Testimony of

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I would like to express my gratitude to Chairman Frank and the Committee for the opportunity to be here today and speak on behalf of the financial services industry and Western & Southern Financial Group (W&S). My name is Brad Hunkler. I am a Vice President and Controller with the Western & Southern Financial Group. W&S is a mutual holding company owned by its policyholders and located in Cincinnati, Ohio. W&S sells mostly life insurance products including traditional life insurance and annuity products. Like other life insurance companies, we have been adversely impacted by losses sustained in the investment in securitized loans. As the witness for the Financial Services Roundtable, I intend to divide my testimony into four parts:

1. Overview and background;
2. Securitization concerns;
3. Pro-cyclicality – and its unintended consequences; and
4. The importance of maintaining independent accounting standards.

Overview and Background

The role of the financial services industry, including non-banking institutions needs to be a significant component of your work in expanding credit to consumers and commercial enterprises. The financial services industry invests in all types of consumer loans including mortgages, credit cards, auto loans, student loans, and many others. The primary investment vehicle for these loans is through securitization. The amount of consumer lending financed by our industry is critically important to maintaining adequate lending capacity for the broader economy. For example, of the approximate $11 trillion of residential mortgages outstanding as of September 2008, banking institutions held approximately $4 trillion as direct loans with the remaining $7 trillion securitized. Of that $7 trillion, banks still held significant investments in securitized loans, but much of those assets were held by non-banking institutions such as insurance companies, pension plans and other institutional investors. Approximately $5 trillion of the $7 trillion were conforming balance mortgages and wrapped through the government sponsored entities. This represents only residential mortgages. Insurance companies also acquire a significant amount of assets securitized by other types of loans as well.

From the insurance perspective, insurance companies acquire these assets due to their high credit ratings and the yield and duration that the securities offer which match the duration of many insurance liabilities. Many insurance companies have ceased to write direct consumer loans and have relied on the securitization markets to provide access to this asset class. As such, the insurance industry has become reliant upon the implicit integrity of the securitization process, including high quality underwriting, rating and structuring of these investments. In addition, many loans are guaranteed by monoline insurers and government sponsored entities – the industry relies on the quality of these credit enhancements as well.

Unfortunately, there were many unknown problems in these areas for the financial services industry as a whole. As such, the industry has been adversely impacted by a lack of regulation, oversight and clarity of the securitization process. Certainly the economic conditions, such as high unemployment and falling housing prices, have adversely impacted the collateral of these assets, but other non-economic factors, that could have been avoided, also have contributed to the losses. As noted in many media reports, this includes: rampant fraud in the mortgage origination and underwriting process; poor underwriting standards that overemphasized rising housing prices and did not adequately consider borrower creditworthiness; monoline insurers whose risk exposures were too highly correlated; inadequate analysis and stress testing from the rating agencies resulting in over-inflated ratings; and a lack of transparency relating to the underlying collateral and deal structure which contributed to inefficient price discovery. These issues are specific to the non-agency mortgage markets. The industry has also been adversely impacted by a lack of transparency and regulatory oversight of the student loan market where the investors who purchased auction-rate preferred securities for short-term liquidity needs are now stuck with the illiquid, long-term securities with uncertain payment provisions.

In addition to the liquidity and valuation challenges, mark-to-market accounting has compounded the problems for the financial services industry. Some institutions generally hold whole loans that are not required to be fair valued, while others, including insurance companies, hold mostly securities which are required to be marked-to-market. These are the areas that I ask the Committee to focus on going forward so that when economic conditions improve, institutions will return to the securitization markets.

Securitization Oversight

The industry needs to rely on certain standards for securitized assets. These standards need to be defined and oversight needs to be provided to ensure that standards are strictly enforced. The following points summarize the areas of concern in the markets for securitized assets:

- **Collateral Information:** The mortgage backed securities (MBS) market lacks a standardization of underlying collateral information, both at the time of securitization and in the ongoing monthly performance reporting. The industry would propose that all collateral information, such as loan-to-value ratios, FICO scores, and other collateral and borrower information be provided in detail within a standardized format to allow for more comprehensive and accurate valuation by investors (similar to the CMBS market).
- **Underwriting Standards:** It is has been extensively reported that mortgage brokers have committed significant amounts of fraud, and bank and Wall Street underwriting due diligence failed to pick this up. As such, the industry is looking for strict enforcement of improved underwriting standards and for originators and perhaps servicers to retain some "skin in the game" in the securitized loans.

