# MARK-TO-MARKET ACCOUNTING: PRACTICES AND IMPLICATIONS

## HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

MARCH 12, 2009

Printed for the use of the Committee on Financial Services

**Serial No. 111–12**

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# MARK-TO-MARKET ACCOUNTING: PRACTICES AND IMPLICATIONS

**Thursday, March 12, 2009**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128 Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Sherman, Capuano, Hinojosa, Scott, Maloney, Moore of Wisconsin, Hodes, Klein, Perlmutter, Donnelly, Foster, Adler, Kilroy, Himes, Peters; Garrett, Price, Castle, Lucas, Manzullo, Royce, Biggert, Capito, Hensarling, Putnam, Barrett, Gerlach, Campbell, Bachmann, Neugebauer, McCarthy of California, Posey, and Jenkins.

Ex officio present: Representatives Frank and Bachus.

Also present: Representatives Moore of Kansas, Watt, Kaptur, and Lee.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order. Pursuant to the committee rules, each side will have 15 minutes for opening statements. Without objection, all members' opening statements will be made a part of the record.

I want to recognize and welcome the many members of the full committee participating in today's hearing who are not members of the subcommittee. And I ask unanimous consent that Ms. Kaptur be allowed to participate in today's hearing and that Ms. Giffords be allowed to submit written questions for the record. Without objection, it is so ordered.

We meet today to examine the much-publicized and hotly-debated mark-to-market accounting rules. A diverse range of opinions has gathered for what I hope will be a thoughtful and constructive discussion. Previously, I have taken the position that the Congress should not interfere through legislation in the area of establishing specific accounting rules. It seemed best that such technical work be left to the regulators, standard setters, and financial experts.

We can, however, no longer deny the reality of the procyclical nature of mark-to-market accounting. It has produced numerous unintended consequences, and it has exacerbated the ongoing economic crisis. If the regulators and standard setters do not act now

to improve the standards, then the Congress will have no other option than to act itself.

To say that the Congress will have to act is not to advocate an outright suspension of mark-to-market accounting. If we do away with this standard entirely, accounting will revert to the very kind of subjectivity and sleight-of-hand that made mark-to-market necessary in the first place. The standard does not provide transparency for investors, but its strict application in the current environment is, in too many instances, distorting rather than clarifying the picture.

Take the case of the Federal Home Loan Bank of Atlanta. Last September, the bank estimated that it would lose $44,000 in cash flows on 3 private label mortgage-backed securities starting in about 15 years. The magic of mark-to-market accounting required this relatively minor shortfall to be treated as an other than temporary impairment loss of $87.3 million. I find that accounting result to be absurd. It fails to reflect the economic reality. We must correct the rules to prevent such gross distortions.

As our witnesses explain the implications of this standard and offer solutions to improve its application, we must bear in mind that fair value accounting is not one uniform rule affecting all parties to whom it applies in the same manner. Many industries have been hit hard by the mark-to-market rules, especially the financial services sector.

Moreover, one industry's predicament may require a unique accounting treatment or regulatory forbearance that will not solve another sector's problems. In pursuing improvements, we need to recognize this fact. We also need to recognize that these matters are technical and complex. Instead of confining our words today to sound bites that too often mischaracterize mark-to-market accounting, we need to explore these complexities and enrich our understanding of the issues.

Those following today's proceedings are most interested in progress and solutions. Accounting regulators and standard setters need to offer us an achievable, concrete idea of what they are doing. As I said earlier, they must also tell us precisely when they will act. In my view, we can no longer wait 15 years, 15 months, or even 15 weeks for change. We need action much, much sooner.

Bank regulators must also consider liberalizing regulatory capital requirements and granting reasonable forbearance in the current economic environment. The Office of the Comptroller of the Currency can be of particular assistance on this issue. I therefore look forward to the Agency's testimony today.

Participants on our other second panel will offer us a wide variety of views from the private sector. The participants on our first panel also need to listen closely to the views expressed during the second panel. These comments will help in the tailoring of specific remedies to address particular needs. One idea worthy of consideration is separating an asset's losses due to credit risk from its losses due to liquidity risk when using mark-to-market accounting.

In sum, mark-to-market accounting did not create our economic crisis, and altering it will not end the crisis. But improving the application of a fundamentally sound principle that is having pro-

found adverse implications in a time of global financial distress is imperative.

Therefore, our hearing today is about getting the Financial Accounting Standards Board and the Securities and Exchange Commission to do the jobs they are required to do. Emergency situations require expeditious action, not academic treatises. They must act quickly.

I would like to recognize Ranking Member Garrett for 3 minutes for his opening statement.

Mr. GARRETT. Thank you, Mr. Chairman. Before I begin, I just seek unanimous consent to enter into the record a letter by a member from California, Mr. Miller, who cannot be with us today because of health reasons. It is a letter to Mary Shapiro, Chairman of the SEC.

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. GARRETT. Thank you. Thank you, Mr. Chairman, for holding this important hearing. I would like to also begin my remarks by noting that I agree with you and Chairman Frank and Ranking Member Bachus that Congress should not be in the business of writing accounting standards. However, I do believe that Congress should perform its proper oversight function.

It is essential that we examine in greater detail what role current accounting standards and the application of the standards have made in the continued deterioration of the marketplace. Since the formal adoption of Financial Accounting Standards 115 in 1993, and continuing with the various other standards up to and including FAS–157 in 2006, the U.S. financial system has moved away from an historical cost accounting system, where assets and liabilities are valued at their amortized purchase price, to a fair value accounting system, whose financial asset and liability valuations are determined by what price they fetch on the open market. This system is intended to provide reliable, real-time information to the investors about the current market value for the price that financial assets and liabilities while minimizing management bias.

I agree that it is a top priority that investors have accurate information about a company's earning potential and liquidity so that they can make informed decisions. Unfortunately, I believe that during the market turbulence over the last year, the fair value or mark-to-market accounting has prevented investors and the general public alike from obtaining a really true value of the money financial institutions, their balance sheets. This method of accounting has its merits when the market is functioning correctly but has a significant downside when the market is broken. Our most profound problems occur when attempting to value illiquid longer term assets, such as mortgage-backed securities, in an illiquid or nonfunctioning market. So attempting to value these types of assets in this marketplace has caused severe price distortions, totally unrelated to any credit loss in the underlying mortgages themselves.

Another problem with mark-to-market accounting that the Federal Reserve Chairman himself, Ben Bernanke, mentioned in a speech just the other day, is its procyclical nature. Now, this is particularly true when coupled with current regulatory capital rules by banks. When the price of assets in a bank's balance sheets are written down, the bank has to raise additional capital by selling

additional assets or stock. These sales put more downward pressure on prices and so it is this negative feedback loop that is exacerbated by the combination of accounting practices and capital requirements. And so I am interested to hear from Mr. Bailey what the OCC and other banking regulators are considering to address how regulatory capital levels are examined during these non-functioning market periods.

Since the financial markets began to rapidly deteriorate during the fall of last year, there have been a number of attempts by Congress and others to ensure that accounting policies set are examined and the concerns raised when making these decisions, and I am pleased the SEC has issued their report that the Economic Stabilization Act required, but I am, as the chairman is, troubled at the lack of speed in these areas. And I realize that FASB is currently reviewing these things and using much deliberation in their process. I wish the Congress would use such deliberation in their processes in a lot of these things, but I think the chairman and I wish for additional speed.

So, in conclusion, I look forward to the witnesses' testimony and hearing greater detail on these matters. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Ranking Member. We will now hear from the chairman of the full Committee on Financial Services, the Honorable Barney Frank of Massachusetts.

The CHAIRMAN. Thank you, Mr. Chairman. You are diligent in pursuing this, you have been one of the earliest to spot this, and I think this is a very important hearing.

Mr. Herz, I will address in part. You know I have generally been a defender of the integrity of the Accounting Board. For example, when there was a great push to alter by legislation accounting for stock options, I was one of those who was opposed to that. I do feel entitled to say, "We told you so." The notion that if you had to expense stock options, this would have terrible consequences, that ranks along with same-sex marriage in Massachusetts as the recipient of doomsday predictions that went nowhere.

But we do have to have you move now. And it is important that we get some speed. I understand sometimes acronyms are important. You are the FASB. In this one, you cannot be the "SLOWSB." We are going to have to have some movement. And the movement we have is clearly in your hands. I say this to the SEC and the OCC. There are two things, it seems to me, that need to be done. First, more realism and flexibility in the mark-to-market. And I understand we all react to past things. My own view is that the negative impact and reaction to allowing Lehman Brothers to fail has had an impact on making people more nervous now. Yes, we had irrational exuberance and excessive elasticity but this is not a time to make up for past mistakes by excessive rigidity, by pretending that there is more reality and certainty to mark-to-market than there is. It should be applied with flexibility.

It does seem to me if you were talking about a member of an asset class that the particular institution has always held to maturity and it is performing and providing an income stream, that the case for substantially devaluing that is a lot weaker than if it is a tradeable asset, if there is a history that that kind of asset is

held. I do not think we have had enough flexibility in how we apply them.

Secondly, and this is important for all regulators, we need to give you some discretion in how you apply, how you react to these things. And I am now asking everybody, the OCC and others, if anything in the legislature, and here is where the legislative role is, if anything in existing legislation deprives you of discretion in how you react in a mark-down to market situation, I insist that you tell us. That is our job. Our job is to think about the extent to which we give you some discretion. There is no point in having these things be so automatic. It does seem to me, as the chairman correctly said, and he has done a lot of work on this, that if the institution, if a bank has to mark down its assets, why it had to do that is something to take into account. If they did it because they made a lot of stupid decisions, that is one thing. If they had to do it because of things that happened in the economy over which they had no control, over assets that are still performing, that is another. And the consequences of a write-down should not be identical in very different situations, and you have to move quickly.

I was pleased yesterday, when I talked about mark-to-market. We got a good reaction from the market. We are not driven by day-to-day reactions of the market, but our job is, I think, to give you the flexibility you need and to help you understand the point. I hope that within a very short period of time, working together, we will have a situation in which we will not be constantly told by the people who are the practitioners that mark-to-market is having undo negative effects and is doing more harm than good.

Chairman KANJORSKI. I thank the gentleman from Massachusetts. Now, the ranking member, Mr. Bachus of Alabama. You have 4 minutes.

Mr. BACHUS. Thank you, Mr. Chairman. I want to share with my colleagues on both sides of the aisle and with the panel and with the audience a true story. It is a story that happened in Alabama over 60 years ago, and it is recorded in a national bestseller by one of our colleagues because he was the little boy in that story, and that is John Lewis. John was playing at his aunt's farm one morning with 15 of his brothers and sisters and his cousins when a storm came. I do not know whether it was a hurricane or a tornado, but we have all been there on the days where it starts pretty sunny and things get dark, the wind picks up, and day turns to night. He records what happens there and he relates it to years later during the civil rights movement.

And here is what he says, well, he talks about what happened that morning, the children, the aunt, his aunt rushed him in the office. The house began to shake, the storm blew, and one corner of the house actually lifted up. And all the kids rushed over to that corner of the house and it settled back down. In a few minutes, as we know from storms, and I have been through one, the other end of the house began to lift up. All the little kids went over to the other end of the house, rushing back and forth. He said America sometimes is like that. Children in a house rocked again and again by winds, one storm after another. The walls around us seem at times as if they might fly apart. That is America today. It is quite a storm. It is the civil rights in Alabama in 1960. So much tension,

so many storms but here is what he said, "But people of conscience never left the house. They never ran away, they stayed, they came together, and they did the best they could." "That is America to me," he said. "Not just the movement of civil rights but the endless struggle to respond with decency, dignity and a sense of brotherhood to all the challenges that face us as a nation as a whole."

Well, let me tell you this gentlemen: We are in that house today, and I see the American people in that house. I see lenders and borrowers. I see the Congress. I see the Administration. Sometimes we are almost like children, rushing from one end of that house to another. We are scared. We have anxiety like those little kids that day. But as I look around that house, and I say this because the last thing we want to do is point fingers because that does not help, it would not have helped then, but as I look around the house, I do not see the Financial Accounting Standard Board. I do not see the engagement. I do not see the urgency. I see the SEC, and I know that, as I said in my prepared opening remarks, we ordered a study, and the SEC reported that there ought to be changes to mark-to-market, and that they were causing distortions in the system. And one of the weakest corners of that house is our financial system and our banking system. They said it was causing real problems there. And back in January, they asked the Financial Accounting Standards Board to join the fight. I see you here this morning. I am glad you are in the house. Let me tell you it is a storm. We cannot just sit around and talk, we need action. We need it now.

Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Bachus. Now, we will hear from Mr. Ackerman of New York for 2 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman. In a perfect world, with a normal and honest market with real transparency and a strong economy, mark-to-market accounting standards make sense. Philosophically, I believe it is important for certain assets of their fair market value but the key word, Mr. Chairman, is "fair." We are in the midst of a recession whose tentacles have spread along Wall Street and constricted our credit and equity markets. In today's economy, the market value of a mortgage-backed security may be only 20 cents on the dollar even though the underlying mortgage may be paid in full, being paid in full with interest.

Today's market is not a fair market. It is not a real market. It is a panic market and it is a buyer's market. Companies are forced to mark their markets, their assets to market despite the fact that they have no inclination to sell them, are watching their company's value disappear. The great unraveling of so many firms' balance sheets is not the consequence of unsound business practices or even declining sales but simply the result of our regulators' unwillingness to implement the more effective accounting rule that will not pull enterprises under the rising tide of an economic crisis.

And let's be clear about the scale of the problem, it is not just the high-flying Wall Street traders who are suffering as a result of the mark-to-market rule. Many of the financial institutions that receive TARP funds, taxpayer money provided to keep our national credit markets operating, our lending institutions that have reserve requirements that they are obligated to maintain by law. They are

forced to mark their assets down to an unrealistic market. They are required to raise enough capital to maintain their reserves in this economy. Where are the financial institutions, the ones in which the taxpayers now have a major stake, going to raise tens upon tens of billions of dollars? Certainly, no one from the extinct investment banks or trading companies in which they used to rely. There is in fact just one place for these banks to go to get the money they need to meet their legal reserve obligations, from you and me, from the members of the committee and the Congress and in the end always from the taxpayers.

The $700 billion emergency bailout we passed last year to revive lending and increase access to credit has been subverted in good measure by mark-to-market accounting. The banks are holding onto the money, at least in part because as mark-to-market accounting standards are forcing them to write down the value of their assets, they are required to meet their reserve obligations. The problem is clear, the solution may be less so. But I am pleased we are focused on finding it. The public does not expect us to be perfect, but they are right to expect us to fix mistakes once they are discovered, and we have discovered a big one.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Ackerman. The gentleman from Georgia, Mr. Price, for 1 minute.

Mr. PRICE. Thank you, Mr. Chairman. Before I begin, I would like to ask unanimous consent to enter into the record testimony from Alex Pollock, who is a resident fellow at the American Enterprise Institute dated today, "Reform of Fair Value Accounting."

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. PRICE. Thank you, Mr. Chairman. I congratulate you and Ranking Member Garrett on holding this hearing. I join others in the belief that Congress should not be in the business of writing accounting standards. However, when economic realities reveal shortcomings in accounting practices, we all should be able to expect that the entities responsible for those standards will respond as quickly as possible.

Process is important, but I believe that the SEC and FASB and other regulators have had more than enough time to gather information and make determinations to help ailing financial institutions. Despite the steps taken by the SEC and FASB, my constituent companies and others around this Nation have yet to experience any relief. We simply cannot wait any longer for some substantive action to be taken to help institutions know how to appropriately classify illiquid assets.

As we are attempting to do everything possible to strengthen our banking system and free up capital and increase lending and stimulate the economy, we must consider ways in which we might be able to do that without expending more taxpayer dollars. Importantly, providing additional guidance to companies on mark-to-market could considerably ease the credit constriction we currently face.

I look forward to working with the regulators to develop positive solutions that will protect the investors while at the same time providing confidence and stability to the financial system as a whole, and I look forward to doing so rapidly.

Thank you very much.

Chairman KANJORSKI. Thank you, Mr. Price. The gentleman from Texas, Mr. Hinojosa, has 1 minute.

Mr. HINOJOSA. Thank you, Mr. Chairman. I thank you for holding this important hearing today. I ask unanimous consent to submit my entire written statement into today's record.

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. HINOJOSA. My abbreviated remarks will summarize concerns and recommendations for today's record. I have a few modifications to the mark-to-market accounting that I would like you to take into consideration. I earned an MBA, and I can read financial statements, and it seems to me that the current mark-to-market accounting is flawed in that only the asset side of the balance sheet is examined.

A well-run banking institution does not have the ability to show that many interest rate risks are offset by funding on the liability side of the balance sheet. Even in the event that there is not an interest rate offset on a bank's balance sheet, the fact that securities carry little credit risk should be taken into consideration. The day-to-day value of the investment should not hinder a bank's ongoing daily operations as long as it has enough liquidity to manage the bank's operations.

I do not believe that I can give all of my statement in 1 minute, Mr. Chairman, but I would like to simply conclude and say that this current mark-to-market system should be modified so that unused capital can be used by the banking system to fund growth and not be squandered into needless collections of idle resources.

I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Hinojosa. And now we will hear for 1 minute from Mr. Castle of Delaware.

Mr. CASTLE. Thank you, Mr. Chairman, and Mr. Garrett, for this meeting. If anyone thinks mark-to-market is not an issue, they should see this room, which is filled both with members and spectators, which is highly unusual for a subcommittee meeting. There is no question that this is a very significant problem. You have investors who want to know what the assets of the banks are. You have banks which are worried about their capital circumstances, and they feel that mark-to-market is injurious to that.

We talk about going back to cost accounting, which may not be the correct way to go, but the bottom line is that I think we need to listen carefully to those who are going to testify here today. We know we have economic problems. We know banks are struggling. There have also been studies about this. The SEC has conducted a study on fair value accounting at the direction of Congress and made several recommendations. FASB has also announced that they will be re-examining these problems and will complete their investigation by the end of the second quarter in 2009. I believe these studies are critical as well. My sense is you are going to have some solution in the middle, that is what we need to try to ascertain, and we in Congress need to help with that. This is a very important issue, I think, to the whole capital structure of banking in our country, and I hope we can work this out.

I appreciate the experts being here, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Castle. And now we will hear from the gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thank you, Mr. Chairman. And I want to thank the ranking member for organizing today's hearing. And, gentlemen, our first panel, I will admit that I think that my colleagues have been far kinder than I feel today about this particular subject.

This is a situation, and I just want to start with the definition of fair value for fair value accounting. Fair value is the price that would be received to sell an asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date. We have known now for at least 6 months, since September, this has been an issue as to whether mark-to-market type accounting, fair value accounting, was exaggerating and multiplying the cycle that we are in.

And whether it is the Comptroller of the Currency or FASB or the SEC, we have—the SEC did a wonderful study, it is about 300 pages long already. We have been dithering while this patient has been sick, and I think giving the medicine that has been making the patient sicker. And I know the chairman does not want us to be doing this in terms of sound bites but the problem has been apparent now for at least 6 months. Mr. Isaac, who is going to be one of our witnesses in the second panel, predicted this 12 years ago, that if we went to mark-to-market accounting in connection with the banking industry, which is a different animal than Hewlett Packard or Colgate Palmolive or whatever else you might want to look at, that we would have this kind of exaggeration within the system.

The SEC, I appreciate your role, you look to investors and their safety. Okay, but there are two other interested groups here that we must consider, and I look to the banking regulators for these, and that is the depositors and the taxpayers. The taxpayers have been getting clobbered for the last 6 months. And we can deal with this. We need to deal with this now. This is not a time for more study; it is a time for action.

I appreciate the chairman letting me make an opening statement.

Chairman KANJORSKI. Thank you very much, Mr. Perlmutter. Now, we will hear for 1 minute from Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman. And before I begin, I would like to ask for unanimous consent that written testimony from the former Speaker of the House, Newt Gingrich, be added to the record.

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. LUCAS. Thank you, Mr. Chairman. And thank you for holding this hearing on this critically important issue. It is important to the stability of our Nation's financial system that we address the effects of mark-to-market accounting rules. The goal of mark-to-market accounting is to increase transparency and confidence. However, certain mark-to-market accounting principles have created unintended consequences that have only contributed to the disruption of the markets. These practices that are used to value assets in illiquid and inactive markets have intensified the eco-

nomic downturn and threatened the health of many of our country's financial institutions. The inability to appropriately value these assets has resulted in uncertainty and worked to further deepen the credit crisis.

I urge the SEC and the Federal Accounting Standards Board to act quickly to make the necessary changes to mark-to-market and provide the appropriate relief and guidance to our financial institutions.

Additionally, as we work to stabilize our financial system and reform our regulatory framework, it is important that we examine all economic policies that pose a systematic risk to our financial system, including accounting practices. That is why I have joined with my colleague, Mr. Perlmutter, in introducing H.R. 1349, to create a Federal accounting oversight board to oversee the accounting principles and practices in an effort to provide a broader economic perspective on accounting rules in the markets. This new oversight framework will provide more flexibility in monitoring and reviewing accounting practices in the present market conditions.

Again, thank you, Mr. Chairman, for this very important hearing.

Chairman KANJORSKI. Thank you very much, Mr. Lucas. And now we will hear from the gentleman from Georgia, Mr. Scott, for 1 minute.

Mr. SCOTT. Thank you, Mr. Chairman. I think to preface my remarks I want to mention two distinguished individuals, one was William Shakespeare who said, "The quest before us today is to be or not to be." Our quest before us today is to suspend or not suspend the fair value accounting. The other gentleman is none other than Warren Buffett. Warren Buffett, on Monday on CNBC, said that mark-to-market accounting should not be suspended, and he made some good arguments to that end. But he also recognized the problems associated with the effects of the impairments taken, especially on assets that are held to maturity. Warren Buffet said that the regulators should consider not requiring additional capital be held against those write-downs. If even an ardent supporter of mark-to-market accounting can point to the problems, should not that problem be fixed if it can be so? So regulators do not have to resort to what amounts to regulatory forbearance. To be or not to be, to suspend or not to suspend, that is the question before us today.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Scott. Now, we will hear from the gentlelady from Illinois, Mrs. Biggert, for 1 minute.

Mrs. BIGGERT. Thank you, Mr. Chairman. I look forward to hearing about very near term action the SEC and FASB plan to take to correct accounting rules that many believe have failed. When I say "failed," I mean rules aimed at transparency, which is important and should be preserved, but rules that simultaneously have facilitated a downward spiral of skewed financial statements, created market volatility and required capital adjustments.

I would like today's witnesses to comment on the idea mentioned in the SEC study on fair value. That study and others suggest that on the income statement and the balance sheet, we should make

a distinction between credit impairments versus impairments due to other factors. In other words, can we preserve transparency and help restore investor confidence and calm market volatility by reporting separately the losses related to declines in expected cash flow versus all other changes in fair value?

I urge the SEC and FASB to refrain from issuing additional meaningless guidelines but instead to get at the root of the problem, which is valuation.

With that, I would conclude, and I look forward to hearing from our witnesses.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert. We will now hear from the gentlelady from New York, Mrs. Maloney, for 1 minute.

Mrs. MALONEY. Thank you, Mr. Chairman, and Mr. Ranking Member. Several years ago, FDR suspended mark-to-market, calling it a destructive regulation. I am beginning to believe that providing reform or flexibility, or reality in the pricing in mark-to-market could be one of the most important reforms which could help us turn our economy around and help with economic growth and stability.

Even Chairman Bernanke, this week, expressed his concern over the mark-to-market rule. And I quote, he first speaks about the importance of improved disclosure and greater transparency as a positive development but then he states, "Further review," and I quote, "of accounting standards governing valuation and loss provisioning would be useful and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency." So I truly do believe that there is a way that we can look at it. Certainly assets that are held to maturity are a different value than ones that are sold today. And we certainly need to look at this.

I completely respect accounting. I support your independence, the need to have an independent body, but this needs to be looked at, it needs to be reformed, and needs to be more realistic and flexible, and I feel that doing so would be one of the most important things we can do to stabilize and help our economy.

I put my statement in the record. Thank you.

Chairman KANJORSKI. Thank you, gentlelady. And now I will hear from Mr. Barrett for 1 minute.

Mr. BARRETT. Gentlemen, thank you for being here. In a different life, I wore a different hat. I was a small businessman, Barrett and Sons Furniture, Westminster, South Carolina, 50 years in business. I could not afford my stock so I would take a loan with the bank floor plan. And my local bank would roll that up, sell it somewhere, and of course according to mark-to-market they had to mark it down to hurt—on their capital. In 50 years, we never failed to make a payment on time. In fact, most of the time, we paid them early. There are 350,000 small businessmen and women in South Carolina, guys, and this is killing them. They cannot get the credit. And they are just like Barrett's Furniture, 50 years, 60 years, 70 years, and we are killing the backbone of this Nation. Listen to what you are hearing. I think you are hearing it, but I am not sure you are listening. Re-evaluate it. I look forward to this hearing.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Barrett. And now Mr. Capuano for 1 minute.

Mr. CAPUANO. Thank you, Mr. Chairman. Gentlemen, thank you for being here. The truth is, I tried to read through most of your testimony, but it does not get to where I want to go, and where I want to go, and I think all of America wants to go, I actually think that you may be the only people in America who do not want to straighten out this mark-to-market thing yesterday, not tomorrow, no more studying. Just get it done. There are a thousand ways to do it. If you are not hearing people, I think you will hear from us. Get it done.

I liked the mark-to-market rule in normal times. It is not normal times. Extraordinary measures are necessary. Stop dithering with it and just get it done. If you get it done right, and you get it done quickly, maybe the taxpayers can avoid getting involved in this bad bank nonsense because all these bad assets, if properly valued and properly addressed by the accountants, can be left on the books of the people who took those risks and still not bring their companies down. This is not difficult. It was easy to put the up-tick rule in, take the up-tick rule out, put it in, take it out. Get it back on. You know it is necessary. Do not make us tell you what to do. You know what has to be done, just do it. Please.

Chairman KANJORSKI. Now, will you tell us what you really believe.

[laughter]

Chairman KANJORSKI. Now, we will hear from Mr. Campbell for 1 minute.

Mr. CAMPBELL. Thank you, Mr. Chairman. There are those who would lay the entire problems of this financial crisis at the risk of mark-to-market accounting and that is wrong, but it is an issue. And there are those who would eliminate mark-to-market accounting completely and that is also wrong because there have been permanent losses experienced in these financial assets, and if we do not recognize those permanent losses, we will have financial statements which will overstate the value and will be artificially inflating the value and health of banks, which we certainly do not want to do at this time. But, similarly, we cannot be taking a long-term asset and marking it to a short-term value, particularly when in the current market there is no real market that exists to determine that short-term value. So, clearly, we need a middle ground. Perhaps that middle ground is a net present value of the expected cash flows and perhaps we are going to hear some of that today. But we do need to get to a middle ground, some fair, actual, best we can estimate. I am a CPA, I know it is difficult, but true accounting value of these assets, and we need to do it quickly.

Thank you. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Campbell. And now we will hear from Mr. Klein.

Mr. KLEIN. Thank you, Mr. Chairman, for holding this hearing. As we all know, it is absolutely essential that investors have reliable information when analyzing investment opportunities. Fair value accounting principles, including mark-to-market rules, are intended to maximize transparency and the ability of the investors to accurately evaluate and compare the financial statements of dif-

ferent business organizations. Yet, in practice, as we know, mark-to-market accounting is flawed, particularly in this environment. And what we know is that in this downturn, even assets that are still performing are facing illiquid markets and determined to have little value. In some cases, this unnecessarily slashes the credit availability that is so sorely needed today. And, as many of the members have said today, we are worried about how small businesses and working citizens in our communities cannot get loans. I am worried about them and everyone else is about the people who are losing their jobs because of this.

Many of the banks made bad loans and banks should be required to deal with this. But we also need to give the banking industry, in some cases, time to strengthen its financial position and forcing them to mark assets to illiquid markets at fire sale prices had wide repercussions for the broader economy. I would suggest that a temporary suspension of mark-to-market rules should be seriously considered and I look forward to your comments on that.

Chairman KANJORSKI. Thank you very much, Mr. Klein. And now we will hear from Ms. Bachmann for 1 minute.

Mrs. BACHMANN. Thank you, Mr. Chairman. Thank you also for this long overdue hearing. I am very pleased that you have convened it. I wish we could rewind the tape back to last September of 2008 because during the height of the debate over the $700 billion TARP bailout, I, along with 60 other Members, wrote the SEC and asked them to suspend mark-to-market and replace it with a form of mark to value that could accurately reflect the true long-term value of institutions' assets. More than 6 months later, we have seen some action on this issue but not enough.

Recently, I read a book that did report on FDR suspending mark-to-market accounting. The book concluded that had FDR suspended the rule earlier, the country would have been spared at least 2 years of the Great Depression.

Last December, when the SEC released their subsequent recommendations, I began hearing from financial institutions in Minnesota that more could be done to both preserve the transparency of bank balance sheets, something that is critical, but also allow them to show a longer term, more accurate value of our assets. Much could be said about undervaluing and overvaluing. However, our financial system needs to find a way to unleash capital sitting on the sidelines, both in investor pockets and on bank balance sheets, so business and consumers alike could return to a stable lending environment.

I have had numerous conversations with both financial service institutions and those in the accounting industry. It seems there must be a way forward on this issue, whether it is suspending mark-to-market and replacing it with something else or altering it in a manner that would help make these clogged assets marketable again.

We agree, both Democrats and Republicans, that something must be done.

I yield back.

Chairman KANJORSKI. Thank you very much, Ms. Bachmann. And now we will hear finally from Mr. Manzullo for 1 minute.

Mr. MANZULLO. Thank you, Mr. Chairman. I am going to be asking a question: Is mark-to-market best when the market does not exist, when there is no market to value the assets? You have a tough job, but the IRS certainly does not use mark-to-market when it comes to valuing the estates of the owners of these small factories in the district that I represent. So on one hand, they cannot get money to run their factories because of mark-to-marketing, and yet some of them die and the IRS says, oh, this is worth "X" amount, and they ignore those same rules. It is the inconsistency of the message. It has resulted in the fact that, gentlemen, we could lose hundreds of factories, thousands of factories, that are hemorrhaging, that simply cannot get money. This Nation will collapse in a long, long depression unless something is modified with the formula that is being used for the purpose of lending out money.

One of the experts, Rich Berg, the CEO of Performance Trust Capital, asked the question in terms from the consumer, the bank manager and the investor the question I am going to ask you, and I thank you for being here today, but I ask you to keep in consideration the fact that in my district alone, in one city, I could lose a couple hundred factories. We are already at 14 percent unemployment.

Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Manzullo. And now I will introduce our first panel. First of all, gentlemen, thank you for appearing before this subcommittee today. And without objection, your written statements will be made a part of the record. You will each be recognized for 5 minutes to summarize your testimony. First and foremost, we have Mr. James Kroeker, Acting Chief Accountant of the Securities and Exchange Commission. Mr. Kroeker, I think we have to identify the fact that your being here took an act of courage on your part, so welcome. We will try and protect you, but if you will summarize your statement.

**STATEMENT OF JAMES KROEKER, ACTING CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION**

Mr. KROEKER. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, thank you for the opportunity to testify here today on behalf of the SEC on mark-to-market accounting, their practices and implications. This testimony is presented on behalf of the Office of the Chief Accountant, which advises the Commission on accounting and auditing matters.

Our Chairman testified yesterday that these are wrenching times and there can be no doubt about the urgency and the gravity of this matter today. Accounting did not cause this crisis and accounting will not end it, but accounting should not make it worse.

On December 30th, the Commission delivered its staff study on mark-to-market accounting to Congress. In this comprehensive study, conducted in consultation with the Department of the Treasury and the Federal Reserve, we did not recommend the suspension of fair value accounting. We do recommend improvement.

Among the study's findings, we found that investors generally believe that fair value accounting increases financial reporting transparency and facilitates better investment decisionmaking. In addi-

tion, after careful study of the factors that led to bank failures in 2008, fair value accounting did not appear to play a meaningful role, but rather we found that failures appeared to be the result of growing credit losses, concerns about asset quality, and in certain cases, the erosion of investor confidence.

We also observed that the abrupt removal of fair value accounting would erode investor confidence, resulting in the potential for further instability in our financial markets.

All of our recommendations are included in my written testimony and are fully described in our study, but I would like to highlight two of our more significant recommendations:

First, we recommend additional guidance be developed to assist in measuring the value of illiquid securities. And, second, we believe that accounting for financial asset impairments should be readdressed. We are working closely with the FASB and others to address these and other recommendations in our study. Consistent with the Chairman's testimony yesterday, the FASB has committed to provide guidance on valuing illiquid securities in a matter of weeks, not months.

Our financial reporting system has long been considered world-class and a major national asset. This world-class reputation has been earned by our ongoing commitment to provide investors with transparency that they need to make better capital allocation decisions. This reputation should be safeguarded by those charged with the stewardship of our capital markets by continuing to hold the needs of investors paramount. Interruptions to financial stability caused by real economic factors should not lure us into suspending transparency and the accompanying clear financial picture and investor confidence that our capital markets depend upon.

To achieve this, we believe an independent accounting standard setter is best positioned to promulgate financial reporting standards for all private industry. And it is important to note that the accounting standards that are the subject of this hearing, those related to fair value, are not just used by financial institutions but by all industries.

Of course, open due process, including thoughtful consideration in the input and the views of investors and the many others who play a critical role in our capital markets is crucial to the FASB in fulfilling its mission.

It is also vitally important to point out that an independent standard setter must still be accountable. Thus, we continue to believe that the FASB must be responsive to the needs of capital market participants, particularly to investors. To be responsive, the FASB must continue on a timely basis to improve guidance available to assist preparers and auditors when making difficult judgments. Further, evaluation of the application of existing standards and practice and timely improvement where warranted are crucial to the success of an independent accounting standard setter. We believe responsiveness is enhanced by a collaborative process between all parties.

My written testimony and our study outlines the history and the use of fair value accounting in broader detail. However, I would like to emphasize today that the use of fair value accounting, primarily for derivatives and for investments that are not held to ma-

turity, were adopted over many decades and after careful consideration, including the evaluation of causes of previous financial crises.

FASB Statement 157, which provides a common definition of fair value and improved transparency regarding fair value measurements did not increase the use of fair value or mark-to-market accounting.

We should not forget that investor confidence is at the heart of efficiency and capital formation. Transparency increases stability by increasing investor confidence and the needs of investors should be the primary focus of financial reporting. Despite the call and the recognition for the need for improvement, in certain practice areas the current standards related to mark-to-market and their transparency should not be suspended.

We at the SEC remain committed to advancing investor confidence and transparency in reporting during this economic crisis.

Thank you for the opportunity to appear here today, and I will be pleased to respond to any questions. Thank you.

[The prepared statement of Mr. Kroeker can be found on page 211 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Kroeker. I appreciate it.

Next, we will hear from Mr. Robert Herz, Chairman of the Financial Accounting Standards Board. And, again, we will offer the same protection to you, Mr. Herz.

**STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)**

Mr. HERZ. Thank you, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee. I am Bob Herz, the Chairman of the FASB, and thanks for letting me participate today.

Our current reporting model in the United States, and indeed across much of the world, includes both historical costs and fair value measurements. Recently, many have criticized the use of fair value in the current environment as overstating the extent of losses and capital erosion and as a factor exacerbating the crisis and have called for it to be either suspended or significantly modified. Others, however, have applauded its use as essential in promptly revealing the extent of problem assets and deteriorating conditions of financial institutions and have urged us not to suspend or weaken the current requirements. Indeed, some, and that is investors, have urged us to extend the use of fair value to all financial assets.

Clearly, there are very strongly held views on this subject. So rather than use my time to debate all the pros and cons, what I would like to do is to provide you some information about fair value and how it is and is not used in financial reporting now. Secondly, on our recent standard setting actions on this subject, including how we have been responding to reporting issues emanating from the crisis and how we are addressing the recommendations in the SEC report. And, finally, some observations about the role of financial reporting and its relationship to economic and regulatory consequences.

Mr. Perlmutter read you the definition of fair value, thank you. Conceptually it is what an asset is worth currently in an exchange between informed parties on an arms-length basis and not its potential value at some future date under different economic or market conditions. And contrary to what some assert, it is not the price that would be received in a fire sale, a distress sale, or a forced liquidation. The standard is quite clear on that point.

As described extensively in the SEC report, the use of fair value by U.S. financial institutions varies considerably, from relatively little by many banks to more general use of so-called mark-to-market accounting by broker-dealers. Mark-to-market accounting occurs when the items are carried at fair value on a continuous basis with the periodic changes in value, that is the mark-to-market adjustments included in determining reported earnings each period. The use of such accounting is generally limited to securities in trading portfolios and accepted for qualifying hedges to derivatives.

Fair value is also used to report securities in what are called "available for sale" portfolios of financial institutions but in such cases, the periodic changes in the fair value are included in what is called "other comprehensive income," which is outside of reported earnings. Investments that are classified as held to maturity are carried on a cost basis. Fair value is then used also to recognize in earnings what are termed "other than temporary impairments" of financial assets where there has been a significant and prolonged decline in their value as can occur in sustained downward markets. Loans held for investment, which comprise the bulk of financial assets for many banks, are carried on an amortized cost basis with allowances for loan losses that are not based on fair value.

Most of these requirements have been in place for a while. Our Standard No. 157 of fair value that we issued in 2006 does not require any new fair value measurements. Thus, it is not surprising that the SEC report indicates that the extensive use of fair value remained fairly constant before and after Statement 157 came into effect. FAS–157 provides a consistent definition of fair value, a framework for determining fair value across varying types of assets and liabilities in differing market conditions and requires significantly expanded disclosures related to the use of fair value. So fair value is not a new concept. Further, the practice of writing down assets in periods of down markets is not new and would apply whether one used fair value or other age old accounting methods, such as lower of cost or market.

What is new of course are the state of the markets that you all commented on. And, clearly, as the crisis has deepened, the values of many financial assets have fallen significantly and the markets for some complex instruments have become increasingly inactive and illiquid. Such conditions pose very significant challenges to the valuation process, often requiring additional data gathering and analysis and the use of sound judgment. It is challenging for the companies that hold these instruments and for their auditors but it is important for investors to get a reasonable idea of the values.

While FAS–157 did not specifically contemplate the current crisis, it did include guidance on determining fair values for illiquid assets for which there may be little or no transaction activity. And

as the credit markets froze in 2008, our staff, together with the SEC staff, provided additional guidance on valuing financial assets in illiquid markets, which we then quickly supplemented with further guidance.

Additionally, consistent with the recommendations in the SEC report and with the very good input we have received at our recent public roundtables and following many, many other discussions with constituents, we have recently undertaken a series of near-term standard setting actions to resolve inconsistencies in the rules relating to impairments of securitized assets, which we did in January, to provide more guidance on dealing with inactive markets and distress sales and also some more disclosures.

Also, consistent with the recommendations in the SEC report, we and the International Accounting Standards Board are undertaking a joint project to more comprehensively improve, simplify, and converge our standards on accounting for financial instruments.

I would also note that over the course of the past year, we have responded to many other reporting issues emanating from the crisis, including issuing new standards to improve transparency around securitizations, the use of special purpose entities, financial guarantee insurance, credit default swaps, and other derivatives.

A few brief comments on the role of financial reporting and its economic and regulatory consequences, including assertions by some that the use of mark-to-market accounting has caused banks to fail and exacerbated the financial crisis.

We agree with the SEC's conclusion that fair value did not cause banks to fail. We also agree with the SEC that suspending or eliminating existing fair value requirements would not be advisable for the role of accounting and reporting standards is to help the investing public in the capital markets with sound, unbiased financial information on companies. Its purpose is not to determine regulatory capital or capital adequacy. That is a matter for the financial institution regulators. But while our roles are different, we have longstanding, and I believe very productive relationships, working relationships, with the regulators wherein we share perspectives, discuss issues, and look for ways to complement and bridge the reporting needs of investors with those of the regulators.

Of course, good accounting and reporting can have economic consequences, including potentially leading to what some term as "procyclical" behavior. Reporting the deteriorating financial condition of a financial institution can result in investors deciding to sell their stock, to lenders refusing to lend, to the company trying to shed problem assets, and to regulators in the capital markets recognizing the institution may need additional capital. Indeed, such procyclical actions are being taken by individuals and families as they see the falling value of their homes and of their 401(k) accounts and decide to spend less, to save more, to sell investments to raise cash. But I think few of us would suggest that we suspend or modify the reporting to individual investors of the fair values of their investment accounts. Thus, to the extent there are valid concerns relating to procyclicality, I believe these are more appropriately and more effectively addressed through regulatory mechanisms and via fiscal and monetary policy than by trying to alter the financial information reported to investors.

Finally, I would like to in these very challenging times assure all the members of the subcommittee of FASB's continuing commitment to work actively and constructively with all parties on these very difficult but very important matters.

Thank you.

[The prepared statement of Mr. Herz can be found on page 139 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Herz.

And now we will hear from the final member of the panel, Mr. Kevin Bailey, Deputy Comptroller for Regulatory Policy at the Office of the Comptroller of the Currency. Mr. Bailey? We will not offer you any protection.

**STATEMENT OF KEVIN J. BAILEY, DEPUTY COMPTROLLER FOR REGULATORY POLICY, OFFICE OF THE COMPTROLLER OF THE CURRENCY**

Mr. BAILEY. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, thank you for the opportunity to be here today to discuss fair value accounting and the practical challenges faced by banks and bank supervisors in the implementation of those standards.

The unprecedented disruption in worldwide financial markets that we have seen over the past 18 months has raised a number of issues about mark-to-markets or fair value accounting, including the very important question of how or even whether fair value concepts should be used in financial reporting and bank regulatory capital.

