the economy, as more write-downs cause more capital and covenant impairments, ending up with loss of lending capacity, or worse, more failed going-concerns. (See New Solutions: QBieSam)
- ▣ **Increased Litigation Risks:** Moreover, participation in the 3221 short payoff refinance program, may cause increased lawsuit claims from investors (in certain tranches) if the result of participation violates the express contract duties, to act in the best interest of the investor (under its pooling and servicing agreement). Although, 3221 respects the sanctity of contract by qualifying its new duty with: “Except as may be established in any investment contract”, it goes on to state: “...a servicer of pooled residential mortgages—“(1) owes any duty to maximize the net present value of the pooled mortgages in an investment to all investors and parties having a direct or indirect interest in such investment, not to any individual party or group of parties; and “(2) shall be deemed to act in the best interests of all such investors and parties...”

3) \$300 Billion Voluntary Solution: HR 3221: Housing and Economic Recovery Act of 2008

- 3221 goes on to frustrate or preclude the test as to any particular investor or interested party, by setting the standard as to all investors or interested parties as follows:
 - “...a servicer of pooled residential mortgages— “(1) owes any duty to maximize the net present value of the pooled mortgages in an investment to all investors and parties having a direct or indirect interest in such investment, not to any individual party or group of parties; and “(2) shall be deemed to act in the best interests of all such investors and parties..”

- 3221 goes on to define the test of how to determine if the duties are satisfied, as follows:
 - “(C) The anticipated recovery on the principal outstanding obligation of the mortgage under the modification (H. R. 3221—157) or workout plan exceeds, on a net present value basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure.”

- **Hidden Gem: A Solution & Joke:** Section (C) allows net present value to be determined by calculating “**anticipated recovery**” of **principal on the modified loan** vs. foreclosure. Hence, the more principal included as outstanding as modified, the more probable a servicer meets the test and protections of this law. Use of QBieSam™ or quarantined principal devices enhance compliance and protections for servicers, and add value under GAAP; if FAS 157 Fair Value does not require forced-sale valuations to be imposed. Joke: Now section (C) does not state “157” in the sentence as quoted, but that section is on page 157 (H. R. 3221—157). *Yes the same 157 as FAS 157 (My kind of joke).*

3) \$300 Billion Voluntary Solution: HR 3221: Housing and Economic Recovery Act of 2008

▣ 3221 New Servicer Fiduciary Duty?

- ▣ Some would argue that **Section 129A** does not create a fiduciary duty or a duty at all, and that this section only contemplates an interpretation of private contractual provisions. Since, the law expressly respects the sanctity of contract, the standards set in 3221 does not appear to provide the servicer optional contractual duties or protections, but it does supply standards of interpretation and protection if same are not clearly defined or preempted by a certain pooling and servicing contract.
- ▣ Since protections are uncertain under 3221, new product modifications that comply with the pooling and servicing duties, as well as 3221 (and 1424), may supply protections for servicers under both, its contractual duties and these new 3221 standards.
- ▣ **HIDDEN GEM:** QBieSam™ quarantined principal modifications may offer the solution around the negative effect of forgiveness of principal on the calculation to maximize the net present value of the pooled mortgage (to an investor and all investors), compared to foreclosure. Alternative GAAP may allow for maximization of valuation to support the servicer's business judgment.

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

FAS 157 (Fair Value Accounting)

10-20-08: One thing is Certain: FAS 157 is Uncertain!

Key questions:

- ▣ Should the Substance of the Modification dictate GAAP?
- ▣ Should Fair Value Accounting be applied in or to ‘disorderly’ and ‘illiquid’ transactions or markets?
- ▣ Is Fair Value Accounting causing excessive write-downs and losses?
- ▣ Is Fair Value Accounting causing broad economic damages and loss, creating a Fair Value Downward Spiral?
- ▣ Are there alternatives to FAS 157?
- ▣ Can GAAP be applied to avoid excessive write-downs and unwarranted losses without changing FAS 157 or suspending 157?
- ▣ Will Fair Value “price” be set by the Treasury (auction) purchases?