- **Deal Structure:** Deal structure can vary from deal-to-deal for non-agency MBS. This includes variability in bankruptcy carve-out provisions and other cash flow triggers. This challenges analysis and has contributed to a lack of transparency that has led to reduced trading of existing securities. Standardized deal structures would help immensely.
- **Rating Agencies:** Rating agencies provided ratings that did not adequately reflect the level of risk in the investments. AAA ratings should only be awarded to securities that have an extraordinary low risk of default. This rating was based on recent historical MBS performance and did not discount the possibility of sustained negative home prices nationwide. Some oversight over this industry needs to be considered as investors need a rating process with integrity and accuracy to foster confidence in valuations.
- **Monoline Insurers:** Monoline insurers were permitted to insure highly correlated assets well in excess of their risk tolerance. Rating agencies assumed only idiosyncratic risk – they never considered a systemic risk event.
- **Auction Rate Securities:** Auction rate securities backed by student loans have traded for some time with minimal government oversight. For the market to function, it relied on the liquidity support of the investment banks that were involved in the trading and their willingness to use balance sheet capacity to provide liquidity. While loans are mostly supported by

> government guarantees, the investment banks became concerned about holding increasing amounts of assets due to insufficient balance sheet capacity and thus, allowed auctions to fail. This has left many holding securities that were thought to be cash or liquid investments, but are now securities with significantly longer-term maturities at short term interest rates with no source of liquidity. The ability to control this market and the auction process by investment banks needs to be addressed by Congress so that the industry can resume investing with confidence in these types of asset classes.

In addition to the improvements in regulation noted above, Congress also needs to continue to address the issue of existing assets on financial statements. At this point, the best thing regulators can do is to choose a course of action and stick to it. The added uncertainty of government intervention in mortgages, housing and toxic assets has significantly deteriorated the markets on these assets. The announcement made by Treasury on March 23, 2009, for the Public/Private Program for Legacy Assets provides good direction and comprehensive action on these issues. We believe that this represents a positive development in this regard.

Mark-to-Market Accounting Concerns

The industry has raised mark-to-market accounting concerns since the first major application of market value accounting in the Financial Accounting Standards

Board (FASB) Statement No. 115. At the time early deliberations were occurring on FAS 115 in the late 80's, interest rates were at all time highs. The insurance industry had extraordinary unrealized losses on its investment portfolios and most, if not all, insurance companies would have shown negative book value at that time. The industry on the whole questioned the usefulness or the meaning of reflecting negative book values due to high interest rates. Having a long-term, cash flow oriented investing strategy allows insurers to manage through periods of interest rate volatility. For some institutions and even for some assets of insurance entities, reflecting market values in the financial statements makes sense. Generally speaking, equity investments are acquired for the purpose of investing and should be carried at market values at all times. But generally speaking, the industry holds mostly fixed income investments purchased for the purpose of providing future cash flows to support future policyholder claims. For these investments, market value accounting provides less meaningful information and should be limited to disclosure.

Today, excessive speculation in the markets has made market prices potentially deceptive when reflected in the equity of financial institutions. I believe that today's markets move well into the extremes of economic cycles. Market participants speculate more on an asset's ability to increase or decrease in value than on its inherent ability or inability to provide future cash flows. This excessive speculation has led to market bubbles and busts. Adding market values to financial statements in this environment can be misleading. During market bubbles, financial statements can illustrate a false wealth effect. This can lead to excessive risk-taking and over-levering non-existent equity. During periods of market declines, the opposite is true. As market values decline, reported losses in excess of real losses can lead to restricted risk-taking and capital preservation. This can lead to irrational exuberance in bubble periods and irrational fear during the busts. While markets can accommodate this type of volatility, the sanctity of the Nation's financial institutions needs to be immune to it.