Implementation of these standards in the context of the current crisis has also caused many to question the extent to which fair value measurement has contributed to procyclicality in the broader economy.

As the primary supervisor for national banks, which hold nearly 70 percent of the Nation's banking assets, the OCC has significant interest in the impact of fair value accounting, especially its effect on capital, a key measure of a bank's health and ability to lend.

The OCC and the other Federal banking agencies use current accounting standards as the starting point in determining inputs to regulatory capital rules but make an independent assessment of bank risk exposures and activities in determining standards of capital adequacy.

There are two critical elements in the development of our capital adequacy standards that I wish to highlight today:

First, our capital adequacy requirements must provide an accurate and timely assessment of a bank's individual risk profile, reflecting a consideration of all material risks. Since these regulatory capital rules are the basis for much of our supervisory program, including limits on loans to one borrower and the prompt corrective action of an early intervention program, an accurate capital regime is critical.

Second, it is also important to limit excessive and unnecessary volatility in capital that could disrupt credit markets and prevent banks from effectively serving their customers. The banking agencies have worked diligently to balance these important objectives as they relate to fair value measurement. Stated generally, and except

for assets that the bank intends to trade in the short term, current capital rules seek to neutralize the effect of temporary fluctuations in the value of financial instruments and incorporate more permanent decreases in value in regulatory capital ratios.

We believe that this approach to fair value measurement strikes the right balance between the need for banks to recognize more permanent changes in the value of their assets and capital, while not subjecting banks to wild swings in measured capital levels.

With that said, we do believe that enhancements to fair value measurement can help address a number of legitimate issues that have been raised during the current crisis. The question in front of us is not whether banks should or should not be subject to fair value accounting. Instead, the real question is what steps can be taken to address the issues revealed by the current crisis so as to improve the application of existing requirements and enhance current practices.

Let me identify two areas for possible enhancement: The first issue relates to the narrow question of how to evaluate assets which a bank determines to be impaired on a more permanent basis. To use accounting terms, these are known as assets that are other than temporarily impaired or OTTI. For most banks, especially community banks, OTTI is the main issue as it relates to fair value measurement. If a bank determines that impairment of one of its assets is other than temporary, the value of the asset on its balance sheet is written down to fair value, with the amount of the write-down reducing current earnings and therefore regulatory capital. Many commentators have described the dramatic effect such action can have on banks and other firms and have raised legitimate questions about the appropriateness of the current application of fair value principles in this area.

As I describe in more detail in my written statement, alternative OTTI models are currently being discussed to address this issue. We believe that such enhancements warrant active consideration by standard setters, and we are prepared to assist in that process in any way we can.

The second issue relates to the broader question of how to value financial instruments for which there is no active liquid market. There is a clear need for additional guidance to address the numerous definitions and implementation questions that have surfaced in recent months. Such guidance would facilitate improvements in the relevance and reliability of valuations and benefit financial reporting regulatory capital and risk management.

Mr. Chairman, as you noted in statements prior to this hearing, fair minded incremental and achievable fixes to the issues with fair value accounting identified in recent months are clearly needed. This hearing is an important step in that direction, and I look forward to answering your questions.

[The prepared statement of Mr. Bailey can be found on page 94 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Bailey. Thank you all for your testimony, but I guess I have something to confess. And, Mr. Herz, you know I have been a regular participant in your yearly visits to my office in discussing FASB, and I have been sympathetic to getting a more transparent system of accounting so that

it can be properly protective of investors. But I would make a comment, particularly in the financial services field, we do not have any investors anymore, the only investors we have are sitting out here and watching this on television; they are the taxpayers of the United States. And they are sort of saying to us, and you heard the comments of this committee, hey, this is our money and every time a rule in accounting that drives down an asset and requires more regulatory capital, that capital is coming from the Treasury or the Federal Reserve backed by the taxpayers of the United States. Why would it not be better to find a methodology that we would not have to make those immediate transfusions, if you will. That is what we are talking about.

Now, it was interesting, and I am getting more positive on the attitude that I hear something happening, as a matter of fact, after this panel is finished, so that you can listen to the next panel, I think we should put a room aside, a conference room and put you all in there with a deadline and 3 hours to work out the conclusions of what should be done. And I want to say that, obviously not that we can do it that quickly, but we cannot waste time. I think you have heard the panel. I think you have heard the members almost to a person indicate that one way or another we are going to find a way to give some relief to the assessment of these assets, and we do not want to play regulators, standard setters, it is not our role, but we want you to do it.

I was for and supported, as you know, the FASB rule in terms of providing for as a protection to mark-to-market and what it would do. But that was before December 7th. Oh, I am sorry, not December 7th, September 15th. That is what happened. Nothing is going back anymore to pre-September 15th just as in 1941 nothing went back to what existed in the world prior to December 7th. I think Warren Buffett is quite correct.

And I was impressed, this morning I did an interview on CNBC and immediately before my interview, they did the national news, and it was such a welcome statement that was made. They said that there is an ongoing third stage study to cure pancreatic cancer and that the success of the study was so great that they decided to suspend, the FDA is going to suspend the study and make the treatment available to everyone who suffers from pancreatic cancer. That is not normal for FDA or a bureaucracy that relevantly to the needs of the population, but I think it is something that our agencies, the SEC and FASB, should model after. We are now at the stage where we have people critical, that do not have to suffer, do not have to die because of this rule if we can find a margin to bring that within conditions.

So I think I speak for the whole committee on both sides. I would have to say you have unified our committee and that is not notorious in Congress, but you really brought about the strongest bipartisanship I have seen in a number of years and everybody is agreeable to that I think on all sides. So you have accomplished something. Now, we do not want you to unify and make us all bipartisan, we want you to act. And I think the message has to be just that clear.

What I am worried about, let me center it on both Mr. Kroeker and Mr. Herz, I still hear a little tinge in your testimony that

somebody else has to do something, either FASB has to do something before SEC does it or SEC has to do something before FASB. Can we say that that is no longer applicable, that concept and that now you are going to take it upon yourselves to do something and even to do something that is not common in this City, pick up the telephone and communicate directly with one another. Do not be passing a lot of paper back and forth. That can follow the conclusion. But if we can get you either in the same room or on the same communication by telephone or otherwise, I really believe that this is a solvable problem. The people on the extremes, that is the purists who are in favor of mark-to-market, they are not going to be happy. The people on the other side who want us to do totally away with the rule of protecting transparency for investors, they are not going to be happy. But we may help save the jobs of several million Americans and keep the whole country out of a worse economic situation than what we presently coming or potentially coming.

So I am not going to ask a particular question because I want to give the rest of the panel the opportunity to ask questions. I just wanted to impart to you unusually I am trying to bring to your attention the fact that this subcommittee, and I think the full committee are prepared to act expeditiously, but we will not act until after we hear some testimony as to how soon. Maybe I could ask, I have 30 seconds left, could either of the two of you give us some indication of how long you think it will be before this problem could be resolved?

Mr. KROEKER. I am happy to start. We have a commitment from the FASB, particularly as it relates to illiquid securities, and they have announced this, to act in a matter of weeks, not months. We work constructively with them daily, and our Office stands fully ready to address the issues in our study. We prefer that the FASB work through that. We stand fully ready to assist the Commission in any way in implementing the actions in our study.

Chairman KANJORSKI. Very good. Mr. Herz?

Mr. HERZ. Yes, as Mr. Kroeker said, we have announced a number of actions, which are detailed in my testimony, around more guidance on valuing inactive and illiquid markets, again trying to emphasize the need for good judgment. That has been one of the kind of frustrating issues in this because I said a standard tells you not to look to distress sales or forced liquidations, it asks you to get a lot of data if any many cases, in these kind of conditions what you ought to be doing is doing cash flow projections, which I think Representative Biggert and Mr. Campbell did, yet somehow the way it is being implemented is kind of on a last trade basis. And that is not the intent. The intent is to try to get a reasonable valuation. And so we are going to keep on putting more guidance out there. I do not know whether at some point we are just basically going to have to say for certain situations, do not use a market-based fair value, just do cash flow projections. And then we have to tell people guidance on that and what you would do in terms of a discount rate.

Chairman KANJORSKI. Are you going to be a little bit more clear in the message you send?

Mr. HERZ. We hope so.

Chairman KANJORSKI. You do understand the message that we are sending?

Mr. HERZ. Yes, I absolutely do, sir.

Chairman KANJORSKI. Okay, Mr. Herz, thank you very much. We will now hear from the ranking member, Mr. Garrett.

Mr. GARRETT. Thank you. And I begin by associating myself with Mr. Campbell's comments with regard to how we got here and it was not all due to accounting issues and what have you and to Mr. Herz's comments to that extent as well. I do not believe though that we got an answer from you, Mr. Herz, as far as a timeline, although I think that is going to be the question my constituents are going to ask after this hearing. I will give you this to keep it in perspective, this Administration believes that it, through Congress, can re-write the entire financial structure of this entire country in the next 6 weeks before they go to G–20. If they can do that in the next 6 weeks, that is what they tell us, can you do this within the next 3 weeks?

Mr. HERZ. We will have a proposal out during that time.

Mr. GARRETT. There you go, I appreciate that. And speaking of timelines, Mr. Bailey, I agree with Mr. Herz that a portion of this should be looked at from the accounting aspect but it sure seems like a portion of this needs to be looked at from the regulatory side as well. What sort of timeframe are we looking at there to accomplish that?

Mr. BAILEY. I think it is a very important question, and I think it is clear that any regulatory regime that is risk sensitive is cyclical in that it reflects that broader economy. I think the issue, which is the issue that Chairman Bernanke raised this week, is whether there is evidence that the regulatory capital rules and accounting standards are procyclical and that they serve to amplify existing business cycles. This is an issue that the OCC, and frankly domestic and international bank supervisors have taken very seriously. And, in fact, the Basel Committee on Banking Supervision had issued in January a proposal that among its provisions would try to address some of the procyclicality inherent in this process.

Mr. GARRETT. By?

Mr. BAILEY. Well, it is open for comment right now, and I think the comment period ends later this quarter. One other thing that I want to highlight—

Mr. GARRETT. That is the end of the game because obviously if one of those banks that they are describing over here, they are saying the comment period is the end of this quarter, so then it gets through the next quarter, so we can go two or three quarters before the banks actually get good words from you guys?

Mr. BAILEY. What we tried to do, as I noted in my statement, is in most cases our regulatory capital regime tries to incorporate and reference GAAP provisions. If there are provision changes in GAAP, the effect on capital would be immediate.

Mr. GARRETT. Okay. You mentioned Chairman Bernanke, under TALP, the chairman says, "The assets investors own will be held in a non-mark-to-market account." If that is the case, what is the Fed saying, and I will throw this out to all of you, with regard to the Fed's view of mark-to-market since they are asking that these assets not be assessed or valuated in that manner? Mr. Kroeker?

Mr. KROEKER. I think that is consistent with the model that we have today for assets that are not held for trading purposes, that is we have available for sale, which is not mark-to-market, and we have held to maturity. But I think that highlights the problem of other than temporary impairment so that when there is a decline in cash flows, expected cash flows, there is a credit loss that is recognized but then it is recognized on a fair value basis that includes all of the issues about liquidity. It is one of the issues that we believe needs to be re-addressed, that is the accounting for impairments and needs to be addressed timely.

Mr. GARRETT. The rest of you for the record are nodding your heads yes, in agreement with that. Well, you can answer that question, you can also answer the question for me so I can understand this better, what is the ability then for an institution to move it from one bucket to the other bucket? And will not the pressure, once everything gets better, because everything is going to get better in this economy because we just did the stimulus, we are now going to do another stimulus now, the economy is going to be great a year from now, will not they be coming back to us and saying, we want to move it from one bucket to the other bucket, it is no longer going to be held for long-term purposes?

Mr. HERZ. Yes, that is a very good observation. You can move from one bucket to another, but if you move into held to maturity, which you can do, it then has to be held to maturity, subject to a few things. You can sell it, if there is credit deterioration, you can sell it. You can sell it if the regulator says sell it. But otherwise you have to hold it and collect the cash flows.

Mr. GARRETT. Now, Europe has allowed this one-time deal to change that, right?

Mr. HERZ. They did it to conform with our rules. They did it in October retroactive to July 1st but to conform with our rules.

Mr. GARRETT. So can you explain that in 10 seconds?

Mr. HERZ. Yes, in their rules, International Financial Reporting Standards, IFRS, did not explicitly address the issue of whether you can transfer from one category to another. We in the United States, we like lots of details, so we have rules relating to that and specifically allow transfers. But when you transfer from either trading or available for sale into held to maturity, there are constraints around held to maturity saying you really do have to hold it to maturity.

Mr. GARRETT. I won't ask a question, but that goes back to what Mr. Bailey and the other regulators might be doing 6 months from now or a year from now, right? Okay.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. We will now hear from the chairman of the full committee, Mr. Frank of Massachusetts.

The CHAIRMAN. The chairman of the subcommittee correctly said there is a very strong contingent here. I will tell you as I walk around the Capitol, increasingly trying to avoid conversations with people, I am most often ambushed by people who want to complain about mark-to-market. So I have a personal interest in your resolving this. But the chairman is right when he talks about the contingency here. I am also pleased that we do have a contingency. Let's be clear, there is no significant support for abolishing mark-to-mar-

ket. There needs to be some form of valuation. We all understand that. And we also agree that there is a very important function here of information to investors, and there is no question, we have investors scared out. That is why I think one of our major jobs is to give investors confidence. I hope by the end of the year we will. And even as we talk about regulation, we are talking about giving the investors more confidence, but that does leave us two areas where I think there seems to be consensus. Mr. Herz, I was pleased that in your statement, you quote Mr. Bernanke. You quote his earlier speech, but of course he made a more recent one. And you are right, you quote him but you say, "I think the accounting authority would have a great deal of work to do to try to figure out how to deal with some of these assets which are not traded, but I don't see a suspension of the whole system." So that is both an affirmation of the need for continuation of mark-to-market as the framework but an acknowledgment that we have to do two things. So there are two things, you have to work on what you're doing.

Let me ask one question because I think this is very important on the whole question of the buckets. You say if you put it in the hold to maturity, what would the penalty be? Who is penalized? Was the SEC penalized or the OCC? If someone appeared to be manipulating, they put it in the sell to maturity bucket, and then they prematurely matured, what would the penalty be?

Mr. KROEKER. The guidance that they have, and this is out of FASB standards, requires you to hold it to maturity and the penalty is that your assertion about other assets that you are holding to maturity is no longer recognized.

The CHAIRMAN. Okay, good, so there is a real bite to that. I think that is important. I thought the gentleman from New Jersey's questions were important. Let me then talk about what is clearly within our jurisdiction, and I address here the OCC and the absent regulators as well, and I think we ought to be clear, and FASB says this, their job is to get the accounting right. Yes, it is important we do that and accounting is not an exact science, and I think there is a consensus that we can do a better job of differentiating but it is also very important that we have a recognition of consequences. One of my former colleagues is in the room today who was here when we did the savings and loan and subsequent, and we toughened up the rules. So it may well be that in reaction to the last crisis, appropriately, 18 or 19 years ago, we diminished discretion that maybe now you ought to have back. So I really want to make a very specific request. I am making this as chairman of the committee, but I think in full cooperation with almost all—maybe all the members of the committee, I really want you now to tell us, you need to volunteer and we are asking you, so you do not have to clear this with OMB or anybody else, we want to know what legislative changes would we have to make to give you full discretion in how you react to the mark-to-market? I think that is absolutely essential.

And as they are doing that, and I would ask, and I think I speak for the whole committee, when I say we want to know those things. We may not want you to exercise it, we may. There may be other differences, but to the extent that there are any legislative mandates which ought to be made a little more flexible, I now ask offi-

cially that you and the others who are paying attention send them to us. And I think those two things in parallel will do a great deal to be helpful. I don't know if anyone wants to comment on any of what I have said.

Mr. BAILEY. Mr. Chairman?

The CHAIRMAN. Yes.

Mr. BAILEY. I think we would be happy to provide that information. As an initial matter, I think there is significant discretion on the part of the supervisors to look at and adopt those portions of GAAP or not to.

The CHAIRMAN. Right.

Mr. BAILEY. That are inconsistent with our prudential safety and soundness.

The CHAIRMAN. Yes, but let me put it, to the extent that there is a diminution in the capital because of a mark-to-market in some ways, I assume do you now have to treat that all the same. It seems to me the diminution of capital because people have been really stupid and irresponsible than if there is a diminution in capital that occurred from a mark-to-market. Do you have the discretion to differentiate there in terms of what the institutions are allowed to lend or what their capital requirements are?

Mr. BAILEY. Mr. Chairman, as I noted in my written statement, I think what we try to do in regulatory capital is try to neutralize some of the temporary fluctuations.

The CHAIRMAN. So the answer is, you do have that discretion?

Mr. BAILEY. Yes.

The CHAIRMAN. Let me just say this in closing, I understand that but I want to be clear, no agency, I hope, 2 months from now is going to tell us that they would have liked to have shown more flexibility but they couldn't because there were statutory obstacles because you have our assurance that we are ready to remove those excessive statutory obstacles. So this is the period. If you think you have the discretion and you are not sure, there is one thing I have learned about in legislating, redundancy is preferable to ambiguity. Do not worry about redundancy. A lot of us are lawyers. We have belts and suspenders and lewd and lascivious and etc., etc., we always like to say things twice, as you noted from the questions. So please err on the side of making sure that you have all the discretionary authority you need. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Frank. And now we will hear from the ranking member of the full committee, Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman. Let me say this to the panel, when I first started making inquiries as to mark-to-market and the distortions in the market, the first reaction I had from many at the SEC and FASB and the accounting industry was this guy does not know fish buckets from accounting buckets, and he does not know bed sheets from spreadsheets. There was some truth in that. I'm sorry to say a lot of truth. But I had been hearing from bankers. I had been hearing from lenders, and I had actually been hearing from bank regulators, both State and Federal, that there was a real problem. I requested this hearing October the 3rd. Now, that was not some coincidental date. That was the date that I received the letter from Robert Denham, your former boss, Mr. Herz,

which basically, as far as I read it, told me to butt out. He basically said, we do not need any political interference. That was also the same day we passed TARP. And the reason for his letter, among other things, was that Roy Blunt and I included legislation in the TARP that said study mark-to-market and determine whether it is distorting valuations or loan provisioning. We also are troubled by, when there is an acquisition, purchase accounting.

As a result of kind of a back and forth, the Washington Post on October 28th, quoting accountants, basically said, do not blame mark-to-market accounting. I never have. I never have. I am not blaming it. And I know the chairman of the subcommittee said it is not the cause of the crisis. No one thinks it is, but a lot of us think that its application in certain respects has worsened us, not only us but Chairman Bernanke, Mr. Dugan, regulators, people I respect. I talked to the former CFO of a bank that was listed as one of the 10 safest, he is a former CEO. He says it is a real problem.

You heard Ms. Bachmann. What many members were advocating was suspending mark-to-market. I was not doing that. I told the Washington Post, and here is what he said, the guy, he tracked down the guy, like I am in a cave and they are pulling me out. "The guy who got that provision in the bill, Representative Spencer Bachus, the ranking minority member, he told me he wasn't trying to politicize accounting." I am not. It just says study it. It doesn't say study it, study to repeal it, it doesn't say do a study to suspend it. But the SEC studied it at our request, and they came back and said it is causing some real problems and they kicked it to you. And there has been nothing done. In fact, from January—well, over 2 months, I think December to February, it took 2 months for you to even announce you all were going forward with the study. And now you are saying it is going to be 3 months. You said you have identified some problems, but it is going to be another 3 months.

One of the things that disturbs me, and you can answer this, you keep saying that you are defending investors, the people who want to buy stocks or banks or whatever, these assets, I understand that, but what about the investors who hold them? What about most Americans who hold those investments and are seeing them unduly diminished or distorted in value? I have discussed with members of your staff, and let me ask you this. I am not an accountant but I went back to an old accounting book and it defines fair market value, which is what we are supposed to have, right, and it seems to be a little different from the mark-to-market. You all use them interchangeably but they are not. And I am glad you agree. Fair market value accounting, which is what we are supposed to have, the price at which property would change hands between a willing buyer and a willing seller. When you come in and put mark-to-market, I am not an enemy of mark-to-market, you are distorting to me the free market because the free market is a willing buyer and a willing seller and until you have that, you don't have a transaction. And I have really never had a satisfactory answer to that.

You know, mark-to-market assumes that you don't have a buyer willing to offer intrinsic or real value or that you have a seller who has to sell. If I put up my house today, and I do not get an offer

for a week, I do not have to sell. But mark-to-market would presume that I had to sell. If I got in my car and it would not crank because the battery was dead, I would not call folks over and say, "Buy this car." Well, they would say, "Well, I would like to drive it around the block." "Well, the battery is dead." I do not have to sell it nor do I have to take it to an auction tomorrow and sell it at an auction. I will just hold on to it. And that is what bankers tell me everyday, but mark-to-market reduces their reserves and is causing them real problems and distortions.

And here we are today. I talked about John Lewis' book. I would invite you to read those two pages, I really would because I want you to buy into this as an urgent situation.

You knew that I was upset by Mr. Denham's letter, but I did not respond going back at him and telling him we are going to do something. I requested this hearing in October. I requested it again in January. And let me say this, Mr. Garrett, I am not giving them 6 weeks. I first contacted you in July of last year. And since that time a lot of my constituents have had loans called, a lot of the businesses, the people I represent have gone under. I would never blame you. I would never blame the accounting industry. In fact, let me say this, empower your accountants, empower your accountants to value property even the way they would like to. Give them some flexibility. And in doing this, do not—please remember in my opinion that mark-to-market, it really interferes with the free market because the free market is a willing buyer and a willing seller and until you have that, you should not have a transaction. And when you assume or force a presumption of a transaction, you devalue property, you devalue assets, you devalue loans.

To the bank regulators, you all have been telling me for 4 or 5 months there were problems with, I got a letter where we swapped a letter back in August where you said it is really hard for us to get an acquiring bank to buy now because you have to write down the asset. I said, "Well, why don't you change the rules or go to the Accounting Board, why don't you go to the SEC," because that has cost taxpayers billions of dollars because that rule has not changed. And the regulators have said since July, it is not the right way to do it. When one bank buys another bank, all the assets have to be written down.

We have all agreed for some months now that should not happen, but it continues to happen, and taxpayers, sometimes a bank is not bought, it fails because of that obstacle. So join us in this House. We are not trying to politicize accounting. We are not trying to suspend the rules, but I am going to go back to what I have always thought, if you do not have a willing buyer and you do not have a willing seller, that is what—is not that the definition? The price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having knowledge of the relevant facts. That is basically what a lot of banks, they are not going to sell, but what you are doing by some of this accounting thing, you are forcing them to write down their assets, which devalues their capital. It sometimes causes a run on their stock, and then they have to sell.

I appreciate it very much.

Chairman KANJORSKI. Thank you very much, Mr. Bachus. And now we will hear from the gentleman from New York, Mr. Ackerman.

Mr. ACKERMAN. It is not that Mr. Bachus did not make his point, but let me tell you what my problem is—if his car doesn't crank, and he unloads it because it is a lemon, why do I have to mark my car down?

Mr. BACHUS. Would the gentleman yield? I would put a new battery in it or I would not have to sell it because it will not crank.

Mr. ACKERMAN. Yes, but that is not my point, my point is if you did sell it, why have you now just established the market? And if someone else's wife runs off with the milkman and his job goes to India and he is having a bad day, why is my house suddenly worth less or why do I have to raise more capital in order to keep it? That is the real problem that exists here.

Let me say this, you have indeed unified the committee. Interesting phenomena in a market that was supposed to be down today, as soon as we all got together, it seems to have peaked over 7,000. Ordinarily, that would not be a big thing to celebrate but this morning you might say that.

I am trying to understand how this is going to work because you seem to all agree that we are going to make a change and that was going to be my question originally, are you going to change? And it seems that you are going to make the change, but the real question is, it is like if you had a horrible situation and you wound up waiting for an ambulance or you were waiting for the fire truck to show up, you only ask one question: When? And this issue, which is a huge issue with the public, and not just here in the walls of Congress. I hear more about this than anything else when I go back to my district, when people talk about financial issues, mark-to-market. And it is not that it is controversial, meaning that there are two sides of issue. Everybody says it has to change, the question is when?

So could you in this timeframe that we are talking about, where my constituents think it should be minutes or days, and we are not talking months anymore but we are talking weeks, maybe 3 weeks, could you walk us through the process so we all understand in the context of what Chairman Frank asked for also, is there anything that we have to do legislatively. What has to happen and how quickly can this happen sequentially? Walk us through this process so we can tick off the days on a calendar and tell people that help is on its way?

Mr. HERZ. Well, from our side, in terms of the additional guidance that I talked about, we will get that out probably in early April. It will be out for comment for a very short timeframe.

Mr. ACKERMAN. In early April? So you are talking about you are not going to get that out for another 4 weeks before you even get that out?

Chairman KANJORSKI. Will the gentleman yield?

Mr. ACKERMAN. Absolutely, Mr. Chairman.

Chairman KANJORSKI. Mr. Herz, I just want to tell you that there are three pieces of legislation presently pending in the Congress in the House. I guarantee you one of those pieces of legislation is going to become law before early April.

Mr. ACKERMAN. I think what the chairman said is if you do not act, we will. The timeframe that you are starting out with, thinking you have the luxury of that much space is not acceptable, I do not believe, to the members of this committee on either side of the aisle. If you are going to act, and we have to respond to what you are going to do, you have to get back real quick and let us know. So maybe you want to start the answer again?

Mr. HERZ. Okay, I have heard you, I have heard you very clearly. We will go back, and we will consider exactly how.

Mr. ACKERMAN. Can you do this whole thing in the 3 weeks that was referenced before?

Mr. HERZ. We probably could.

Mr. ACKERMAN. Will you do this within 3 weeks?

Mr. HERZ. I have to talk to the other members of my board.

Mr. ACKERMAN. When will you talk to them?

Mr. HERZ. I will talk to them when I get back tonight.

Mr. ACKERMAN. Tonight?

Mr. HERZ. Yes.

Mr. ACKERMAN. Mr. Kroeker, with the right cooperation between the two of you, can you do this in 3 weeks?

Mr. KROEKER. We can absolutely work with the FASB in that timeframe.

Mr. ACKERMAN. Within that timeframe?

Mr. KROEKER. We expect within in that timeframe and we, as I said in my testimony, we expect action within weeks, not months. The Commission, the staff, my staff stands ready to assist the Commission in any way possible if we do not see that action.

Mr. ACKERMAN. So if the press wanted to report accurately, we could have this fixed in 3 weeks?

Mr. HERZ. We could have the guidance in 3 weeks, whether it would fix things is another question. I hope it will.

Mr. ACKERMAN. I am not talking about the result out in the street, but I am talking about fixing the problem.

Mr. HERZ. Yes.

Mr. ACKERMAN. In terms of what we all have been talking about.

Mr. HERZ. Yes.

Mr. ACKERMAN. That can be done in three—it will be done in 3 weeks, can and will?

Mr. HERZ. Yes.

Mr. ACKERMAN. Can and will?

Mr. KROEKER. Yes.

Mr. ACKERMAN. I yield back the balance of my time.

Chairman KANJORSKI. The gentleman from Delaware, Mr. Castle?

Mr. CASTLE. Thank you very much, Mr. Chairman. I want to go sort of behind the accounting on this a little bit and look at the assets that these financial institutions own and get your comments about that. Obviously, we are dealing in terms of what we have to do with the mark-to-market with illiquid, not active assets. And I do not know if either you or any principals in your agencies or your agencies in general have commented on those particular so-called assets, on whether or not the banks or the financial institutions should be holding them? And a related question is, is anything being done to set up a market for these assets? The real problem

is that there is no market for them. They are illiquid, and they are not actively traded and you sort of based it on some trade that may have happened weeks before or whatever it may be, so is any effort being made, is there anything we could be doing or anybody could be doing to set up some sort of a better market that would give it true value so instead of worrying about whether we have fair value or cost accounting, we actually can look at something and determine the value of it? So I am interested in any comments that you know of in your agencies that have been made concerning the particular assets and whether the financial institutions should even be holding them. And if they are going to hold them, what kind of marketing circumstances, either are being set up or could be set up or anything we could do to encourage that? And I would ask all of you to comment on that if you could in any order.

Mr. KROEKER. With respect to whether these assets should be held by financial institutions, I defer to the banking regulators. I think that is a policy issue within their purview. In terms of improvements to the markets, again I am in the Office of the Chief Accountant advising the Commission on accounting and auditing policy matters but there are certainly steps in place to address the securitization market, improvements to the transparency and the disclosure. I am happy to work with our legislative affairs group to get back to you more fully on that question. It is outside my particular area of expertise.

Mr. CASTLE. I appreciate it. Mr. Bailey?

Mr. BAILEY. Based on our understanding of the issues facing banks and valuations in illiquid markets, I think it is a pervasive issue. It may have much more relevance in certain contexts to complex financial instruments, but I do not think there are any issues we are aware of where there have been arguments that the banks have the legal ability to hold the asset. And I think it is much more a reflection of the marketplace and some of the valuation challenges they have seen in dealing where there is no observable market, no observable inputs, and no active market for trading. But, again, we are not aware that there are legal issues associated with the ability of banks to hold those assets.

Mr. CASTLE. Mr. Herz?

Mr. HERZ. I would just like to observe that I think Chairman Bernanke was exactly right, this whole issue is an issue about how do you value very uncertain cash flows. And that is what it is all about here. We have uncertain cash flows for some of these things because they are inherently complex. They were highly financially engineered, some of these things. There is considerable—there is not a lot of price discovery, as you said. And there is considerable uncertainty about the underlying collateral, that is the loans that back these securities as to what the economic trajectory is going to be. And then finally there is uncertainty right now as to what the government's plans are in regard to purchasing those assets. So all of those combine to get a very thorny valuation problem. That is why part of the issue in giving guidance to people is so difficult. Other than say, "Get the facts, here is the objective and do your best."

Mr. CASTLE. Well, I appreciate your answers. Mr. Bailey, I am a little concerned about whether or not we should be looking at

these investments, and they are, as was indicated, highly financially engineered, they are leveraged and they have led to a lot of problems. And I am not too sure that banking regulators should not be looking at that in some way or another.

Mr. BAILEY. We have certainly spent a lot of time looking at these complex instruments. And you are right, there is the valuation of the cash flows and the associated collateral does present a lot of challenges, both to banks and to supervisors. And we do spend a lot of time making certain there is a realistic valuation of the assets which is a particular focus of our supervisory program. In fact, in my written statement, I do provide and cite two different documents that do try to highlight some of the associated challenges on valuation for those complex instruments. And what we are trying to do in this context is trying to improve best practices within the industry about how to realistically value those complex instruments and, again, dealing with the issues identified today, dealing with the uncertain cash flows and the collateral issues. Again, we are happy to engage in that discussion with you more fully. We have to make certain that these issues are being conveyed in a way that makes sense.

Mr. HERZ. Can I also note, as I did in my testimony, that loans, just whole loans, are not mark-to-market at all. The accounting for that has nothing to do with either mark-to-market or fair value unless they are loans that are held for sale, then there is a lower of cost or market approach. Property normally is not fair valued either, so what we are talking about here is a range of securities, particularly securitized assets that came out of CDOs and things like that.

Mr. CASTLE. Exactly, some of the fair value is something we do not know how to evaluate is the problem basically. Thank you, gentlemen. I yield back, Mr. Chairman.

Mr. ACKERMAN. [presiding] Thank you, Mr. Castle. The gentleman from Massachusetts for 5 minutes, Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman. Mr. Chairman, I do not think I can improve on the questions you asked and more importantly the answers the gentlemen gave. Three weeks sounds good to me. I actually think it is a little late, but I will take what I can get. But I do want to take some time to talk about some of the comments that were made, "Accounting did not cause the problem." I agree, it did not cause it, but it certainly was complicit in the problem. The SEC certainly was complicit in the problem. The OCC certainly was complicit in the problem by a lack of doing anything. Each one of you, just one item alone, SIVs. Nobody had anything to say about them. Everybody said they were perfectly fine, take these special investment vehicles of a regulated bank, take them off the books, do not count them, no big deal. Every one of them came back to bite us and every one of your agencies was complicit in allowing that to happen. Okay, yesterday's news, but my hope is that in the next not 3 weeks but at least soon thereafter, those are gone forever, forever.

Accounting not a problem, fair market value, I like the concept. I totally agree we need to get to it, but I also know that right now I am not painting the house, the house is burning. I voted for things here that I do not normally like. I do not like some of the

things the Fed is doing, but I know they are necessary in these times. I certainly do not like the Federal Government investing in private companies, but I know it is necessary at this time. We are out of the usual, we are out of the ordinary. This is not regular accounting issues. You would not be here if they were. This is a crisis, we need you to help. I do not want Congress to do this, you do not want Congress to do this. Do not let us. This is not where we belong. Do not make us have to do this.

And, again, your comments, to Mr. Ackerman particularly, the 3-weeks comment is very good. Now, again, I would like to see what you do in 3 weeks, and I hope we do not have to have you back here, but whatever you want to call it: suspend; adjust; amend; clarify. Toxic assets became bad assets and now they are "legacy" assets. Did any of you come up with that term, because if you did, good job, good job. At the same time, they are all the same things. What I want, probably I may be alone on this panel on this, I want when you finish changing or amending or clarifying these rules, I want then our friends at the Treasury and the Fed to use these new rules to avoid the whole concept of the bad bank. The idea of taxpayers taking these assets off the books should not be necessary if you allow thoughtful, reasonable, temporary accounting rules to keep them on the books of the people who took the risks. Keep them off the back of the taxpayers. If you do not do that, my expectations will have no choice but to take them off those books and it is unnecessary.

Two of you represent taxpayers, one of you does not, but I am sure you do represent taxpayers on the other side of the table. Do what you can for us, and again you have already answered the questions I had with Mr. Ackerman. You know that you will be held accountable to them, and I look forward to what you provide us in that three week period.

With that, Mr. Chairman, I yield back the balance of my time.

Mr. ACKERMAN. Thank you, Mr. Capuano. Mr. Price for 5 minutes.

Mr. PRICE. Thank you, Mr. Chairman. I apologize, I had to step out, but I understand that, Mr. Herz, you said that within 3 weeks, you will be able to issue new guidelines, is that correct? I am over here.

Mr. HERZ. That is what I am going to go back and talk to my board members about, remember I have one vote of five. But, clearly, I will take back your clear, very clear message from today, but I cannot myself do it. I have four other very conscientious board members.

Mr. PRICE. Do we need to bring the other four in here?

Mr. HERZ. I do not know. I will talk with them. They may be watching right now. We will do everything that we can.

Mr. PRICE. Let me follow up on that. I am interested in a 3-week timeframe, I think that is great. I am over here. But I am more interested in what guidance is going to come out. The guidance that FASB has already given has not been helpful. Tell me what kind of guidance you believe you can give that will be helpful to my constituents and folks all across this Nation who absolutely need a solution to this?

Mr. HERZ. I believe that, and again this is part of the frustration also on our part because the fair value measurement approach has within it an ability to do cash flow modeling rather than just take prices in the market that might have been fire sales, that you do not really know. We have told people repeatedly it is not a last trade model, particularly in these kinds of markets. Yet, for some reason, we are told that that keeps on happening.

Mr. PRICE. Why do you believe that keeps happening?

Mr. HERZ. Well, we are told that there are kind of institutional and cultural aspects in the system. One is that from the bank point of view, the preparer point of view, unfortunately, many of these institutions do not have the internal expertise to do the cash flow modeling of some of these complex items. And, unfortunately, because there was no market infrastructure set up around these things and periodic reporting, like we have for corporate bonds and corporate stocks, there is not standardized information always readily available.

Mr. PRICE. So the examiners are more strict than they otherwise need to be?

Mr. HERZ. No, I do not think it is the examiners. I think the preparers do not necessarily have the expertise and may not want to have to pay for an outside valuation person.

Mr. PRICE. Well, the word that we get from back home is that the examiners are remarkably strict and want absolutely every "I" dotted and "t" crossed. And, consequently, I believe that guidance ought to be more specific for the institutions that you are looking at so they know what the rules are. Right now, they do not know what the rules are.

Mr. HERZ. Well, I think the rules are pretty clear, but we are going to have to give them some more examples, for example.

Mr. PRICE. With all due respect, if the rules were clear, then you would be able to be fully culpable for what is happening because what is happening is not working, correct?

Mr. HERZ. The rules, as I said, there is a second factor that I also wanted to talk about, is you talk about the examiners, the anecdotal feedback we get also is that there is a bias, a little bit of bias in the auditing system to look for trades rather than to do the cash flow modeling. And I do not know. The SEC study, their data was as of the third quarter of last year but seems to back that up a little bit. Either that or there are trades going on. Now, I do know that for example one major financial institution very recently decided to re-position itself and get out of a lot of these things and did it in an orderly way but at very low prices, very, very low prices.

Mr. PRICE. My time is about to run out, but I want to get to one other issue and that is that we hear that mark-to-market protects investors. Tell me other than short traders, how does mark-to-market protect investors, especially on mortgage-backed securities that are going to be held to maturity, performing?

Mr. HERZ. Well, the securities may be held but investors are buying and selling everyday, their decisions are not held to maturity decisions.

Mr. PRICE. Investors right now are getting killed on this stuff.

Mr. HERZ. They are getting killed because the values are very low.

Mr. PRICE. And the values, is it not true that the values are low because of the accounting rules that are being enforced right now by FASB and others?

Mr. HERZ. That is a matter of whether you think those values are realistic or not. I do have some concerns, again, about this last trade phenomena, which is not the intent of the standard. I would also say, however, that loan accounting, and I think all the supervisors agree with this, nationally and internationally, loans are overstated on company's books.

Mr. PRICE. Mr. Chairman, my time has expired, but I would appreciate it if we might be able to get from FASB and others the specific guidelines that you are considering that you believe will allow that greater flexibility.

Chairman KANJORSKI. We have an agreement that you will supply the members of the committee with that?

Mr. HERZ. Immediately, when we prepare the proposal, we will send it to you.

Chairman KANJORSKI. Thank you very much, Mr. Herz.

Mr. BACHUS. Mr. Chairman, can I make a 15-second comment?

Chairman KANJORSKI. A moment for comment is recognized.

Mr. BACHUS. I think sometimes why accountants may be applying something is that they are covering themselves. And if you can give them—and the regulators sometimes, the examiners, they are covering themselves, but if you can give them some cover, if you can give them—and we do have lawsuits in this country, and I think the fear of litigation, the fear of somebody coming back and saying you should have done it a different way. And you could give them some cover and a reasonable cover or flexibility.

Chairman KANJORSKI. Thank you very much, Mr. Bachus. The gentleman from Colorado, Mr. Perlmutter?

Mr. PERLMUTTER. Thank you, Mr. Chairman. Gentlemen, I appreciate your testimony. I understand that 3 weeks, again I am somebody who thinks we have studied this plenty, and I appreciate the SEC's voluminous study of this, but this is about discounted cash flows giving some kind of recognition to the value of these portfolios that is just not there in the market because it is illiquid. And it has caused a lot of damage and continues to cause a lot of damage by exaggerating this. Everybody has been pounding on you, Mr. Herz, but I am looking at the regulators on either side of you, and I am not happy. I think the mission of the SEC is not to really supervise the banking industry, so you have a narrower vision than what I think needs to be considered here. And I am afraid on the banking side of this that the examiners are not exercising the discretion that may be or may be not that they have. And the rapidity of the cycle that we have seen is something none of us could imagine. Now, on this committee we have had so many hearings over the course of the last year that now it is obvious to us. And so time is of the essence, gentlemen. Three weeks is too much, Mr. Herz. I think you could do it now. You all know what is going on here.

So let's just talk about an example that really was disturbing to me involving the Federal Home Loan Bank of Seattle, just what I

read in the newspaper, an anticipated loss of $12 million turns into a write-down of $300 million. And then it places whatever covenants they have with the regulatory community in jeopardy. So, Mr. Bailey, how does that happen?

Mr. BAILEY. As I understand the example, what you had in that situation, and again this is going from memory, was an asset that the company deemed to be impaired on an other than temporary basis and therefore had to fair value the asset based upon existing markets and the marketplace, as we discussed just a minute ago, and reflect that change in fair value in earnings. One of the issues that we have identified as certainly worth additional scrutiny is described in my written statement. Identified in the SEC study, and echoed by a letter from the Center for Audit Quality, is the issue of whether there should be a possible enhancement to the OTTI model to address this very issue: to try to differentiate between the credit-related impairment and the non-credit-related impairment in determining what is the proper accounting. And in that context, one of the ideas being circulated is that the credit-related impairment would continue to go to earnings but the non-credit-related impairment, that reflects much of the liquidity discount that we have talked about today, would not go in earnings but would go in OCI.

Mr. PERLMUTTER. All right.

Mr. BAILEY. And from our standpoint, therefore, would not affect capital.

Mr. PERLMUTTER. Okay, and Mr. Lucas from Oklahoma, Mr. Donnelly from Indiana, Mr. Green from Texas, and I have a bill to try to give you guys the discretion or create a board that is looking beyond just the SEC's vision of investors, which I credit them, that is their job. You guys have a broader job. Everybody needs to be looking at the whole field because what is happening to us, and you have heard it from virtually every member who has spoken, is as this credit, as the capital collapses, the credit on a leverage basis comes in at 10 times or more. So $50,000 needed for capital, nobody is investing right now; $500,000 in loans called. And in Colorado, businesses then cannot renew lines of credit and people are laid off. And between the credit side of this thing and then the job layoff side of this thing, it is getting worse and worse. Now, we can turn this around. And I think we are. But you have to move on this thing. We cannot study it anymore.