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

- How have or will Fair Value 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. Earnings reported in the income statement was the driver of the markets. Now "Fair Value" has shifted focus to the balance sheet; with some \$500 billion in write-off losses recognized thus far. We have also seen 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 requires marking debt to market. This has affected financing growth with debt. Interest (ownership) in other companies may allow for enhanced mark to market balance sheet reporting of same over historical cost (www.MarketDevaluation.com).
- **Hidden GEM Observation:** New FAS guidance will now change the focus from Mark-to-Market to Mark-to-Model.

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

FAS 157 (Fair Value Accounting): What is Fair Value Accounting?

Statement 157 establishes a single definition of fair value and a framework for measuring fair value in generally accepted accounting principles (GAAP) that result in increased consistency and comparability in fair value measurements. A fair value measurement represents the **price** at which a transaction would occur between market participants at the measurement date. As discussed in Statement 157, in situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an **exit price** notion) that is not a forced liquidation or distressed sale at the measurement date.¹ Even in times of market dislocation, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value. Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales. (FSP FAS 157-3)

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

FAS 157 (Fair Value Accounting): What is Fair Value Accounting?

(FSP FAS 157-3) b

- b. In determining fair value for a financial asset, the use of a reporting entity's **own assumptions about future cash flows** and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. Statement 157 discusses a range of information and valuation techniques that a reporting entity might use to estimate fair value when relevant observable inputs are not available.² In some cases an entity may determine that observable inputs (Level 2) require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement...

(FSP FAS 157-3) b: c:

- **Broker (or pricing service) quotes** may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In an active market, a broker quote should reflect market information from actual transactions. However, when markets are not active, brokers **may rely more on models with inputs based on information available only to the broker**. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

FAS 157 – The Fair Value Accounting Debate

- ▣ On October 10, 2008 FASB issued FSP FAS 157-d and No. FAS 157-3 in an attempt to clarify guidance for application of Fair Value GAAP (FAS 157).
- ▣ Bankers are calling for the suspension of Fair Value Accounting and FAS 157. Investors are opposing the call for suspension. The SEC is reviewing the matter and has the authority to suspend Fair Value Accounting. On October 13, 2008, in a letter to Chairman Cox (SEC), the American Bankers Association called for the suspension of FAS 157, and made the following observations:
 - ▣ CEO Edward Yingling states, that "the FASB had the opportunity to provide useful guidance with FSP FAS 157-3, . . . it apparently *still* refuses to recognize the realities of the current situation." He states that new FASB guidance requiring "liquidity risk, from the buyer's perspective, to be included in the cash flow calculation," brings the guidance back to distressed sale values. "The FSP is circular," he writes. (Accounting Web)
 - ▣ The SEC and FASB joint statement stated: "the concept of a fair value measurement assumes an orderly transaction between market participants. . . . Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence."

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

FAS 157 – The Fair Value Accounting Debate

SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (September 30, 2008):

- **Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?** Yes. When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable. Statement 157 discusses a range of information and valuation techniques that a reasonable preparer might use to estimate fair value when relevant market data may be unavailable, which may be the case during this period of market uncertainty. This can, in appropriate circumstances, include expected cash flows from an asset.
- **Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?** The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

FAS 157 – The Fair Value Accounting Debate

On October 10, 2008, the Chairman Robert Herz, of FASB acknowledged:

- ▣ FAS 157 works better in liquid markets, that concept is more difficult during times of illiquidity. (CFO.com)
- ▣ FASB probably did NOT contemplate the current situation when it wrote SFAS157. (Financial Week)

Other Industry Leaders Step Up:

- ▣ Robert Rubin, a director of Citigroup and former U.S. Treasury Secretary call for the suspension of mark-to-market (Fair Value) accounting as it was worsening the crisis in the banking system. (Financial Post Oct. 1 2008)
- ▣ Jeff Mahoney, GC for the Council of Institutional Investors opposes any suspension of mark-to-market accounting as it just reveals that some of those loans aren't as valuable as previously reported.