Pro-cyclicality

To address pro-cyclicality, some would suggest providing a counter-cyclical regulatory capital model and retaining market values in reported financial statements. I do not believe this represents a sound approach. Reported financial statements that show excessive volatility and potentially negative book values can fuel adverse consumer activity. If regulatory reporting results show strong financial strength through this reporting mechanism, it has the potential to be dismissed or even worse it can discredit the regulatory capital model altogether. Wearing my insurance hat, I could follow on that this is the case today in the insurance industry. Insurance companies have reported unrealized losses in their GAAP financial statements while properly reflecting statutory capital well in excess of levels normally required to retain existing financial strength ratings. But during the first quarter of this year, many insurance companies received two or more rating notch downgrades and saw significant declines in their stock prices. Some insurance companies also saw adverse policyholder activity with higher surrenders. This occurred in spite of the fact that regulatory capital remained strong for many of these institutions. With GAAP and regulatory accounting showing different results, conservative investors tend to migrate to the least favorable outcome. Therefore, although regulatory capital may be a more accurate reflection of solvency, it potentially could be disregarded by analysts, investors, and even consumers. This can result in economic hardship for an otherwise healthy financial institution.

Market Prices

Market prices, though, do provide beneficial information for financial statement users. They provide an objective source of value and can be a proxy for value in active, rational markets. Also, market prices are the value that can be exchanged if assets are required to be liquidated. In addition, some assets are acquired for the purpose of trading and should therefore reflect the market prices in the balance sheet. Investors have spoken clearly that fair value accounting provides meaningful information. But the desire for objective financial data has led to the replacement of the principles of prudence and conservatism with fair value accounting. Therefore, I believe that the primary measurement attribute should be cost for cash flow investors. Losses should be recorded when cash flows are impaired up to the amount of the impaired cash flows. Then to accommodate the needs of investors, a fair value supplement can be provided and made available concurrently with reported results. Fair values would then represent exit values and reflect the impact of liquidating financial instruments if required.

I believe that this approach has merit. It reflects the needs of investors yet does not subject the industry's financial statements to the whims of the markets. It is this approach that the financial services industry has supported since the first broad issuance of a fair value standard with FASB Statement No. 115 in 1993. But this is not the apparent direction of the FASB or the International Accounting Standards Board (IASB). Fair value accounting continues to be incorporated into the financial reporting standards over the objections of many industry groups. The FASB has continued to introduce fair value requirements regardless of whether an active market exists or has ever existed for the asset or liability. This topic was well-vetted in your March 12 mark-to-market subcommittee hearing. I would like to add to that testimony by saying this is not a concern that is being raised for the first time by the industry. Even when benefited by the reporting of fair values, the industry has consistently had concerns regarding the application on fair value reporting.

The FASB has a more than adequate due process in the exposure and issuance of new standards. It is open and transparent, collects data from all sources and it is conducted in a timeframe that accommodates all parties. But the problem is that preparer concerns have held little weight in the ultimate decision on the issuance of new standards. Instead investor concerns – primarily the voices of large investor organizations – have driven the FASB agenda in support of all financial reporting on a fair value basis. What is interesting, though, is that as the FASB has continued to introduce new fair value measurement requirements, equity analysts continue to guide companies to exclude the results of these fair value changes from the core operating earnings that they report in their earnings release. What equity analysts are interested in is understanding run-rate earnings and the growth in earnings so that THEY can determine the fair value of the company based on its operating results and ability to provide future cash flows.

A Thoughtful Congressional Role in Accounting Standard Setting

Congress can play a role in the oversight of the FASB due process. They can oversee it and ensure that all voices are not only collected, but given due consideration in the creation of new standards. What is important though is to retain the ultimate independence of FASB to create standards without political interference. This is a difficult balance and to the extent that any role is created by Congress it will need to be carefully thought through to limit its authority to just the observance of an adequate due process.

Congressional input into the standard setting process should be considered as well. Today, Congress has the authority to speak directly to the FASB as was done at the March 12, 2009, hearing. Moreover, though, Congress can comment on any FASB proposal that was issued through the FASB due process. From time-to-time, individual Representatives have provided comment letters to FASB and, given the extent of taxpayer investment in financial institutions, I would encourage more Congressional input and oversight of the setting of accounting standards. Furthermore, Congress should consider the need for a process to provide feedback to FASB on proposed accounting standards.

Conclusion

In conclusion, I come to you today to provide some background information on the role of the financial services industry in lending within the securitization markets. In your valued oversight role of FASB in the accounting rulemaking process, the Roundtable believes that your focus should include:

1. Securitization concerns;
2. Pro-cyclicality – and its unintended consequences; and
3. The importance of maintaining independent accounting standards.

I thank you for the opportunity to be here today and look forward to your questions.