Mr. Herz, I understand that. Frankly, I think it needs to be a broader view than the SEC in determining how these accounting standards apply to the banking sector because the banks have a different role in a vast way. And we have spent $700 billion-plus to try to keep the banks moving, so it lubricates this economy and credit is extended, and we do not lay people off. And it has happened overnight. It is resting on your shoulders. It did not start with you, but I will tell you this is exacerbating it.

And with that, Mr. Chairman, I will yield back.

Chairman KANJORSKI. Thank you very much, Mr. Perlmutter. Now the gentlelady from Illinois, Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman. My question is for Mr. Kroeker. In the SEC study on fair value, the report indicated that credit impairment could be reported separately from impairments

due to other factors on the income statement and on the balance sheet. Do you think that this alternative could benefit investors and the marketplace in general?

Mr. KROEKER. We had a lot of input in the study on a model that would separate the credit, just exactly what Mr. Bailey was talking about, the credit aspects of impairment from the liquidity or the other components. And I think if displayed properly, we can keep the same amount of information while showing the illiquid piece of the impairment somewhere else other than the income statement. I think that can be done. We have heard challenges that banks may face in separating the two, but I do not think that that should at all detract us from moving forward on that idea.

Mrs. BIGGERT. How would that benefit then the investors and the marketplace?

Mr. KROEKER. I think the investors would still have the information about both the current value of the asset. They would also then have a better understanding of management's view of the underlying cash flows, that is how much is credit impaired and how much of the decline in value may relate to other factors.

Mrs. BIGGERT. And then are you aware of any efforts underway to implement something like this?

Mr. HERZ. This is something that we are looking at together with the International Accounting Standards Board because if we change our model, the advice we have gotten from the G–20, from the Financial Stability Forum is if you are going to radically change the existing model, make sure that it is done on a uniform international basis because what happens is all sorts of versions of accounting arbitrage start to happen when we have different rules in one jurisdiction versus another. So that is specifically one of the things we are looking at in that effort.

Mrs. BIGGERT. Well, I think we certainly have to do something and you have not been moving on your guidance. Mr. Kroeker, can you give us a commitment to repair OTTI by the end of this quarter? Your letter of October 2008 requested that FASB repair this expeditiously and that was October of 2008.

Mr. KROEKER. I can give you a commitment that my staff will work as diligently as possible to assist the Commission. I cannot commit the Commissioners, but my staff will stand ready to commit or to assist in any way necessary.

Mr. HERZ. One of the specific aspects of that was on the SEC report related to some inconsistencies in the OTTI rules related to securitized assets, which is particularly the problem area we are talking about. We dealt with that in January.

Mrs. BIGGERT. And you have come out with that in writing?

Mr. HERZ. Yes, we issued something already.

Mrs. BIGGERT. Okay, could you send that to us, please? All right, but it seems the problem is we really have—I am going back to Mr. Ackerman's question that you talk about the guidance, I do not know if you then agree with this other proposal?

Mr. HERZ. I personally do not. I agree with going to my personal model of what financial instruments ought to be accounted for, is that if you are going to trade them or sell them, they ought to be at a mark-to-market basis. If you are going to hold them for cash collection, they ought to be on a discounted cash flow basis.

Mrs. BIGGERT. Well, don't you think that we need to use all the tools to address these issues squarely and in an assuredly meaningful way? It seems like we are just going on and on and on. When Secretary Paulson came to us and said that the whole economic industry or the economy was going to crash if we did not act immediately, now maybe we did not get it right in all aspects, but we really tried to do something. And we just have you come in and, okay, we will do it now, we will do it now, and we are just not seeing it.

Mr. HERZ. It is reflected in the SEC study, and we have held a lot of public roundtables and the views that you will hear from bankers and their trade groups is not necessarily the views you will hear from investors. And they have urged us not to weaken the current rules. Now, providing better guidance to get the rules applied in a way we intended is what we are trying to do in this very fast period.

Mrs. BIGGERT. Well, this is a real hot potato, and I think you mentioned taking some action, but I do not think it is enough. Maybe you have good intentions, but they have not resulted in an adequate response. So I think there is more that you can do and can do it much faster, and I would appreciate that if it happens.

Mr. HERZ. I have to tell people here on public television, the rules—the standard allows for the exercise of appropriate judgment. I am going to say that, I am going to say again. It cannot with illiquid markets and complex securities be a mechanical exercise.

Mrs. BIGGERT. Well, we hear a lot about how complicated it is, but please move ahead.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert. And now we'll hear from the gentlelady from Ohio, Ms. Kaptur.

Ms. KAPTUR. First of all, I want to thank Chairman Kanjorski for holding this hearing and allowing me the courtesy to sit in. I used to serve on this committee and have not for several years, but I think this is the most important hearing that this Congress has held in this new Congress. And I want to commend the gentleman for his leadership. I want to commend the members who are here, Mr. Perlmutter, for the legislation that he has offered, Mr. Bachus, who has been a strong voice on this, Mr. Campbell, Mrs. Biggert, Mr. Manzullo. It is interesting who is in the room. This is a rather difficult area for the general public to understand about what is happening in our economy. I assume the people gathered here understand its significance. It is too bad all of America does not understand how important this is. So I really want to thank, and I cannot thank Chairman Kanjorski enough for his leadership and his knowledge. You are definitely the right man in the right place at the right time. And I wanted to put that on the record first.

Number two, I want to say that when I served on this committee, I fought against what has happened to our real estate finance market and I lost. And they told us back then that after what happened with the Resolution Trust Corporation and all that debt that was put on the American people, $150 billion worth financed through our grandchildren, we would never have another real estate problem in finance because they were going to securitize it. And then, "Congresswoman, you do not really understand, we will

never have another real estate implosion." And people who spent their life in housing said, "There are booms and busts. And you in the commercial banking world and you investors, you do not understand real estate. Oh, no, Congresswoman, we understand housing, we can do it." I remember those days here and then we moved into interstate banking and these institutions got bigger and bigger and more irresponsible and lacked prudence and they destroyed our community banks, our thrifts, the prudent lending where character, collateral and collectability had been the standard to Wall Street gambling. That is the way I look at it.

So, Mr. Herz, you have a difficult job. You have a really difficult job. But what I can tell you is that in communities like mine, I have told my people to squat in their houses, to get a lawyer because we have had 10 percent of our homes foreclosed and if something does not happen, it will be 20 percent. And now people are losing their jobs by the scores because whole credit markets are frozen and now they are losing their homes because they do not have jobs. So this thing is just snowballing to a point that none of us want to happen. For the life of me, I cannot understand why last year, Secretary Paulson did not suspend mark-to-market. To have this kind of a conversation, maybe it happened and nobody knew about it, but we have destroyed more capital inside our financial system through mark-to-market than we have been able to pour in at the top through taxpayer dollars. And every day the hole gets deeper, so somehow your wisdom has to factor in. And I hope that whatever is done will re-empower eventually local lending like we used to know it where the real estate market is not relegated to a Robo-dial system where somebody calls you and you want to refinance, you do not even know this character over on the other side of the country and there is no prudence, there is no proper underwriting and appraisal. So you have a real knot to unwind here, but all I am telling you is I agree with those who want some type of temporary quick action because communities like mine, sir, gentlemen, they are falling off the edge. And this real estate issue and valuation is absolutely critical, critical. In places like Cleveland, and I do not even represent Cleveland, entire neighborhoods are now vacant. And I want to place in the record a story from the New York Times last Sunday regarding what is happening in Cleveland.

So I have two quick questions, and I appreciate being able to say this today: Are you going to fix the OTTI by April 1st? You sort of answered that, but give us an absolute sense of that. And then I want to ask you, what do you think about the fact that over two-thirds or more of the credit instruments that were used to finance this real estate are not on the books of normal banking institutions? How do you deal with that from an accounting standpoint as you think about mark-to-market? Could you give us a sense of that? You can possibly fix the ones on the books of normal institutions, and we will hear more in the next session from those who have actually accomplished it in past meltdowns in our real estate market, but how are you going to deal with the CDOs and the securitized debt obligations and the overledgering? Yes, Mr. Kroeker, and then Mr. Herz?

Mr. KROEKER. With respect to the CDOs and the off-balance sheet accounting, it is an area that we identified at the SEC very

early on. In fact, in January of 2008, we sent a letter to the FASB because of concerns that we had with respect to needed and necessary improvement in off-balance sheet accounting. The FASB has exposed a document that would improve off-balance sheet accounting is right now in the midst of re-deliberation. And, Bob, or Mr. Herz, I do not know your timeframe?

Mr. HERZ. It should be finalized next month but it would be effective next year. And a lot of people have concerns about that because although they agree with the notion, they do not want the idea of impeding the revival of the securitization market, which I take it would not bother you. But the plan is to finalize in May and effective January 1st, so that a lot of these things that are now in off-balance sheet vehicles would be on the books of the sponsoring entity, the bank.

Mr. KROEKER. In the meantime, you have added additional disclosure to address that exact issue because there is a tension of putting assets on balance sheet and then the related regulated capital impacts.

Ms. KAPTUR. Mr. Bailey, you wanted to comment?

Mr. BAILEY. Yes, we have obviously had discussions with the standard setters in the SEC on the changes to FAS–140 and FIN 46R, which is what is being referred to here. And clearly, depending upon the nature of the changes, that will have a significant effect on bank capital ratios because essentially you are dealing with off-balance sheet activity and bringing it on balance sheet, and the issue is what is the regulatory capital consequence of bringing those activities back on balance sheet? Again, that is an issue that we provided comments on in earlier discussions of these changes, and I think we are most anxious to understand what these proposals are going to be. And, frankly, then we will have to determine the regulatory capital effect of this change in GAAP.

Ms. KAPTUR. I did not hear a clear answer. Mr. Chairman, will you fix the OTTI, following on Mrs. Biggert's question, by April 1st?

Mr. HERZ. The OTTI issue, as I said in January, we issued something that dealt specifically with other than temporary impairment for securitized assets, which was mentioned in the SEC report.

Ms. KAPTUR. Well, are you saying that is applicable by April 1st?

Mr. HERZ. It is applicable now. It was applicable at year end.

Ms. KAPTUR. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much. Now, we will hear from Mr. Campbell for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman. I want to go to these buckets things that we are talking about. Now, if I am a bank, I am a financial institution, and I tell you that this bunch of mortgages, mortgage-backed securities, whatever, that I am intending to sell it, so you want to value it—potentially value it one way. And then I change my mind because I do not like the market that is out there, I do not like the price that I am getting so I am going to hold it for a while. I guess the question I have is the problem I am having these are things which help the maturity means potentially 30 years, certainly at least 10 years. Somebody can change their minds in that time and not trying to manipulate the

accounting rules or the regulatory process, how do you deal with that or why do you get punished for that?

Mr. HERZ. The standard that was developed, this is Standard No. 115, which was developed after the S&L crisis. It has the three buckets and there is a lot of flexibility. There is more flexibility of going into trading or into available for sale but once you go into held to maturity, you are kind of chained in unless the regulator tells you have to sell. You can sell if there is a credit deterioration and a few other things but it is basically that. And I think the thinking at that time was when you are in held to maturity, you are at cost subject to other than temporary impairment. The thinking at that time was really at that time, the SEC at that time and the FASB at that time really believed that everything should be at fair value and not having something have fair value ought to be tightly restricted.

Mr. CAMPBELL. Okay, and as you suggested perhaps in normal times, net present cash flow, expected cash flow would be the same as what you would achieve in the marketplace but that is clearly not the case today. And I guess the problem I am having is that, and I understand the complications with getting the net present value cash flow, but that is a number which if you look at what has happened, it would be declining on an orderly basis for the value of most of these assets. And if an institution decides that all right we are going to unload this thing now for whatever reason, we need the capital, whatever it may be, we need the cash, whatever, then they will have a loss and they will take a big loss on their fairly short term. I guess what is wrong with that kind of approach?

Mr. HERZ. It is again everything gets to the issue of uncertain streams of cash flows in these instruments. There are ranges of cash flows and the people who, the market prices of these, people do not like them but they take into account the ranges and the degree of uncertainty around those ranges, and that is why you get—the illiquidity is also part of that factor, is the inability to put the credit problem in a box. And so that is the prices are very, very low because of the whole uncertainty around the ranges of future cash flows in these things and in this whole economy.

Mr. CAMPBELL. Are you looking at all at any of those three boxes in your review?

Mr. HERZ. Well, we are looking with the International Accounting Standards Board to completely revise this model, but we want to do it on an international basis so that what we do in the United States would be the same as in Europe, as in Japan, across all the institutions, and that is what we have been asked to do by the G–20, by the Financial Stability Forum, by the SEC. If we are going to do a major re-vamp, we should not just do a United States only.

Mr. CAMPBELL. Okay, so even if in 3 weeks you come out with a proposal.

Mr. HERZ. A proposal in 3 weeks is more guidance on using the existing model.

Mr. CAMPBELL. Because what you are talking about would take some time?

Mr. HERZ. Oh, it will take more than a year on an international, anybody working on an international basis will appreciate that.

Mr. CAMPBELL. I will just in my final moments here make a comment, which is what we do not want here, I think what you do not want, what all of you should not want is for us to set the accounting rules. We do not want to politicize the fair valuation and the fair statement of accounting and what experts believe is the best form of presentation to determine the fair value of a company or an asset or whatever it is. We really do not want that, and the best way to avoid that is to act expeditiously and clearly cautiously but expeditiously so that we do not ever want to go down the road of politicizing the value, the accounting rules or the accounting value of companies. That is not good for anybody anywhere.

So thank you very much. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Campbell. Now, we will hear from Mr. Donnelly.

Mr. DONNELLY. Thank you, Mr. Chairman. And I apologize, I had to step out for a meeting. But to give you a little background, in my district right now, in Elkart County where the President visited, unemployment is 18.3 percent as of right now. And the main culprit is a complete lack of credit for the products, for the companies, for floor plan financing. And the financial institutions are telling us we cannot lend, and we cannot lend in large part because of mark-to-market. And so this is not an academic exercise for the people who live in my area, this is a dad or a mom who lost their job because the product is not being built, because people who went to get financing for the product cannot get financing. And so to us, this is food on the table. And when assets are not intended to be sold for 15 to 20 years, and do have some predictable income stream, are valued at such a low figure, it goes to more than just accounting class, it goes to families who are now going to food pantries. And so this is very, very real to us. And I wanted to ask Mr. Kroeker what can be done to improve the accuracy in determining the risk of these products, to come to a fair valuation in your judgment?

Mr. KROEKER. We talked about a number of—

Mr. DONNELLY. And I apologize if you talked a little bit about this, I'm sorry.

Mr. KROEKER. A number have been talked about, but I think partly it is emphasizing and clarifying the objective of fair value and that is it is not to peg assets to distressed sales, it is not to look at the last trade that was a fire sale and mark your asset to that value, it is how—I think the guidance, the improvements need to focus on how in illiquid markets, when you have distress sales, how do you come to a reasonable assessment of what a willing buyer and willing seller would transact that, how do you use the cash flows to do that.

Mr. DONNELLY. And there is no desire to do a rush to judgment, but we do not have the luxury right now to sit here and for the next couple of years argue about mark-to-market because it went up two points in the last month, from 16.3 to 18.3. And I did a conference call yesterday with the companies and one CEO after another, "We just cannot get credit, Joe." That is what they told me. And the financial institutions who were there who used to provide credit said, "Credit is frozen. Mark-to-market is absolutely killing us." And so I am a proud co-sponsor of Mr. Perlmutter's bill be-

cause we just do not have the time anymore. We have been at this for 6 months, and I respect your bona fide but it is the real deal for us.

Mr. Chairman, thank you for your time.

Chairman KANJORSKI. Thank you very much, Mr. Donnelly. And now we will hear from Mr. Lucas for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman. Gentlemen, a study by Paul Volcker of the Group of 30, for them, I should say, of the Group of 30, said that, "Mark-to-market accounting was, if anything, procyclical, that it exacerbates the ups and the downs." Would you agree with that, that the system we use now presently exaggerate values in good times as well as slam things down disproportionately in bad times?

Mr. HERZ. I personally believe that any time you report current news, and mark-to-market is you get your 401(k) statement or your investment account statement, it is on a fair value basis. It shows the current values of your investments. If they are going up, you feel real good, there is a wealth effect. And if things are bad, you kind of pull in your horns. And that is the same with getting the employment information and all of that. I think it does have behavioral effects.

Mr. LUCAS. Mr. Bailey?

Mr. BAILEY. As Chairman Bernanke indicated earlier this week, there is clear evidence that there are procyclical effects from a number of public policy initiatives, including accounting and capital. And I think that is a reality that the public policymakers have looked at and frankly have tried to deal with. For example, the OCC and the SEC are actually co-chairs of a project of the Financial Stability Forum to address procyclicality in current provisioning practices. There are other discussions in the Financial Stability Forum to deal with procyclicality in capital and valuation and leverage and many of those projects are expected to be discussed at the G–20 summit in early April. One of the efforts of these projects in the FSF is to explore the procyclical effects of these various initiatives and to see what steps can be taken to mitigate those effects. This has been an active issue, and again we have worked closely with the SEC on the provisioning issue. That is something we have spent considerable time on over the last 6 months to try to mitigate this problem.

Mr. KROEKER. I would absolutely agree with that, and I think it is important, to Mr. Bailey's point, that there is actually a work stream looking at whether or not historical cost accounting because many believe that loan accounting, which was done at historical costs and the related impact of provisioning and when you provide that bad news is equally procyclical. So I think studying not only the fair value impact of that, and I think there are changes that we have talked about, and they need to be done in timeframes that we have committed to but bad news has a tendency to foster bad results.

Mr. LUCAS. Well, just remember, gentlemen, we all play by the rules in this economy that are laid out for us. You all are involved in a very key point of laying out the ground rules. The concern out in the countryside is that for a focus on the trees, so to speak, that you have missed the forest fire that is going on around us all. Ed

and I, in the form of H.R. 1349, are trying in a responsible way to create a bill that will—a board that will bring in many more perspectives or more perspectives to help encourage thoughtful policy and help move thoughtful policy along a little bit quicker. We cannot stand and let the forest burn totally to the ground, and you by your actions in the coming days and months, doing what is prudent, what is proper, what is in line with your education, your background and your experiences, can help fight this fire.

So, Mr. Chairman, I encourage my colleagues to join Ed and I on 1349, encourage our friends at the table here to move diligently to do what they know to be the right thing, and yield back, sir.

Chairman KANJORSKI. Thank you very much, Mr. Lucas. And now we will hear from Mr. Manzullo.

Mr. MANZULLO. Thank you, Mr. Chairman. Do either of you three gentlemen have any background in manufacturing?

Mr. KROEKER. I do not.

Mr. HERZ. I have audited manufacturing companies.

Mr. MANZULLO. Pardon?

Mr. HERZ. I was an auditor in my prior incarnation and I audited manufacturing companies.

Mr. MANZULLO. Okay, okay, well, that would make sense. You are not a tool and dye maker, you are a CPA by background, is that correct? And I appreciate that. So you know what goes on in manufacturing. The problems that we see is the, and Mrs. Kaptur and I have spent a lot of time on manufacturing, I probably have 2,000 factories in our congressional district, is that the standard that is used to valuate securities is also used to valuate the assets that are used for a loan at a bank. It bleeds all the way through. And industry after industry after industry, and Mrs. Kaptur could tell you the same story, comes to us desperate. Manufacturing companies that have never missed a payment, that have assets 7, 8, 9, 10 times greater than what their operating loan would be, that even if they were closely held, never laid off, they just ate up, did not declare a dividend, and now we see a whole new pattern where trustworthy business people, retailers and manufacturers, are being wholesale destroyed. I am talking about the destruction of manufacturing in America that will push this Nation into the deepest recession the world has ever seen. If we do not make things, we will collapse. That is the impact of the mark-to-market rule.

Perhaps you do not see that from your perspective because you have to be objective obviously, you have to find out what is the best standard to use. But I can guarantee you this, the IRS does not use mark-to-marketing. When one of these small business people die, the IRS is in, especially now that the death tax will come back again, they somehow find a value as to these assets. And what is going to be interesting is, and when I practice law and I had a situation like that, we oftentimes had to get a loan at a bank to take those assets that the IRS is taxing so much on that the people could not pay. This is how wild this thing is.

I know we are not here to lecture you because that does not do any good because it just does not do any good. I know you are concerned about it, but when a system that is in place is not working. For example, Mr. Kroeker, you talked about eight different recommendations that you came up with the SEC, they are just rec-

ommendations to make recommendations. You never really got into the meat of it. The accounting for financial asset impairments should be readdressed. That is what you come up with in your December 30th report. That does not help the hundreds of thousands of manufacturers, especially the little guys, who actually have orders.

What we have now is we actually have manufacturers with real life bona fide orders, they have been praying for orders, and now they have been cut off on their line of credit. And you know what is happening? Those jobs are going overseas. They are going to China, they are going to Korea, they are going all over the place. It is so destructive to have an inflexible system that you have because what I am explaining to you is what these guys are going through. Banks want to lend. The community banks have deposits, they are ready to lend. Look at the people who have been long-time customers, for 30 and 40 years, generations of manufacturers. Gentlemen, they cannot get any money. What do I tell them?

Mr. KROEKER. Our study did provide recommendations, but we do not expect it to stop there. Those recommendations were made to both the FASB, some of those relate to us. As I said, we expect action on those recommendations in weeks, not months. My staff does not generally set GAAP directly. That authority rests with the Commission, and we have looked to the independent standard setter, whether it be the FASB or their predecessors, the Commission has that ability. My staff stands ready to assist the Commission in any way possible in implementing those recommendations.

Mr. MANZULLO. Mr. Herz?

Mr. HERZ. At the risk of sounding a little argumentative, but the SEC did a study and if you go past the very largest banks and look at smaller banks and community banks and all that, most of their assets, the great preponderance of their assets are not subject to fair value. If you had a community bank that just took in deposits and made loans, there would be no fair value on it.

Mr. MANZULLO. No, but they are applying the fair value standard to the security for the loans.

Mr. HERZ. To the extent that they have purchased securitized assets, these problem assets, then they know they are subject to fair value if they are not being—

Mr. MANZULLO. It is bleeding all the way through is what I am saying because the regulators are, perhaps, Mr. Bailey, you have the answer, the regulators are picking that up and the examiners are virtually applying mark-to-marketing to the value of the assets for these secured loans.

Mr. BAILEY. And we have obviously explored this issue quite a bit, but when you look at the average community bank, and this is as of year end data, less than 1 percent of their assets are in trading assets. In less than 1 percent of their assets, these changes in fair value were reflected in earnings. However, not to repeat myself, I think that further highlights what we said in testimony: The fair value issue for the vast majority of community banks relates to the OTTI issue since they do not have trading assets. And, again, that is the issue presented here—whether the assets are AFS or held to maturity. However, there is the potential for the cliff effect that was described, I think there are potential opportuni-

ties to address that problem through adjustments to fair value—to the impairment model for OTTI.

Mr. MANZULLO. Well, you better move quickly. They are barely hanging on.

Chairman KANJORSKI. Thank you very much, Mr. Manzullo.

Mr. MANZULLO. Thank you.

Chairman KANJORSKI. Now we will hear from the gentleman from California, Mr. Sherman.

Mr. SHERMAN. I thank the chairman. I have been reluctant to see Congress legislate Generally Accepted Accounting Principles. And, in fact, I believe we have never done so. I think the FASB has made some mistakes. I think we in Congress, particularly those of us with a perverse interest in accounting theory, have a right to comment, maybe even persuade. I think perhaps their biggest mistake, other than perhaps mark-to-market, but the biggest mistake is FASB No. 2, where you are writing off R&D expenses just because it is easier to do so and insulates the accounting profession from lawsuits rather than because it helps our economy or our markets.

Today, we have major banks and other regulated companies really issue three different income statements. One is their tax return. You have tax accounting, it reaches a particular answer as to net income. The second is financial accounting, set by the FASB and related agencies, Generally Accepted Accounting Principles. And the third is not GAAP but rather RAAP. This does not mean the accountants involved can be called rappers but does the FASB have any objection to this government not setting what is GAAP but setting what is RAAP and in fact is not that what we have traditionally done in this country?

Mr. HERZ. Well, Kevin would probably know better than me. Congressman Sherman, I was disappointed not to see you earlier, so I am glad you are here. After the S&L debacle, Congress, as I understood it, and I do not know whether it is in FIREA or FIDICA, basically said that to the bank regulators that their accounting can be no less stringent than GAAP. Those were the words I understand were used. But that relates to the reporting, not fully to assessments of regulatory capital and capital adequacy, which the regulators do have some flexibility on.

Mr. SHERMAN. So but in terms of the century-long tradition of the private sector establishing GAAP, that would not be changed if we asked the regulators in determining when prompt corrective action was necessary to look at a modified financial statement, a RAAP financial statement, and perhaps even reverse the policy you just identified.

Second is I understand the accounting theory of mark-to-market, but your marking to market only a certain portion of the balance sheet while the rest of the balance sheet uses traditional historic accounting costs. And I am not sure that you improve it. And one of the purposes of accounting is to allow you to compare similar companies and to see their results. It is my understanding if one bank invests in a bunch of business loans that are not securitized, that are not—and let's face it, we are in a recession, all that business loans are 20 percent less valuable than they were when they were made. They use traditional historic accounting to determine,

and they might write them down a certain amount. If another bank, virtually the same economic circumstance, they invest in business loans, similar businesses, they are both lending to restaurants, for example, but they are investing in a securitized package. And they could be identical, one is Burger King loans, one is McDonald's loans, that you mark-to-market the second bank and if there is a market failure, that is a massive write-down. So the question is, does it make sense for the FASB—now, in normal times, mark-to-market is not that big a deal, two portfolios, one dealt with historically, one dealt with mark-to-market. They are going to about the same because the market is logical but at this time, when mark-to-market gets you a crazy result because there is no market, and where you are supposed to mark-to-market only marketable securities but instead you are marketing to market securities that used to be marketable that are not marketable—they are legally marketable now but as a practical matter not marketable, does it make sense to have mark-to-market of formerly marketable, now no longer practically marketable, securities? How is that for a long question?

Mr. HERZ. Thank you. Very good elucidation. First of all, a couple of points. One, you are correct that the accounting for loans and securitized loans is not the same. I think most investors—a lot of investors would say they ought to be the same, they ought to both be on fair value. Other people would say, no, they ought to all be on cost or cost subject to impairment or discounted cash flows.

Mr. SHERMAN. Is there anybody who supports the present system where apples on one balance sheet and oranges on another?

Mr. HERZ. I do not think so and, as I mentioned, we have a project jointly with the International Accounting Standards Board pursuant to recommendations from the securities regulators, the G–20, the Financial Stability Forum, to re-do the basic accounting for financial instruments but do it on an international basis.

The second point I want to make is although we might not like it, there are transactions going on for some of these things, albeit at very low prices. I am aware of a major financial institution who recently moved a lot of these problem assets at very low prices and they did it in orderly way.

Mr. SHERMAN. Which, if anything, just illustrates how non-comparable those two banks that I described, how your present system is indefensible and how your international process if probably not going to yield any results any time, which is why if you guys cannot act quickly and logically, perhaps the regulatory accountants need to act and depart from what is a somewhat illogical and certainly slow process that you have.

I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Sherman. In reward for patience, I am going to recognize the gentlelady, Ms. Jenkins.

Ms. JENKINS. Thank you, Mr. Chairman. I, too, have heard from a lot of financial institutions in my district on their concerns with mark-to-market standards, and I want to proceed quickly but responsibly. Both Chairman Frank and Mr. Sherman now have touched on this, but I would like to follow-up a bit on the issue of regulatory authority. And perhaps Mr. Bailey might have some ad-

ditional insight, and what I would be curious to hear is, when assessing the regulatory capital of a financial institution, should bank regulators make adjustments to reverse write-downs that relate to the illiquid state of our markets today? And, more broadly, what authority do bank regulators have to impart flexibility in regulatory capital requirements. And if the authority exists, to what extent has that authority been used?

Mr. BAILEY. That is a very good question, and I tried to address that important question in my written statement, but let me try to summarize the issues. Obviously, when we determine our capital adequacy regulations, we try to use GAAP as a starting point in that assessment process in part because it does reflect a general market acceptance of how those assets and liabilities and equities should be reflected on bank balance sheets. We do, however, make our own determination as to how those inputs should be reflected in our capital adequacy framework. For example, good will is completely recognized under GAAP but that is not reflected in bank balance sheets because of the clear valuation issues associated with that. So we do have a large degree of flexibility, and we have exercised it. And, again, as I indicated in my oral statement in the beginning, I think what we have tried to do is balance the need for a risk sensitive capital framework, which again is a critical focus of our attention, while at the same time trying to constrain volatility in resulting capital ratios. What we have done, and again but for these trading portfolios, we have tried to neutralize the effect of temporary fluctuations in value from capital but reflect permanent changes in value in bank capital ratios.

We do have a significant degree of flexibility, and we have exercised it. But I do want to make one other cautionary point. One of the things that we have looked to in this context is trying to make certain that bank financial statements, including bank capital ratios, have a degree of acceptance in the marketplace by both investors and the broader community. We have seen some evidence recently that rating agencies and other users of financial statements are creating their own metrics to determine capital adequacy. What we want to do is make certain that our capital adequacy regulations do reflect the reality that is relevant both for banks as well as users of financial statements, in part because our capital role is the foundation of significant parts of our supervisory framework. And, again, I think what we want to do is maintain the clear relevance of our capital ratios for a broad array of purposes, both supervisory and market related.

Ms. JENKINS. Thank you. If I might just follow up, I have also seen some proposals, which I understand would separate out credit and non-credit losses. Non-credit losses would be recognized as other comprehensive income and not hit the regulatory capital. Would any of you like to share with the committee your thoughts on that proposal?

Mr. BAILEY. I can start off. We have discussed that issue quite a bit, and I think that is appropriate because it is perhaps one of the most obvious issues that would warrant our attention.

As it relates to the capital ratio, to the extent that you reflect in earnings, and therefore capital, the OTTI impairment that is related to credit, while reflecting the other impairment—the non-

credit impairment that is generally associated with liquidity discounts—in other comprehensive income, not earnings and therefore not capital, we would further reduce the volatility of regulatory capital ratios. Again, under that revised OTTI impairment process, you are only reflecting the credit-related impairment as a change in capital. And, again, the more liquidity based volatility is in OCI, other comprehensive income, and therefore not regulatory capital.

Ms. JENKINS. Okay.

Mr. KROEKER. I agree. I actually think it can provide additional transparency to investors by giving them both a perspective of the credit impairment, as well as the impact on valuation of liquidity.

Ms. JENKINS. Okay, thank you. Thank you, Mr. Chairman, I yield back.

Chairman KANJORSKI. Thank you very much, Ms. Jenkins. And now we will hear from the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I appreciate that. And I wanted to ask Mr. Bailey a question as we look at this mark-to-market at the heart of a larger issue that I think needs to be addressed by this committee and that is the procyclical nature of capital valuation tools that are being used by regulatory bodies when they compound or exacerbate the peaks and the valleys in the market's performance. And the history of this goes back many years, or at least we have some history in the 1930's and now we have a recurring problem. But regulatory capital, by its very nature, should not take the long view when it comes to valuation when you have a situation where the market becomes so distressed as it is right now. I think you have to take the long view. And day-to-day valuations, when they are assessed in this manner, when the markets are going up, fair value accounting valuations artificially inflate the bank's capital and encourages additional risk taking, encourages additional lending and investing and in that sense helps create a balloon. And when the markets decline, as we have seen over the last year, the very opposite is true.

We had, I think in 1938, the government suspended this kind of—for regulatory capital this kind of valuation because of this concern. And it came back in, I think, September of 2007, whenever FAS–157 was put into play, and so now we have this same problem. The observation has been made that if this rigid mark-to-market accounting had been in effect during the 1990's when we had our banking trouble, virtually every major commercial bank in the United States would have collapsed because of the loans they had made in Latin America and in commercial real estate. So we would have had the same kind of consequence that we had during the Depression. That is not to say this caused it but it compounds the problem. And this does not go to the question of giving the investors this information. You can certainly do this. The question is the OCC has the capacity to act on this and so does the SEC. So I just wanted to ask about regulatory forbearance on the part of the OCC given the current stress that our markets are under and what that would mean in terms of providing some respite for many of our financial institutions without impacting the extent to which these firms disclose their assets because we can still have the disclosure for the investors in the financial statements. And so, hence, my—

I have wondered for some time why there is not another standard if you are independent and you can make this decision?

Mr. BAILEY. I think you raise a very important question, and I think there is an important issue that we are looking at in this context and clearly procyclicality is one of those considerations. In any risk-based regulatory regime, there will be cyclicality because again—

Mr. ROYCE. Right, but you are making the capital calls.

Mr. BAILEY. Correct.

Mr. ROYCE. And the capital calls are frankly what is signaling the market to respond and make these runs on these institutions.

Mr. BAILEY. I completely agree. By definition, risk-based rules should be cyclical. I think the issue and the problem that arises is whether it is also procyclical in amplifying the peaks and drops of the normal business cycle.

Mr. ROYCE. Right.

Mr. BAILEY. And that is certainly an issue that we are exploring in various forums, both domestic and international. But I think what we are trying to do in this context is trying to make certain that our risk-based capital ratio is just that, it is reflective of risk. To the extent we can neutralize the procyclical effects of that regime, we are actively trying to do that.

Mr. ROYCE. I understand that, but the banks are arguably twice as well capitalized, well maybe not by these standards, but let's put it this way, twice as much cash in the institutions and yet undercapitalized as we continue to apply this standard. And that is the conundrum I guess we are in.

And to go back to my other point about the 1990's, in retrospect, had we had this standard, we would be in exactly this same cascading effect on the market today, right?

Mr. BAILEY. I think the thrift crisis of the late 1980's and early 1990's is very informative in this process. And I think one of the things that would serve to exacerbate the problem and frankly introduce more insidious moral hazard issues is when institutions are allowed to simply ignore their problems. I do not think anybody wants to do that.

Mr. ROYCE. No, I do not either but you have the authority here, so I guess just to get back to a pointed question, why not use it?

Mr. BAILEY. We have used it. And I think when you look at what we have done in terms of those portions of GAAP that we have not reflected in our regulatory capital regime, I think we can provide you with additional information on that in writing. As an example, goodwill, which if recognized would introduce additional volatility, especially in today's market, is not reflected in capital. And, as I said, generally what we have tried to do is neutralize temporary fluctuations in valuations from regulatory capital. But, again, I think it is important for us to reflect permanent changes in a bank's valuation in capital, which we have. But, again, I think what we have strived to do throughout this process is eliminate those temporary fluctuations that would result in wild swings in bank capital ratios from the regulatory capital regime. And I think we had done that.

Mr. ROYCE. Well, I think at the end of the day, if you see the banks with twice as much capital and afraid to loan because of the

consequences of putting into motion the valuation and then the capital calls that the regulators put on the institutions and then the raids on the stock, I think you are kind of in a vicious circle here, which until it is addressed might lead us to the conclusion that maybe in 1938, the government was right to lift the rule.

Mr. BAILEY. Let me be clear, I think we certainly acknowledge that changes are needed in this broad sphere, especially as it relates to how banks need to value and reflect instruments that are clearly in an illiquid market with no observable pricing.

Mr. ROYCE. Right, thank you, Mr. Bailey.

Chairman KANJORSKI. Thank you very much, Mr. Royce.

Mr. BACHUS. Mr. Chairman?

Chairman KANJORSKI. Yes?

Mr. BACHUS. Could I just, for the record, were you talking about Long Term Capital Management and the moral hazard that arose out of that and the Third World debt crisis?

Mr. BAILEY. Yes.

Mr. BACHUS. And that absolutely, I think, is part of what happened more recently.

Chairman KANJORSKI. Thank you very much, Mr. Bachus. And now we will hear from the gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. I wanted to follow up on my comments, my opening comments, in case anybody might not have followed up on the concerns that Mr. Buffett raised on CNBC on Monday. But just prior to getting to that, could you clarify something for me? There is FAS 157, which is used, but there is also a FAS 114. There is some confusion as to the application of FAS 114, especially relative to our smaller community banks. In the process of treating FAS 157 as a standard, are we going to use FAS 114 and treat it in the same fashion that we are treating FAS 157? And if you could just briefly just answer that and explain to me the difference and why the smaller community banks are concerned about this? Why doesn't 157 float across all of them? And what is it about FAS 114 that has a greater applicability to smaller banks?

Mr. HERZ. Thank you. FAS 114 deals with loan accounting and loan loss accounting. You make a loan, the loan is carried on a historical cost basis and then when there are probable losses, an allowance is created based upon probable losses, what are called incurred losses. It has nothing to do with fair value.

FAS 115, they were both done together after the S&L crisis, deals with accounting for securities. And there are essentially three buckets: there is held to maturity, which is a cost subject to impairment; there is available for sale, which is fair value on the balance sheet but not in the income statement unless there is an impairment; and then there is a trading account, which is mark-to-market, what people refer to as mark-to-market accounting.

Mr. SCOTT. Okay.

Mr. HERZ. The issue, and I think Mr. Sherman got into that a little bit, is that you may have loans that become securitized into securities and there is a different accounting once you securitize them. You go into the 115 accounting rather than the 114 accounting. FAS 157 did not introduce any new fair value requirement at all. All it did was provide a definition and some guidance on how

to do it and a lot more disclosures in the footnotes of where fair value is used and how it impacts the balance sheet and the earnings.

Mr. SCOTT. Okay, well, I hope that that certainly clears it up for some of our smaller banks. Let me go back then to my original point in our conversation with Mr. Buffett, the two points were how do we deal with the problems that are associated with the efforts or the effects of the impairments that are taken on assets that are held to maturity?

Mr. KROEKER. I have seen accounts of his remarks, and I think, as I have seen those accounts, obviously I cannot speak for Mr. Buffett, I think he was calling for suspension of mark-to-market for regulatory capital purposes. As I have seen the accounts of the remarks, it was that assets—fair value may be good for purposes of general purposes.

Mr. SCOTT. Yes, I think what his concern was he was saying should not regulators be required to have additional capital to be held against the write-downs.

Let me ask you, loans held in the portfolio and the loans that make up a mortgage-backed security perform virtually the same for purposes of contractual cash flows and should be treated the same for accounting purposes. What are you going to do to clarify the valuation of mortgage-backed securities, particularly those that are held to maturity in illiquid and non-functioning markets as we have today?

Mr. KROEKER. As we discussed earlier, this is one of the key recommendations in the SEC study on off-balance sheet. We expect to see action in a matter of weeks. Again, there was discussed a 3-week timeframe. We can certainly from our standpoint deal with a 3-week timeframe in providing additional guidance but much of that rests with Bob, as he has discussed.

Mr. SCOTT. Okay. May I ask one final question, Mr. Chairman? One of you is the Comptroller General's Office represented here.

Mr. BAILEY. Comptroller of the Currency.

Mr. SCOTT. Okay, Comptroller of the Currency. Well, Mr. Eugene Ludwig, a former Comptroller of the Currency, stated that, "Perhaps the most dangerous aspect of mark-to-market rules is requiring the re-marking of other than temporary or impaired investments. The impairments are severely driving down the values of held to maturity assets. Accounting rules should not become a market factor and application of the OTTI has become such." My question is what are you doing to control this?

Mr. BAILEY. I agree with Gene Ludwig's position on that. And, again, as it relates to the issue we have talked about during this hearing, and frankly probably in each of our written statements, is again how do you treat OTTI? And, again, I think we have seen, and has been demonstrated very compelling stories about significant cliff effects associated with valuation issues once an instrument is impaired and then must be fair valued. And I think that what that gets to is the issue we have talked about today is whether in fact you can differentiate within that impairment the credit portion and non-credit portion. And if in fact you only put the credit portion through earnings, and therefore capital, it would have a significant less volatile effect. And I think we have all acknowl-

edged that there are operational challenges associated with differentiating between credit and non-credit impairment. But, frankly, since it is such a focus of the issue and a focus of the comments, I think it is incumbent upon us to see if we can work through those issues. To me, that is the most significant fair value challenge for community banks.

Mr. SCOTT. Okay. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Scott. And now, Mr. Grayson.

Mr. GRAYSON. Thank you, Mr. Chairman. Gentlemen, there seems to be a clamoring for changing the mark-to-market rules that seems to come largely from institutions that may be insolvent, and that is the pattern that I am seeing. And I am wondering if we should try to apply this to other situations in everyday life. I will give you two examples, if you want. I am 6'4." It is pretty uncomfortable for me to sit in airplane seats, and sometimes, to be honest, I bump my head when I am going through a tight door passage. I am wondering if we should eliminate mark-to-market rules and also make inches larger so that I would only be 5'8."

We have a lot of traffic on the Beltway, I got a suggestion from Freddie Mac recently that if we could just change the ratio of circumference to diameter, pi, if we could just change that ratio, that would move the beltway further away. So Freddie Mac says to me that it wants to eliminate mark-to-market rules and increase pi to four to alleviate the beltway traffic.

I got another suggestion from AIG. The suggestion is that since the Wizards loss to New Orleans this week by a score of 109 to 98, they want to eliminate the mark-to-market rules, and they also want to make sure that 98 is more than 109 in the future so that the Wizards will have won that game.

Gentlemen, does it make any sense to kill the messenger when mark-to-market tells you that an institution is insolvent? Let's start with Mr. Kroeker?

Mr. KROEKER. We do not recommend suspension of fair value, and so to your direct question, no. But there are issues that in our study we think warrant improvement, including the operation of the determination of fair value as well as how to calculate and report other than temporary impairments. But as it relates to the score keeping, if you will, we do not recommend the suspension of fair value.