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

On October 13, 2008, CEO of the American Bankers Association, Edward Yingling called for the following actions by the SEC:

1. **Override** FSP FAS 157-3 and **replace it with guidance** that clarifies that fair value in an illiquid market does not include forced or distressed sales.
 2. Provide guidance on “other than temporary impairment” as requested in ABA’s letters to the SEC and to the FASB.
 3. **Suspend** the proposal on accounting for securitizations.
 4. Suspend work by accounting standards setters on any projects that would require fair value in any future accounting standards pending Congressional review of the study mandated by the Emergency Economic Stabilization Act.
- ▣ **Observation:** One of the fundamental problems with Fair Value Accounting is it requires companies to write down the value of assets quarterly at the open market price as defined as the current price that similar assets are selling for even when the company has no intention of selling them. (Peter Clime, SEC Eyes Mark-to-Market Accounting Rules)
 - ▣ **HIDDEN GEM:** One principle difference in how forgiveness modifications can help overcome this problem is to legally structure the forgiveness of principal modification quarantining the total amount of the debt in tact and due without extinguishment of debt, even if the monthly payments are restructured and based upon the reduced principal amount for purposes of a payment schedule, reserving all future appreciation to the participants. Simply creating deferred seconds may not qualify for similar treatment. (See QBieSam™)

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

Why is there such disagreement over the application of 157?

There are many reasons, one is the inherent differences on how to characterize a financial vs. a nonfinancial asset.

a. VIEW A: Proponents believe that the impaired loan is a financial asset. Paragraph 6 of Statement 159 defines a financial asset as one which includes a contract that conveys to one entity a right to receive cash or another financial instrument from a second entity. Proponents believe that this right to receive cash also includes the right to receive cash from the sale of collateral in a defaulted loan. Further, they believe that in the current credit environment, the consistency, comparability, and transparency that Statement 157 provides to users is important.

b. VIEW B: Proponents believe that while the asset being recognized is the loan, the recognition of that impaired loan is typically based entirely on the fair value of a nonfinancial asset. View B proponents believe that if the holder of the loan were to sell the loan at the measurement date, they would not receive an amount equal to the fair value of the underlying collateral. This is because a market participant would require to be compensated for the risk being assumed as well as anticipated foreclosure costs in order to obtain rights to the collateral. (Prop FSP FAS 157-b)

▣ **GEM:** Nonfinancial Assets were/are not subject to Fair Value, as yet.

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

What to do? What's it all mean?

- Most recently, the SEC has declined comment, but will hold a Roundtable on Oct. 29, 2008. It indicated that it will have a **Study** per HR 1424 available on **January 2, 2009**. James Kroecker, SEC Deputy Chief Accountant (former Deloitte & Touche) will head the effort. Necessary guidance on the application of “other than temporary impairment” in illiquid markets remains **unresolved**.
- Meanwhile, Q3 and Q4 could be devastating, unless companies apply strong **judgment** based on the recent guidance, and include “**internal assumptions**”, based upon “**models**” and other internal inputs to value securities including greater use of “**intrinsic valuation assumptions**.”
- Note that Joyce-Bell, analyst at Standard & Poor’s said there might be a short-term earnings boost through a mark-up for some previously written-down assets, “as values are based in greater use of intrinsic valuation assumptions.”
- It is fair to say that we are now in a period of **MARK-TO-MODEL** or **MARK TO INTERNAL JUDGMENT**, not simply a MARK-TO-MARKET analysis.
- Of course, FAS 157 does NOT supply any express SAFEHARBOR. So with “judgment” comes enhanced litigation risks.
- GAAP requires we reflect the best and most accurate valuation, with **adjustments to reflect the “substance” or “nature”** of the transaction.
- The FASB examples suggest use of internal modeling that reflects price in normal market conditions as it acknowledged that price in distressed markets or forced sale transactions, might not be fair value.

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

HOW DO WE DETERMINE PRICE In TREASURY AUCTIONS? HR 1424 (the TARP Program) is designed to be a market auction pricing mechanism. FAS 157 looks to “price” to establish the Fair Value. Will the price paid for distressed mortgages create the Fair Value price? **Is auction pricing Fair Value?** FASB staff observations on July 2008 didn’t believe auction pricing would be an issue, so they took no action. See Valuation Resource Group Summary Of Discussions Dated July 2, 2008; located on: <http://www.troubledassetsrelief.net>

“Issue 2007-7 Assets Acquired through an Auction

▣ *Background*

14. The definition of fair value under Statement 157 is the price received to sell an asset in an orderly transaction between market participants at the measurement date. In an auction, ordinarily the acquirer prevails by bidding an amount that is greater than the other market participants. The acquirer may be able to offer a higher price as a result of synergies that may not be available to other market participants. This situation raises questions on how the market participant view should be applied in determining fair value in auction scenarios.