Mr. GRAYSON. But isn't that really the heart of the matter, isn't it the heart of the matter that people not only want to change the rules in the middle of the game, but they want to change the rules and the game is already over? Mr. Herz?

Mr. HERZ. I do not know whether the game is over or not, I am just a humble accounting standard setter, but I will observe a couple of things to that point. The bank stocks continue to trade well below their accounting book value. A majority of the bank stocks are well below their accounting book value. The acquisitions you saw of I think it was National City by PNC and Wachovia by Wells Fargo, the prices paid by the acquiring banks for the acquired banks was like 30 percent of the recorded book value. So if the write-offs are excessive, one would have expected not to have that kind of thing. I think some of the mark-to-market write-offs may

be a little bit excessive but remember that the single largest financial asset of most of the banks, once you get past the money center banks, are loans and loans are carried on a cost basis that does not timely reflect the problems that may underlie, the allowance for loan losses lags the problems.

Mr. GRAYSON. So let's be clear about this, Mr. Herz, what you are saying is that the stock market in its infinite wisdom is telling us not that mark-to-market rules have made companies mark down their book values too much but maybe the accounting rules have made them not mark down their book values enough, is that what the stock market is telling us right now?

Mr. HERZ. Yes, I think there are two—I think that is right, I think there are two aspects to that: One, is that there is skepticism, A, over the loans; and, B, there is skepticism as to whether or not the OTTI write-offs have yet been taken because there is this kind of dam effect and people kind of—you get like a year, sometimes more, it has to really have been a sustained downward value for a long period of time. And so when the problems started to surface in September of 2007 or August of 2007, the write-downs only really started really in the third quarter of 2008, year end, still because you get this grace period. There is a cushion.

Mr. GRAYSON. So what you are suggesting, Mr. Herz, is that there may be institutions that are insolvent, and they have not been forced to write down their books to point yet and those are maybe the same institutions that are asking us to modify the mark-to-market rules so that they will not have to admit that they are bankrupt, is that correct?

Mr. HERZ. I share your point of view, and I will tell you that I get calls and visits from some of those institutions that are now in government hands, usually about 2 weeks before they get taken over, trying to get the accounting changed.

Mr. GRAYSON. Sorry, would you explain that a little further? And then my time is up.

Mr. HERZ. Well, a lot of the people who have been the loudest complainers, and there are valid issues and we are going to address them, so there are some real valid issues, and we are going to try to address them and give better guidance and that, but clearly some of the most vocal opponents of fair value and mark-to-market have been some of those institutions that subsequently failed.

Mr. GRAYSON. Thank you.

Mr. HERZ. And they have had to have billions of taxpayer dollars put into them.

Mr. GRAYSON. Thank you all, and thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Grayson. Well, I think we may have hit a spot where we can give some relief to this panel and give a little time to the next panel so they can adjust their lives accordingly. The situation is that we are going to have a series of votes in just a few minutes that will probably take up to 1 hour to clear. So when I dismiss this panel, we will not seat the next panel until approximately 2:15 p.m..

In the meantime, before I dismiss this panel, I just wanted to say that we took very seriously the comments today in regard to a commitment very seriously to work on the next 3 weeks and get that work done expeditiously, I hope as soon as we leave here today.

And that in order to help that along, and to ensure that we can keep tabs that it is occurring, that when the Congress returns from the Easter Passover work period, we will convene a new hearing of this subcommittee to specifically get a report on the success of the progress that was indicated today. And that will put a heavy burden on the three panelists and their respective organizations, but by that time, if satisfactory work has not been reported to the committee before the convening of that next session, we will be working on the legislation that we will be able to move through the House expeditiously to cure the problem. I look forward that it will not have to be happening. I look forward to your assistance in that. And if there is anything we can do, as the chairman originally indicated and several other members of the committee, if you need anything, please feel free that you communicate directly and immediately. And we have a new gadget up here in Washington called the telephone, so it does not necessitate a letter, it does not necessitate anything else. We can be talking instantaneously, and we are available to do that.

And with that in mind, I thank this panel. You certainly have endured a lot of, shall we say, subtle criticism, and not too subtle, I suspect. But we look forward to working with you. We thank you for your attention to this, I guess particularly Mr. Kroeker and Mr. Herz you took the brunt of our session today, but we are waiting for you, Mr. Bailey, if you are not successful, if you do not put this together and we get a bad report back, we will give you equal treatment next time. So thank you very much for being a lively first panel, and to the second panel, we will convene at 2:15 p.m.

[recess]

Chairman KANJORSKI. First of all, I want to thank the panel for being so courteous toward us to wait over to this hour. We will try and move it along as quickly as possible. We have sent all the whips out to alert the members to get over here or suffer penalty of death and that is possible. We have your written statements that will be made a part of the record. You each will be recognized for a 5-minute summary of your testimony. And, as you may have gathered, I am a little on the lenient side but sometimes at this hour of the day, even my patience gets tried and I get to be nasty. So if I whip you down, I will apologize ahead of time, but I will still whip you down.

First, we are going to have Mr. Jeff Mahoney, general counsel of the Council of Institutional Investors. Mr. Mahoney?

## STATEMENT OF JEFFREY P. MAHONEY, GENERAL COUNSEL, COUNCIL OF INSTITUTIONAL INVESTORS

Mr. MAHONEY. Chairman Kanjorski and members of the subcommittee, good afternoon. I am Jeff Mahoney, general counsel of the Council of Institutional Investors. It is a real honor for me to appear before you today on behalf of the Council. I have brief prepared remarks and would respectfully request that the full text of my statement and all supporting materials be entered into the public record.

The Council is a not-for-profit association of more than 130 public, corporate, and labor pension funds with assets exceeding $3 trillion. Our members are obviously quite diverse and include the

Pennsylvania State Employees' Retirement System, Johnson & Johnson Corporation, and the IUE–CWA Union Pension Fund.

Council members are generally long-term shareowners, responsible for safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the country. Since the average Council member invests approximately 60 percent of its entire pension portfolio in U.S. stocks and bonds, issues relating to U.S. corporate governance, including issues relating to financial accounting and reporting, are of great interest to our members.

As an initial matter, the Council's policies reflect our members' views that:

First, the goal of financial accounting and reporting and accounting standard setters should be to satisfy the information needs of investors, the key consumers of financial reports.

And, second, the needs of investors are most likely to be met if the responsibility to promulgate accounting standards resides with an independent private sector organization that employs a thorough public due process that actively solicits and gives preeminence to the views of investors.

Although we believe that the current U.S. accounting standard setting structure and process can, and should be, further improved, we would strongly oppose any legislative or regulatory effort that would diminish the independence of accounting standard setting and provide certain industries with direct or indirect control over the outcome of that process. In our opinion, we must avoid changes to the accounting standard setting that may cater to the short term self-interests of a particular industry to the detriment of the short- and long-term interests of investors and other market participants.

Second, we generally agree with the findings of the United States Securities and Exchange Commission's recent report and recommendations to Congress that have been discussed earlier today. More specifically, we agree with the Commission's findings that existing fair value accounting standards for financial instruments, if properly applied, increase the quality of information provided to investors about those contracts by better reflecting the current economic reality.

We note that the Commission's findings are generally supported by a July 2008 Council-commissioned White Paper entitled, "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch." That White Paper is included as an attachment to the full text of my testimony for your information and review.

Consistent with the Commission's findings, the White Paper concludes that because of its timeliness and relevance, fair value accounting reduces uncertainty over time much more quickly than other existing accounting measurement approaches. As a result, fair value accounting has the ability to assist in actually mitigating the duration of a financial crisis. Many financial experts agree that Japan's failure to embrace fair value accounting for the financial assets of its troubled financial institutions back in the 1990's unnecessarily exacerbated that country's economic woes for an entire decade.

Finally, we believe that the most appropriate approach to addressing concerns about the procyclical effects of fair value account-

ing is not to change the accounting standards that provide information to investors but instead to encourage the U.S. financial institution regulators to exercise their authority, which Mr. Bailey said today that they do have, and which they have done on a number of occasions in the past, to modify, if they deem necessary, fair value accounting or other accounting principles for regulatory capital purposes. That approach allows the regulators to appropriately address their responsibilities to foster safety and soundness and financial stability of U.S. financial institutions without further lowering investor confidence by denying investors the information they need to make economic decisions.

Mr. Chairman, when I receive my quarterly 401(k) statement, I see current economic reality. Those who invest in U.S. financial institutions, and other U.S. companies, deserve to see the same economic reality. Fair value accounting for financial instruments gets investors closer to that goal.

In closing, we look forward to continuing to work cooperatively with the Financial Accounting Standards Board, the Securities and Exchange Commission, this subcommittee, and all other interested parties to further improve financial accounting and reporting. Our aim is always to provide constructive input and support to ensure that financial reporting continues to evolve to better serve the needs and demands of U.S. investors, the U.S. capital markets, and the U.S. economy.

Thank you, Mr. Chairman, for inviting me to participate at this hearing, and I look forward to responding to your questions.

[The prepared statement of Mr. Mahoney can be found on page 220 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Mahoney. I did not want to miss that. Next, we will have Ms. Cindy Fornelli, executive director of the Center for Audit Quality.

Ms. Fornelli?

**STATEMENT OF CYNTHIA FORNELLI, EXECUTIVE DIRECTOR, CENTER FOR AUDIT QUALITY**

Ms. FORNELLI. Thank you, and good afternoon, Chairman Kanjorski and members of the subcommittee. I am Cindy Fornelli, the executive director of the Center for Audit Quality. And you have my written testimony, so what I would like to do this afternoon is reiterate three critical points that have already been made this afternoon—that were made this morning, which I suppose is a hazard of being on the second panel.

First of all, for over 30 years, fair value accounting has contributed to increased transparency in financial reporting. Fair value's application has room for improvement but, as the recently congressionally-mandated SEC study confirms, loan losses and runs on the bank caused the current financial crisis, not fair value accounting. Therefore, suspending fair value accounting will not fix the problem and, as the SEC also noted, could further erode investor confidence. Thus far, Congress, regulators and standard setters wisely have resisted pressure to abandon the basic principles of fair value accounting, which is to provide current financial information to investors. To suddenly stop reporting current values, especially in a

time of crisis, could make matters worse by adding uncertainty to investors.

Second, the challenges faced by financial institutions in meeting their capital requirements are critical and are legitimate policy issues for prudential regulators, but dealing with capital adequacy concerns by suspending or significantly altering fair value accounting would only serve to obscure current realities, further undermine investor confidence, and prolong the current crisis. Investors need to know the current values of loans and securities in order to make rational investment decisions. Regulators need to know the current values of loans and securities in order to make rational policy decisions.

The application of fair value standards can and should be improved and as quickly as possible. However, as we heard this morning from Deputy Comptroller Bailey, banking regulators have the authority to determine whether or how current valuations affect capital requirements and make adjustments accordingly. While accounting standard setters need to improve the application of their standards, prudential regulators should consider improving application of their capital requirements.

Third, while we vigorously support the continued use of fair value measurements, we believe there are ways to improve the application of those measurements. The Center for Audit Quality put forward a number of specific recommendations in its November comment letter to the SEC during the SEC's fair value study, including: number one, how to value an asset in a time of changing, disrupted or illiquid market conditions, such as we have now; number two, how fair value measurements might differ for different types of assets and liabilities under various market conditions; number three, how to achieve clear and more transparent disclosures about the assumptions and methods applied in the fair value measurement process, as well as the conditions present in a particular market; and, number four, how companies recognize periodic changes related to credit losses versus other types of losses in income in their financial statements to address the temporary impairment issue that was discussed at length this morning.

Recognition of non-credit-related investment losses, outside of income, would help address assertions that fair value accounting forces institutions to use overly pessimistic market prices to value their assets and liabilities.

The CAQ and the audit profession stand ready to assist in the application of these improvements once they are in place. The bottom line is we all want swift and meaningful action to address the current crisis, but as we respond to the crisis, we should remain true to fundamental market principles. Investor confidence and the reliability and transparency of financial reporting is critical to our financial system's long-term wellbeing. We must pursue only those solutions that do not put that confidence at risk, and there are such solutions on the table, as we discussed this morning.

Thank you for the opportunity to share my views, and I am happy to answer questions.

[The prepared statement of Ms. Fornelli can be found on page 131 of the appendix.]

Chairman KANJORSKI. Thank you very much, Ms. Fornelli. Next, we will have Mr. Thomas Bailey, chairman of the Pennsylvania Association of Community Bankers and president and CEO of Brentwood Bank.

Mr. Bailey?

**STATEMENT OF THOMAS BAILEY, CHAIRMAN, PENNSYLVANIA ASSOCIATION OF COMMUNITY BANKERS, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, BRENTWOOD BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA**

Mr. BAILEY. Thank you, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee. I appreciate the opportunity to provide a community banker's perspective on the current application of mark-to-market accounting. I am chairman of the Pennsylvania Association of Community Bankers and also testifying today on behalf of the Independent Community Bankers of America.

Chairman Kanjorski, PACB and ICBA salute your leadership in calling this important hearing. These rules are exacerbating the financial crisis. As president and CEO of Brentwood Bank, a $450 million asset bank serving the South Hills of Pittsburgh, I can tell you about the impact that these accounting rules are having on my marketplace. Through the 9 months ended December 31, 2008, Brentwood Bank has granted $64 million in business loans, mortgages, and consumer loans, while continuing to maintain a delinquent loan/asset ratio of less than one quarter of one percent.

Brentwood Bank has taken approximately a $2 million OTTI charge, which represents a lost opportunity to finance $20 million in loans based on a 10 percent equity requirement. This represents 30 percent of the loans we have made in the past 9 months.

The application of mark-to-market is frozen markets and is the heart of the problem. When these rules were developed, this unprecedented situation could not have been imagined. FASB has not taken action and the problem is getting worse. While total suspension of mark-to-market accounting is appealing, we know that there are many concerns about how the capital markets may respond, which is why we offer an alternative approach which conforms with existing accounting rules.

PACB and ICBA support transparency of financial statements. Current mark-to-market accounting rules hinder transparency and distort the true condition of financial institutions holding mortgage-backed securities, particularly private label securities and other debt securities.

Fair value applications in an illiquid market result in a disproportionately greater write-down than anticipated credit or economic losses. Here is a real life example, which can be found on page 3 of my statement. An institution holding private label mortgage-backed securities with initial carrying value of $125 million is represented in bar graph one. An analysis of future cash flow concludes the securities would suffer a future loss of about $16.7 million in a rigorous process described in my written statement. However, when fair value is developed in today's illiquid market, that

institution had to take a $58.9 million charge, over 3 times as much as the true economic loss.

What we heard this morning will not help this situation. The January guidance did not solve the problem. While this is only one example, there are over $400 billion of other securities held by the Nation's insured financial institutions that could meet a similar fate. These statistics do not include debt securities held in other large financial services businesses, such as the insurance industry.

Financial institutions are concerned about the procyclical nature of mark-to-market standards in the current environment. They are extremely hesitant to risk purchasing assets that could result in future material write-downs if an impaired credit loss may occur. Thus, mark-to-market creates a self-fulfilling downward spiral for the prices of MBS, other asset-backed and debt securities.

OTTI rules raise the specter of future write-downs that could further weaken capital positions. This could contribute to the hoarding of capital at many banks. This prudent reaction to guard against future accounting-driven losses likely inhibits the flow of badly needed credit. OTTI rules also have inadvertently thwarted the government's extraordinary efforts to replenish the financial industry's capital. This is a paper loss and does not reflect economic reality.

We do not believe Congress should write accounting standards; however, continued application of this accounting standard based on valuation derived from a dysfunctional market only serve to compound the current systemic risk. Therefore, we propose Congress must hold FASB accountable and ask the SEC and FASB to apply existing accounting rules that apply to loans held in portfolio to asset-backed and other securities. The determination of whether OTTI exists, as well as the magnitude of the loss recorded, should be based on rigorous credit analysis appropriate to the characteristics of the security. This change would not hinder transparency and would actually improve comparability and consistency. Our proposal is similar to international accounting standards' rules that apply, FAS 5 and FAS 114, like treatment of OTTI, of MBS and permit the recognition of future gains against recorded OTTI losses.

Mr. Chairman, this hearing and the recent legislation introduced by your colleague, Representative Perlmutter, are crucial steps in breaking the logjam associated with mark-to-market. All of the subcommittee members must be publicly commended. I stand ready to answer any questions.

[The prepared statement of Mr. Bailey can be found on page 112 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Bailey. And next we will hear from Mr. Lee Cotton, past president of the Commercial Mortgage Securities Association.

Mr. Cotton?

**STATEMENT OF LEE COTTON, PAST PRESIDENT, COMMERCIAL MORTGAGE SECURITIES ASSOCIATION**

Mr. COTTON. Good morning or good afternoon. We did start this morning. We would like to thank you and Representative Garrett for having us today and for your leadership in this process. As you

said, I am Lee Cotton and I am the past president of the Commercial Mortgage Securities Association.

CSMA, as we are called, represents all the players in the commercial mortgage securities business, from issuers to servicers to people who underwrite loans to people who sell loans. It is a broad consortium of folks. These participants have come together over the last 15 years to try to create a very transparent market and in that regard we are proud of the investor reporting package that we have put together, which provides clear, concise data on all of the securities that have been issued. To that end, you can go find a mortgage in your districts and you can understand what is going on in that mortgage.

From that point of view, what we are very worried about is the application of fair value accounting. By "application," I mean the practical application. We urge you, as we saw you do this morning, to address this issue, particularly with FASB.

Today, as you well know, there is no market for commercial mortgages, the same as Mr. Bailey's problem. No investors are buying securities, which provides no liquidity to the market. It is not purely an issue of the banks or regulated banks, it is an issue of investors' willingness to buy securities backed by commercial mortgages.

In 2007, over $240 billion in CMBS was issued. In 2008, $13 billion. And then for the last 9 months, zero. As we approach the next 18 months with billions of dollars, hundreds of billions of dollars of commercial mortgages coming do, there is really at this point no source for those.

As Treasury Secretary Geithner said, "No economic recovery plan will be successful until it re-starts the securitization markets." We believe that these rules as applied are going to help re-start that market.

I do have one concern with FASB and that is they are seriously considering abandoning the vehicle through with securitization can be done, through FAS 140 and FIN 46. That would be taking away with one hand what you are so hard are getting back in the other.

The issue this morning that was discussed about procyclical activity is the one that I think we can focus on for a minute and then we will talk about our recommendations. If an asset is sold, and a discussion was held earlier this morning about a willing seller/willing buyer, there are buyers who are forced to sell because they have been marked. When that sale takes place, then there is a cash transaction that you can hang your hat on and the pricing has been established, but that seller was not necessarily a willing seller, he or she was in a position, they had to sell by virtue of being marked down. And that marked-down position crystallizes a loss, which then further exacerbates as it works through the system. That is the problem I think that we all here have.

We are not against fair value accounting. We are not against transparency. As an organization, as I said before, we have worked very hard to create transparency. But as it is interpreted today and applied, it falls very, very short in non-functioning or illiquid markets, and that is the concern that we have. The guidance that you all asked for this morning from FASB and from the others in the

panel this morning will be very, very helpful to our industry and other financial industries as they approach this issue.

CMBS as a whole has had a very, very strong function and a default history, less than 50 basis points of defaults for the last 2 or 3 years, we are now all the way up to 125 basis points. There is no question that will increase, but it does not increase to the level that the pricing in the marketplace is presently showing us. The issue is really how you set the price and how you set the price can be done with hard work, credit work, credit analysis, understand the cash flows available and the assets and come to a conclusion, not just go ask for three bids from three bidders who are unwilling to own those assets and then assume that that is the value. And I heard this morning FASB say that these are these procedures that you can go through, and the third one is to go and do the hard work, but the accountants have not yet gotten to the hard work part.

I am getting a sum-up sign, so I am going to speed up.

We are urging clear and strong guidance, as I have said. That guidance needs to give, or as someone said this morning "empower" the accountants to be able to go to the third level and actually do the credit work, actually understand the assets, understand the loans below the securities. The guidance needs to be clear and specific in the non-functioning markets. Define what a non-functioning market is and then help the accountants do their jobs. We are not picking on the accountants but help them do their job.

And, finally, the policymakers must recognize the difference, as was discussed earlier today, of impairment caused by credit, true losses taken, and impairment caused by the market dysfunction and the volatility and the illiquidity in the marketplace. We are not opposed to fair value. We believe that on paper it works terrifically but in practice, particularly today in an illiquid market, it is very, very difficult to undertake. Until these issues are addressed, we think there will be a frozen credit market in the markets that I represent, which is commercial mortgages and other markets as well.

I thank you for your time, and I am willing to take questions.

[The prepared statement of Mr. Cotton can be found on page 125 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Cotton. And next, we will hear from Ms. Tanya Beder, chairman of the SBCC Group.

Ms. Beder?

**STATEMENT OF TANYA S. BEDER, CHAIRMAN, SBCC GROUP**

Ms. BEDER. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, thank you for inviting me to testify today. My name is Tanya Beder. I am chairman of SBCC Group. We are an independent advisory firm. We assist firms who are bleeding money, and we help firms to seize opportunities in the market as well. The firm was founded in 1987, and has a broad array of clients. In the current crisis, we have advised on multi-billion dollar liquidity runs, on hundreds of billions of dollars worth of CDOs and for numerous people who are experiencing problems in the current market.

This is a period of significant global recession and prolonged mayhem in the market. In fact, if there is a light at the end of the tunnel, it may well be an oncoming train.

An important aspect of the financial health of this Nation is the quality and the integrity of financial information, and I applaud this committee's focus on this important topic of mark-to-market. I would like to submit my written testimony for the record and now summarize my testimony with the following statement.

Mark-to-market accounting should not be thrown out. In normal markets, unless there is manipulation, mark-to-market represents fair value well. However, in distressed markets where only fire sales are taking place and in over-fueled markets, often mark-to-market is based only upon one price. In such markets, marking to an independent third-party model may be a better approximation for fair value.

I have four recommendations for the subcommittee's consideration:

The first is that the committee should encourage standard setters and regulators to provide users with urgent help to distinguish between going concern and liquidation valuation in an illiquid market. Do not abandon mark-to-market but allow for additional measures, such as mark-to-model from independent sources. Additional disclosures should be made so that it is clear when different approaches are employed.

We should also distinguish in over-heated markets when different approaches are taken. Remember in just about every financial disaster we have had, and certainly all of those that I have assisted firms with, profits typically precede losses, and there were numerous profits in the CDO space and in the credit default swap space, among other credit-linked areas before we got into these problems.

The second recommendation is that there should be a more flexible approach to defining fair value. None of the single measures are the best choice across super-heated, normal, or distressed market conditions. The subcommittee should promote more supervisory activity and provide the necessary tools to the supervisors, both analytic and monetary tools, to keep up with the firms they supervise. I would note that in most cases this does not mean more regulation but more effective regulation. However, in a few cases, and in particular I would highlight the work I did in Orange County and Florida's local government investment pool, the unregulated investment pools could stand additional oversight.

My third recommendation is to encourage the standard setters and the regulators to implement multiple measures and to promote their collective value. A prominent feature of the gains and losses in the current market, both on the way up and on the way down, was tremendous oversimplification.

The final recommendation is to reduce the procyclical impact of the current approach, and I do believe it is quite procyclical. It is not just a question of the mark-to-market accounting, I also believe it is heavily fueled by the fact that everyone uses the same accounting approach. We saw during the Long Term Capital Management problems that numerous people doing the same things create a herding effect and a common reaction. If the same accounting is

used for all firms, we also risk a situation where reactions are exactly the same, both in heavily fueled markets and in markets that are in trouble.

I will close by saying that one of the things that came up this morning is how do you do this in 3 weeks, which is the deadline that was tossed out. I add an endnote that one of the things that makes it very difficult for firms to operate quickly are perceived liability issues that surround mark-to-market. If firms are forced without addressing that issue to pick a price to put on instruments, a safe price may be 3 cents because a firm may then only be sued for 3 cents. This needs to be in the forefront alongside of the need to address things in a speedy fashion.

Thank you very much, and I look forward to your questions.

[The prepared statement of Ms. Beder can be found on page 120 of the appendix.]

Mr. PERLMUTTER. [presiding] Thank you very much, Ms. Beder.

Now, we will hear from Robert McTeer, a distinguished fellow from the National Center for Policy Analysis for 5 minutes. Thank you, sir.

**STATEMENT OF ROBERT D. McTEER, Ph.D., DISTINGUISHED FELLOW, NATIONAL CENTER FOR POLICY ANALYSIS**

Mr. MCTEER. When I moved to Texas in 1991 to become president of the Federal Reserve Bank there, someone gave me a little book of Texas wisdom entitled, "Don't Squat With Your Spurs On," and one of the most useful jewels out of that book has turned out to be, "No matter who says what, if it don't make sense, don't believe it." Well, what has been going on with mark-to-market accounting just doesn't make sense to me.

Much of our recent wealth destruction resulted from slavish adherence to an accounting dogma that never should have been applied to banks and other regulated financial intermediaries in the first place. Thousands of banks, thrifts, insurance companies, and credit unions, who had absolutely nothing to do with making or securitizing subprime loans, are victims, not villains. They invested in mortgage-backed securities because they thought they were safe and liquid, as indicated by their triple A rating. When subprime mortgages in the pools began defaulting at a high rate, the market for the bonds dried up. Yet, the rigid application of mark-to-market rules, enforced by regulators and gun-shy internal and external auditors, forced drastic write-downs even when their owners were both willing and able to hold the securities until the market improved or even hold them to maturity if necessary.

Even though the bonds were not traded, most of the underlying mortgages were still generating income and still are. The larger tragedy not from the write-downs per se but from the resulting decline, dollar for dollar, in regulatory capital. Hypothetical or potential losses in securities result in actual or real losses of capital if the securities were in an account labeled, "Securities for Sale" rather than "Securities Held to Maturity." It would be a simple matter to change the labels but contrary to what I heard this morning, I am told that the accounting rules do not allow it. Fixing that would be an easy interim step.

A closely related question is whether the impairment in individual mortgages is classified as "temporary" or "other than temporary," in which case they must be written off. Logic would suggest at least that any excess of capital written off that way could be added back to capital or accreted if the original judgment is proved too pessimistic. It is my understanding that most of the regulators concur with this but are hesitant to allow it because it has to be reported back to the Congress if they do. Reassurance on that score from you would be helpful. They do have the authority I am told, the just need a nudge.

I have heard it said that mark-to-market was considered fine for banks until the market turned against them. This is not entirely true. Chairman Greenspan wrote a 4-page single-spaced letter to the SEC urging them not to apply mark-to-market to commercial banks because their business model is that of a trader but involved holding assets on their balance sheet. His letter is dated November 1, 1990. A little later, in 1992, Treasury Secretary Brady wrote a similar letter to the SEC, and in 1992, so did the Chairman of the FDIC. Now, we fast forward to 2009 when Paul Volcker, speaking as chairman of the Group 30 Experts, released the results of their study of the financial crisis. His recommendation number 12 says, "(a) Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments in distressed markets; and (b) the tension between business purposes served by regulated financial institutions that intermediate credit and liquidity risks and the interest of investors and creditors should be resolved by the development of principle-based standards that better reflect the business model of these institutions."

If a mortgage pool collateralizing a security becomes impaired, the negative impact is multiplied. For example, if a bank buys a bond with 1,000 underlying mortgages, and a few of these mortgages become other than temporarily impaired, the bank has to write-down and lose regulatory capital on the whole bond, not just on the impaired mortgages. And I believe one of you cited this morning the example of the Home Loan Bank of Seattle, which expects ultimately to have a $12 million loss on a portfolio that it was required to write down by $304 million. Now, you cannot unscramble an egg but if the bank that had the 1,000 mortgages on its books as a mortgage-backed security could have the same mortgages on its books individually, the write-downs could be much more modest.

While the original markdowns may not be justified, they do tend to be self-fulfilling. The resulting loss of capital may attract increased supervisory attention, which perversely may lead to higher capital requirements just as capital is becoming scarce. The bank's worsened condition may bring higher FDIC deposit insurance premiums as well. Restrictions on growth may then follow so that the weakened banks cannot try to grow out of their problems. The motive here is to preserve and protect the insurance fund. The banks after being restricted in their accumulation of capital reserves during the good times have their requirements increased when they can afford it least. The FDIC, after having to keep its premiums

low during the good times, has to raise them during the bad times. In the present case, an alternative needs to be found.

This whole perverse, procyclical sequence of events started in my example with unnecessarily rigid application of mark-to-market accounting.

Mr. PERLMUTTER. Mr. McTeer, if you could wrap up.

Mr. MCTEER. Okay. Well, I will just say this, I started off with a little homily out of the book. Another one is, "If you keep doing what you're doing, you'll keep getting what you're getting."

Thank you, sir.

[The prepared statement of Mr. McTeer can be found on page 304 of the appendix.]

Mr. PERLMUTTER. Thank you, Mr. McTeer.

And now our final panel member, the Honorable William Isaac, chairman of The Secura Group of LECG. Mr. Isaac, for 5 minutes?

**STATEMENT OF THE HONORABLE WILLIAM M. ISAAC, CHAIRMAN, THE SECURA GROUP OF LECG**

Mr. ISAAC. Thank you. I really want to commend the committee for this hearing, particularly this morning. I really enjoyed it; it is a ray of hope that somebody finally is focusing on these issues and trying to get FASB and the SEC to do something. I raised this issue about a year ago, and I have been on it ever since. And I am just appalled that we have spent $700 billion of TARP money, the FDIC is asking for another $500 billion. We are taking all this taxpayer money when the SEC and FASB are sitting on their hands not addressing a very fundamental problem in this banking crisis, and I am incensed and I am glad you are. I felt better this morning than I have felt for a year just watching this committee do its work, and I congratulate you. And I hope you hold their feet to the fire. I hope on April 1st if they have not gotten this thing fixed, that you will do what you have promised to do, that you will legislate issue because they just have been terribly negligent and arrogant not to deal with this issue. If I am sound angry, it is because I am. I am very angry.

I was chairman of the FDIC in the banking crisis in the 1980's, and I can tell you that it was a far more severe banking and economic problem than we started out with here. Now, we are approaching that one, but it did not start out that way, it did not need to be that way. The mark-to-market accounting is a very, very serious problem. In the 1980's, we had a 21.5 prime rate. We had a severe recession with the unemployment rate reaching the neighborhood of 11 percent. We had massive insolvencies in the third industries, the S&L's and the savings banks. We had money center banks that were loaded with to their gills with Third World debt. We could have marked all of those to insolvency if we had wanted to play by today's rules, we would have, and we would have created a depression in a crisis, we would not be sitting here talking today because we would probably still be in the recession or the depression. We had real estate problems all of the country. We had major banks, Continental Illinois, the Nation's 7th largest bank went down. We had regional banks all over the country, including 9 of the 10 largest banks in Texas fail. There was not any forbearance back there. We did not have to deal with mark-to-market account-

ing. We tried to clean up the problems in an orderly way, but we had handled 3,000 bank failures.

And I hear my colleagues down at the other of the table talking about Japan. Japan is totally irrelevant. They did not have fair value accounting to apply. They did not ignore fair value accounting; they did not have it. And the United States did not have it in the 1980's. We did not need it. We dealt with our problems, Japan did not, but fair value is not a part of that discussion. To say that we have had fair value accounting for 30 years is not the truth. We have not had fair value accounting for 30 years. We may have had some form of it on trading accounts but not the kind of fair value accounting that they have here.

I want to talk about the fact that fair value accounting or I call it mark-to-market accounting but there is nothing fair about this accounting. It is bad accounting. But we have destroyed $500 billion of bank capital in the past year through this mark-to-market accounting. That is $5 trillion of lending capacity that has been crushed by FASB and the SEC. It has led to unemployment, and loss of homes by millions of people. The harm is just enormous.

And it is not as if they went into this without warning. In 1938, President Roosevelt and the Secretary of the Treasury and the bank regulators got rid of mark-to-market accounting because it was holding us in a downward spiral, we could not get out of the Depression and so they abolished it. In 1990, when the SEC started down this path of having mark-to-market accounting again, they were warned, as Bob said, by the Secretary of the Treasury, the Chairman of the FED, and the Chairman of the FDIC, do not do it, you are going to have major problems if you do. And I think that the Secretary of the Treasury was particularly prescient with his comment, it was Nicholas Brady and let me read it. This is a March 24, 1992, letter to the chairman of FASB. They did not pay any more attention back then than they do now. "Mark-to-market could result in more intense and frequent credit crunches since a temporary dip in asset prices would result in immediate reductions in bank capital and an inevitable retrenchment in bank lending capacity. Finally, it is inappropriate to apply mark-to-market accounting to only a portion of a bank's balance sheet, as would the FASB proposal. This could exacerbate the public's perception of systemic instability even when the industry's underlying businesses are solid."

I came across this last night; I had forgotten about it. But I appeared on an FDIC panel in the banking crisis of the 1980's and the lessons learned, this was in January 1977, I found this online—1997. Paul Volcker and I were both on this panel. They asked us about mark-to-market accounting, 1997, not in the context of today's crises, Paul Volcker said this: "I think pushed to the extreme, mark-to-market is nonsense for a bank. The idea that we have to be so precise about mark-to-market accounting for an institution that is supposed to liquid funds and transform it into something longer while we tolerate enormous uncertainties in accounting on other parts of the balance sheet, and in industry generally, does not make sense to me."

Here is what I said: "If we had mark-to-market accounting back in that period, in the 1980's, and if we had wanted to, we could

have closed every savings bank in the country at a cost to the FDIC of tens of billions of dollars." That is what the numbers were. We had documented it in the Savings Bank Task Force. So we could have shut them all down. Mark-to-market spent tens of billions of dollars. I say the social cost of that would have been inordinately high. I think doing everything by the numbers without discretion is a mistake. People keep on pushing for mark-to-market accounting, prompt corrective action and the like, and the next time we have an AG bank crisis or a savings bank crisis or a LDC debt crisis, I think we are going to regret that we have those laws on our books. I think it is going to tie the regulators' hands in a way that is going to precipitate a crisis that could otherwise be avoided.

Do not let up on these guys, go after them. If April 1st comes, and they have not fixed this, then nail them, please.

Thank you.

[The prepared statement of Mr. Isaac can be found on page 198 of the appendix.]

Mr. PERLMUTTER. Thank you, Mr. Isaac. I will begin by asking a few questions, and I would start with you, sir. Today, what would you have this panel do other than hold those guys' feet to the fire, if we were to change the law today, what would you seek?

Mr. ISAAC. Enshrine yourselves for this hearing today. I think it is just fabulous. I really mean that. It is a ray of hope in a really dire economic situation. I am all for good accounting, and I want fair accounting, not the kind of fair accounting they want, the kind that just looks at a computer screen, which is where the prices are dictated by some short seller who thrives on chaos. I want somebody to go in and do some economic analysis on these assets and nobody is doing that now. I think the accountants need to get in there, roll up their sleeves, and start looking at the cash flows.

Mr. PERLMUTTER. All right, but let me, I want to be the devil's advocate here. We listened to the SEC, FASB, one of the comments, sort of tangential comments was that the banking regulators have the discretion today. Why aren't they exercising some discretion to not just blindly apply a principle or a standard that does not seem to work in a disorderly market like we have today?

Mr. ISAAC. There is a lack of confidence in the system right now because nobody knows what is going on. All we know is short sellers and other speculators do not want to buy this stuff so they mark way it down and we say, "Okay, that is the price." The banks say, "No, it isn't. It really isn't the price." I have a chart in my testimony I do hope you will look at because it gives a really good example of what is going on. I think that if you have a bank announce that they have, let's say, a $30 billion, Gotham Bank announces a $30 billion mark-to-market loss and they report that under the mark-to-market rules. And then the bank regulators come along and say, "Well, okay, there is that loss but you really do not have to count it for bank capital purposes," I do not think we solved the problem. We still have people asking, what is the price, what is the right number? The regulators, the FASB and the SEC are saying there is a $30 billion loss, which there really is not, but the bank regulators are saying, "Well, you do not have to count it. We will give you forbearance." And that does not give people

confidence in our system. One thing you knew in the 1980's is when the bank regulators came in and did an examination, that they were trying their best to mark the portfolio to its actual economic value. And that is what we have to restore, is we ought to be dealing with true economic value through accountants going in and doing their job and bank examiners going in and doing their jobs. It does not do any good to have FASB pretending that there is a $30 billion loss, there is not, and the regulators saying, "Well, we are not going to honor your pretend numbers." That does not restore anyone's confidence.

Mr. PERLMUTTER. Let me ask Ms. Fornelli, what would you have us do today? You have heard a lot of testimony today, you obviously have heard from us, and we are not happy about what is going on here because you are focused on investors, we have to focus on the broader field of depositors and taxpayers on top of that. So what would you have us do?

Ms. FORNELLI. I would have you do what I think you have heard the majority of your panelists—both this morning and this afternoon—say, and that is a two-pronged approach. One is on the regulatory capital side with the banking regulators, as Mr. Bailey outlined earlier this morning. And then the other is addressing these application problems with fair value accounting, both in the proposals that FASB talked about with how to better apply or give better guidance as to how to apply fair valuations in an illiquid or a highly distressed market. And also on the OTTI side, that we also heard about this morning, which I do not think is a current FASB proposal. So I think if you attack the problem from those two prongs, I think that that is what you should do. Push us to do those two things.

Mr. PERLMUTTER. Does anybody else have a specific suggestion, and then I will turn the microphone over to the ranking member? Thank you all very much, and I will yield now to Mr. Garrett, oh, to Mr. Neugebauer?

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I think as we go down this discussion that we have heard today, I think one of the thoughts that comes to my mind is it is like going to the doctor and the doctor says, "You have cancer." And you go home and your wife says, "Well, how was your doctor's appointment?" I said, "Well, fine." She said, "What did he say?" "Oh, he said he had a call." And that is not full disclosure. Some of our financial institutions, not all of them, but some of them have some very cancerous assets in their portfolio and some of these are very highly leveraged institutions, and their ability to manipulate their valuation of those assets can materially impact the value that the investment community might place on that institution. While I understand there are other institutions that are holding assets and they may be a of a different quality, I think one of the problems with the whole subprime and all of the securitized transactions that we have done, they are very complex, they are layered and very hard to identify exactly what is the actual risk within those portfolios. So one of the things that I think has to happen here is that we have to make sure that we do not lower the standards so that we can allow institutions that may be should not continue to be able to operate or should not be operating, somehow to give them a free pass, while at the same

time making sure the investment community is rewarding those companies out there that are actually managing their business in an appropriate way.

The question I have, I think, Mr. Bailey, you mentioned that you had taken a write-down. Do you have a model that you used to valuate your mortgage portfolio to determine what the value of your portfolio is?

Mr. BAILEY. Yes, sir, we follow the FASB guidelines right now but in that instance, we are looking at a mortgage security that is basically has some credit issues in it, and as we do a rigid credit analysis, we say, okay, using the example, you pay a dollar for it, there are credit issues, it may be only worth 90 cents but because you have to go out and get a market price for it and no one is in the market these days and they quote you 60 cents, you are taking a charge of 30 more cents, the difference between the 90 cents and the 60 cents.

Mr. NEUGEBAUER. Are you using an internal model or are you using a recognized model?

Mr. BAILEY. We are doing the analysis but then the FASB guidelines, as I understand them, would require you to write down the market value.

Mr. NEUGEBAUER. Yes, but I want to be clear, you are using FASB guidelines, but you are using your own model?

Mr. BAILEY. Correct.

Mr. NEUGEBAUER. Is that correct?

Mr. BAILEY. That is correct.

Mr. NEUGEBAUER. And so another bank down the street who might be your competitor maybe believes that he is following the FASB guidelines and he is using his model or her model, that could be a different valuation, is that correct?

Mr. BAILEY. That is correct.

Mr. NEUGEBAUER. Then how do I know then what, if I have both banks side by side, how do I know which is the healthier bank?

Mr. BAILEY. I am having the same problem, Congressman. I guess one of the examples is we rode down to Washington, we were looking at, talking about different banks and their financial statements that were out, all big accounting firms came out and had analysis, it appeared to me, Tom Bailey, the banks that got TARP took big write-offs. The banks who did not, did the analysis and came up with a number. All the accountants signed off on them, but here is where I see the taxpayers and you are footing the bill for the uncertainty in this rule.

Mr. NEUGEBAUER. Well, I think there is opportunity in the marketplace if there was an ability for investors to understand the actual condition of a lot of these institutions and maybe a lot of these securities. I am told that there are ways to dig down into those portfolios and actually determine those, but what those people also tell me is that that is the assumption that this is as worse as it gets and that where we saw in the headlines today is that foreclosures actually increased in the month of February and Freddie Mac and Fannie Mae and actually had a moratorium on foreclosures. And so what we do know is the universe is not static and that things are getting worse.

I think one of the questions I have to the panel, in the short period of time I have left, is if you can use a market valuation process that everybody uses, but use a disclosure box or an addendum that says this is the assets we hold, we are currently valuing these assets internally based on this. Now, this is the way we have to disclose them but if on your balance sheet you disclosed how many you have, what your default rate is, what your projected cash flow was on the security when you bought it, what it is today, obviously the industry could develop some standards, if that was in your footnotes, then I think possibly that would bring some transparency to the marketplace where I could then make a decision whether to invest in your bank or Mr. Cotton's bank or somebody else's bank, would the panel respond to a suggestion like that? Mr. Mahoney?

Mr. MAHONEY. Thank you, Congressman. Fair value accounting by itself is not sufficient, there also needs to be robust disclosures about fair values. So a proposal along the lines of your suggestion, we could certainly be supportive of. The White Paper that I attached to my testimony does include a recommendation about some additional disclosures. So that would be something that the investor community would be very supportive of, to have more robust disclosures around both impairments as well as other changes in fair value. Thank you.

Ms. FORNELLI. Yes, Congressman, I would note that the Securities and Exchange Commission currently allows that type of disclosure, not in the footnotes to the financial statements but in the management's discussion and analysis. So there is nothing to prevent management from making those kinds of disclosures about the assumptions that they are making about their cash flow predictions. And, in fact, one of the recommendations that the Center for Audit Quality made in its November comment letter was to have the SEC to give even more clarity around that so that people are comfortable using that mechanism of disclosure.

Mr. ISAAC. If I may?

Mr. NEUGEBAUER. Mr. Isaac, yes?

Mr. ISAAC. I would like to respond to that. I think that first of all, I am all for all the disclosure anybody wants to make. The problem we have here is they are running these losses, these market losses, through the income statement, which scares the public when they see multi-billion dollar losses being announced that are not real. The public does not know they are not real but they are not real. And they are running it through the capital account and for every dollar that goes through the capital account, you are diminishing $10 of bank lending capacity. So I am all for all the disclosures you want to make but you do not run the mark-to-market losses through the income statement and balance sheet. That is the problem with this accounting system. And what we do need is bank examiners and accountants in there with their sleeves rolled up, giving these assets a true economic value so that we can all know what they are.

But in my chart here, we have a bank that has a portfolio that it expects, this is one bank and one portfolio in that bank, they have taken nearly a billion dollars of write-offs that do not need to be because their belief is, their firm belief is based on economic analysis that the losses in this portfolio will be zero. Worst case

they can come up with is $100 million of loss. They have had to take a $913 million loss, this is mark-to-market rule. And so we just destroyed $1 billion of capital in this bank needlessly, which is $10 billion of lending. And that is just one portfolio in one bank. So the problem is we are destroying capital, and we are taking it out of earnings and we are scaring the public and making them think this problem is worst than it is.

Chairman KANJORSKI. Thank you very much, Mr. Neugebauer. Ms. Kaptur of Ohio?

Ms. KAPTUR. Thank you. Mr. Chairman, and again, my compliments to you for a great hearing and one for the Nation. I hope that some individuals over at the White House and at Treasury will be influenced by what is said here today because they need to hear this. Mr. Isaac, you are uniquely qualified, I appreciate all the witnesses being here, but I do not know too many living Americans who have been involved in resolving over 3,000 insolvent institutions and who have served presidents, both Democratic and Republican presidents, and who have a track record that demonstrates they know what they are doing and they have a written record existing over 35 years of solid and sound financial advice.

I am going to ask a question and then make a reference to something else while you are thinking of the answer, but if President Obama were in this room, and you were to advise him what to do in order to begin addressing this situation, I know you know the answer to that, but while you are thinking of how you want to order that answer, let me just say that it is an amazing to me as a citizen of our country that the housing market is the cause of this downturn and yet we seem uniquely unable to get our arms around that with all of the brilliant people that we have heard from this morning. And I do not know if it is partly a political problem of people being afraid of what happened with Enron and being gun shy or afraid with what has happened with AIG and therefore we do not want to be politically perceived as doing something that is irresponsible. But we all have to figure this out together and the lack of our ability to do that has created situations in places like I live where credit has totally seized up, where our auto dealers cannot get loans from banks, where our region is one of the three leading solar centers in the hemisphere, we cannot get loans to hire people right now to bring up our factory floors to meet orders that are pending all over the world. The banks cannot make the loans. I see people being laid off in my region, and I am saying, why can't all these brilliant people in Washington get their act together? And I look at the Treasury, Secretary Geithner was up here this week, we met with President Obama yesterday on the whole budget problem, why can't we get together on this, what is hampering our ability to do that? I leave that question hanging out there. Is this a sad condition of our age where we have become so individualistic and our agencies have become so stove-piped that we cannot seem to do this together? Is there something that is really fundamentally wrong? But somehow we have to pull together here.

Mr. Isaac, if President Obama or Michelle is listening, you have served other Presidents, you served President Carter, you served President Reagan, presidents who actually accomplished something

when they were in office, what could you add, what could you say to the President?

Mr. ISAAC. Thank you. I guess I would have a few things I would say and one is that the SEC needs to be brought into the solution here, they should not be out on the side sitting on their hands the way they have been. And so I would have, if I were advising President Obama, I would say, "Get the chairman of the SEC into your office and tell him that they are going to deal with the up-tick rule, and they are going to control the short selling activity." And tell them they are going to reform this mark-to-market so that it really is not so destructive of the capital in the banking system.

The second thing I would say is we need to get the securitization markets working again. The Fed has a program they have started, and I think they need to go faster on that and they need to do more. They need to do more and more and faster, they have to get on it because we really need to get securitizations going again. I would make it more clear than we have that the United States stands behind its banking system. We are not going to nationalize the banks, but we are going to do whatever it takes to right this system and make it work because if we do not get the banks working right, the rest of it is not going to work. So we really have to start there and get that fixed and mark-to-market is an important part of that, the restrictions on short sellers is an important part of that. I think he has announced a housing program, I support it. I think we need to help people who are losing their homes, and we need to stabilize the housing markets.

And then, finally, something I feel, he ran on a message of hope and optimism, and I think he needs to get that message out there. He forgot it after the election for a while, and I think it is time to see—Franklin Roosevelt did it. He said, "The only thing we have to fear is fear itself." Ronald Reagan said, "It is morning in America again." And we need hope, and we need an optimistic president and we need optimistic congressional leaders in my opinion, who can give somebody a reason to go out and buy a new car or a new washing machine. Right now, people are scared. We really have scared the public. So those are my thoughts.

Ms. KAPTUR. Thank you.

Chairman KANJORSKI. Thank you very much, Ms. Kaptur.

Mr. GARRETT. I am optimistic. I am going to buy a new car actually.

[laughter]

Mr. GARRETT. And I will get a good deal. And if at the end of this if someone will give me a list of the accomplishments during the Carter Administration, I will be looking for that.

laughter]

Mr. GARRETT. Some technical things, can someone talk to me—

Ms. KAPTUR. I hope the gentleman will yield on that point.

Mr. GARRETT. Well, when I am done, yes.

Ms. KAPTUR. I think each of you can help answer that question for one.

Mr. GARRETT. With regard to OTTI, help me understand some of this stuff with regard to that. The trigger right now is what, basically a dollar diminution in value that you see as far as opposed to some other proposals that are there saying that it should not be

there but it should be a material diminution as a trigger with regard to what the impairment is? No? Okay. The second question—Ms. Fornelli, do you know where I am going on this?

Ms. FORNELLI. Well, as you know, I am not a CPA, but we can get that answer to you.

Mr. GARRETT. Okay. The second question then is with regard to gains, and I think someone else on the panel talked about this before, and I think the first panel did as well and how it should work, whether or not you permit a gain or other positive adjustment in the valuation of it which you do not incur right now? In other words, normally I think I discussed with you some of you before, some of the balance, it just ticks, ticks, ticks down but if it is in the accounts that are held for long term, you do not see that tick back up again. Mr. Isaac?

Mr. ISAAC. I think that is right. I think you mark down and the only way you get that value back is to sell it.

Mr. GARRETT. Sell it.

Mr. ISAAC. And a lot of banks do not really want to sell it because they are good yielding investments, they want to hold them.

Mr. GARRETT. Right.

Mr. ISAAC. But they are stuck.

Mr. GARRETT. Right, so what do we need to do about that or should put it what should we be doing about that?

Mr. ISAAC. Well, I think what really needs to be done, as I understand it, and I am not an accountant and do not aspire to be one but, as I understand it, the OTTI problem is that you have two kinds of things that are causing us to mark down based on other than temporary impairment, one is the potential for credit loss there. And I would not argue with that. If you have credit losses, you ought to mark it down or anticipated credit losses, that ought to be marked down, and I do not think that is controversial. The issue is we are marking down for market swings as well, and that is highly destructive.

Mr. GARRETT. But going forward, if you have, if you are holding and you actually see an appreciation of that, right now, as you said before, you cannot—

Mr. ISAAC. You cannot mark it up.

Mr. GARRETT. You cannot mark it up.

Mr. ISAAC. —is my understanding.

Mr. GARRETT. Right, and there might be a benefit to that.

Mr. ISAAC. There would be but it would be better not to mark it down at all.

Mr. GARRETT. Right.

Mr. ISAAC. And for market moves, just mark down the credit losses or the anticipated credit losses.

Mr. MCTEER. Sir, I have been told by a banker that if you have been too pessimistic in marking them down, you are not allowed to put it back when it turns out that you are wrong. I have also been told that the regulators have the authority already to change that, but they are somewhat reluctant to use that authority, because there is some provision that says if they use that authority and do that, they have to report back to Congress that they have done it, and they are reluctant to do that. That is all I know.

Mr. ISAAC. And my understanding is that if they do bring it back, if the regulators allow it to come back, they bring it back, the accrete it over time, whereas the hit is taken all at once. And so the best thing to do is not to mark it down.

Mr. GARRETT. I understand, I am just trying to think what else we may do. Let me go to Mr. Cotton or other people, you talked at the beginning of your testimony with regard to the application that is going on right now, and I think we are all across-the-board in agreement on the application of the current rules is not what we would have them. I am concerned even after 3 weeks from now or 4 weeks from now, we get the new rules, whether or not they are going to have enough clarity to actually get the application there, so I just appreciate your thoughts on that. But even if that does not occur that we get to the point where we want to be on this, right, one of the other recommendations was is that we deal with the financial institutions and deal with what some of the members here have talked about as far as the regulators, as far as having them basically solve the problem for us, right, that does not do it for you folks?

Mr. COTTON. No, that does not. Most of the conversation this morning, and actually at this table, has been about banks, and I think there is a missing element here and that is investors, like I have been for the last 10 or 15 years. Investors who use other people's money through funds that they have raised, for instance pensioners from Pennsylvania invested with me over the last 15 years, they are being harmed because we are unable to value these assets where we see them as valued. We, as the people who made the investment, did our work, did our analysis, understood the assets that were involved, and we have an opinion on value. We give that opinion to an accountant who says, "Well, that is interesting but can you get me three bids from the street?" Well, those three bids from the street bear no resemblance to the value. As I said before in my comments that commercial mortgages today, if they are securitized, have a very low delinquency rate, and the portfolio that I used to run, and I retired in December, but in that portfolio, it is maybe 1 percent delinquency. And the people who manage that portfolio understand what is in it and can present the data. They have the cash flows, the rent rolls, they understand the assets. They can present that data, but if you do not go to the level three, as it is called, in the guidance for the accountant and have the accountant have the ability to understand what is involved in the asset. As Mr. Bailey said, he can look at the loan in his book and he can make a determination if he is going to get paid back or not and come to a value and take a credit impairment if it is appropriate. In our case, we looked at the portfolio and said our portfolio has very little losses that we can see coming forward, yet when put to bid, the value goes through the floor. Commercial triple A CMBS today is trading a dollar price of 65 cents. That would lead me to believe that the buyer thinks there is 35 cents lost in every bond at the triple A level. To get to a loss at a triple A level on a CMBS, you would need to have over 30 percent of the pool completely written off. In an environment of 2 percent delinquencies, in an environment of 8 percent delinquencies, you are never going to get to 30 percent loss. However, the market has priced it there. Why? The

buyer today is not the buyer who has traditionally bought those assets, particularly the buyer recently who is a buyer who says, "I am private," or "I am a hedge fund" or I am some other vehicle that does not report mark-to-market, so I will take advantage of you who do report mark-to-market, and I will give you a bid. And if you are desperate and you are forced to sell, you will actually sell your bond, and I will take advantage of that. So that 35 percent loss expectation at the triple A level on CMBS, which is so far from the reality, becomes the reality.

Mr. GARRETT. For everybody, for the regulator. Thanks, I appreciate it.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. Now, we will hear from the ranking member of the full committee, Mr. Bachus.

Mr. BACHUS. Thank you. Mr. Isaac, you were talking about market confidence and fear and optimism, and I agree totally with you. I actually issued a statement the day before yesterday that said that, "Warren Buffett's recent comments that markets are confused are fearful are right on point. Contributing to the current market confusion and fear is the constant stream of inconsistent, inaccurate and exaggerated statements concerning our economy and financial institutions from both the Administration and Congress." Everything from statements about our large financial institutions are all walking dead or zombies.

I want to apologize to you, when you came to the Hill in July of last year and started talking about mark-to-market, quite frankly, I was on the other side. And but I did realize, I was hearing from bankers and insurance executives and everything else that it was causing real disruptions, and I knew that it was in valuation. But, as I result, I did respond by putting into the October 3rd, when we passed the TARP bill, a thing to study it. And as soon as I did, folks came after me. The Washington Post, on the 20th, I would like—well, first of all, the Financial Accounting Foundation, which is over the FASB, they wrote me a letter where they basically admonished me and said that Congress ought to stay out of their business and not play politics with accounting standards, which I actually agree that we should not play politics.

But I read in January, Mr. McTeer, that you wrote about the Fed spending tremendous, extraordinary efforts, hundreds of billions of dollar in the Treasury, hundreds of billions of dollars of the taxpayers and all the regulators and yet FASB and the SEC, which has the right to order them to do things or do it themselves, were just missing. They were missing in action. And I really thought that the October 3rd provision that Roy Blunt and I put in there that said do a study, The Washington Post attacked me and said we do not know anything about accounting, but we did know that it was causing distortions. And the SEC, the amazing thing to me, they came back with a report and it said there are problems, there are distortions, there needs to be something done. So they agreed with much of what you all said today, and they referred it to FASB and it was like the dead letter file. Everyday, American businesses struggle, American taxpayers, and there was just no sense of urgency. I believed really this hearing is a real driver towards that. And, Mr. McTeer, I read your article in January and said let's in-

vite this guy, and so I appreciate your testimony. I have been following your blog, and I am going to introduce his article, "My Mark-to-Market Nightmare." I wish every member would read that.

I read a statement at the start of the hearing that John Lewis wrote a national best-selling book, he and I are both from Alabama, where he said that one of the things about America is they confront and overcome challenges but everybody is in the house together working hard. And FASB and the SEC, they have not been here. People of conscience, he said, coming together. And I think after today they will be. I am optimistic.

One thing that has troubled me more everyday is this idea that adjusting, and I have a hard time, fair value accounting means a willing buyer and a willing seller, so we do not have that. So there is a difference between—and some of my staff disagrees with me, but there is a difference in that and mark-to-market because you actually interfere with a bank or someone's decision, they will not sell, like I do not have to sell my house today, so I do not have to sell my car today, I do not even have to take it to an auction tomorrow. But really banks, they are being pushed to arbitrarily assuming there is a transaction.

And I know, Mr. Mahoney, you represent some of the investor groups, but I want to remind you that I think sometimes when you talk about investors, they are really speculators. Investors, most Americans are investors for the long haul. They have pension plans, they have 401(k)s, and they are really more affected by pricing this stuff down everyday than by not. Yes, people want to buy, they want to know what something is worth. But those are more active markets, so I think that the investors ought to get on the side of doing something about this because I think they have a whole lot more to lose.

I have a question for each of you, and I do not know, I think we are going to do a second round, and I will actually ask questions. I often criticized my members for making speeches instead of asking questions, so if we can have a second round?

Chairman KANJORSKI. You can take the question now if you like.

Mr. BACHUS. We will do that. So I will yield back, but I think—

Chairman KANJORSKI. You can take the question now if you like?

Mr. BACHUS. I will take the first one. Mr. Cotton, the commercial mortgage-backed securities market uses a synthetic instrument and the CMBS index to find observable market prices, your testimony indicates that the CMBS index has been trading at a price that suggests a 99 percent default rate. Should accounting rules force CMBS market participants to mark to an inaccurate barometer of fair value given the performance of CMBS loans? That is what we call a leading question?

Mr. COTTON. Yes, sir, I feel led at this moment. I believe what was said in the testimony, and previous people from our organization have said it, there was a time that CMBS priced to a 99 percent loss expectation. I think if you heard what I said a minute ago, presently the cash bond is pricing assuming that there is a loss in the triple A, both of those do not bear a resemblance to the underlying performance of the assets because the buyer and seller, particularly the buyer and seller of the index, he or she is trying

to hedge a position one way or the other. They are making a bet. It is not a lot different than betting on a fly going up a wall, as I used to say when I lived in Australia. It is a gamble. The fundamentals do not bear any resemblance to either of those at this moment. And I think what we are talking about here is trying to get back to fundamentals.

Mr. BACHUS. Thank you. Mr. McTeer, I read your blog where you advocate an approach that would split impaired assets into a credit loss component and a liquidity market component, how would this approach mitigate exaggerated hypothetical losses that could cause the collapse of a financial institution?

Mr. MCTEER. Well, I think it would mitigate it in the sense that it would limit the write-downs, the write-downs that were justified by actual credit impairment. If it is done well, it would not cause write-downs because of illiquidity and a cyclical market.

Mr. BACHUS. I actually had an insurance executive who proposed the same thing that you did, I do not think he had read your remarks, you had not read his, but he said it is important to make those distinctions.

Ms. Beder, is it, is that pronounced right? In your experience, have you seen a reluctance by firms to value their assets using level three models because of concerns that those valuations would not be accepted by auditors? And, if so, what can be done to encourage firms to use level three valuations with confidence?

Ms. BEDER. Yes, your question is a common concern of people. The difficulty right now in going to level three accounting is that distressed market prices exist for some of the underlying instruments that are involved in the securitized securities. So, for example, there are some dealers who are still maintaining prices for residential mortgage securities, about 3 cents for BB securities and up to 30 cents for AA, which implies that over 70 cents is going to default or that the dealers fear the liquidity environment. That being said, residential sales in many markets are happening at or near the value of 75 cents of peak values, so the loss is maybe 25 cents, it is certainly not 70 cents on the dollar. The challenge is that in going to level three in the model, you have to justify often to the audit firms why you are not using that "market" of 3 cents or 30 cents underneath the instruments. This is why the single measure is failing.

The argument that Mr. Cotton is making and also that Mr. Isaac and Mr. McTeer have made is that firms have to be able to use judgment and they have to be able to use model prices. These must make sense. The concern on the part of the accountants and others is how do you ensure that the assumptions that are going into those models are valid and that they are not pie in the sky in terms of assuming that all is well when all is not and how do you get to the right number?

If you put alongside the mark-to-market number, which I do not advocate throwing out, a mark-to-model number that firms may use with some type of independent verification, this should give the firms information that they need and it will not force the unnecessary write-downs that are harming firms.

Mr. BACHUS. All right, thank you.

Chairman KANJORSKI. Thank you very much, Mr. Bachus. And now we will hear from Mr. Price?

Mr. PRICE. Thank you, Mr. Chairman. And I want to thank the panelists for their tolerance and forbearance of our schedule today. Mr. Mahoney, you have been around this business for a good long time. Have you played any role with any other institution prior to coming with the Council of Institutional Investors?

Mr. MAHONEY. Yes.

Mr. PRICE. And what would that be?

Mr. MAHONEY. I was a staff person at the Financial Accounting Standards Board. I actually started off as a project manager involved in helping the development of accounting standards. And then after that, it was my job to talk about accounting standards and explain them to Members of Congress and others.

Mr. PRICE. So you worked at FASB?

Mr. MAHONEY. Yes, I did, and I am now a co-chair of an advisory committee of a group of investors who provide input into the FASB process. We try to collect the views of investors from across this country. We have a good cross section of investors on that group. We try to explain to the FASB how we believe accounting standards should be changed to benefit investors.

Mr. PRICE. I am glad you mentioned one of our letters because a letter of October 29, 2008, states that you wrote that you believe that FASB staff position issued on October 10, 2008, was largely responsive to the recommendation that was provided, do you still believe that?

Mr. MAHONEY. I am sorry, that was which letter?

Mr. PRICE. The letter of October 29th, in your testimony, 2008 to Ms. Harmon at the SEC?

Mr. MAHONEY. At the time, there were questions about the application of fair value accounting in illiquid markets.

Mr. PRICE. Do you still believe it?

Mr. MAHONEY. And the FASB provided an example and some additional guidance as to how to apply Statement 157 in an illiquid market.

Mr. PRICE. Did it work?

Mr. MAHONEY. It appears that there are still some application problems.

Mr. PRICE. Thanks, I am going to try to stick to my 5 minutes.

Mr. MAHONEY. Sure.

Mr. PRICE. And I appreciate that. Mr. Isaac, I share your anger, I want to thank you for your perspective, I want to thank you for the communication that you brought to our conference and to the Congress last fall. If we had followed your advice, we would not be in the boat we are in right now. I want to ask you why you think that FASB and the SEC have not acted properly or promptly, what is driving them, what is their motivation?

Mr. ISAAC. I am not a psychologist any more than I am an accountant, but I will give you my take on it. I believe that it is very difficult to admit when you have done something that did not work out as badly as this thing. This has been a major, major, major loss of taxpayer money that is attributable and great instability in the economy and the financial system and it is hard to own up to that when you are an important part of the cause. I also think, my im-

pression is the accounting profession generally likes the fact that they can look at a computer screen and get a price off of that and not have to take any risks by actually getting in and valuing assets. They would rather do it that way, it takes the heat off of them. And so those are my guesses.

Mr. PRICE. At some point, you have to quit digging though, right?

Mr. ISAAC. It is time for us—I believe it was Representative Bachus who said it is time to all get in the house. We have a problem, we have to get together and we have to do whatever needs to be done to get it fixed. And I do not see how we do that without FASB and the SEC being part of the solution. Or if they are not part of the solution, finding somebody else to do the job.

Mr. PRICE. Right, well, we are trying to push them in that direction, and we appreciate your input sincerely. Mr. Bailey, my bankers are saying the same thing, that they are having huge problems. I wonder if you might share with us how the dialogue has changed, that is different now than what it was prior to the crisis with the regulators between your banks and you, what has changed in that dialogue, anything?

Mr. BAILEY. Could you clarify, I am not sure what you are asking?

Mr. PRICE. In terms of their interaction with you, what they are talking with you about, what they are requiring of you, how strict they are, has that relationship changed at all?

Mr. BAILEY. It has slightly. In fact, on Monday, I got a call from the FDIC, when you file your quarterly report, they noticed the mark-to-market adjustment, the dialogue, they understood it, they have other banks in fact in the northeast region, which is where I am from, they said there are no credit issues, loan credit issues in western Pennsylvania, they are investment issues. And when they first came in last summer and did an exam, it was what is the market price, what is the market price? Now, they are listening to the level three pricing.

Mr. PRICE. So they are moving in a positive direction?

Mr. BAILEY. It appeared, the staff person who called me. I do not know if the higher-ups are.

Mr. PRICE. Mr. Bailey, I want to follow up with you and, Ms. Beder, each of you had very specific recommendations, and I wonder, my sense is that the SEC and FASB could institute a lot of those recommendations without any action by this committee, do you believe that and would you highlight the ones that you believe they could institute without legislative action?

Ms. BEDER. Sure. I believe that the one thing they would have to do is clarify the definition between what is a liquid and illiquid market and when one might move away from the mark-to-market accounting. Mark-to-market is a fallacy when there is no market.

Mr. PRICE. And they have the authority to do that right now, as I understand it, is that correct?

Ms. BEDER. I believe that they allow those calculations in the footnotes, and I think that what would help the market tremendously though is not to require just the sole mark-to-market measure in the accounting statements, that is also part of the problem, it is fueling the difficulty in very highly liquid markets and in illiquid markets.

Mr. PRICE. Great, thank you. My time has expired, Mr. Chairman. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Price. Mr. Isaac, I understand you have an appointment, you may have to leave. Because we have kept the panel so long, certainly we will understand if you have to leave and feel free to do so whenever you have to.

Mr. ISAAC. Thank you, sir.

Chairman KANJORSKI. We have about four more members who have some questions, and we will try our friend from California, Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman. Mr. Isaac, before you leave, I could not agree with you more that there is a tendency at the FASB to design accounting standards so that whatever is being reported is verifiable, incontestable, easy to determine, and impossible to sue about rather than reflective of reality. And if baseball had been designed by umpires, and umpires faced not only video instant replay but lawsuits, there would not be a strike zone because you would get sued every time. And you were not here earlier necessarily to hear me rail against FASB No. 2, which is depressed investment in research, because if you do the accounting the right way, accountants have to look at which research programs were successful and which were not, and it is easier to simply assume that all are not.

It is hard for Congress to get into the business of legislating Generally Accepted Accounting Principles and that has always been a private sector function but regulatory accounting principles have traditionally been a governmental function. If we were to modify mark-to-market for RAAP, while leaving GAAP the way it is, I realize that we might not be helping CitiGroup share prices, but my goal is to just keep banks lending and keep the regulators from taking them over when they should not. If we change RAAP without changing GAAP, do we solve the problem?

Mr. ISAAC. Mr. Sherman, I think that that is better than doing nothing, but I worry about it because if Gotham Bank reports a $30 billion loss because of mark-to-market accounting, the holding company is a public company.

Mr. SHERMAN. Right.

Mr. ISAAC. And it reports a $30 billion loss, I think you have created a huge psychological and fear problem in the marketplace about that and the regulator can say, "Well, we do not care about that, we are going to count that $30 billion as part of capital, we are not going to make them write it off for regulatory purposes." It does not seem to me that does much to restore confidence, you would just have two parties arguing about what is the right value. It seems to me that one of the reasons why we were able to get through the 1980's with those massive banking problems successfully is because somebody was in charge. We did not turn it over to the marketplace and have it be a free-for-all. And by somebody in charge, I mean the bank regulators were in charge. They were in charge of the accounting, they were in charge of examining the books and deciding who had what amount of capital, what had to be written off, and the marketplace could say, "Well, we do not think the regulators are doing a good job," or not, but there was

somebody in charge, there was a way to determine values. And we maintained stability and order while we were failing 3,000 banks.

Mr. SHERMAN. If I can interrupt, the other concern is, okay, mark-to-market marks things down too low.

Mr. ISAAC. Right.

Mr. SHERMAN. Let's say we do away with mark-to-market, what is the risk that more traditional accounting methods fail to adequately reserve for doubtful accounts and that we end up with an accounting statement that is not only—well, that is simply too generous even on a hold to maturity basis?

Mr. ISAAC. Our experience during the 1980's was not that accountants and bank examiners were being too soft, we had the opposite fear, that accountants were being too cautious and bank examiners were being too cautious and were causing more write-downs than were necessary and therefore we had more bank failures than we should have had. That would be my assessment of the 1980's, having been on duty, that if anything, the system was overly conservative but it was not wild like today where we are letting short sellers determine how much something is worth, and we are blindly accepting their valuations.

Mr. SHERMAN. I believe my time has expired. Thank you very much.

Chairman KANJORSKI. Thank you very much, Mr. Sherman. And now, we will have Mr. Manzullo.

Mr. MANZULLO. Thank you. I recall in September, Mr. Isaac, we were in a room with Dennis Kucinich, and I think Marcy Kaptur was there and a lot of other Democrats, a lot of Republicans, and we were pleading with Secretary Paulson, pleading, screaming at him, "FDIC has the authority to insure any amount of any FDIC institution, please do it immediately." He said, "No." He went about his bad assets, and you talked about your experience. "No, we do not want to do that." He talked about exchanging the high-quality commercial paper for an infusion of capital. "No, we do not want to do that." And we also obviously talked about FAS 157 and no one would do anything.

But I think here is the problem, I can quote from Ms. Fornelli's statement, she says, "The crisis has been caused by loan losses and runs on the bank, not fair value accounting." And then I quote from the man on the street over there, Mr. Bailey, he says, "The application of mark-to-market in frozen markets is the heart of the problem." I mean either mark-to-market is a problem or it is not a problem, and I see two planes of very honest, distinguished, dedicated people and you are simply not connecting. But let me tell you where the connection comes in, mark-to-marketing is destroying manufacturing in America. Let me say it again: Mark-to-market is destroying manufacturing in America. Let me say it 3 times. You do not know unless you are on the streets and Mr. Bailey knows. You do not know what is happening to manufacturing in this country when they are barely holding on with one regulation after the other coming from Washington and all types of new exotic products coming out of the White House. People who have had loans with the same institutions, the same amount of sales, the same collateral, are being told by their bankers that we cannot give you any more money because of mark-to-marketing.

Now, either I have several hundred lawyers on my hands, representing several hundred industries in the City of Rockford, which had 25 percent unemployment in 1980 and lost 100 factories and 10,000 highly skilled jobs, or people think mark-to-market is some type of philosophy just hanging out there. And all I hear is we have to address this, we have to do this, and meanwhile no one does a dang thing. Nothing is happening. Can't you see how critical this is? If you do not understand mark-to-marketing, if all you do is argue about it, then throw the damn thing out, excuse me, and put something else in place but what is at stake are all these industries. I do not think you have any idea how fragile manufacturing is in this country. Is mark-to-marketing a part of the problem or not, Mr. Bailey?

Mr. BAILEY. Yes, sir, it is.

Mr. MANZULLO. Why is it a problem? You meet these people all the time just like I do?

Mr. BAILEY. We heard the gentleman from FASB this morning talk about that investments are only a small piece, yet the FDIC reports $400 billion of assets are in these securities, $400 billion. If we take a conservative estimate, the way things are right now in mark-to-market, it would not be unreasonable to take say 25 percent of that would be impaired. Okay, that is $100 billion; $100 billion hit in capital is $1 trillion in lending ability from banks.

Mr. MANZULLO. Ms. Fornelli, is mark-to-marketing a cause of the problem here?

Ms. FORNELLI. Mark-to-marketing, and I do not just think that the SEC found this, Chairman Bernanke, Treasury Secretary Geithner, did not cause the credit crisis that we are in but certainly, as we all have heard today, and I think that we all agree, mark-to-market accounting needs to be improved.

Mr. MANZULLO. I understand that but no one has any exact things on how are you going to improve it. It is not working. Whatever you do, whatever guidance you give, it is not working. Things are locked.

Ms. FORNELLI. But I think there are ways to improve it, and we have all put those out.

Mr. MANZULLO. Well, the crisis came in September. This is now the middle of March. That is what this man was doing here screaming with a bunch of members and no one had done anything in 6 months.

Mr. BAILEY. Congressman, I think we have suggested, and I think I have heard some other people here, it is more falling FAS 114, which would be separate the credit from the market price.

Mr. MANZULLO. Well, let's just get it done. Why can't we just do it and move on? Value these assets honestly.

Mr. COTTON. I am not sure it is in the control of the people sitting at this table, sorry to interrupt.

Mr. MANZULLO. I understand. Is anybody here from the OCC or the SEC, anybody here in the room.

Mr. COTTON. They were here this morning.

Mr. MANZULLO. No, no, is anybody here in the room now to listen to this testimony?

Mr. BACHUS. They are on our side.

Mr. MANZULLO. I do not see anybody there. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Manzullo. Now, our final on the Republican side, Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman. I would like to ask a question just about some of these assumptions that you read in the financial press just to kind of weigh this assertion. And I suspect that Steve Forbes kicked this off with his argument that in the early 1990's with the financial problems, that if we had mark-to-market, virtually every major financial institution would have been undercapitalized, and we would have had a crisis that he argues would have been on an order of the Depression in the 1930's if it had really been deployed or enforced and argued it was dropped in 1938, partly for this reason, in 1938, came back in the fall of 2007, I guess is when FAS 157 was implemented. So he would argue that this has greatly compounded the problem. I would just like to go to the assessment about the early 1990's and just have a little reflection and thinking about some of the problems we faced then, what would have been the consequences?

Mr. ISAAC. I would be happy to respond to that since I was there.

Mr. ROYCE. Mr. Isaac?

Mr. ISAAC. And it was really the 1980's, more than 1990's. The 1990's were a mop of the 1980's.

Mr. ROYCE. Early 1990's is what we remember but, yes, the late 1980's was the problem.

Mr. ISAAC. The 1990's were the mop of the S&L problem, from 1989 forward, we just mopped up the S&L problem. Prior to that is when we really had the serious, we were in really serious soup in the mid-1980's. We had $200 billion of insolvency in the S&L industry, and the savings bank industry if you had marked them to market. We did not have to, but that is what you would have had is $200 billion of insolvency. All of the money center banks were insolvent if you had marked—virtually of them were insolvent if you had marked their Third World debt portfolios to the then prevailing market prices. The markets had dried up and nobody wanted the stuff just like today. There is no question that we would have failed thousands, we failed 3,000, we would have failed thousands of additional banks and thrifts during the 1980's and early 1990's, including all of the money center banks. We had a standby plan to nationalize them if we had to, and we would have if we had to, and so it was a very, very serious time. And we could not have coped with it under today's mark-to-market rules, just could not have coped with it.

Mr. ROYCE. Mr. Cotton, did you have commentary on that front?

Mr. COTTON. Well, I was a borrower in the 1980's so I was probably on the guilty side of that equation at the time. But I think what Mr. Isaac saying, and I think what you are hearing from all of us is that if you are looking for an immediate answer from a screen, you will get an easy answer and that screen answer may not be anywhere near the reality. We are advocating that the accountants be given the authority to do level three work and be encouraged to do level three work, and then they have to make a judgment. And I think they have to be in some way be comforted that that judgment does not necessarily lead to a lawsuit. I thought the metaphor used earlier about the strike zone was an interesting one. If the auditors are afraid of their shadows, it is easy to go to

a screen and say there is the price. But if the price is the wrong price but it is the easy price and that is where they go, I think we make this mistake and we exacerbate this.

Mr. ROYCE. Well, let me ask another question because we have another debate going on on International Financial Reporting Standards and GAAP is very much rules-based, and we are tied to those rules. The Brits and others approach this from a little different vantage point, principles-based. Would going to IFRS standards lead us down a road that in some way gets us out of the box that we are in here? I do not know.

Mr. COTTON. I am not an accountant, so if you are asking me that question.

Mr. ROYCE. Okay, all right.

Mr. COTTON. It missed me.

Mr. ISAAC. My concern about that, the international rules are actually better than ours on OTTI is my understanding, but my fear of going to the international rules is if we think FASB and the SEC are slow, bureaucratic, and lethargic, you ain't seen nothing yet. I am scared to death of going to—subjecting ourselves to an international standard. This hearing today would irrelevant if you had international standards because you could not do anything about it. So I really think that is a dangerous thing and the SEC is headed down that path, and I think we ought to get them off that path.

Mr. ROYCE. Going back to my original point, I will have Mr. Bailey give me your assessment? Last question, your assessment going back to the late 1980's, what is your perspective now just thinking about that? We have the figure there, $200 billion insolvency in the financial assessment there, what would you—how would you think in respect to that?

Mr. BAILEY. I was just coming into the industry at that time so I could not comment, I am sorry.

Mr. ROYCE. Okay. Well, anyway, my time has expired, Mr. Chairman. Thank you very much.

Chairman KANJORSKI. Thank you very much, Mr. Royce. We have a request for a second round, does anybody want to indicate what they are in favor of there at the table? But I have not had my round so I am going to take at least a portion of my round. Look, Mr. Manzullo was somewhat threatening to the table but to my knowledge none of you are presently regulators or involved in any of the standard setting.

Mr. MANZULLO. Mr. Chairman, I owe an apology to—the frustration level is extraordinarily high, and I thank you for your indulgence.

Chairman KANJORSKI. I appreciate that. I just wanted to make sure that they did not go home for the weekend and feel really under the weather because of that. No, the reality is it brought something up to me that this hearing really represents to me and some of our problems that we have been discussing today and some of our responses to those problems. We had our first hearing at this committee, not as a committee hearing this year, on January 5th. And that was the Madoff scandal that occurred over Christmas. Our first opportunity to get to the Madoff scandal was January 5th, and some of the members may recall that, but it had to be a meeting of the committee and not a hearing because we had not

formally met in the new Congress since the new Congress did not take its oath of office until January 6th, and therefore we were not an organized committee of the House and could not proceed that way. Some of us tend to be formal that way, others would like to say, "It is still the same problem with the same people, let's get at it." And I think that is the frustration that I am hearing from a lot of the members here at the meeting and from the panel, that we are sick and tired and we are not going to take it anymore, and that we do not care for perfection or idealism, we really want to get the job done.

And I think the message, I hope the message went out to our earlier panel, and I know they are watching this in that secret room that we have set up, maybe they have resolved this whole problem already for us, but I hope they are watching us or they are talking about what may have transpired here this afternoon because we expect those three gentleman representing three distinct agencies of the United States Government to show the American people, show the street and show everybody else that they can function. And I was very serious when I told them as soon as we get back from the Easter break, which will be in more than 3 weeks, we cannot meet exactly on the third week because we will be out of session in the Congress and not available, but we will have a hearing if we are not notified in the meantime that there is a change of the rule.

I think we ought to pursue these matters this way, and sometimes stretch the practicality of what we can do and sometimes stretch the rules. These are extraordinary times. I think sometimes some of us in government and in leadership have failed to impart the importance of our economic distress to the American people. I have been going about doing that as much as I can not only in my district but on a national level because if we do not have the importance of the problem, we will not direct our attention adequately to the problem. It is probably the most serious economic problem in my lifetime that I can think of. And since I am older than anybody sitting at that panel, I would conclude it is the worst of any of your problems.

Now, I like where this hearing went today, and that is why I really want to commend my friends on the Republican side as well as all my friends on the Democratic side who are here, that we really had a coming together and that coming together occurred because we are starting to begin to recognize a very important factor. We are only going to survive as a country and as an economy if we do realize how important this problem is and that we use all our imagination to address it as clearly as possible. And I think that may have started today, and I want to compliment my friends on the Republican side because if it did not start today, I want it to start tomorrow but I think it may have. And it is important that we continue this process, not only at the next hearing on mark-to-market but so many other hearings that we are going to have on reforming regulation and doing so many other things that we have scheduled.

I intend to schedule as many hearings as physically and humanly possible, and we have one limitation; we do not have enough hearing rooms. But if we could, we would appropriate sufficient

amount of money to double the House size so we could have that, but unfortunately, that could not be completed for at least 8 to 10 years, maybe with the Architects of the Capitol, it would take 20 to 30 years. That being the problem, unfortunately we will have to meet at the curbside. And that may be the best place to meet, particularly if it is cold enough in the winter in Pennsylvania, we will get some action done very quickly because it usually works that way in Pennsylvania. We will stay out of Florida because all of us would love to go down there and spend a whole day at the curbside.

That all being said, we are going to attend to this. We appreciate each and every one of your contributions. As I heard your contributions today, you have all had really unique things to say of how this could be approached. Your first situation was maybe we would do it on the regulatory capital side a lot easier than doing it on the accounting side. And I seem to sympathize with that. But the answer to that or your action, using your experience, Mr. Isaac, on the other side, that you have had that experience and our people on our side have had that experience, and we had a call upon, that is why you are here. And we did listen to Marcy Kaptur. She said, "You want an expert in this field, go get Isaac." That is why you are here.

And all of the rest of you represent so much of the best and the brightest and ablest, and I am proud of you because you gave honest responses in your testimony as to what we should do. You are going to make it a little easier for us to proceed but proceed we will and proceed we shall.

And I dare say I do not know whether we are going to have an effect on the market but the last reports we had on the Dow, it was significantly up to—it closed, is that it, at 239.66, the third day in a row. That is pretty good. Even if we did not have anything to do with it, and I doubt we did, it is going to give everybody a nice weekend, 3 days up positive on the Dow. And I want to close with that. We can sit around here and condemn every practice and every idea and everybody's judgment, including the accountants, and damn sometimes they make tough judgments that are hard to compliment, but the reality is that we can change the economy of the United States if we just are getting positive, if we just start realizing that we can do it. We may go home tonight and wake up tomorrow, as we are preparing to shave, and I do not know what the equivalent is on the feminine side but whatever it is, you will see the enemy very early in the morning, it will be in that mirror that you are looking at. We are the enemy if that is what it is. And it is what we can do individually and collectively that can move this system along.

I urge you to join this and in spite of all the comments about Republicans and Democrats fighting and the tough political system, that is malarkey too. I firmly believe that this Congress is going to come together, the Senate is going to come together and the Congress is going to come together with the President, and we are going to lick this problem and solve this problem, but it is going to start with the contributions of folks like yourselves who stayed here this late into the evening to help us get some idea of what this is all about.

So I thank you for doing so and before we adjourn, I have to make some statements for the record. The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Before we adjourn, the following will be made part of the record of this hearing—questions submitted by Congresswoman Giffords and the written statements of the folowing groups: the Mortgage Bankers Association; the Group of North American Insurance Enterprises; the American Bankers Association; the Council of Federal Home Loan Banks; the National Alliance of Community Economic Development Associations and other signatories; the American Council of Life Insurers; and the United States Chamber of Commerce.

Mr. BACHUS. That is all one letter.

Chairman KANJORSKI. It is?

Mr. BACHUS. Yes, it is just one letter.

Chairman KANJORSKI. No, each individual is a statement.

Mr. BACHUS. Oh, is it a statement?

Chairman KANJORSKI. The National Association of Federal Credit Unions, the Credit Union National Association. And without objection, it is so ordered that they are entered into the record.

And we only have them enter individual comments like that so we can keep hiring printers to keep the economy going, so you understand that. I know in Alabama you would not necessarily know that, Spencer. But anyway this panel is presently dismissed, and this hearing is—

Mr. BACHUS. If you will dismiss them, but I have some more things to put in the record.

Chairman KANJORSKI. Oh, absolutely.

Mr. BACHUS. Go ahead and let them leave.

Chairman KANJORSKI. If the panel wishes to leave, they are free to leave. Mr. Bachus, do you wish to make any motions?

Mr. BACHUS. There are at least six recommendations that FASB and the SEC and bank regulators have identified specific proposals, and I would like to introduce a document outlining, these are things that they have already said need to be done, okay?

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. BACHUS. Second, I would like to introduce the testimony of Chairman Bernanke where he said that accounting standards were causing valuation distortions and impacting loss provisioning and also that it was discouraging lending and it had restrained lending, which was the same thing that some of our members said.