▣ *FASB Staff Observation*

15. The staff believes that this issue won’t lead to any significant diversity in practice. Accordingly, the staff believes that this issue does not warrant any Board action at this time. The staff will continue to monitor this issue. “

4) SEC & FASB New Guidance: FAS 157 Fair Value Accounting

HOW DO WE DETERMINE (EXIT) PRICE?

- ▣ Jeffrey Aberdeen of Commerce Bancshares said, “The exit price is virtually impossible to come up with...trying to apply FAS 157...only if the results are in a range of what they (auditors) have seen elsewhere...” (CFO.Com) “...it still includes exit (price) values...” (MarketsMedia) “Most of our troubles...where we have to employ lower of cost or market...in the exit price.” (MarketsMedia)
- ▣ If GAAP requires us to reflect the substance or nature of the asset, liability, transaction or market condition, we must take into account the legal and financial structure of the troubled asset, and the structure of the MODIFICATION.
- ▣ If we modify or restructure loans in default or foreseeable default, by common risk characterization (or as individual loans) as based upon internal expert modeling, and take into account, the expected return, future cash flow (discounted, effective interest rate, adjusted yield), and loss or gain of principal and interest (under applicable FAS Rules), we will arrive at a more reflective “exit price” or enhanced valuation of the asset base, with more valuable mortgage servicing rights, and lesser loss contingencies, including lesser CDS liabilities, and lesser internal company credit risks.
- ▣ **GEM: How? New Modifications.** We need to find modifications that afford the borrower true affordability on a monthly cash basis (to reduce default and re-default rates) with lower monthly payments (based upon a reduced principal balance, with or without flexible payment plans), and legally allows for return of all of the investment made by investors (lenders or holders), and provides incentives to add guarantees or insurance as credit enhancements (authorized under HR 1424), all consistent with HR 3221 while respecting the sanctity of contract. This may require an Opt In Mod™ situation. (See QBieSam™)

▣ Principal Forgiveness SAMS – Wilbur Ross

News - 2008: Principal reduction or forgiveness modifications started to get some traction about June 2008. On June 17, 2008, Richard Ivar Rydstrom, Esq., Chairman of the Coalition for Mortgage Industry Solutions, held a Summit in Washington DC on new solutions for the mortgage crisis. Richard Rydstrom interviewed billionaire Wilbur Ross about new shared appreciation principal reduction or forgiveness modification solutions. *This concept is a shared appreciation (gain) mortgage modification arrangement wherein the lender and insurer (FHA) are entitled to receive the lesser of 25% of gain appreciation or the amount forgiven or guaranteed, respectively. It would allow the FHA to guarantee \$1 of existing troubled mortgages on primary residences for each \$1 forgiven by the lender. The lender would be able to resell the guaranteed portion of its principal amount.* That would help create “liquidity” in the mortgage loan marketplace, which is at a crisis stage at this time because “securitization” has all but ceased to exist.

5) Wilbur Ross Solutions: Principal Reduction & New Insurance Guarantees

▣ Principal Forgiveness SAMS – Wilbur Ross

News - 2008: Wilbur Ross has also suggested another approach as follows (the author's non comprehensive account only):

Public – Private Guarantee Solution:

- ▣ Set up an insurance guarantee program.
- ▣ The government would guarantee 50% of the mortgage that had been reduced to true net value after selling commissions, etc.
- ▣ The guaranteed amount (50% government amount) could be separately sold by holder/lender at a much lower yield than the mortgage itself.
- ▣ Enable the holder/lender to pay a 2 ½% per year Insurance Fee to the government.
- ▣ At first sale, share proceeds of appreciation as follows:
 1. 1/3rd to Government
 2. 1/3rd to Lender/Holder
 3. 1/3rd to Borrower (Homeowner)
- ▣ Making it transferrable/assumable will lessen the need for new replacement mortgage.
- ▣ The 50% can come over to the next owner from the government guarantee at low rates and supply liquidity to the original lender.
- ▣ It can be backed by reinsurance.
- ▣ Wilbur Ross indicated that he would be interested in making a \$1 billion infusion for this purpose.
- ▣ **GEM Observation:** This supplies incentives, enhanced certainty, and liquidity.