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. BACHUS. And the procyclicality in the regulatory system. Mr. McTeer's, "My Mark-to-Market Nightmare" dated January 11th. And basically what we have here is that we have set on our—on October 3rd, I first put this in the bill and asked SEC to study it. It was not until February the 18th that FASB even announced they were going forward with a study and that is about $1.5 trillion of taxpayer's money in the gap. I would introduce his article. Steve

Forbes', "Bad Accounting Rules are the Cause of the Banking Crisis."

When Mr. Isaac said it in July, and I do not agree with this by the way, I do not think they are the cause. I believe that they have contributed to there not being a recovery, and I know Ms. Fornelli, she was asked by the member do you think it caused it, and I think you and I agree it did not cause it, but it sure has inhibited some of the interpretations, it has certainly inhibited a recovery.

Ms. FORNELLI. And I do think that some of the things that this panel talked about, both in our testimony and on the panel, the FASB guidance that this subcommittee demanded of FASB in the next 3 weeks as well as the other than temporary impairment improvements. And that does need to happen, and so we stand by that as well. I think those will make immense improvements to the application.

Mr. BACHUS. I agree. I would like to introduce The Washington Post article talking about where we introduced it and put in the bill and also it is titled, "Don't Blame Mark-to-Market Accounting." They actually talk about the bank regulators say it is not a problem but obviously it is now, and they all acknowledge it including Comptroller Dugan. My statement on, "Unreasonable Criticism Has Created an Atmosphere of Fear and Confusion." John Lewis, Congressman Lewis, I would like to introduce the two pages of his book, "Walking in the Wind," which I think ought to be a model for every member as we approach this problem.

And, finally, a letter that Roy Blunt and I wrote to Chairman Mary Shapiro, and very similar to what Chairman Barney Frank and Chairman Chris Dodd have also written similar letters. With that, I would ask that they be introduced into the record.

But I think where we start is where FASB and SEC have already acknowledged in their study, that these are problems and things that need to be fixed and whether bank regulators, including Chairman Bernanke, they have made specific recommendations for changes. It seems like those ought to be a given. Thank you, Mr. Chairman.

Chairman KANJORSKI. I agree, and without objection, all of the documents suggested by Mr. Bachus will be entered into the record.

Anything else good for the order? Mr. Garrett, do you have a statement that you would like to make?

Mr. GARRETT. I have a statement.

[laughter]

Mr. BACHUS. I just have one other one, the October letter from the Financial Accounting Foundation.

Chairman KANJORSKI. Without objection, it is entered into the record.

Mr. BACHUS. They really admonished us for trying to interfere with FASB. Thank you.

Chairman KANJORSKI. It is entered. And now I am not even going to ask the question again, the hearing is adjourned.

[Whereupon, at 4:30 p.m., the hearing was adjourned.]

# A P P E N D I X

March 12, 2009

Statement of Representative Ron Klein
3/12/09

Thank you, Chairman Kanjorski, for holding this important hearing. It is absolutely essential that investors have reliable, unbiased information when analyzing investment opportunities. Fair value accounting principles, including mark-to-market rules, are intended to maximize transparency and the ability of investors to accurately evaluate and compare the financial statements of different business organizations. Certainly, these are laudable principles that enjoy near universal support. Yet, in practice, mark-to-market accounting has shown significant flaws, and a critical examination of these rules in the current environment is required.

Defenders of the current mark-to-market rules argue that these rules are not responsible for the current economic downturn. And I agree that bad loans and mortgage underwriting principles, a proliferation of exotic and barely understood financial products, and a lack of proper regulatory oversight are just a few of the contributing factors of the current crisis. However, mark-to-market rules seem to have unnecessarily accelerated the downturn.

Mark-to-market accounting rules in the current environment create a self-reinforcing downward spiral that force margin calls, requiring firms to liquidate assets, which causes a further loss in value. In turn, this reduces liquidity even further, freezes credit markets, and destroys the confidence of a bank's trading partners and the public at large. In the current environment, even assets, particularly non-mortgage asset-backed securities, that are still performing can face illiquid markets, and be determined to have little value. This unnecessarily slashes credit availability that is so sorely needed today.

Yes, many of the major banks made bad loans. There are toxic assets on their balance sheets that will have to be written down, and banks will be required to take significant losses. But we need to give the banking industry time to strengthen their financial positions, and forcing them to mark assets to market that they are not planning to immediately sell has wide repercussions for the broader economy.

I am worried about the small businesses and hard-working citizens of South Florida that can't get loans. I am worried about those who are losing their jobs because credit is unavailable to their businesses. There has to be a middle ground between valuing securities at cost and marking assets to illiquid markets at fire sale prices during a credit crunch and a nationwide loss of investor and consumer confidence.

Even healthy local and regional banks are afraid to make loans because they could soon be significantly be marked down by an accountant because of poor market sentiment, even if the borrower is extremely creditworthy. A temporary suspension of mark-to-market rules should be seriously considered.

Yesterday, even Warren Buffett, who has in the past been a defender of mark-to-market rules, called for a suspension of mark-to-market accounting rules in the current economic climate. This indicates that even the most sophisticated investors are now realizing that mark-to-market accounting is not working. I look forward to today's discussion, and a fresh look at the desirability of mark-to-market accounting rules.

For Release Upon Delivery
10 a.m., March 12, 2009

**TESTIMONY OF**

**KEVIN J. BAILEY**
**DEPUTY COMPTROLLER**
**OFFICE OF THE COMPTROLLER OF THE CURRENCY**

**before the**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES**

**of the**

**COMMITTEE ON FINANCIAL SERVICES**

**of the**

**UNITED STATES HOUSE OF REPRESENTATIVES**

**MARCH 12, 2009**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

## I. Introduction

Chairman Kanjorski, Congressman Garrett, and members of the Subcommittee, my name is Kevin Bailey, and I am the Deputy Comptroller for Regulatory Policy at the Office of the Comptroller of the Currency (OCC). I appreciate the opportunity to discuss the use of mark-to-market accounting in the current environment, and the implications that has on regulatory capital requirements and bank supervision. I applaud your timely focus on this important issue.

In my testimony today, I will provide relevant background on the accounting requirements under U.S. generally accepted accounting principles (GAAP) for financial instruments that are marked-to-market, the regulatory capital requirements established by the federal banking agencies in this area, and the practical challenges faced by banks and supervisors in the implementation of these requirements.

The unprecedented disruption in world-wide financial markets over the past eighteen months has fostered considerable debate on the costs and benefits of fair value measurement, including the appropriate use of fair value in financial reporting, bank regulatory capital, and macro-prudential assessments, such as pro-cyclicality and the effects on the real economy. The OCC believes that this debate has identified a number of legitimate issues regarding the current application of fair value accounting, and we are actively working with the Securities and Exchange Commission (SEC), accounting standard setters, the Basel Committee on Banking Supervision, the Financial Stability Forum, and other interested parties to address these challenging questions. In order to advance those discussions in an open and expeditious manner, I describe below the fundamental principles underlying the OCC position in these discussions:

- Fair value measurement provides critical information on the value of financial instruments to investors, supervisors, and other users of financial statements. For many types of financial instruments, especially trading assets, fair value represents the best estimate of value as of the measurement date. While additional steps can and should be taken to enhance existing standards, the OCC believes that it is inappropriate to suspend current fair value measurement. In

view of the concerns identified, however, additional analysis is needed before consideration is given to expanding fair value measurement to other financial instruments.

- Additional measures should be taken to improve the application of existing fair value requirements. We support current efforts of the SEC, standard setters, the Basel Committee, and other groups to enhance current practices, especially as it relates to the application of fair value measurement in illiquid markets and the treatment of assets whose value is impaired on a more permanent basis.
- In assessing the application of GAAP-based requirements in regulatory capital, the banking agencies should continue to consider the critical need for risk sensitivity in regulatory capital while seeking to limit volatility that is temporary in nature from resulting capital requirements. In that process, the agencies should continue to evaluate relevant supervisory, financial reporting, and macro-prudential considerations.

## II. Background on Fair Value Accounting

Mark-to-market or fair value accounting has been an essential element of accounting standards in the United States and elsewhere, for decades. For assets and liabilities subject to fair value requirements, firms must report the fair value of the positions they hold on their balance sheet and the periodic changes in their fair value on either the income statement or in a separate component of equity. For U.S. firms, GAAP, administered by the Financial Accounting Standards Board (FASB), determines the extent to which assets and liabilities are measured at fair value and the extent to which these changes in fair value are recognized in earnings. In this determination, FASB and international standard setters employ the so-called "mixed attributes" model, in which different valuation criteria are applied to different types of assets and liabilities depending on their characteristics and on how the firm intends to use the financial instrument. In addition, accounting standard setters have established other valuation requirements for financial instruments that are not required to reflect periodic changes in fair value in income, requiring that such financial instruments be assessed for impairment. Each of these valuation concepts are described more fully below.

Valuation of Financial Instruments

Under the mixed attributes model, certain financial instruments are subject to fair value measurement on a mandatory basis, while other instruments are assessed using historical cost-based and impairment valuation concepts. Stated generally, the current accounting framework requires fair value measurement for financial instruments held for trading purposes, available-for-sale (AFS) assets, and all derivatives. Financial instruments that the firm determines will be held-to-maturity (HTM), most loans, and liabilities are not fair valued and are measured at amortized cost, with loans held-for-sale valued at the lower of cost or fair value. Accounting standard setters also provide firms the option to measure and report at fair value certain financial assets and liabilities that would otherwise be valued and reported at amortized cost (fair value option). As of December 31, 2008, approximately 25 percent of national banks' assets were accounted for or subject to fair value measurement.[1] The vast majority of these assets are either assets in banks' trading portfolios (and thus largely confined to the largest banking institutions that have active trading operations) or AFS assets.

The above paragraph provides a description of how firms reflect the value of financial instruments on their balance sheet. Equally important is how periodic changes in fair values are reported in a firm's income statement. As will be discussed later, this reporting is a key factor in determining bank regulatory capital requirements. For financial instruments carried at fair value, the period-to-period unrealized changes in fair value are either recognized through income, or are reflected in the equity section of the balance sheet in accumulated other-comprehensive-income (OCI). With respect to the national bank data noted above, approximately 12 percent of national banks' assets (primary trading assets) are accounted for at fair value with changes reflected in earnings. For the remaining 13 percent of the assets, primarily securities held as AFS, changes in fair value are reflected in OCI, unless the firm determines that the instrument has "other-

[1] As reported in the bank regulatory financial reports (call reports). Banks are required to prepare call reports in accordance with US GAAP.

than-temporary" impairment (OTTI). A more detailed description of the GAAP framework is provided below.

Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (FAS 115), is the principal standard in accounting for debt and equity securities and was issued in 1993. There are three potential investment categories outlined in FAS 115: HTM, trading, and AFS. HTM debt securities are measured at amortized cost on the balance sheet when the bank has the positive intent and ability to hold those debt securities to maturity. Trading securities are bought and held principally for the purpose of selling in the near term and are measured at fair value with changes in fair value recorded in current period earnings. AFS securities are investments not classified as trading or as HTM and are recorded at fair value with changes in fair value flowing through OCI. Equity securities are classified as trading or AFS. As discussed more fully below, decreases in the value of AFS and HTM securities can be recognized through earnings if the firm deems such securities to be impaired on an other-than-temporary basis.

Financial Accounting Standard No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (FAS 159), issued in February 2007, allows banks to report designated financial assets and liabilities at fair value with the changes in fair value included in earnings. In general, a bank may elect the fair value option for an eligible financial asset or liability when it first recognizes the financial instrument on its balance sheet. A bank's decision to elect the fair value option for an eligible item is irrevocable.

The accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities are set forth in Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended (FAS 133), which was issued in 1998. FAS 133 requires all derivatives to be recognized on the balance sheet as either assets or liabilities at their fair value.

As previously noted, most loans that banks hold on their balance sheets are recorded at amortized cost, with changes in their fair value generally not recognized in income. Loans that a bank holds for sale, such as those related to pending securitization activities, are measured at the lower of cost or fair value. Decreases in the fair value of loans held-for-sale below their cost are recognized in income.

Definition of Fair Value

FASB Statement No. 157, "Fair Value Measurements" (FAS 157), issued in September 2006, defines fair value, establishes a framework for measuring the fair value of assets and liabilities based on a three-level input measurement hierarchy, and requires disclosures about fair value measurements. Prior to this guidance, fair value was defined in multiple standards.

Under FAS 157, fair value is defined as "the price that would be received to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date."[2] That standard also articulates a hierarchy of input preferences for the measurement of fair value. The highest priority, or Level 1, is given to quoted prices in active markets for identical assets or liabilities, such as widely traded investment securities. Level 2 inputs to valuation are those based on quoted prices other than those included within Level 1 that are observable for the asset or liability, either directly or indirectly. Finally, if Level 1 and Level 2 inputs are unavailable, then Level 3 inputs are used. Level 3 inputs are unobservable inputs for the asset or liability that reflect the firm's own assumptions regarding valuation. As defined, therefore, application of fair value measurement does not require the presence of liquid markets. The fair value of financial instruments can be estimated when a market for that instrument does not exist, either through the use of valuation models developed by the firm or through independent brokers, such as consensus pricing services. Based on information from a recent study on mark-to-market accounting, the SEC has provided information on the current

[2] FAS No. 157, paragraph 5.

classification of assets in the fair value hierarchy.[3] As it relates to the banks included in the study, 82 percent of assets measured at fair value were measured using Level 2 inputs, followed by 11 percent using Level 1, and 7 percent using Level 3.

Impairment

Even if a financial asset is not subject to fair value measurement, fair value concepts may become relevant if the asset is considered to be impaired. Under GAAP, there are multiple sets of impairment rules for financial instruments, depending on the characteristics, form, and intended use of the asset. For example, for most loans, impairment is based on bank management's estimate of incurred credit losses and is accounted for in the allowance for loan and lease losses. For AFS debt and equity securities and HTM debt securities, impairment occurs when the fair value of a security is less than its (amortized) cost basis. If impairment is judged to be OTTI, the individual security is written down to fair value and the amount of the write-down reduces current earnings.

There are no bright lines in discerning whether a decline in the value of a financial instrument is other than temporary. Rather, this is a judgmental determination of the individual firm considering various factors, including:

- The length of time and the extent to which the fair value has been less than its carrying amount;
- The financial condition and near-term prospects of the issuer; and
- The intent and ability of the firm to retain its investment in the issuer for a period of time sufficient to allow for an anticipated recovery in fair value.

[3] *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting*, United States Securities and Exchange Commission (SEC Fair Value Study).

## III. Background on Capital

An important intersection between fair value accounting and prudential regulation and supervision occurs in the realm of bank regulatory capital requirements. However, before turning to the interaction between fair value accounting and regulatory capital, it is useful to provide a short, high-level description of the regulatory capital framework.

For over two decades, U.S. banks have been subject to risk-based capital requirements. These requirements, which are based on the international framework established by the Basel Committee on Banking Supervision (Basel I Framework), define regulatory Tier 1 and total capital, and specify how bank assets are to be risk-weighted under this regime. Tier 1 capital is defined to include common stock and retained earnings, as well as certain perpetual preferred stock. Total capital includes all capital elements included in Tier 1 and also includes instruments that are junior to depositors but not as equity-like, such as subordinated debt.

Under the Basel I Framework, each balance sheet asset generally is assigned to one of a handful of risk-weight buckets. Assets such as cash and U.S. Treasuries require no risk-based capital, while commercial loans and most consumer loans, which comprise the largest portion of most banks' assets, are assigned a capital charge of 8 percent. In other words, corporate loans must have $8 of capital set aside for every $100 in loan amount. The risk-based capital standards also take into account derivatives and other off-balance sheet exposures such as loan commitments and letters of credit. Banks must hold capital against these off-balance sheet items based on various risk factors, including for example, counterparty credit risk and the length of the commitment.

The OCC's risk-based capital rules require banks to have a minimum of $4 of Tier 1 capital and $8 of total capital for every $100 of risk-weighted assets. It is important to note, however, that these are minimum levels, and banks are expected to hold capital above that level, commensurate with the level and nature of all of their risks.

In 2007, the federal banking agencies adopted the Basel II advanced approaches framework (Basel II Framework) which certain large, internationally active banks are expected to begin using no later than April 1, 2011. The Basel II Framework is designed to be significantly more risk sensitive than the risk-bucket approach used in the Basel I Framework. For example, under the Basel II Framework, rather than assigning all corporate loans the same risk weight, the risk weight will vary based on a bank's internal assessment and knowledge of the borrower and the nature of collateral provided.

In addition to these risk-based capital requirements, banks are also required to meet a leverage ratio requirement. The leverage ratio serves as a complementary and relatively simple measure of capital adequacy. The leverage capital requirement is calculated as Tier 1 capital, as described earlier, divided by adjusted total assets, which generally approximate total assets reported under GAAP. Banks are required to maintain a leverage ratio of at least 4 percent – or 3 percent if they are considered to be operating in a very low risk manner.

Regulatory capital rules are a cornerstone of our supervisory regime, incorporated directly into various rules, such as those used to determine the amount banks can lend to one borrower, invest for community development purposes, and lend to an affiliate. In addition, the Prompt Corrective Action regime imposes increasingly severe supervisory limitations when bank capital ratios falls below specified levels, such as restrictions on asset growth, expansionary proposals, and dividends issuance.

## IV. Interplay Between Fair Value Accounting and Capital

While the federal banking agencies use GAAP as a starting point in determining inputs to the regulatory capital rules, there are many important deviations that arise from the different goals of financial reporting and prudential regulatory capital requirements. As noted above, for example, the risk-based ratios include not only GAAP-based balance sheet assets, but also measures for counterparty credit risk for derivative contracts and risks related to off-balance sheet exposures in the form of letters of credit and loan commitments. Additionally, while recognized as an asset under GAAP, goodwill is

deducted from banks' calculations of Tier 1 and total capital due to its difficulty in being realized separate and apart from the rest of the bank's assets and ongoing operations. Below, I describe how the regulatory capital rules align with, and deviate from, the accounting rules as they relate to fair valued assets. Broadly speaking, all of the regulatory capital regimes – Basel I risk-based, Basel II risk-based, and the leverage ratio – deal with fair-valued assets similarly. Therefore, the discussion below will not distinguish between these frameworks, but speak of them in a more comprehensive manner.

In general, regulatory capital requirements include any changes in fair value of exposures where those unrealized gains or losses flow through earnings.[4] In other words, unrealized gains and losses in the fair values of exposures such as trading book exposures and exposures that are measured using the fair value option (FAS 159) are generally included in regulatory capital calculations. Because many of these assets are held with the intent to trade or sell them over a relatively short time horizon —at which time changes in their value will be realized as a gain or loss —using their fair values in regulatory capital calculations is an appropriate reflection of their effect on a bank's current financial and economic position.

In contrast, changes in unrealized fair value gains and losses that do not flow through to earnings are generally not included in regulatory capital calculations. For such fair valued instruments, the unrealized gains and losses flow through OCI, rather than through earnings. This treatment neutralizes the effect of unrealized fair value gains and losses in AFS debt securities for purposes of evaluating regulatory capital adequacy. The basis for this treatment is that these unrealized gains and losses are more temporary in nature, since the bank is not holding the securities for short-term trading purposes. This treatment avoids introducing excessive volatility into regulatory capital measures for

[4] One exception to the inclusion in regulatory capital of unrealized gains and losses that flow through earnings relates to a bank's own liabilities. The banking agencies expect banks to neutralize or reverse from regulatory capital any unrealized fair value gains and losses on their liabilities that are attributable to changes in the bank's own creditworthiness. Adjusting regulatory capital in this manner keeps a bank from recognizing any benefit in its capital position resulting from its own credit deterioration.

changes in market values that might prove to be short lived. Without this treatment, temporary changes in a security's market value due to movements in interest rates could result in regulatory capital changes that would affect its capacity to lend and could trigger more permanent regulatory sanctions, including Prompt Corrective Action restrictions and penalties.

Certain other fair-valued exposures such as pension assets and liabilities are treated similarly to AFS debt securities, with unrealized gains and losses flowing through OCI. A different approach is used for AFS equity securities where unrealized losses, but not unrealized gains, are included in Tier 1 capital. The unrealized gains are allowed to be included in total capital, but only after a significant hair cut or discount. This more conservative approach for AFS equity securities reflects the fact that, unlike AFS debt securities, AFS equity securities have no maturity date, and unrealized losses on AFS equity securities may not necessarily be recouped when equity securities are sold and unrealized gains may be temporary.

While the regulatory capital rules neutralize the effect of *temporary* fluctuations in AFS debt securities and pension accounts, the rules do incorporate more *permanent* decreases in value. This is accomplished through the recognition of impairment in value of financial instruments that are deemed OTTI. As noted earlier, write-downs for OTTI are taken through earnings, and these write-downs also flow through to regulatory capital for both AFS securities and for held-to-maturity securities. Table 1 summarizes the interplay between accounting and regulatory capital for certain financial instruments. In summary, bank regulatory capital rules use GAAP as a starting point for assessing capital adequacy and, generally, fair value changes that are recognized in a bank's income statement are incorporated in a bank's regulatory capital levels.

**Table 1**
**Accounting and Capital Treatment for Bank Assets**

| Asset Type | Balance Sheet Valuation Criteria | Effect of Changes in Fair Value in Financial Reporting under GAAP | Effect of Changes in Fair Value on Tier 1 Regulatory Capital |
|---|---|---|---|
| **Equity Investments** | | | |
| Trading | Fair Value | Changes recognized in earnings. | Changes recognized in capital through earnings. |
| Available for Sale | Fair Value | Changes reflected in OCI. No affect on earnings until sold or OTTI. | Unrealized losses recognized in capital; unrealized gains excluded until sold. |
| **Debt Investments** | | | |
| Trading | Fair Value | Changes recognized in earnings. | Changes recognized in capital through earnings. |
| Available for Sale | Fair Value | Changes reflected in OCI. No effect on earnings until sold or OTTI. | Changes not recognized until sold or OTTI. |
| Held to Maturity | Amortized Cost | Changes in fair value not recognized unless OTTI. | Changes not recognized unless OTTI. |
| **Direct Investment in Loans** | | | |
| Held for Sale | Lower-of-cost-or-fair value | Declines below cost recognized in earnings. | Declines below cost recognized in capital. |
| Held for Investment | Amortized Cost | Changes in fair value are not reflected. Impairment is recognized through earnings based on incurred credit losses. | Changes in fair value are not reflected. Impairment is recognized in capital through earnings based on incurred credit losses. |

## V. Challenges Faced by Bank and Supervisors

The unprecedented disruption that we have seen in the financial markets over the past eighteen months have fostered considerable debate on the costs and benefits of fair value measurement, including the appropriate use of fair value in financial reporting, bank regulatory capital, and macro-prudential assessments, such as pro-cyclicality.[5] The OCC believes that this debate has identified a number of legitimate issues about the current application of fair value and we are actively working with the SEC, accounting standard setters, the Basel Committee, the Financial Stability Forum, and other interested parties to address these challenging questions. As I noted previously, the fundamental principles underlying the OCC position in these discussions are:

- Fair value measurement provides critical information on the value of financial instruments to investors, supervisors and other users of financial statements. For

[5] See, e.g., *The Global Financial Stability Report*, International Monetary Fund, Chapter 3 (October 2008)

many types of financial instruments, especially trading assets, fair value represents the best estimate of value as of the measurement date. While additional steps can and should be taken to enhance existing standards, the OCC believes that it is inappropriate to suspend current fair value measurement. In view of the concerns identified, however, additional analysis is needed before consideration is given to expanding fair value measurement to other financial instruments.

- Additional measures should be taken to improve the application of existing fair value requirements. We support current efforts of the SEC, standard setters, the Basel Committee and other groups to enhance current practices, especially as it relates to the application of fair value measurement in illiquid markets and the treatment of impairment for OTTI assets.
- In assessing the application of GAAP-based requirements in regulatory capital, the banking agencies should continue to consider the critical need for risk sensitivity in regulatory capital while seeking to limit volatility that is temporary in nature from resulting capital requirements. In that process, the agencies should continue to evaluate relevant supervisory, financial reporting, and macro-prudential considerations.

In the sections below, I discuss the application of these broad principles in the context of the most significant fair valuation implementation issues faced by banks and bank supervisors – the treatment of financial instruments deemed to be OTTI and the valuation of financial instruments for reporting and capital purposes. For OTTI, the issue is when and whether, in the current constrained markets, a decline in the value of a debt security should be considered other-than-temporary. With regard to valuation, a critical issue has been the appropriateness and methods by which banks ascertain the fair value of an asset when the markets for such assets are highly illiquid or non-existent.

OTTI

As noted earlier, under GAAP, a security is considered impaired when its fair value is less than its carrying value. If a bank determines that the impairment is other-than-temporary, the individual security is deemed OTTI and its carrying value on the balance sheet is written down to its fair value, with the amount of the write-down reducing current earnings. The OTTI decision for a given asset is a judgmental decision of the bank, considering various factors related to the depth and duration of the decrease in the value of the asset. Because OTTI reflects a more permanent decrease in the value of the security, the OTTI write-down is reflected in regulatory capital.

We believe that the treatment of OTTI in our current capital rules has struck an appropriate balance between risk sensitivity and the concern over excessive capital volatility. While introducing some additional volatility, recognizing the change in value of the OTTI asset serves to better reflect the current risk profile of the institution in regulatory capital. Such early recognition of troubled assets within the capital regime can spur action by bank management and advances critical supervisory objectives, especially the agencies' Prompt Corrective Action regulations.

In light of that current treatment, the OCC believes that standard setters should continue consideration of enhancements to OTTI requirements that could improve both financial reporting and regulatory capital. One such possible enhancement was identified in the recommendations in the SEC's Fair Value Study. Under the proposed enhancement, the OTTI model could be revised to recognize in income only that portion of OTTI related to credit losses. The remaining decline in fair value, the non-credit loss portion (such as a liquidity discount) would be recognized in OCI. Such a change would reduce volatility, while still reflecting credit-related losses in earnings and regulatory capital. In the Fair Value Study report, the SEC indicated that "this model has the potential to provide investors with both fair value information as well as transparent information regarding the cash flows management expects to receive by holding investments, rather than through accessing the market currently. That is, such a model would appear to help bridge the gap between the current fair value and the value expected from holding

investment positions until markets return to normal liquidity levels."[6] While there are operational challenges with delineating credit from non-credit impairment for a given financial instrument, the OCC believes that this is an idea worth pursuing.

Valuation

As noted above, GAAP establishes a hierarchy of input preferences for the measurement of fair value. While the clear preference is for quoted prices in active markets for identical assets or liabilities, the existence of such active, liquid markets is not required for the application of fair value measurement, and, more importantly, such markets are currently not the norm. As noted previously, the SEC's Fair Value Study, indicates that 82 percent of the assets measured at fair value in banks were measured using Level 2 inputs. The study also indicated that for many Level 2 assets, it appeared that banks generally used an alternative pricing method that did not rely on observable quoted prices for a given asset, but rather, used quoted prices for similar assets or a combination of Level 2 inputs. In this environment, price discovery is particularly difficult for complex financial instruments, due to the complexity of the payoff structures, and the links between valuations and the underlying risk factors. Even the most sophisticated institutions are challenged in this environment to determine fair values, as evidenced by the increasing volume of Level 3 exposures.

Community and mid-sized banking institutions face a similar problem, albeit one which affects debt securities in AFS and HTM accounts, and which can have a greater proportional impact on their regulatory capital. Lacking the resources of the larger firms, community banks face a difficult challenge in determining the fair value of their AFS and HTM securities, as their investment portfolios have become more complex over time. In particular, valuations for various private mortgage-backed securities and other forms of structured mortgage and corporate debt have proven to be very difficult to value in the current market environment.

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[6] SEC Fair Value Study, page 205.

The OCC has actively participated in supervisory and policy initiatives to enhance valuation practices within financial institutions. These efforts were designed to identify effective and ineffective valuation practices for complex or illiquid financial instruments and to emphasize the critical importance of robust risk management and control processes around the measurement of fair values and their reliability. I want to emphasize three such initiatives as particularly relevant: (i) the Senior Supervisors Group[7] report *Observations on Risk Management Practices during the Recent Market Turbulence*, March 6, 2008 (SSG Report); (ii) the Basel Committee report *Fair value measurement and modeling: An assessment of challenges and lessons learned from the market stress*, June 2008 (June BCBS Report); and (iii) the Basel Committee consultative document *Supervisory guidance for assessing financial instrument fair value practices*, November 2008 (November BCBS Report).

These initiatives put forward a number of important observations and supervisory expectations relevant to the issues before this Subcommittee:

- "The Supervisors' assessments of valuation practices have stressed the importance of consistent application of independent and rigorous valuation practices across the firm. At firms that performed better in late 2007, management had established, before the turmoil began, rigorous internal processes requiring critical judgment and discipline in the valuation of holdings of complex or potentially illiquid securities. When these firms reached decisions on values, they sought to use those values consistently across the firm, including for their own and their counterparties' positions." SSG Report, page 3
- "[F]irms that faced more significant challenges in late 2007 generally had not established or made rigorous use of internal processes to challenge valuations. They continued to price the super-senior tranches of [collateralized debt obligations] at or close to par despite observable deterioration in the performance

[7] The Senior Supervisors Group is a group of supervisors organized at the request of the Financial Stability Forum to evaluate the effectiveness of current risk management in financial institutions. The seven supervisory agencies included within the Group are: the Office of the Comptroller of the Currency, the U.S. Securities and Exchange Commission, the Federal Reserve Board, the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, and the U.K. Financial Services Authority.

of the underlying [residential] MBS collateral and declining market liquidity. Management did not exercise sufficient discipline over the valuation process: those firms generally lacked relevant internal valuation models and sometimes relied too passively on external views of credit risk from rating agencies and pricing services to determine values for their exposures." SSG Report, page 3.

- "[T]he market turmoil highlighted the difficulties in estimating fair values due to the lack of liquidity in the markets, the complexity of some financial instruments, and the shift by some banks to more model-based methodologies which increased the use of unobservable inputs. . . The absence of a price from a liquid and actively traded market means that the valuation must rely on models or proxy-pricing methodologies as well as on expert judgment. The outputs of such models and processes are highly sensitive to the inputs and assumptions adopted, as well as being subject to estimation error and uncertainty. Moreover, calibration of the valuation methodologies is often complicated by the lack of readily available benchmarks. Finally, the liquidity of the markets varies over time, introducing further variability to the estimation of the fair values for financial instruments." June BCBS Report, page 3.
- "The relevance and reliability of valuations are directly related to the quality and reliability of the inputs. A bank is expected to consider all relevant market information and other factors likely to have a material effect on an instrument's fair value when selecting the appropriate inputs to use in the valuation process. It should maximize the use of relevant observable inputs and minimize the use of unobservable inputs when estimating fair value using a valuation technique. However, observable inputs or transactions may not be relevant, such as in a forced liquidation or distressed sale, or transactions may not be observable, such as when markets are inactive. In such cases, the observable data should be considered, but may not be determinative." November BCBS Report, page 6.

## VI. Conclusion

In conclusion, the valuation of financial instruments in the illiquid markets so prevalent today, especially as it relates to complex financial instruments, is exceedingly difficult. It

is, therefore, incumbent on supervisors and standard setters to continue efforts to enhance current practices through additional guidance and consultation with representatives of the industry, investors and other interested persons. As part of that process, we will continue to assess the challenges and benefits of fair value measurement as we consider its use in financial reporting, risk management and regulatory capital.

**Statement of Thomas Bailey**
**President and CEO, Brentwood Bank**

**On Behalf of**

**The Pennsylvania Association of Community Bankers**
**And**
**The Independent Community Bankers of America**

**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, House Financial Services Committee**

**Mark-to-Market Accounting:**
**Practices and Implications**

**March 12, 2009**

Chairman Kanjorski, Ranking member Garrett and members of the Subcommittee. I appreciate the opportunity to come before you today to provide a community banker perspective on the current application of mark-to-market accounting. My name is Thomas Bailey and I currently serve as Chairman of the Pennsylvania Association of Community Bankers (PACB). PACB is the oldest state banking trade association in the nation dating back to 1876, consisting of 150 community banks with combined assets exceeding $90 billion and employing over 30,000 men and women. I am also testifying today on behalf of the Independent Community Bankers of America[1].

I am also the President and CEO of Brentwood Bank. Brentwood Bank serves the South Hills of Pittsburgh. Since putting its roots down more than 86 years ago, Brentwood Bank has been fulfilling the financial needs of individuals, businesses, families and the community we serve. With assets of approximately $450 million and capital of $25 million (equity $37 million less FASB 115 adjustment of $12 million), Brentwood Bank was able to generate approximately $70 million in business, mortgage and consumer loans in its last fiscal year with no repossessed assets and less than ¼ % of assets in delinquent loans. Through the nine months ending December 31, 2008 Brentwood Bank has granted more than $64 million in loans (commercial $38 million, mortgage $15 million and consumer $11 million). We achieved all this while continuing to maintain a delinquent loan to asset ratio of less than ¼ of 1%.

Chairman Kanjorski, PACB and ICBA salute your leadership in calling this important hearing. The bank presidents who lead PACB have watched and listened to the debates regarding fair value accounting, mark-to-market and other than temporary impairment (OTTI). We understand the day-to-day effects that these accounting standards have upon Main Street banking. We have first hand experience on how these rules are an exacerbating factor in this financial crisis.

PACB took the unusual step of forming a committee to explore the issues surrounding fair value accounting. The committee's mandate was to describe the problem in simple and easy to understand terms and make related recommendations to correct the problem on a short term and long-term basis. The recommendations I present today reflects the work of PACB's committee.

The issues before this subcommittee today strike at the heart of how community bankers will serve their marketplaces in the months to come. In the case of Brentwood Bank, we have taken approximately $2 million in OTTI charges. That $2 million in charges represent lost opportunity cost to finance an additional $20 million in loans based on a 10% equity requirement. This represents 30 percent of the loans we have made in the past 9 months. It has also made the Bank a bit more conservative as it looks at new lending opportunities.

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[1] The Independent Community Bankers of America, the nation's voice for community banks, represents 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community.

With all the economic crises facing this country right now, the application of these rigid accounting rules, in these times, is much like throwing gasoline on a raging inferno. Those who serve on the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) that oversees the FASB must be held to account. This hearing will be important step in bringing full public disclosure to the actions of the SEC and FASB and to get a clear understanding of how they can assure the public that action will be taken.

The application of mark-to-market in frozen markets is the heart of the problem. When these rules were developed, this unprecedented situation could not have been imagined. If FASB does not take action quickly, the problem will get worse. The close of the first quarter is only a few weeks away, and the second quarter 3 months after that. The FASB does not seem to realize the urgency of the situation. While the total suspension of market-to-market accounting is very appealing, we know that many have concerns about how the capital markets may respond to that and suspension may not be possible. Thus we offer an alternative that would address only OTTI recognition. I address our proposed solution later in my statement but now would like to explain why the rules need to be changed.

**Current OTTI rules present a distorted financial picture of Fair Value.**

PACB and ICBA support transparency of financial statements. Current mark-to-market accounting rules hinder transparency and distort the true condition of financial institutions holding mortgage backed securities (in particular private label mortgage backed securities), asset backed securities (including consumer loan-backed and student loan backed securities targeted by the Treasury for support) and other debt securities. This, in turn, has a highly negative impact in trying to get credit flowing in these important sectors of the capital markets.

Under U.S. GAAP (see attachment 1 for a description of current rules) a company must evaluate its investment securities portfolio to determine whether fair value is lower than book value. OTTI results when the collection of all contractual cash flows are not deemed probable. In addition, some auditors have insisted on OTTI write-downs simply because current market values were very depressed, even if the institution did not reasonably expect to lose any principal or interest.

If the company determines that it does not expect to collect all of the contractual amounts due on an investment security over the life of that security, the company must mark the investment security down from its carrying value to its current fair value, even if it intends to hold the investment security until recovery.

The following are critical points when considering how fair value accounting works today:

- Fair value is difficult to measure in an illiquid market. Fair value accounting, as currently defined under GAAP is based on an "exit price" from a market participant's point of view. However, the today's markets for the assets we are discussing lacks trading volume, observable inputs, reasonable bid/ask spreads, or willing buyers to support the valuation of these securities. This results in companies recording write-downs disproportionately greater than the anticipated credit or economic losses.

- When a security is deemed to be OTTI, the entire amount of OTTI loss is charged against earnings with no ability to write back up the security if the fair value recovers in the future, other than accreting the non-credit portion of the loss into income over the life of the security.[2]

- The entire reduction in fair market value includes both the write-downs attributable to credit losses and to losses due to liquidity. Estimates of credit losses themselves are variable and subjective, based on forecasts of how underlying loans may perform in the future – assumptions that may or may not actually come to pass.

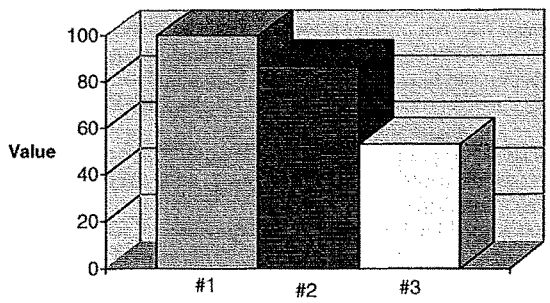
Example

I would like to move from the theoretical to the actual by presenting a real-life example about how a financial company developed an estimated credit loss and then what the resulting write-down was based on current accounting rules.

An institution holding a private label mortgage backed security (PLMBS) with an initial pre-OTTI carrying value of $125.1 million (bar #1 in the graph below) determined through analysis that the security would suffer a future economic losses resulting in a credit loss of $16.7 million (represented in the second bar). The analysis assumed an unemployment rate in the high teens and further assumed that 44% of the loans backing the security would go into default, including 35% of those loans that were current as of year-end. The scenario further projected a loss on the defaulted loans of 45%.

The process to arrive at this economic loss of $16.7 million was rigorous. However, when the fair value is developed in today's illiquid markets, that institution had to take a write-down of $58.9 million, over three times as much as the economic loss (as presented in the third bar).

This additional write-down as represented by the differences between bar #3 and bar #2 is the direct result of the application of OTTI in a dysfunctional market.




[2] A description of current accounting rules can be found at attachment 1.

While this is one example relating to one security, there are billions of dollars of other securities held by the nation's insured financial institutions that could meet a similar fate. According to the FDIC Statistics on Depository Institutions published as of December 31, 2008, there are more than $2 trillion of debt securities held by the banking industry. Approximately $1.8 trillion are classified "Available-for-Sale" and more than $230 billion are classified "Held-to-Maturity". There are $280 billion of PLMBS and $130 billion of other asset-backed securities. These statistics don't include debt securities held in other financial service businesses such as the insurance industry.

Many of the markets for these assets on the books of banks are simply not functioning today.

**Negative Impact of Current Accounting Rules**

Current accounting rules are hurting the market's ability to revive and establish market-driven pricing. Financial institutions are not willing to risk purchasing assets that could result in a future material write-down if an immaterial credit loss may occur many years in the future. The number of transactions continues to decline and the already weak market becomes nearly invisible. The current financial reporting requirements create a self-fulfilling downward spiral for the prices of MBS, other asset-backed securities, and other debt securities.

For those financial institutions that carry PLMBS and other asset backed securities on their books, OTTI rules raise the specter of future write-downs that could further weaken capital positions. This could contribute to the hoarding of capital at many banks. This prudent reaction to guard against future accounting-driven losses likely inhibits the flow of badly needed credit.

In addition, the rules make it undesirable to sell these assets, even if an institution wanted to at prices that reflect economic losses embedded in the securities. Many investors do not want to sell an asset in this illiquid market at fire sale prices causing the seller to lock in a severe loss and give up future expected income accruing from that asset. This further freezes this market and only makes matters worse.

Another point to consider is that FHLBank stock is a big investment for community banks across America. OTTI accounting write-downs have caused FHLBanks to reduce or suspend dividends to member financial institutions which means some FHLBank member institutions are carrying a non-earning asset. In addition the negative news about FHLBank earnings which are so impacted by these misleading accounting rules have raised the cost of funds for thousands of banks and savings institutions that borrow from the Home Loan Bank System.

OTTI rules also may be thwarting inadvertently the extraordinary and expensive efforts of the Congress, the Treasury Department, the Federal Reserve and the Federal Deposit Insurance Corporation to improve the current situation and driving up the costs of these efforts. Unprecedented amounts of funds are pouring into the financial services industry to replenish the capital lost as a direct result of this accounting rule. This is a "paper loss" and does not reflect reality.

We do not believe the American taxpayers want their tax dollars used to cover up a "paper loss." We also know, as do you, that the American public wants these dollars to be put to work in communities across America, but our accounting rules make this more difficult.

**Proposed Solution**

Chairman, Kanjorski, your letter of invitation asked that we address whether current rules can be revised going forward. We do not believe Congress should be writing accounting standards. However, when markets cease to function as we have experienced over the past several months, continued application of an accounting standard based on valuations derived from a dysfunctional market only serves to compound the problem.

Congress must hold FASB accountable for allowing this situation to exist and to encourage FASB to rectify this situation by providing OTTI guidance that will improve financial reporting in these unique market circumstances. Congress should ask the SEC and FASB to apply existing accounting rules that apply to loans held in portfolio to asset backed securities and other debt securities for which the institution has the intent and ability to hold.

The determination of whether OTTI exists as well as the magnitude of loss recorded should be based on a rigorous credit analysis appropriate to the characteristics of the securities, taking into account the nature of any credit enhancements. Any OTTI should reflect the true economic loss (i.e., probable credit losses). If economic losses change, such changes would be recognized immediately through earnings. To accommodate the existing GAAP fair value framework and provide transparency as to the recorded amounts, the OTTI loss on held-to-maturity (HTM) debt securities should be separated and reported in two components: (1) through earnings for probable credit losses and (2) through the footnotes to financial statements to disclose the fair value of the securities.

This proposed solution would also work for Available-For-Sale securities that the institution intends to hold until recovery. The OTTI loss should be (1) recognized through earnings for probable credit losses and (2) all other portions of the loss (such as from liquidity discounts) will remain in accumulated other comprehensive income (loss) in stockholders' equity until the security is sold or matures.

It is worth noting that this change would not hinder transparency and would actually improve comparability and consistency. All institutions have, for many years, reported the fair value of all financial assets in their financial statement notes annually. FASB recently increased the frequency of that reporting requirement to quarterly.

This is similar to International Accounting Standards (IASB) rules that apply FAS 5/FAS 114-like treatment for the OTTI of MBS and permit the recognition of future gains against the recorded OTTI loss.

Mr. Chairman and members of the Subcommittee, thank you again for your attention today and I would be happy to answer any questions you might have.

**Attachment 1**

**Current Accounting Rules**

U.S. GAAP has three classifications for investment securities and the related accounting for each is summarized below:

*Trading Securities* – are marked to market (fair value) through the income statement.

*Available for Sale Securities* - are marked to market (fair value) through the equity section of the balance sheet entitled Accumulated Other Comprehensive Income. These securities must be evaluated for OTTI on a quarterly basis. If they are deemed to be OTTI, which generally means there is some level of expected credit losses embedded in the security sometime in the future, then it's write-down to fair value is currently recognized in the income statement.

*Held to Maturity Securities* – are recorded at cost on the balance sheet and their fair value is disclosed in the footnotes to the financial statements. The financial institution that owns these securities must have both the ability and intent to hold them to maturity; in fact, U.S. GAAP does not permit their sale except under rare instances. These securities need to be evaluated quarterly for OTTI, and if so deemed, then they must be written down to fair value through the income statement.

Given the current market conditions, there is a large difference between the expected credit losses in these securities and the fair market values. The difference between the credit loss and the fair market value is recognized from an accounting prospective as additional yield on the security over its remaining estimated life. The security may not be written back up if the fair value recovers.

Current U.S. GAAP for the recognition and measurement of impairment losses differs for loans and asset-backed held to maturity securities even though the securities are comprised of a pool of loans.

GAAP treatment for loans: GAAP for recognition and measurement of impairment for loans held by creditors, such as mortgage loans held as investments by banks, follows "the loan impairment model". This results in loans reported at amortized cost less an allowance for loan losses computed based on incurred credit losses. Credit losses or economic losses are generally computed as the present value of expected future cash flows on the loans.

- The loan impairment model provides for recognized reserves (equal to estimated incurred credit losses only) with future changes in the required level of reserves affecting earnings in future periods.

GAAP Treatment for Securities: GAAP for recognizing and measuring OTTI for investments in securities – even assuming the investor has the ability and intent to hold the

debt security to maturity (HTM); requires the use of fair values as defined by GAAP (FAS 157). This guidance defines fair value as the "exit price" which would take into account estimated credit losses and a discount for market participants' assumptions about illiquidity, interest rate risk, etc.

- The entire amount of the OTTI loss on HTM investments is charged against earnings with no adjustments allowed in future periods for any recoveries if fair value increases.

# Mark-to-Market Accounting: Practices and Implications

Written Testimony of Tanya S. Beder[1]
Chairman, SBCC Group Inc.

Prepared for the U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

March 12, 2009

Chairman Kanjorski, Ranking Member Garrett and other members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, I would like to thank you for the opportunity to testify at this hearing. Today I will discuss the implications, particularly to financial firms, in managing under mark-to-market accounting. My testimony is based upon 30 years of experience across both increasing and declining market environments of what works and what does not work. I also suggest ways that I believe regulators and standard-setters may address these issues.

At present, I am Chairman of SBCC Group Inc., an independent advisory firm that I founded in 1987. SBCC's work is both reactive and proactive. For example, we assess and contain existing risk problems that cause firms to bleed money as well as help firms to seize opportunities. I have worked on numerous projects borne from the financial distress of the stock market crashes of 1997, 2001 and 2008-9; the asset/liability and savings & loan crises of the late 1980s; the derivatives losses of the 1990s (Orange County, Bankers Trust, David Askin's Granite Funds, CMOs, inverse floaters, kitchen sink bonds); the LTCM and currency crises in 1998; the bursting of the credit bubble and meltdown that began in 2007. In this current crisis I have advised on multi-billion dollar liquidity runs, valuations and losses in the credit space (default swaps, CDOs, CLOs, CBOs, CDSs, ABCP and derivatives), on how to retool risk oversight and risk management, liquidity issues and new business matters driven by the current risk/return landscape.

We are in a period of significant global recession and prolonged mayhem in the financial markets. The United States faces an "economic Pearl Harbor" and has seen its economy "fall off a cliff," according to Warren Buffett earlier this week. "We are in a very vicious feedback cycle. It will end…but how fast we get there depends not only on the wisdom of government policy, but the degree to which it's communicated properly."[2] The debate on fair value and mark-to-market accounting standards deserves to be in the spotlight. Their application has been a

[1] This draft dated March 9, 2009. The views in this testimony are my own and should not be taken to represent the views of SBCC, Yale University, Columbia University, the International Association of Financial Engineers, the National Board of Mathematics and their Applications, the LongChamp Group, OpHedge, or any principal or other individual or entity associated or affiliated with any of the foregoing. The author makes no representations or warranty, either expressed or implied, as to the accuracy or completeness of the information contained herein, nor is she recommending that this testimony serve as the basis for any investment decision – this testimony is for information purposes only. I am grateful to Charles Lucas, Dr. Toncred Styblo, Leon Metzger, Barbara Matthews Todd Groome and my colleagues at SBCC for helpful comments and discussion.
[2] CNBC interview of Warren Buffet, March 9, 2009.

primary consideration to market participants during times both good and bad. The over-arching goals must be to rebuild confidence, maintain integrity, promote safety and soundness, and encourage the right kind and amount of capital flows.

My testimony is summarized by the following: Mark to market accounting should not be thrown out. In normal markets mark to market represents fair value well; However, in distressed markets where only fire sales are taking place, marking to independent, third-party models may better approximate fair value. I offer four recommendations for the Subcommittee's consideration:

## 1. On Suspending Mark-to-Market Accounting

I do not support a suspension of fair value accounting that uses Mark to Market as its proxy. In the current environment I believe such a change would promote a further crisis of confidence. If Mark to Market were suspended -- even temporarily -- in favor of some version of discounted present value with conservative but not extreme default probability assumptions, I believe experts and laymen alike would be outraged. I agree with Chairman Barney Frank, "...if you were to abolish mark-to-market ... you would get a negative reaction again on the investor side.[3]" I do support permitting the use of Mark to Model from an independent source in addition to Mark to Market as I believe it improves fair value determination.

Recently, tens of trillions of credit-risky assets – some considered plain vanilla a mere three years ago – have changed from valuation available from one or more dealers to valuation only by the user or by the user's independent valuation agent. As the credit markets collapsed beginning with the subprime crisis, dealers stopped providing valuations for many securitized instruments. An example of a securitized instrument is a collateralized debt obligation (CDO) which is based on the performance of a pool of underlying credit-risky instruments. These may be bank debt loans, commercial real estate loans, high quality residential mortgage loans, manufactured housing loans, subprime or Alt-A loans, auto loans, student loans, consumer credit card loans or just about any other type of loan that exists. As the crisis deepened, dealers also stopped providing, or held constant at deeply reduced levels, valuations for many of the underlying loans to the securitized instruments.

For example, for the multi-trillion dollar mortgage backed securities market (MBS), one major dealer stopped providing spreads and has only provided a constant dollar price ranging from distressed levels of $3 for B-rated MBS to $30 for AA-rated MBS for the last 4 months. Other dealers stopped providing spreads or prices altogether.

The dilemma is clear. The dealer quote implies that the true value of the best housing stock is 30% of its previous highs or that dealers are risk averse and are interested in purchasing such assets only at distressed prices. Yet many actual housing sales are currently occurring at prices over twice that level (75% of their previous highs). The contrast between actual trading prices in the housing market, and the values of the housing stock as implied by transaction prices in the financial markets are vastly different. I support Chairman Bernanke's statement that "we need to do a lot more to provide guidance to the financial institutions and to the investors about what are

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[3] Transcript of Chairman Frank's March 5, 2009 Press Conference

reasonable ways to address valuation of assets that are being traded or if traded at all in highly illiquid, fire-sale type markets."

A widespread reaction of the Enron and related scandals was to push hard to reduce flexibility in the application of accounting rules and the potential for similar deeply misleading if not fraudulent disclosures. But the present circumstances demonstrate the drawbacks of going too far in the direction of rigid application of inflexible rules, especially if misleading market valuations or gaping inconsistencies of valuation result.

**Recommendation:** The Subcommittee should encourage standard setters and regulators alike to provide users with urgent help to distinguish between going concern and liquidation valuation in an illiquid market. Do not abandon mark to market. Additional measures such as mark to model from independent sources should be added. Additional disclosure should be made so that it is clear when different approaches are employed.

## 2. On "Fair" Value

At certain times, a Mark to Market price is fair value. At other times a Mark to Model price is fair value. In my opinion, a fire sale price is rarely a fair value.

Paul Krugman reported in a recent column[4] in *The New York Times*, "market value is the only true measure of value". But what happens when there is no market? There is little doubt that when markets function, they are competitive and effective in evaluating, combining, analyzing and disseminating information. But when markets do not function, participants must operate without mission critical information. In this case, as we observe in the current crisis, the market becomes prone to fear, rumor, wishful thinking or even denial. Many banks, insurance companies, and other intermediaries taking credit risk had capital at roughly 10% of total assets as the crisis started. In a world of credit-risky assets that are marked to "market" at half of face value, all such intermediaries cease to be viable as losses exceed capital by multiples. The intermediaries become bankrupt squared or cubed. If substantial assets should be marked down 25% rather than 60%, there still is severe damage, but it is a more manageable situation. Thus, getting to the right number – or surrounding the right number via multiple measures – is critical.

Given the uncertainty over the health of many traditional financial intermediaries, new shadow bankers are filling the gap. In increasing numbers, residential housing sales that first fell through due to a lack of financing are being closed with loans being made by the sellers. Institutional investors and corporate treasurers forced to set up securities operations when money managers closed or busted special purpose vehicles distributed securities in kind are setting up direct investment operations[5]. Vulture investors are circling to invest – if they can -- at fire sale prices. Ultimately the markets will unlock. Will it be more within shadow banking than traditional intermediaries, or the other way around? No matter which way, we need better supervision, more flexible standard setting (for example across normal and distressed markets) and more effective regulation.

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[4] Paul Krugman, "The Big Dither", *The New York Times*, March 5, 2009

[5] For example, tri-party repo, receivables factoring and other short-term investment activities

**Recommendation:** The Subcommittee should promote a more flexible approach to defining "fair" value. None of the single measures are the best choice across super-heated, normal and distressed market conditions. The Subcommittee should promote more supervisory activity, and provide the necessary tools to the supervisors (both analytic and monetary) to keep up with the firms they supervise

## 3. We Should Not Rely on Single Measures

I am unable to join those who call for a ***single*** approach whether it be Mark to Market, Mark to Value, Mark to Model or "Mark to Moosh[6]." In reading much of the past year's writings and testimony on this topic I was struck by how often the word "single" appeared as a qualifier in taking the position for or against the Mark to Market approach. Imagine if a doctor were to make a critical diagnosis based on a single test result. Often, multiple measures are required, for example to distinguish between an acute infection and a terminal illness. Each measure reveals valuable – yet different -- information to aid in the collective diagnosis. Relying on a single measure may lead to the wrong conclusion. This also is true in today's complex financial markets. Measures such as Mark to Market, Mark to Value and Mark to Model typically produce different numbers. Taken collectively the measures have the greatest value. Each measure – and how far apart the measures are at different points in time -- reveals important information about an asset or a liability or about a firm or a market. Add to these risk management accounting – which affords a look at future values in addition to backward-looking values – and an even better picture evolves.

Current accounting standards do not allow multiple measures, but insist on a single measure. While other valuations can be disclosed in footnotes, many users rely only on the accounting values. For five decades economists and accountants have debated the relative merits of historical-cost, fair-value and other accounting measures. Recent market events do not demonstrate that Mark to Market should be abandoned but rather that other measures should be used to a greater degree alongside. Widely-used single measures can and will be arbitraged, and certainly played a role along with too many simplifying assumptions and too much liquidity in the meltdown. In my experience the desire to simplify accounting, risk and return views – and to produce single "answers" played a significant role in numerous financial losses.

**Recommendation:** The Subcommittee should encourage standard setters and regulators alike to implement multiple measures and promote their collective value. Managers, boards, regulators and other overseers should be well-trained in the strengths and weaknesses of the various measures.

## 4. On pro-cyclicality

The use of Mark to Market for valuation tends to be pro-cyclical. Values are overstated in good times and understated in bad times, neither of which serves the interests of stakeholders or strengthens incentives for investors to take a long view.

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[6] Transcript from "Roundtable on Mark-to-Market Accounting" before the Securities and Exchange Commission, October 29, 2008

The following story illustrates the point. It is drawn from numerous real projects and transactions over the past few years: In the early 2000s a collateralized debt obligation ("CDO") was purchased by an investor for $100 million. For several years, the dealer provided the sole valuation for the instrument at or close to par. These were recorded as the Mark to Market value by the investor for accounting purposes. Note that it is common for complex instruments such as CDOs that only one dealer is willing to provide ongoing Mark to Market values to the investor. Most often, these values are provided by the originating dealer who sold the instrument to the investor. In our story, after the market dislocation in 2007, the dealer reduced the valuation to $90 million and then stopped providing a valuation altogether. At this same time, droves of investors in the 50+ trillion credit derivative space were left without their previous source for a Mark to Market value as dealers stopped providing quotes.

The Mark to Model value for the CDO was $ 75 million at the time of purchase, and $50 million at the time the dealer stopped providing valuations. There is no doubt that the Mark to Market treatment turbo-charged the valuation positively at the time of purchase and maintained a substantial premium to Mark to Model up to the time that the dealer stopped providing valuations. In my experience, Mark to Market and Mark to Model values converge when markets are normal and diverge when markets are over-heated or illiquid. The benefit of using the measures together is clear: with both pieces of information, the user may determine the premium paid by the investor to enter the trade ($25 million), perhaps indicating that the market was over-heated for CDO-type investments. Providing such information to regulators and other stakeholders may be useful in the assessment of future bubbles.

Also important to consider is whether a "one size fits all" approach to accounting standards reduces the diversity of market participants approach to investment and trading styles in the markets. In any given market environment differences exist among and between global banks, broker dealers, regional banks, insurance companies, pension funds and asset management firms, among others. They have varying business considerations and time frames to hold assets and different abilities to do so (due to liquidity pressures or the absence thereof) in order to realize the intended value.

Diversity supports market stability, and reduces the potential for pro-cyclical and thus financially unstable behavior. The current Mark to Market financial reporting promotes common market and risk management approaches and therefore pro-cyclical behavior. A "one size fits all" approach may lead to a "crowded response" by risk managers when markets become extremely volatile or disrupted. The negative impact of this was exemplified during the LTCM crisis in 1998.

**Recommendation:** The Subcommittee should make it a priority to reduce the pro-cyclical impact of the current approach. This includes promoting multiple measures and reducing the likelihood that market participants will act in concert due to "one size fits all" approaches. Disclosure should be increased regarding the use of single mark to market prices for complex instruments and whenever measures diverge under different methodologies.

Thank you. I welcome any questions you may have.

**Statement of the**

**COMMERCIAL MORTGAGE SECURITIES ASSOCIATION**

**Before the**

**UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES**
**SUBCOMMITTEE ON**
**CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**Hearing on "Mark-to-Market Accounting: Practices and Implications"**

**March 12, 2009**

The Commercial Mortgage Securities Association ("CMSA") is grateful to Chairman Kanjorski, Ranking Member Garrett, and the Members of the Subcommittee for giving CMSA the opportunity to share its perspective on "mark-to-market" and the overall Fair Value Accounting ("FVA") standard. In particular, we will discuss how this standard, as currently being implemented, exacerbates the tremendous challenges facing the $3.4 trillion commercial mortgage market, and our belief that accounting policymakers can and must find workable solutions that dampen FVA's pro-cyclical effect, while also providing the transparency the FVA framework was intended to promote.

CMSA is the collective voice of the commercial real estate capital market finance industry, representing the full range of market participants including investment and commercial banks, rating agencies, accounting firms, servicers, other service providers, and investors such as insurance companies, pension funds and money managers. One of the crowning achievements of our association's efforts has been the development and implementation of a standardized CMSA Investor Reporting Package®, which has brought unparalleled transparency to our market by providing detailed bond, loan and property-level information for all commercial mortgage-backed securities (CMBS) securitizations.

The CMBS market is a responsible and key contributor to the overall economy that has provided a tremendous source of capital and liquidity to meet the needs of commercial real estate borrowers. Until recently, CMBS supported the commercial real estate market that fuels our country's economic growth, while helping provide jobs and services to local communities, as well as housing for millions of Americans in multi-family dwellings. Unfortunately, turmoil in the financial markets coupled with the overall downturn in the U.S. economy have brought the CMBS market to a standstill and created many pressing challenges. In fact, although the CMBS market provided approximately $240 billion in commercial real estate financing in 2007 (nearly 50% of all commercial lending), it provided only a small fraction (less than $13 billion) in 2008 with no new lending in more than two quarters, despite strong credit performance and enormous demand for capacity from borrowers. As such, CMSA has been actively working with financial regulators and policymakers to explore ways to get credit flowing again.

While CMBS market participants are struggling with the paralyzing effect of the credit freeze, they are simultaneously faced with the highly problematic and related effect that the FVA standard is having on their balance sheets, which must be addressed before new lending can occur. The problem is not with the FVA standard as written and intended per se – in fact, CMSA supports FVA, and we believe it works when the markets are functioning and there is not extreme volatility or disruption in those markets. However, CMSA strongly believes that the FVA standard, as currently implemented, has negative unintended consequences when the markets are illiquid and/or highly volatile. For these reasons, as explained below, CMSA urges accounting policymakers to give reporting entities specific, consistent direction on applying FVA in non-functioning markets, and also urges policymakers to address the adverse, pro-cyclical effect of current practice with respect to recognizing impairments.

**Background**

As the name implies, "Fair Value Accounting" (of which "mark-to-market" accounting is a subset), involves the valuation of assets or liabilities by reference to some objective, reliable measure in the market. FVA is implemented in the United States through Statement of Financial Accounting Standards ("SFAS") 157 (or "FAS 157"), promulgated by the Financial Accounting Standards Board ("FASB"), which the Securities and Exchange Commission ("SEC") has designated as the standards-setter for financial reporting. FAS 157 bases the concept of fair value on an "exit price," and provides a hierarchy of inputs used for fair value measurement based on the degree to which the inputs are observable in the market. "Level 1" in the hierarchy includes inputs that are based on quoted prices in active markets for the identical asset or liability. "Level 2" includes quoted prices of similar instruments in active markets and observable market information on valuation parameters or market-corroborated information (i.e. "observable market data"). "Level 3" corresponds to measurements that incorporate significant externally unobservable inputs that reflect the reporting entity's own assumptions and judgments regarding valuation parameters that market participants would use, such as adjustments for risk (i.e., "mark-to-model"). As a general matter, the FVA standard requires a reporting entity to use the highest level of factors for which reliable information is available.

**The Problem: Market Disruptions and FVA**

In theory, the availability of these three levels of input should afford a reporting entity sufficient flexibility to utilize whichever level is most appropriate for the prevailing market conditions. Thus, in the case of the present market disruptions that have led to pricing distortions, the current FVA standard should allow reporting entities to move to Level 3 for securities, which would enable them to incorporate internal management's assumptions and judgments to produce realistic valuations.

However, despite what is intended, FVA does not provide this flexibly in practice. This unfortunate result is due to a lack of clear, consistent, and specific guidance from accounting policymakers (FASB, the SEC and PCAOB) about when a market is sufficiently "non-functioning" to permit a reporting entity to rely on Level 3 data for securities. In addition, because of the FVA standard's emphasis on "observable" market data, reporting entities are encouraged to assign depressed values to securities that are the product of the current market illiquidity and a superficial valuation analysis, as well as other constraints on institutions. This application is in lieu of engaging in a more principle-based analysis of the value of their securities, which more expressly requires an assessment of the quality of data and relies on multiple inputs, thus leading to a more analytical assessment of value. Put simply, we have found that while the FVA standard works "on paper," it is not working "in practice."

The CMBS market offers a compelling example of the pricing and valuation difficulties that market participants face under the current application of FVA. Even though illiquidity (the lack of CMBS issuance or robust trading), volatility, and the overall economic downturn have combined to batter the market, CMBS loans are still performing today and our market's fundamentals remain relatively sound, which essentially means most CMBS investors are receiving principal and interest each month.

However, market illiquidity and volatility result in distorted data being used to value assets, despite the performance and cash flow that investors holding these assets are receiving. Indeed, a strict interpretation of the FVA standard's "observable market data" can result in the use of "synthetic instruments" (or "derivatives") to determine pricing. In the CMBS market, the synthetic instrument used is often the CMBX index, which – incredibly – at times has been trading at a price that suggests 99% default rates, so this clearly is not an accurate barometer of fair value given the performance of CMBS loans. In another example specific to our market, because CMBS can be relatively liquid compared to other asset types, an investor may reluctantly sell CMBS, albeit at "fire sale" prices. Although such a distressed sale is not the orderly type of transaction that forms the basis for FVA, the fact that a small number of these sales occur results in such "fire sale" prices being used as a benchmark upon which FVA determinations are made, creating an unrealistic, and self-perpetuating, downward pressure on valuations for CMBS.

This type of pricing distortion, or "under-valuation" in this case, does not provide the kind of transparency investors and the market need, and is a particular disservice to investors who intend to "buy and hold" as well as investors who do not intend to sell the CMBS assets unless the price reflects what they believe to be the fair value of those

assets. Investors thus can experience severe economic stress as a result of mark-to-market losses, despite the fact that highly-rated securities themselves may be projected – even today – ultimately to experience little or no real economic loss.

These artificial devaluations are having a far-reaching ripple effect on the economy. Accounting rules are not supposed to drive business decisions, at least theoretically. Today, however, the application of FVA is impacting such decisions, as the artificial downward valuations contribute to the inability of institutions (who lack balance sheet capacity) to extend or refinance loans without a viable and stable secondary market. Yet, Treasury Secretary Geithner explicitly stated in his testimony before the House Financial Services Committee on February 10, 2009 that "[n]o [economic recovery] plan will be successful unless it restarts the securitization markets." It follows that the adverse impacts of FVA must be addressed now, because they effectively undermine all of the efforts undertaken by Congress and the Administration in recent months to address the crises in both "capital" and "liquidity," which are essential to new lending.

In our view, none of these ramifications was an outcome that was intended by the accounting policy constituencies that created the FVA framework. But, with capital and liquidity now at a premium, and as the government embarks on the numerous initiatives put in place to provide liquidity and facilitate lending, it is critical that policymakers ensure that accounting standards do not undercut these broader efforts. The application of the FVA standard in non-functioning markets needs to be addressed immediately, and should be among the highest priorities for all policymakers in order to assist in our financial recovery.

**Possible Solutions**

We appreciate the attention that Congress has already devoted to this issue. Although Section 132 of the Emergency Economic Stabilization Act of 2008 ("EESA") authorized the SEC to suspend SFAS 157, the SEC has not done so. The SEC did, however, conduct the study and publish the report on the effects of FVA as was directed by Section 133 of EESA. As part of this process, the SEC also held a series of public roundtable discussions on the issue, in which CMSA participated on two separate occasions.

In the SEC's FVA report, the Commission acknowledges, among other things, that there is a need for additional guidance or best practices for determining fair value in illiquid or non-functioning markets; that there should be improvements in the application and practice related to FVA especially as they relate to estimates based on "observable inputs" (i.e., Level 2 data) and "unobservable inputs" (Level 3 data); and that there should be additional guidance concerning when observable market data should be supplemented with or replaced by externally unobservable data in the form of management estimates.

CMSA along with representatives of many other industry sectors have long urged the SEC and FASB to do precisely what the SEC has suggested in its report. Preliminarily, our members believe a workable solution lies within the existing FVA

framework. Thus, CMSA has asked the SEC and FASB to issue guidance on FVA clarifying that in disrupted markets such as those we now face, Level 3 data may be relied upon for securities, and we asked for clarification regarding when a market is "non-functioning." The Public Company Accounting Oversight Board, which governs the work of auditors, has likewise been requested to ensure that its standards concerning FVA are brought into line with the SEC report's conclusions and our recommendations.

It is worth noting that the Center for Audit Quality, which represents auditors, has similarly suggested that additional guidance needs to be provided about the circumstances in which it is appropriate to shift from Level 2 to Level 3 inputs when valuing an asset in a time of changing or disrupted market conditions. Likewise, our view is generally consistent with the recommendations in the recently released Financial Reform Report from the "Group of Thirty" ("G30"), the international body of public and private sector experts on economic and financial issues, of which former Federal Reserve Chairman Paul Volcker serves as Chairman of the Trustees. The G30 report recommended that "fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments and distressed markets." Chairman Volcker testified about the G30's recommendations at a February 4, 2009 hearing before the Senate Banking Committee.

Unfortunately, however, the additional guidance that the SEC and FASB have provided to date, though well intentioned, has fallen short of our markets' needs. Essentially, reporting entities have merely been told that they have the flexibility to rely on Level 3 data for securities in non-functioning markets, but without concrete, specific guidance on when they may do so, and without information on what criteria the SEC and PCAOB would use to evaluate that decision with hindsight. In sum, the current guidance has not been sufficient to allow reporting entities to move to Level 3 with any degree of comfort, and we do not foresee markets returning to a completely normal state without some attention to pricing distortions that result from the current application of FVA. While the new short term projects announced by FASB on February 18, 2009 to provide additional guidance on fair value measurement and disclosure are welcome, this effort will not go far enough to addressing these issues.

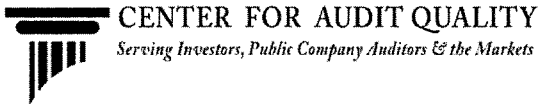
Accounting policymakers must give reporting entities the direction they need to rely on Level 3 data, starting with a clear, specific definition of when markets are "non-functioning." Further, the description of "non-functioning" should encompass a broader range of market conditions than what is currently contemplated in FAS 157, which is essentially limited to circumstances where a market is "non-existent." This acknowledgement is necessary because a market may be so severely disrupted that there is little or no trading, but under the "non-existent" standard, one trade (which most likely would represent a distressed sale or forced transaction), would put the market back into the realm of a "functioning" one. This practice is certainly cause for concern and confusion for the CMBS market. As mentioned, the CMBS market is, at times, relatively more liquid than other types of assets an investor may own, and may be sold at "fire sale" prices as a result. A distressed sale is not the orderly kind of transaction that forms the basis for FVA, but the fact that a small number of such sales occur is interpreted to mean the market does not meet the "non-existent" characterization under FVA, so under the present implementation there would never be cause to utilize Level 3 data for CMBS

valuations. Equally problematic, the "fire sale" price the distressed seller receives then becomes a benchmark upon which an FVA determination is to be made, putting added unrealistic, downward pressure on FVA valuations for CMBS. Thus, a significant decline in the number of orderly transactions, and the presence of sales primarily made by distressed sellers, are examples of circumstances that should be recognized by FAS 157 as hallmarks of a "non-functioning" market justifying a move to Level 3 data.

Additionally, CMSA believes that the problem we are now experiencing highlights the need for a more thorough examination of current "impairment" accounting models for financial instruments with a view to fully understanding their impact in non-functioning markets so that other necessary changes may be made as the markets stabilize. Specifically, accounting policymakers need to address an issue that exacerbates its pro-cyclical effect during credit and liquidity crises – the consideration of a liquidity premium "discount" along with an expected credit loss when recognizing impairment charges. Reconsideration of the models for recognizing impairments is also a recommendation made in the SEC's report on FVA. CMSA strongly agrees, and urges that this issue be addressed quickly and meaningfully because the current practice can subject investors to severe economic stress by requiring them to recognize an exaggerated level of loss despite the fact that the highly-rated securities themselves are projected to experience little or no real economic loss. Such a rubric does not provide the type of transparency needed by the market and investors who ultimately are critical to borrower access to credit. A more realistic approach is to recognize impairment only to the extent of the expected credit loss.

Further, CMSA strongly believes there is a continued role for Congress to ensure that accounting policymakers take all necessary steps toward addressing pricing and valuation issues in a meaningful manner, and assuring that the views of all constituencies are considered. We respectfully request that Congress continue to focus on the improvements that are needed in this area by mandating that the accounting policymakers (SEC, FASB and the PCAOB) take action to implement the changes they already have acknowledged are necessary by a date certain.

In conclusion, we support the FVA standard. However, while it works "on paper," action must be taken to ensure that it works as envisioned "in practice." We would urge a prompt consideration of, and response to, these issues in order to fully address and alleviate challenges facing the financial sector and overall U.S. economy.




**Testimony of Cynthia Fornelli**
**Executive Director, Center for Audit Quality**
**Before the**
**United States House of Representatives Committee on Financial Services**
**Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises**
**Thursday, March 12, 2009**

**Full Text of Testimony**

**Introduction**

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee, I want to thank you for giving me the opportunity to participate in today's hearing on the future of fair value accounting. My name is Cindy Fornelli and I am Executive Director of the Center for Audit Quality (CAQ). The Center for Audit Quality was created to serve investors, public company auditors and the capital markets. The Center's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Our Governing Board consists of leaders from the public company audit profession, the American Institute of Certified Public Accountants (AICPA), as well as individuals representing the issuer, investor and academic communities.[1]

The views of the CAQ and the public company audit profession on the issue of fair value are grounded in two fundamental beliefs: first, that transparent and relevant financial information is the foundation of our capital markets; and second, that investor confidence depends on this transparency and relevancy.

Promoting sound capital markets in the interest of the investing public is the core mission of the public company audit profession. Auditors contribute to this vital goal by conducting high-quality, independent audits of public company financial statements and attesting whether those reports have been prepared consistent with U.S. Generally Accepted Accounting Principles (U.S. GAAP). Auditors do not promote the success of any company or pick winners and losers. That is the job of the markets themselves. Investors will only feel confident in the legitimacy of the markets when they know that the financial reporting rules are clear and that there is a neutral party — the auditor — assessing that the standards are being followed.

It is from this perspective — and in recognition of the extraordinary crisis facing the markets and our entire economy — that the CAQ views the issue of fair value accounting. We would offer the following points for consideration by the Committee:

- First, over the last 30 years, fair value accounting has contributed to increased transparency in financial reporting. While the specific standard for applying fair value measurements at issue

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[1] The Center for Audit Quality (CAQ) is an autonomous public policy organization serving investors, public company auditors and the capital markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants. For more information, visit www.thecaq.org.

today — FAS 157 — has room for clarification and improvement, neither this standard nor fair value accounting generally are the root cause of the current financial crisis.

- Second, the challenges facing financial institutions in meeting the capital adequacy requirements of existing prudential regulations are legitimate policy issues. But, changing accounting standards to address capital adequacy requirements or to remove much-needed transparency would likely undermine investor confidence and could prolong the current crisis. Capital adequacy concerns are more appropriately addressed by the relevant regulatory agencies.

- Third, while we support continued use of fair value measurements, we recognize that there is value in considering ways to improve its application.

- Finally, irrespective of the specific issue of fair value accounting, the existence of an independent, unbiased standard setter for accounting standards is fundamental to investor confidence and must be reaffirmed and preserved. Any changes to accounting standards should be subject to the unbiased, open, and independent process of the Financial Accounting Standards Board (FASB).

**The Value of Fair Value**

The CAQ recognizes that the critique of fair value standards is rooted in the desire to address issues that have arisen in today's urgent, complex and far-reaching financial crisis. The crisis has been caused by loan losses and runs on the bank, not fair value accounting. While we support further clarification and improvement of how fair value measurements are made and presented in the financial statements, the CAQ believes that (1) the current use of fair value measurements for financial instruments in the financial statements should not be changed at this time; (2) the basic objectives of fair value measurements under FAS 157 are appropriate; and (3) neither currently required or permitted fair value measurements nor FAS 157 should be suspended. Significantly altering or suspending fair value would not only fail to mitigate the crisis, but such a move would make it worse by further undermining investor confidence by raising suspicions that the rules were changed in order to obfuscate current asset values.

In analyzing the merits of fair value accounting, it is important to recognize that it is not a new concept. In fact, fair value has been used for more than 30 years and has steadily emerged as a critical driver of increased transparency in financial reporting. There are two significant examples where many have suggested that a requirement to measure distressed assets at fair values, rather than historical values, could have resulted in declines that were less severe, less protracted or both, due to the earlier identification of losses and the associated corrective action that could have been taken.

First, during the savings and loan crisis in the 1980s, financial statements prepared for regulatory capital purposes, using principles other than U.S. GAAP, obscured the then-declining state of certain financial institutions' assets and liabilities. In any of these institutions that later failed, the resulting damage to the federal deposit insurance funds was much larger than it otherwise would have been had fair value principles been required.

Similarly, in Japan in the 1990s, in the face of steep losses at some of its largest banks, the Central Bank of Japan instituted a system of establishing loan loss allowances that were not fully consistent with the declines in recoverable value of those loans. Instead of stimulating growth, however, this action undermined the confidence necessary for growth. Investors lost confidence in their ability to assess the economic strength of financial institutions — and absent that confidence they decided not to invest in those companies. This move away from transparency did not lead to stability. It simply led to uncertainty, which in turn contributed to the so-called "lost decade" in Japan.

More recently, FASB issued FAS 157, which contrary to popular misconception did not introduce a single new instance under which fair value accounting was required. Rather FAS 157 provided a consistent definition of fair value and a consistent framework for its application. FAS 157 is best understood as the latest evolution in an ongoing effort to provide investors transparent information about the economic realities of companies, including financial institutions, in which they may choose to invest their money. The call to suspend FAS 157, or to do away with fair value accounting, runs counter to this historical drive toward increased transparency at a time when that transparency is of critical importance.

FAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. FASB issued FAS 157 to address the complexities caused by differing definitions of fair value, the lack of related implementation guidance, and difficulties caused by multiple fair value methodologies. Stated differently, FAS 157 itself does not prescribe any particular accounting treatment or require fair value accounting. Rather, it provides a consistent measurement methodology for applying existing fair value requirements, centralized in one standard. In addition, FAS 157 simplifies and codifies related guidance within generally accepted accounting principles (GAAP) and requires increased disclosure of the methods and inputs used in fair value measurements of a company's assets and liabilities.

These improvements were intended to result in increased consistency and comparability in fair value measurements as well as provide users of financial statements with better information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period. Thus, FAS 157 permits investors to better assess for themselves the reliability of the fair value measurements that have been included, and the overall picture that a company presents in its financial statements.

To accomplish this goal, FAS 157 establishes a consistent fair value objective to measure the price to sell an asset or transfer a liability in a transaction between a willing buyer and a willing seller. Embedded in FAS 157 is a hierarchy of valuation techniques that varies based on the availability of observable market information.

The CAQ believes that the objective of fair value measurements of financial instruments is just as important to investors when markets are illiquid as in other times. Valuing financial instruments absent a uniform methodology such as that prescribed by FAS 157, particularly in illiquid markets, would result in inconsistent measurements and would not provide users with the most transparent or relevant information about the value of a company's financial instruments.

Suspending fair value accounting or FAS 157 would eliminate an important tool for making transparent the economic health of publicly traded companies. It would not address the underlying economic

problems and would create a new set of challenges as investors lose confidence in the relevance, reliability and transparency of financial reporting generally. As the Securities and Exchange Commission (SEC) reported in its December 2008 study, recent bank failures primarily were caused by problems in the quality of loan portfolios and inadequate liquidity and were not caused by fair value and mark-to-market accounting. Further, the SEC concluded that abruptly removing fair value and mark-to-market accounting would erode investor confidence in financial statements.[2] As discussed below, the question we should be asking is not whether to eliminate or suspend fair value accounting, but rather what steps can be taken to improve the application of fair value.

**Addressing Capital Adequacy Concerns**

The impact of the financial crisis on financial institutions has raised questions about the impact of accounting on regulatory capital requirements and has caused some to question whether the primary focus of financial reporting on the needs of investors remains appropriate, or whether financial reports should serve also a prudential and regulatory purpose. In an August 2008 report of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR), it was recommended that financial reporting should be undertaken primarily for the benefit of investors.[3] Earlier, the CFA Institute reached a similar conclusion and asserted that "[investors] and creditors need timely, relevant, complete, accurate, understandable, comparable, and consistent information ... to evaluate the potential risk and return properties of securities and to determine appropriate valuations for them. The purpose of audited financial statements, prepared according to high-quality financial reporting standards, is to provide the needed information."[4]

The financial stability of regulated institutions is, in part, the responsibility of their respective regulators. While we do not advocate departure from fair value accounting for either regulatory capital or investor reporting purposes, clearly, regulators need to form their own judgment on capital requirements. We support appropriate moves to improve regulation to respond to recent events, but we also believe that regulatory requirements should be kept separate from setting accounting standards and should not dilute the quality of financial reporting that is so important to investors. We should not confuse the independent FASB's role to develop and improve financial accounting and reporting standards with the role and responsibilities of the regulatory bodies charged with the oversight of the safety and soundness of financial institutions.

Investors need to know the current values of loans and securities in order to make rational investment decisions; regulators need to know the current values of loans and securities in order to make rational policy decisions. Whether or how those values affect capital requirements, and whether they should result in an institution running afoul of capital requirements, is a decision to be made by regulators. If there is a problem with a financial institution meeting capital requirements, the solution should focus on

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[2] Securities and Exchange Commission, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting (Dec. 2008), available at http://www.sec.gov/news/studies/2008/marktomarket123008.pdf.

[3] Securities and Exchange Commission, Final Report of the Advisory Committee on Improvements to Financial Reporting (Aug. 2008), available at http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.

[4] CFA Institute, A Comprehensive Business Reporting Model 6 (July 2007), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n6.4818.

regulatory requirements, not on denying the current valuation that results from the underlying fair value principle.

**Proposals for Improving Fair Value and Addressing the Financial Crisis**

It is critical to the transparency of financial reporting and confidence of investors that fair value accounting standards be preserved. The question we should be asking is not whether to retain fair value reporting, but what steps can be taken to improve the application of fair value standards going forward. As a relatively new standard for applying fair value measurements, it is not surprising that FAS 157 could benefit from certain clarifications.

On Feb. 18, 2009, in response to recommendations in the SEC's study on mark-to-market accounting as well as input received from FASB's own Valuation Resource Group, FASB added multiple important projects to its agenda. Those agenda projects are intended to improve (1) the application guidance used to determine fair values and (2) disclosures of fair value estimates. (The FASB's Valuation Resource Group is a group of valuation and accounting professionals who provide FASB staff and Board with information on implementation issues surrounding fair value measurements used for financial statement reporting purposes.)

One major criticism of fair value accounting is that it can be difficult to apply in illiquid markets. FASB's projects on application guidance will address this concern by helping to: determine when a market for an asset or a liability is active or inactive; determine when a transaction is distressed; and apply fair value to interests in alternative investments, such as hedge funds and private equity funds. The project on improving disclosures about fair value measurements will consider requiring additional disclosures on such matters as sensitivities of measurements to key inputs and transfers of items between the fair value measurement levels.

FASB has indicated that its timetable for completion of the application guidance is in time for financial reporting for the quarter commencing April 1 of this year and the completion of the disclosure guidance will occur in time for the annual report of the current calendar year.

In addition, FASB has also recently initiated projects to require disclosures about the value of financial instruments included in quarterly as well as annual reporting effective with the current quarter. Further, predating the SEC's fair value study, on Dec. 15, the FASB added an item to its agenda to consider permitting entities to recover certain previous write downs, or impairments, when evidence exists that the impairment has reversed.

In all, FASB has seven active projects that it has classified as "credit crisis" projects. Of these projects, three are directed at valuation of assets in difficult-to-value situations, two are directed at enhanced disclosures about fair value, and the additional two are directed at accounting for credit derivatives and the previously mentioned project to consider reversals of write downs under some circumstances.

The CAQ is supportive of the efforts of FASB to address these improvements in financial reporting, and while there may be additional aspects of fair value that need to be considered, the FASB's open deliberative process and its current timetable should provide us and others the opportunity to address these concerns on a very current basis. For example, in its comment letter to the SEC during its study of the fair value issues, the CAQ made several recommendations that could be considered by FASB, including some of which are likely to be addressed by the newly added projects. Those recommendations included the following:

- First, FAS 157 does not provide clear guidance about how to evaluate inputs when valuing an asset in a time of changing or disrupted market conditions. Guidance to aid in determining when a market is active or inactive, or when a particular transaction would be considered a "distressed" or "forced" sale not constituting evidence of fair value, would assist in exercising judgment in this area.

- Second, while FAS 157 creates a valuation method based first on principles and then provides certain examples in its appendices, providing more specific examples of the fair value measurements of various types of assets and liabilities under varying assumed market conditions would be very useful.

- Third, additional guidance on presenting, in financial statements and notes, the periodic changes in asset valuation would be helpful to provide more useful information to investors.

We also believe that the concerns expressed about the application of FAS 157 in distressed or illiquid markets could be addressed, at least in part, through clearer and more transparent disclosures. These disclosures could include information about the conditions present in a particular market and the assumptions and methods applied in the fair value measurement process. The recently added FASB projects provide an opportunity for consideration of these enhanced disclosures.