6) New Principal Forgiveness Modifications without Loss Write-Offs!

- ❑ FAS (financial accounting standards) require us to measure the extent of collateralization supporting the obligations. We must ask: **Is there a Modification Device that can increase the measure of collateralization to enhance value** to a more accurate Fair Value, or must we just throw our arms up and continue to apply non-accurate techniques in measuring loan value or Modifications under Fair Value during disorderly non-liquid markets?
- ❑ The new law (1424) is primarily designed to provide a “Market Pricing Mechanism” for troubled mortgage and loan assets which are riddled with pricing uncertainties by having Treasury purchase the assets at a price expected to be above the current extremely low “Fire-Sale Prices”, but below a highest “Hold-To-Maturity Price”. The auction is to be at the lowest price possible and maximize the value to the taxpayer.
- ❑ **Guaranteed or insured quarantined principal modification** devices like QBieSam™, structured properly with respect to accounting rules, contract principles, and the new law opportunities, allow for a maximization of expected net present value comparison calculations, maximization of taxpayer return, maximization of investor(s) return, and maximization of borrower monthly affordability and return of equity.

6) New Principal Forgiveness Modifications without Loss Write-Offs!

▣ Quarantined Built In Equity - Shared Appreciation Modifications™

New FAS Solution: Quarantined Built In Equity - Shared Appreciation Modifications™ | QbieSam™

*** There is No Reason for Massive Write-Downs or Principal Forgiveness Loss, When We Can Quarantine It!**

*** There is No Reason Why We Cannot Reach True Monthly Affordability for Borrowers!**

- ▣ Instead of wading in the quagmire of the slippery slope of FAS 157 “Fair Value”, which will cause more bank write-downs and more restrictions on the ability to lend, we should use FAS 5 (Accounting for Contingencies) with the solutions articulated by billionaire Wilbur Ross regarding principal forgiveness modifications, and QbieSam™ or Quarantined Built In Equity Shared Appreciation Modifications™ (www.qbiesam.com) as offered by the author, which preclude an event of actual principal loss forgiveness at the outset resulting in a very small net present value discount for the foreseeable loss of principal over the expected (longer) life of the loan (modification). This would allow for “true affordability” for borrowers as the monthly payments would be based on the much lower un-quarantined principal amounts and allow lenders, insurers, and borrowers to share in the total upside of appreciation over time, which may result in a 100% recovery for all parties. QbieSam™ – a Equivalent Hold-To-Maturity pricing device (and In-Substance Collateral Defeasance Enhancement) that can be insured and guaranteed, that adds value to the loan, adds obligors, on the loan or portfolio, and allows for sales before maturity with shared appreciation benefits at first sale or “determinable dates” or future events. It allows for Equivalent Fair Value (“EFV”) based upon estimates of future cash flow and the aggregate payments of principal and interest and appreciation, to be received under FAS rules. It allows for collateral enhancements and offsets on guarantees and Treasury bonds with terms equal to the remaining modified term with coupon rates that add to necessary income to offset contracted P&I (or expense, cost) payments. The new law allows the Treasury to create insurance and guarantee programs to support modifications. Bonds, or guarantees (insurance policies) can be assigned to an Enhancement – Defeasance Trust for pass thru periodic cash flow payments to holders and servicers until maturity.

6) New Principal Forgiveness Modifications without Loss Write-Offs!

- ▣ Quarantined Built In Equity - Shared Appreciation Modifications™

New FAS 5 Solution: Quarantined Built In Equity - Shared Appreciation Modifications™ | QbieSam™

- ▣ There is no reason why we must have a modification plan that would require the lender to realize a loss at the outset, along with the assumption of additional FHA insurance risks and costs. Lenders are not motivated to volunteer into such a plan, but a quarantined principal plan would give lenders the necessary incentives to participate. There is no more time for delay. En mass or extremely effective mortgage and consumer credit loan modifications (www.sdirt.com) must occur immediately. There should be no adverse tax, liability, legal or credit (FICO) consequences for all parties to mortgage and consumer loan modifications, whether tied to a securitized pool or not. We must untangle the unintelligible, un-reconciled web of restriction, now.
- ▣ **QbieSam™ is a “Hold-To-Maturity” Equivalent Pricing Device with Collateral Offset Enhancements, that maximize value and avoids further severe write-downs.**

6) Plain English suggestions for Industry Specific & Immediate Solutions

The new law authorizes use of new **enhancements** to achieve risk adjustments and a more accurate or Equivalent Fair Value (“EFV”) concept. These might come in the form of less risky collateral backed by insurance, guarantees, Treasury Bonds, Annuities and new contractual modifications like QbieSam™. We should also consider tradable insured investment funds that supply minimum funds to satisfy the concomitant risks aligned in that fund while building fund equity, such as Foreclosure Mortgage Insurance Investment Funds™ (FMII™). For more information go to www.foreclosuremortgageinsurance.com. We should also consider amending HR 3221 to include properly aligned incentives and protections from liability for all market participants including borrowers, and extending the voluntary principal forgiveness modification (and short pay refinance) opportunities. Lenders are not keen on losing principal and incurring risk without sharing in the upside SAM (shared appreciation mortgage). Let’s refine that concept and offer a new version of principal reduction where lenders would not necessarily lose principal from forgiveness, but quarantine principal (to levels which build in equity) to allow for a more “affordable” monthly payment for the borrower, but maintain the right of the Lender to share in the appreciation over time (i.e.: QbieSam™ or Quarantined Built In Equity Shared Appreciation Mortgage™ (www.qbiesam.com)). For a discussion of principal reduction modifications, see the June 2008 webinar discussion between Richard Ivar Rydstrom, Chairman of CMIS, and Wilbur Ross, Chairman of WL Ross & Co. LLC, at the Executive Leadership Summit of the Coalition for Mortgage Industry Solutions (CMIS) at Dickstein Shapiro in Washington DC. For further information contact the American Legal & Financial Network (AFN), Matt Bartel, Chief Operating Officer, at mbartel@e-afn.org.

CONCLUSION: Where We Must Go! Fire in the Fireplace!

- It's true that the industry ran hot over the last boom years. The housing and mortgage industries were on fire. The fire got out of the fireplace and caused great destruction.
- But we need the fire. The fire is the solution. Let's keep the fire, but put it back in the fireplace. We need to enhance homeownership financing with more refined controls. We need to reach for growth in homeownership and the economy at the same time.
- In the immediate term, we need to do everything we can to keep the people in their homes, and lenders in their loans. With the new laws, this may require serious government guarantees, insurance or ownership. We need immediate and en mass or highly efficient loss mitigation and modifications.
- Loss mitigation and modifications must be sustainable. Therefore, the monthly cash payment must truly be affordable to the borrower or your efforts will fail and cost must more then necessary as the re-defaults will negatively impact "modeling" and management estimates of common risk characteristics pool-wide.

Join The AFN Debate Team

GET INVOLVED: JOIN THE AFN DEBATE TEAM TO HELP RESOLVE THIS HISTORIC CRISIS!

Contact: Comprehensive Legal Authorities & Practices Task Force (CLAPT) – **William M. LeRoy**, CEO, American Legal & Financial Network (AFN) is the chair of this AFN task force. The AFN has chosen Richard Ivar Rydstrom, Chair of CMIS, to co-chair its **Comprehensive Legal Authorities & Practices Task Force** which will focus upon identifying federal, state, local and practice barriers to cooperation and reconciliation of conflicting consumer, industry, governmental and regulatory authorities and practices seeking to respond to the housing crisis, and work to develop more uniform approaches and solutions. Today we are announcing the **Bankruptcy, Modifications & Foreclosure CLAPT** initiative which will give voice and reconciliation to the mortgage banking and investor community, and the varying bankruptcy or trustee interests. (See www.clapt.org or www.e-afn.org)

Conclusion

Question & Answer Period

If you have any further questions that were not addressed in this presentation, or want to contact one of our speakers, please email Matt Bartel, COO of AFN, at mbartel@e-afn.org.

Thank you for your participation in this webinar. Please complete the brief survey which you will be directed to at the conclusion of this presentation.

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