The SEC could also provide interpretive guidance that would clarify that entities that apply fair value accounting to financial assets and liabilities could provide any other relevant information regarding those assets and liabilities in Management's Discussion and Analysis. Of course, there is nothing to prevent a financial institution from providing such disclosures voluntarily, as contemplated by the letters from the SEC staff to public company management in March and September 2008. Such disclosures would help address the assertions of some who believe that fair value accounting forces institutions to use overly pessimistic market prices to value their assets. Investors and other financial statements users could look to these disclosures to make an informed judgment about the current financial position and estimated future cash flows of the entity.

**The Importance of Independent Standard Setting**

Accounting standards derive their legitimacy from the confidence that they are established, interpreted and, when necessary, modified based on independent, objective considerations. The development process must be free — in both fact and appearance — of outside influences that inappropriately benefit any particular participant or group of participants in the financial reporting system. Even the appearance of outside influence could create doubts about the integrity of the system. That's dangerous because once confidence in the process is lost, then confidence in the standards themselves and the willingness to follow them will erode as well.

In the context of accounting standards, that independent, objective standard-setting function has been fulfilled for more than three decades by FASB. Since 1973, FASB has engaged in an extensive deliberative process before it adopts any accounting standard. FASB's standards-setting process permits robust participation by all constituents, including the SEC. In fact, the SEC's CIFiR, which was established "to examine the U.S. financial reporting system, with a view to providing specific recommendations as to how unnecessary complexity in that system could be reduced and how that system could be made more

useful to investors," recently studied this very question and concluded that, "[i]n general, we believe the design of the U.S. standards-setting process, including the process of issuing authoritative interpretive implementation guidance, and the role played by each participant are appropriate." The CAQ supports that conclusion.

CIFiR, in its final report to the Commission, found that five steps could improve FASB's standards-setting process: (i) increase consideration of investor perspectives; (ii) enhance governance and oversight; (iii) improve process; (iv) clarify the role of interpretations; and (v) improve standard design. The CAQ generally supports CIFiR's recommendations.

The CAQ firmly believes, however, that any changes to the standards-setting process should enhance, or at least be consistent with, the most important characteristic of any standards-setting process: independence. The current FASB process is independent, transparent, and subject to full public scrutiny. FASB's independent status contributes greatly to investor confidence by developing the accounting standards that define our financial reporting system based on objective analysis and not special interest preferences.

The urgency of the economic crisis only increases the need for procedural safeguards to protect against interventions that, while well-intentioned, are ultimately misplaced. Open process and independence are important to ensure the legitimacy of the standards-setting process, and to protect the goals of transparency, relevance and usefulness in financial reporting that have been hallmarks of decades of standards-setting efforts in the United States. Irrespective of one's views of any particular accounting standard, our entire system is best served by preserving the independence of the standard-setter.

**Conclusion**

The current crisis has created an appropriate desire for swift and meaningful action. Members of Congress and others who have contributed to the policymaking process deserve credit for summoning the will to confront this challenge directly and boldly.

Yet in responding to the crisis of the moment we must not lose sight of the fundamental underpinnings of our system. None is more critical than investor confidence in the reliability and transparency of financial reporting. That confidence is preserved by relying on an independent standard setter to promulgate accounting standards based on unbiased consideration; that confidence is bolstered by the assurance that those standards, independently and objectively derived, will not be suspended or changed in response to outside pressure; and that confidence is secured by all market participants working collaboratively to improve the quality of financial reporting through improved standards and implementation.

Reaffirming these core principles is the best and surest path toward bolstering investor confidence. In doing so, Congress can avoid the risk of exacerbating the current crisis and can help keep us on the road to a swift recovery. Fair value accounting did not cause our difficulties, and abandoning it will not solve them. Steps can be taken to improve the application of fair value standards going forward, and the CAQ stands ready to work with policymakers, regulators, standard setters and preparers to help accomplish this.

Thank you for the opportunity to be here. I look forward to working with the Subcommittee on these issues.

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

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**Summary of Key Points from Testimony of Robert H. Herz**

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1. The mission of the FASB is to establish accounting and financial reporting standards for public and private companies and not-for-profit entities that if faithfully implemented will provide investors and other users of financial statements with relevant, reliable, and transparent information about a company's financial condition, results of operations, and cash flows. The FASB follows an open, thorough, public due process for standard setting that involves exposure of proposals for comment, roundtables, and extensive gathering of input from constituents.

2. The role of accounting standard setters is to develop accounting standards that help provide transparency in general-purpose financial statements of reporting enterprises that are used by investors and others to make capital resource allocation decisions. The information needs of those parties often differ from that of financial institution regulators, who focus on safety and soundness, capital adequacy, and financial stability. So, while financial institution regulators start with the GAAP numbers, they have discretion to make adjustments in computing regulatory capital and assessing capital adequacy.

3. The current reporting model in the United States and across much of the world includes both historical cost and fair value measurements. This mixed attribute model, which requires certain items to be measured at fair value, has been in place for many years. Further, the practice of writing down assets in down markets is not new and would apply whether one used fair value accounting or other age-old accounting methods such as lower of cost or market. Contrary to some assertions, FASB Statement No. 157, *Fair Value Measurements*, does not require any new fair value measurements. Nor does it require the use of fire sale or liquidation prices. Rather, Statement 157 provides a consistent definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

4. The use of fair value accounting varies significantly among financial institutions. At one end, broker-dealers and other very major financial institutions make broad use of mark-to-market accounting (in which changes in fair value are included in reported earnings) to measure assets and liabilities in their trading accounts. At the other end, most banks measure the bulk of their assets and liabilities based on historical cost.

5. While some believe that fair value accounting has exacerbated the crisis and have called for its use to be suspended, others, primarily investors and other users, support the use of fair value accounting. Those supporters believe that fair value accounting provides relevant and comparable financial information to aid in understanding the risks and financial condition of financial institutions and that suspending fair value would diminish the quality and transparency of reporting

for investors. Indeed, some have urged the FASB to extend the use of fair value to all financial assets, noting that investors seem to continue to believe that bank assets are overstated as evidenced by market valuations of many publicly traded banks at well below their reported book values and recent acquisitions of major banks at fractions of book value.

6. In response to calls for the suspension or modification of fair value accounting, Congress asked the Securities and Exchange Commission ("SEC") to study fair value accounting. In the SEC's recent report to Congress on mark-to-market accounting, the SEC recommends against suspension of fair value accounting and concludes that fair value accounting did not cause bank failures. Those failures were more likely due to probable credit losses, concerns about asset quality, and in some cases, eroding lender and investor confidence.

7. However, the SEC did recommend certain improvements in the application of fair value accounting. The FASB and the SEC staff have been providing guidance to improve the application of fair value accounting, particularly in regard to the valuation of complex and illiquid securities, emphasizing the need for the exercise of appropriate judgment in such circumstances. The FASB has also held several roundtables with the International Accounting Standards Board ("IASB") and many meetings and discussions with regulators, companies, investors, and other parties, to discuss reporting issues emanating from the global financial crisis. The FASB has recently undertaken a series of near-term projects in response to those issues to provide further helpful guidance for valuing items under current conditions, to eliminate certain inconsistencies in the rules relating to impairments of securities, and to further enhance disclosures. Also, the Board and the IASB decided to jointly undertake a project to consider broader improvements in the accounting for financial instruments. The Boards established a senior-level Financial Crisis Advisory Group to assist them in evaluating major issues to be addressed in that project, as well as consider various other reporting issues arising from the global financial crisis.

8. Good accounting and reporting can have economic consequences, including potentially leading to what some term as *procyclical* behavior. Reporting the deteriorating financial condition of a financial institution can result in investors deciding to sell their stock in the entity and lenders refusing to lend to it, to the company trying to shed problem assets, and to regulators and the capital markets recognizing that the institution may be in danger of failing and may need additional capital. Indeed, individuals and families may take such procyclical actions when they see the falling value of their homes and of their 401(k)s and decide to spend less and to sell investments in order to raise cash in troubled times. But few would suggest suspending or modifying the reporting to individual investors of the current values of their investment accounts. Thus, to the extent there are valid concerns with procylicality, these concerns are more effectively and appropriately addressed through regulatory mechanisms and via

fiscal and monetary policy, than by trying to alter the financial information reported to investors and the capital markets.

**Testimony of**
**Robert H. Herz**
**Chairman**
**Financial Accounting Standards Board**
**before the**
**U.S. House of Representatives Financial Services Subcommittee**
**On Capital Markets, Insurance, and Government Sponsored Entities**
**March 12, 2009**

**Full Text of Testimony**

**Introduction**

Chairman Kanjorksi, Ranking Member Garrett, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). Thank you for inviting me to participate in today's important hearing.

I have brief prepared remarks and would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

My testimony this morning includes a brief overview of the FASB, including the importance of our independence and due process to our mission of developing high-quality financial accounting and reporting standards for both public and private enterprises. My testimony also describes the differing roles of accounting standard setters and prudential regulators, discusses the concepts of fair value accounting and measurement, provides some observations on recent calls to suspend the application of fair value accounting, summarizes research on the impact of fair value accounting on financial institutions, explains the purpose and provisions of FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("Statement 157"), and reviews some of the issues surrounding the application of this standard and how the Board has been addressing those issues.

**The FASB**

The FASB is an independent private-sector organization. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the U.S. economy because investors, creditors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[1] is a critical aspect of the standard-setting process and fundamental to our mission, because our work is technical in nature and designed to provide preparers with the guidance necessary to report information about their economic activities. The guidance creates the yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, creditors, and the U.S. economy.

The FASB's authority with respect to public enterprises comes from the U.S. Securities and Exchange Commission ("SEC" or "Commission"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 35 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC issued a Policy Statement in 2003 reaffirming this longstanding relationship.[2]

The Policy Statement, consistent with the language and intent of the Act,[3] also reemphasizes the importance of the FASB's independence described earlier. It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the

[1]Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).
[2]Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003).
[3]Sections 108-109; the legislative history of the Act is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

> maximum credibility in the business and investing communities.[4]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"), is responsible for maintaining active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, the Public Company Accounting Oversight Board ("PCAOB"), and ultimately the SEC.

**What Process Does the FASB Follow in Developing Accounting Standards?**

Because the actions of the FASB affect so many organizations, its decision-making process must be fair and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure require an extensive due process. That process involves public meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views.

The Board makes final decisions only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. It is also focused on making technical, rather than policy or legal, judgments. In making those judgments, the FASB's mission and Rules of Procedure require that the Board balance the often-conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

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[4]Page 5 of 8.

**The Role of Accounting Standard Setters and the Role of Prudential Regulators**

The primary roles of accounting standard setters and prudential regulators are fundamentally different. Accounting standard setters focus on developing accounting standards that help provide transparency in general-purpose financial statements of reporting enterprises that are used by investors and others to make capital resource allocation decisions. The information needs of those parties often differ from that of regulators, who are largely concerned with safety and soundness and financial stability. Accounting standard setters stress the importance of having the information in general-purpose financial statements be *neutral*, that is, free from bias. The goal is to provide information useful to users of financial statements in their decision making. Such users include present and potential investors, lenders, suppliers, and other trade creditors, customers, employees, governments and their agencies, and the public. Primacy is given to the informational needs of investors (both equity and debt security holders).[5]

The focus of financial reports is on the communication of information to investors and the capital markets to facilitate informed investment decisions, without which markets do not function well. This focus informs the structure and purpose of the financial accounting and standard-setting process and the resultant standards.

A paramount goal of the federal government has been to ensure the stability of the financial system. A principal policy tool used to achieve this goal has been the prudential regulation and supervision of financial institutions, which is designed to remove or lessen

[5]The Advisory Committee on Improvements to Financial Reporting (CIFiR) to the SEC states the following in Recommendation 2.1 of their Final Report (August 2008):

> Investor perspectives are critical to effective standards-setting, as investors are the primary consumers of financial reports. Only when investor perspectives are properly considered by all parties does financial reporting meet the needs of those it is primarily intended to serve. Therefore, investor perspectives should be given pre-eminence[15] by all parties involved in standards-setting.

> [15]We recognize the need for balance among all parties involved in the standards-setting process. We do not intend to suggest by this recommendation that investor input trumps all others. Instead, in cases where constituent views cannot be reconciled, we believe that the investor perspective should be afforded greater weight.

the threat of systemic instability, as well as, in the case of commercial banks and other deposit-taking institutions, to protect customer deposits.

In the aftermath of the 1980s savings and loans crisis, Congress enacted laws stating that the accounting standards used by bank regulators had to be at least as "stringent" as U.S. generally accepted accounting principles ("GAAP"). Thus, regulatory capital requirements for banks in the United States start with financial information provided in accordance with GAAP. However, the laws also provide the regulators with discretion to adjust GAAP numbers when establishing capital adequacy guidelines governing loan capacity and other regulatory requirements. The regulators also have other tools at their disposal to address the financial positions of financial institutions, including liquidity and collateral requirements and risk concentration rules. So, while financial institution regulators may base computations of regulatory capital on GAAP numbers, their decisions on capital adequacy and responses to capital impairments cannot and should not be driven solely or mechanically by balance sheet results. Their role is different from that of accounting standard setters whose standards are not specifically designed to meet the objectives of prudential regulation. But, while our roles are different, we have longstanding and productive working relationships with financial institution regulators, both at the national and the international levels, wherein we share perspectives, discuss current issues, and look for ways to complement and bridge the reporting needs of investors and regulators.

**What Is Fair Value Measurement and Its Role in Accounting?**

The current reporting model in the United States and across much of the world includes both historical cost measurement and fair value measurement. As the current financial and economic crisis has deepened and broadened, there has been considerable focus on the subject of *mark-to-market* or fair value accounting. In discussions on this subject, it has become clear that there are a number of misconceptions about fair value accounting.

**As detailed extensively in the recent SEC Mark-to-Market Report to Congress,[6] the use of fair value in financial reporting is not new.** In fact, it has been in place for many decades, principally for financial assets. However, fair value is not required for all financial assets. Whether and when fair value is required depends on the types of financial assets that are the subject of the accounting and, to varying degrees, the reporting entity's intent with respect to those assets. Moreover, when fair value is required, it is not always required on an ongoing basis (which is so-called mark-to-market accounting). Some fair value measures within GAAP are one-time and event driven, such as the valuation of assets and liabilities in business combinations; certain types of inventory and long-held assets; and certain retirement obligations initially recognized at fair value. Other fair value measures are recurring, such as the accounting for marketable securities classified as trading securities and derivatives (with certain exceptions for hedges). This is so-called mark-to-market accounting, which also can be voluntarily elected under an available fair value option. Fair value also is used to report securities in available-for-sale portfolios of financial institutions and other entities, but, in such cases, the periodic changes in fair value are included in what is called *other comprehensive income*, which does not affect reported earnings.

Fair value is used to recognize impairments in the value of financial assets. For example, under the standards applicable to impairments, (1) available-for-sale securities and held-to-maturity debt securities have for many years been written down to fair value through earnings if impairment is other than temporary and (2) mortgage loans held for sale are reported at the lower of cost or fair value on an ongoing basis (a continuous impairment notion). Thus, the requirement to write down financial assets in down markets is hardly new and would apply whether one used fair value accounting or other age-old methods such as lower of cost or market. Finally, it is important to note that loans held for investment, which make up the bulk of financial assets for many banks, are carried at amortized cost subject to loan loss allowances that are not based on fair value.

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[6]Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, Office of the Chief Accountant, Division of Corporation Finance, United States Securities and Exchange Commission, December 30, 2008 (SEC "Mark-to-Market Report").

**Some Observations on Recent Calls to Suspend Application of Fair Value Accounting**

In recent months, there have been calls by certain parties to suspend fair value accounting and, specifically, the application of Statement 157. Some commentators have asserted that the fair value standards promote undesirable "procyclical" behavior by requiring write-downs of financial assets that may be exaggerating losses, further driving down asset values, affecting capital ratios, and tightening the availability of credit, thereby causing a further downward spiral in assets prices. While sound and transparent reporting can have economic consequences, including potentially leading to procyclical behavior, it is not the role of accounting standard setters or general-purpose external reporting to try to dampen or counter such effects. Highlighting and exposing the deteriorating financial condition of a financial institution can result in investors deciding to sell their stock in the entity, in lenders refusing to lend to it, to the company trying to shed problem assets, and to regulators and the capital markets recognizing that the institution may be in danger of failing and need additional capital. Indeed, individuals and families may take such procyclical actions when they see falling values of their homes and their 401(k)s and decide to spend less and to sell investments in order to raise cash in troubled times. But I think few would suggest suspending or modifying the reporting to individual investors of the current values of their investment accounts. Thus, to the extent there are valid concerns with procyclicality, these are more effectively and more appropriately addressed through regulatory mechanisms and via fiscal and monetary policy, than by trying to suppress or alter the financial information reported to investors and the capital markets. Moreover, in our view, the standards are not the underlying source of the write-downs. Some of the most vocal critics of the standards have come from institutions that subsequently failed and have had to seek financial assistance from or been rescued by the federal government. As discussed in detail below, there is considerable evidence that underlying economic conditions are the fundamental source of those write-downs.

In the words of some investors, "Blaming fair value accounting for the credit crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are

sick."[7] The fact that fair value measures have been difficult to determine for some illiquid instruments is not a cause of current problems, but rather a symptom of the many problems that have contributed to the global crisis, including lax and fraudulent lending, excess leverage, the creation of complex and risky investments through securitization and derivatives, the global distribution of such investments across rapidly growing unregulated and opaque markets that lack a proper infrastructure for clearing mechanisms and price discovery, faulty ratings, and the absence of appropriate risk management and valuation processes at many financial institutions. Many of the complaints about fair value also seem to arise in the context of its impact on capital adequacy. As previously noted, while the consideration of the impact of fair value accounting on bank regulatory capital is a very important issue, it is beyond the purview of the FASB.

For accounting standard setters, the fundamental question about fair value accounting is whether it provides investors with the relevant information with which to judge current and potential investments. In developing the fair value measurement and reporting standards, the Board has repeatedly been told by investor organizations and other users that fair values of financial assets and liabilities are more relevant for their decision making than historical cost. Over time, historical prices of financial instruments become increasingly less relevant in assessing an entity's current financial position. Many investors have made it clear that, in their view, fair value accounting allows companies to report amounts that are more relevant, timely, and comparable than amounts that would be reported under alternative accounting approaches, even during extreme market conditions.

Companies' ability to manipulate their reported net income may be more limited when amounts are reported at fair value on a regular or ongoing basis, because changes in the values of assets and liabilities are reported in the period they occur, not when they are realized as the result of transactions. During the savings and loan crisis, there was considerable criticism of the practice of *gains trading,* under which institutions would "cherry pick" appreciated securities for sale thereby boosting reported earnings, while in

[7]Dane Mott and Sarah Deans, *Accounting Issues: Q&A on Financial Instrument Accounting During the Credit Crunch*, Global Equity Research, J.P. Morgan (July 28, 2008).

accordance with regulatory accounting requirements not recognizing the unrealized losses on other securities they were holding. Gains and losses resulting from changes in fair value estimates reflect economic and market events that companies and investors may find relevant to their decisions. Thus, fair value accounting has helped investors and capital markets more quickly identify where problems exist and react to those problems. The Center for Audit Quality, the Council of Institutional Investors, and CFA Institute issued the following joint statement on October 1, 2008:

> Suspending fair value accounting during these challenging economic times would deprive investors of critical financial information when it is needed most. Fair value accounting with robust disclosures provides more accurate, timely, and comparable information to investors than amounts that would have been reported under other alternative accounting approaches. Investors have a right to know the current value of an investment, even if the investment is falling short of past or future expectations.[8]

In its recent report to Congress, the SEC reported that investors have repeatedly told the Commission that fair value information is vital in times of stress and that suspending the fair value information would weaken investor confidence and result in further capital market instability.[9]

Ben Bernanke, chairman of the Federal Reserve System Board of Governors, testified in a hearing of the House Financial Services Committee on monetary policy and the state of the economy on February 25, 2009. During that hearing, Chairman Bernanke was asked to discuss the pros and cons of suspending mark-to-market accounting. Chairman Bernanke responded that "...the basic idea of mark to market accounting is very attractive, the idea that wherever there are market values determined in free exchange, that those market values should be used in valuing assets so that investors would have a more accurate sense of what the institution is worth. So that's the principle and it's a good principle in general." Mr. Bernanke noted that difficulties with mark-to-market accounting arise when markets become illiquid or do not function. And, he stated, "So some real challenges there and I think the accounting authorities have a great deal of

[8]"Joint Statement of the Center for Audit Quality, the Council of Institutional Investors and the CFA Institute Opposing Suspension of Mark-to-Market Accounting," Press Release (October 1, 2008).
[9]SEC Mark-to-Market Report, pages 1, 139–144.

work to do to try to figure out how to deal with some of these assets, which are not traded in liquid markets. But I don't see a suspension of the whole system as being constructive because there is a great deal of information in valuing many of these assets according to market principles."

As the SEC concluded in its report to Congress, suspending or eliminating the current fair value accounting requirements would diminish the quality and transparency of reporting and could adversely affect investors' confidence in the markets. In turn, this loss of confidence could also cause downward pressure on the financial markets and the economy and additional financial instability.

**Impact of Fair Value Accounting on Financial Institutions**

The SEC, Merrill Lynch, and the FASB staff have performed research on the impact of fair value accounting on financial institutions. Each group studied the linkage between fair value accounting and recent bank failures and concluded that fair value accounting did not appear to play a meaningful role in bank failures. The SEC Mark-to-Market Report describes the SEC's study on this issue. Dividing the failed banks by asset size, the SEC analyzed 22 banks' use of fair value measurement over a 3-year period, evaluating the impact of fair value measurement on capital adequacy relative to loan losses and other factors affecting the capital position of the banks. The SEC found that for most of the failed banks, fair value accounting was applied in limited circumstances and did not have a significant impact on the banks' capital. The SEC concluded that fair value accounting did not appear to play a meaningful role in bank failures in 2008 and that the failures were more likely due to probable credit losses, concerns about asset quality, and, in some cases, eroding lender and investor confidence. Furthermore, the Commission reported that for banks that recognized sizable fair value losses, the reporting of these losses did not appear to be the cause of the failure. The SEC also noted that market concerns about these banks, as evidenced by their share price, appeared to indicate that the marketplace factored in losses for those banks that had not been recognized in GAAP reported income.[10]

[10]SEC Mark-to-Market Report, pages 4, 97.

The SEC also examined the impact of fair value accounting on financial institutions' balance sheets. They found that the majority of a bank's assets are not reported at fair value. Their analysis illustrated that 31 percent of total bank assets were reported at fair value as of first quarter 2008 and that 30 percent of those assets reported at fair value constituted investment securities classified as available-for-sale with changes in fair value recognized in other comprehensive income (a component of equity). It is our understanding that unrealized gains and losses on available-for-sale securities are added back for Tier 1 regulatory capital purposes. The SEC determined that 22 percent of total assets were reported at fair value with changes in value affecting income, primarily comprising trading securities and derivatives.

For broker-dealers, the SEC determined that 50 percent of total assets were measured at fair value and that changes in the value of almost all of those assets were reported in the income statement. The SEC found that broker-dealers reported large trading and derivative instruments portfolios, which were measured at fair value. Specifically, those assets constituted 43 percent of broker-dealer total assets.[11]

Merrill Lynch's research report states that recent bank failures and earnings weakness had far more to do with poorly performing loans than with mark-to-market accounting. The loans that had caused these problems were not accounted for at fair value but on an accrual basis of accounting. Under this accrual method, loss reserves are gradually added, producing a charge to earnings, as delinquencies are observed and actual losses are incurred. Reviewing 2008 data, Merrill Lynch found that rapidly rising credit loss provisions had a much greater impact on a bank's financial condition than the impact of mark-to-market losses.[12]

The FASB staff also analyzed institutions that were closed by the Federal Deposit Insurance Corporation between January 25, 2008, and October 31, 2008. The FASB staff's findings are consistent with the SEC's conclusions that fair value accounting was applied in very limited circumstances at those institutions. In addition, the FASB staff

[11]SEC Mark-to-Market Report, pages 47, 50.
[12]Guy Moszkowski, Edward Najarian, M. Patrick Davitt, and Christopher Black, *Does TARP Point to Suspension of Mark-to-Market?* Banks-Multinational/Universal, Merrill Lynch (October 24, 2008).

analyzed investor pricing of commercial banks by looking at their market values. The staff found that, as of November 3, 2008, more than 50 percent of publicly traded banks were trading below tangible book value. Based on November 3, 2008, stock prices, 52 percent of all U.S.-listed commercial banks (358 banks) were trading at less than tangible book value; 236 of those banks were trading at less than 80 percent of tangible book value. Investors' pricing of banks suggests that they viewed bank net assets as overstated, not understated, as would be the case if fair value adjustments were causing excessive write-downs of bank assets. Similarly, a Bloomberg News analysis of two major commercial bank mergers in 2008 involving the acquisition of National City by PNC Financial and the acquisition of Wachovia by Wells Fargo shows that the consideration paid was significantly less (in both cases about 70 percent less) than most recently reported book value before acquisition, suggesting that fair value markdowns recorded by the acquired institutions may not have captured all of the information relevant to a willing buyer.[13]

**FASB Statement No. 157, *Fair Value Measurements***

Much of the current criticism of fair value accounting has been directed toward Statement 157, issued in 2006. Here, too, we believe there are a number of misconceptions.

Contrary to the assertions of some, Statement 157 did not introduce mark-to-market or fair value accounting and did not expand the range of items that are required to or permitted to be measured at fair value. Rather, Statement 157 improves the consistency and comparability of fair value measures within GAAP by more clearly defining fair value, establishing a framework for measuring fair value, and expanding disclosures about fair value measurements. **It does not change which assets and liabilities companies report at fair value.** Before Statement 157, numerous accounting standards provided guidance about fair value measures. However, that guidance evolved piecemeal over time and was dispersed throughout several pronouncements.

[13]Jonathan Weil, "Wachovia Shows Why No Bank's Books Are Trusted," Bloomberg.com (October 30, 2008).

Differences among that guidance created inconsistencies and added complexity to GAAP.

Before the issuance of Statement 157, there were varying definitions of fair value, including fair value exit and entry price (purchase price). Statement 157 defines fair value as an exit price. **For an asset, the fair value estimate is determined by reference to the price that would be received in an orderly transaction for the asset at the measurement date (an exchange price notion), not, as some have asserted, the price that would be received in a fire sale or forced liquidation transaction for the asset at the measurement date**. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market before the measurement date. In contrast, a fire sale or forced liquidation transaction is one that involves market participants that are compelled to transact (under duress) and allows for little (or no) exposure to the market before the measurement date. Statement 157 clarifies that the fair value estimate is intended to convey to investors the value of an asset or liability at the measurement date (a current value), not the potential value of the asset or liability at some future date under different economic or market conditions.

Statement 157 also establishes a fair value hierarchy that prioritizes the inputs that should be used to develop the fair value estimate. The fair value hierarchy prioritizes quoted prices in active markets for identical assets or liabilities (Level 1). In the absence of quoted prices in active markets for identical assets or liabilities, the fair value hierarchy allows for the use of valuation techniques (for example, pricing models) that incorporate a combination of other inputs. Those other inputs consist of observable inputs that are reasonably available in the circumstances, including quoted prices in markets for comparable assets or liabilities (Level 2), and unobservable inputs, including the reporting entity's own analysis of the underlying economic data that market participants would factor into the pricing of the asset or liability (Level 3).

The fair value hierarchy prioritizes observable inputs over unobservable inputs. By distinguishing between inputs that are observable in the marketplace and, therefore, more objective and those that are unobservable and, therefore, more subjective, the hierarchy is

designed to indicate the relative reliability of the fair value measures. When there is little or no market activity for comparable assets or liabilities at the measurement date (illiquid markets) or when information about transactions involving comparable assets or liabilities is not publicly disclosed, the fair value estimate might rely principally on unobservable inputs (Level 3 estimates). Like many other estimates used in financial reporting, Level 3 estimates can be difficult and require the use of significant judgments. However, as previously noted, many investors have stated that those estimates provide more relevant and useful information than alternatives that ignore current economic and market conditions.

To provide investors with enhanced information about a company's fair value estimates, Statement 157 requires new disclosures about the company's use of fair value measurements and their effects on the financial statements. Before Statement 157, a few of the accounting pronouncements that require fair value measurement also required disclosures about those measurements. Statement 157 significantly expands those disclosures. In general, under Statement 157, the new disclosures are based on the fair value hierarchy. Statement 157 requires a company to disclose (1) its fair value measures at each reporting date, (2) where in the fair value hierarchy the measurements were determined, and (3) a roll forward schedule of assets and liabilities carried at fair value using Level 3 inputs, and the amount of unrealized gains and losses not yet realized that are included in earnings. In addition, Statement 157 requires a company to annually disclose its valuation techniques and discuss any changes in those valuation techniques.

Statement 157 is a principles-based standard that requires the application of sound judgment in determining fair value estimates. Judgment is not new in accounting; however, the increased attention on fair value estimates and principles-based standards has increased focus on the use of judgment. In its final report to the SEC, CIFiR recommended that the SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments, including the factors that it considers when

making this evaluation. That recommendation also included a suggestion that the PCAOB should adopt a similar approach with respect to auditing judgments.[14]

**FASB Implementation Activities Relating to Fair Value Measurements**

A number of issues have been raised about fair value or mark-to-market accounting, including assertions by some that the use of fair value measurements in the current environment understates the "true" or "fundamental" value of financial assets, thereby overstating the extent of "true" losses. The Board acknowledges that there are significant challenges to estimating fair value, particularly in illiquid markets, requiring the gathering and analysis of relevant data and the exercise of sound judgment. Those challenges do not mean fair values should not be estimated and reported, supplemented by robust disclosures. The FASB is responding, as appropriate, to these issues and concerns. As part of its normal due process, the FASB monitors the implementation of new accounting standards in a number of ways, including ongoing discussions and consultations with the SEC, regulators, companies, auditors, and a variety of users. The FASB has been actively working with the SEC and the federal banking regulators to monitor the implementation of Statement 157 to determine if additional clarification or guidance is needed to improve the application of the standard. The FASB has also established the Valuation Resource Group ("VRG") to provide the Board with information about implementation issues on fair value measurements in financial reporting and the variety of viewpoints associated with those implementation issues. The VRG is composed of a cross-section of industry representatives, including financial statement preparers, auditors, users, and valuation experts. Representatives of the SEC, the PCAOB, the American Institute of Certified Public Accountants, and the International Accounting Standards Board ("IASB") also observe VRG meetings.

In addition, the FASB reviews publications and articles issued by users and others that discuss the fair value requirements and their use in financial reports. Companies and auditors submit questions to the staff via the FASB's technical inquiry process. The FASB Board and staff members meet at least quarterly with representatives from the

[14]CIFiR Final Report, Recommendation 3.5, page 13.

PCAOB and the SEC to discuss matters of mutual interest. Similar meetings also are held periodically with federal banking regulators.

Since the issuance of Statement 157, the Board and FASB staff have taken significant actions, addressing application issues relating to Statement 157 and other GAAP affected by the global financial crisis. First, after extensive consultations with participants in the capital markets on the application of fair value measurements in the current market environments, the SEC staff and the FASB staff jointly issued a news release in September 2008 to address a number of practice issues where there was a need for immediate additional guidance. That news release provided additional interpretative guidance to address fair value measurement questions that have been cited as most urgent in the current environment, including the valuation of Level 3 assets and valuations generally in distressed markets.[15]

Second, on October 10, 2008, the FASB issued additional guidance in the form of a FASB Staff Position ("FSP") to clarify the application of Statement 157 when markets are not active.[16] The guidance in the FSP is consistent with and amplifies the guidance in the September press release. The FSP clarifies the application of Statement 157 in three main areas:

1. When markets are dislocated, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. In other words, the determination of whether a particular price is forced or not should be made at the transaction level, not the market level. Proper consideration should be given as to how recent the transaction occurred and the volume of the transaction relative to the market for the item.
2. 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. Regardless of the valuation technique used, an entity must include appropriate

[15]See Attachment 3.
[16]See Attachment 4.

risk adjustments that market participants would make for credit and liquidity risks.

3. Broker (or pricing services) 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.

Third, in November and December 2008, the FASB, along with the IASB, held three public roundtables, one each in the United States, Asia and Europe, to discuss concerns arising from the global financial crisis. The roundtables were designed to provide members of the Boards with input from a wide range of stakeholders, including users and preparers of financial statements, governments, regulators, and others, to help the Boards identify accounting issues that may require urgent and immediate attention to improve financial reporting and help enhance investor confidence in financial markets. The Boards asked roundtable participants to identify broader financial reporting issues arising from the global financial crisis. Topics discussed at the roundtables included issues relating to the impairment of financial assets, fair value measurement, reclassification of financial instruments, disclosure issues relating to fair value and the impairment of financial instruments, and potential steps that could be taken to provide additional application guidance on issues arising in the current environment.

After considering the extensive input received during the roundtables, as well as after numerous consultations with constituents and U.S. regulatory agencies, on December 15, 2008, the Board decided to undertake four short-term projects to improve and simplify the accounting practices for financial instruments, focusing on improving the impairment models for investments in debt and equity securities and enhancements to the disclosures about certain financial instruments.[17]

- The first project resulted in the issuance of FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20.* This FSP is designed to achieve more consistent determination of whether other-than-temporary impairments have occurred to available-for-sale or

[17]See Attachment 5 for the news release on projects added to the FASB's agenda in December 2008.

held-to-maturity debt securities. When a security has been other-than-temporarily impaired, GAAP requires that the security be marked down to its fair value.

- The second project, FSP FAS 107-b and APB 28-a, would amend existing fair value disclosure requirements for financial instruments to require those disclosures on an interim basis.

- In addition to the two FSPs, the FASB is working on two other short-term projects to address issues about measurement and reporting of financial instruments. The first would clarify when embedded credit derivatives are not required to be recorded at fair value. The second would allow companies to reverse a previously recognized impairment charge through earnings for debt securities classified as held-to-maturity or available-for-sale when evidence exists that a recovery has occurred. The second project is being conducted jointly with the IASB.

Fourth, the FASB and the IASB decided to jointly undertake a project to consider broader improvements in the accounting for financial instruments. The Boards also established the Financial Crisis Advisory Group ("FCAG") to assist them in evaluating major issues to be addressed in this project, as well as consider various other reporting issues arising from the global financial crisis. Comprising recognized leaders in the fields of business and government, the FCAG's primary function is to advise the Boards on the standard-setting implications of the global financial crisis and potential changes to the global regulatory environment.[18] The FCAG will consider how improvements in financial reporting could help investor confidence in financial markets. The FCAG also will help identify significant accounting issues that require the Boards' urgent and immediate attention, as well as issues for longer-term consideration. In providing that advice, the FCAG will draw upon work already under way in various jurisdictions on accounting and the credit crisis, as well as information gathered from the FASB-IASB roundtables. To

[18]See Attachment 6 for a list of FCAG members.

date, the FCAG has held three meetings and plans to hold two or more additional meetings prior to issuing its final report in mid-2009.

Fifth, in response to the recommendations contained in the SEC Mark-to-Market Report, as well as input from the FASB's VRG and others, the Board recently added several projects to its agenda intended to improve the application guidance used to determine fair values and disclosure of fair value estimates.[19] The projects on application guidance will address determining when a market for an asset or liability is active or inactive; determining when a transaction is distressed; and applying fair value to interests in alternative investments, such as hedge funds and private equity funds. The project on improving disclosures about fair value measurements will consider requiring additional disclosures on such matters as sensitivities of measurements to key inputs and transfers of items between fair value measurement levels. The Board is devoting substantial staff resources to these projects and plans on completing the projects on application guidance by the end of the second quarter of 2009 and the project on improving disclosures in time for year-end 2009 reporting.

Sixth, over the past year the Board has issued new standards and additional guidance on various other issues relating to the financial crisis, including securitizations, special-purpose entities, financial guarantee insurance, and credit default swaps and other derivatives. The Board is currently completing deliberations on two projects to amend the existing accounting guidance for transfers of financial assets and consolidation of thinly capitalized (special-purpose) entities. The project on transfers of financial assets is intended to (1) address concerns about the use of off-balance-sheet entities, (2) simplify the guidance on accounting for transfers of financial assets, and (3) improve consistency and transparency in accounting for such transfers. The project on consolidation of thinly capitalized entities is intended to address concerns about the application of that guidance as a result of recent market events. Specifically, the Board is considering amendments that may (1) require companies to reconsider their involvements with thinly capitalized entities more frequently and (2) alter how companies determine whether they must

[19]See Attachment 7 for the news release on projects added to the FASB's agenda in February 2009.

consolidate a thinly capitalized entity. In conjunction with those projects, the Board issued an FSP in December 2008 to enhance disclosures about transfers of financial assets and companies' involvements with thinly capitalized entities.[20] Those disclosure requirements became effective at the end of 2008.

Finally, the Board is working with both the Financial Stability Forum and members of the "G20" on issues relating to concerns about the potential procyclical effect of fair value accounting on the capital position and balance sheets of financial institutions and companies.

**International Financial Reporting Standards**

In addition to the joint efforts with the IASB previously described, the IASB currently has been working on a fair value measurement project to consider fair value measurements broadly, focusing on the definition of fair value and the framework for measuring fair value.

As part of that effort, the IASB exposed Statement 157 for comment by its constituents. The IASB is now in the process of developing a standard that would be substantially convergent with Statement 157 and has also recently made changes to its disclosure requirements to parallel those of Statement 157.

**Conclusion**

For accounting standard setters, the fundamental question about fair value accounting is whether it provides investors with the relevant information with which to judge current and potential investments. Accounting standard setters focus on developing standards that help provide transparency in general-purpose financial statements of reporting enterprises that are used by investors and others in their decision making. The information needs of these parties often differ from that of prudential regulators, who are largely concerned with safety and soundness and financial stability.

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[20]FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (December 11, 2008).

Many investors, financial analysts, and others have indicated that fair value accounting has been instrumental in providing financial statement users with important information about the current values of a company's financial assets and with better and more timely information about the risks faced by financial institutions in the current environment. Calls for suspending or eliminating the fair value standards are misdirected. The standards are not the underlying cause of the write-downs in financial assets, but rather reflect the underlying problems with those assets. Now, more than ever, transparency is essential in bringing critical information to investors and the capital markets. Fair value accounting helps provide the transparency and comparability that are vital to investor confidence.

That is not to say that fair value is perfect or is the universal panacea. There are many challenging issues, particularly in illiquid markets. Mark-to-market works best in sound, active, liquid markets. Therefore, while it is in our collective interest to try to keep improving disclosures about and techniques for valuing items in illiquid markets, it also would be worthwhile for policymakers and regulators to take steps necessary to create sound markets. Sound markets require a proper infrastructure to facilitate the flow of information, ascertain price discovery, support the necessary clearing mechanisms, and allow for informed and knowledgeable market participants. Effective oversight and regulation are also key ingredients of sound markets, as are the exercise of appropriate due diligence by investors and proper risk management processes by financial institutions.

We understand that determining fair value in illiquid markets can be challenging and requires significant analysis and judgment to accomplish. To the extent legitimate issues are raised about our standards, we pledge to continue to work with our colleagues in the financial reporting and regulatory system to examine and address those issues and to continue to strive to improve accounting standards for the benefit of investors and the capital markets.

Thank you Mr. Chairman. I would be pleased to answer any questions you may have.

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

**Attachment 1**

**Summary and Introduction of FASB Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities***

**Summary and Introduction of FASB Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities***

## Summary

This Statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Those investments are to be classified in three categories and accounted for as follows:

- Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

This Statement does not apply to unsecuritized loans. However, after mortgage loans are converted to mortgage-backed securities, they are subject to its provisions. This Statement supersedes FASB Statement No. 12, Accounting for Certain Marketable Securities, and related Interpretations and amends FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, to eliminate mortgage-backed securities from its scope.

This Statement is effective for fiscal years beginning after December 15, 1993. It is to be initially applied as of the beginning of an enterprise's fiscal year and cannot be applied retroactively to prior years' financial statements. However, an enterprise may elect to initially apply this Statement as of the end of an earlier fiscal year for which annual financial statements have not previously been issued.

## Introduction

1. This Statement addresses the accounting and reporting for certain investments in debt securities and equity securities. It expands the use of fair value accounting for those securities but retains the use of the amortized cost method for investments in debt securities that the reporting enterprise has the positive intent and ability to hold to maturity.

2. This Statement was undertaken mainly in response to concerns expressed by regulators and others about the recognition and measurement of investments in debt securities, particularly those held by financial institutions. They questioned the

appropriateness of using the amortized cost method for certain investments in debt securities in light of certain trading and sales practices. Their concerns also were prompted by the existence of inconsistent guidance on the reporting of debt securities held as assets in various AICPA Audit and Accounting Guides. The AICPA's Accounting Standards Executive Committee (AcSEC) and the major CPA firms, among others, urged the Board to reexamine the accounting for certain investments in securities.

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

**Attachment 2**

**Summary of FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements***

**Summary of FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements***

This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

**Reason for Issuing This Statement**

Prior to this Statement, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. Moreover, that guidance was dispersed among the many accounting pronouncements that require fair value measurements. Differences in that guidance created inconsistencies that added to the complexity in applying GAAP. In developing this Statement, the Board considered the need for increased consistency and comparability in fair value measurements and for expanded disclosures about fair value measurements.

**Differences between This Statement and Current Practice**

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

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

This Statement emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, this Statement establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own

assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The notion of unobservable inputs is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In those situations, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity must not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

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

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

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

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

This Statement expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures

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

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

**How the Conclusions in This Statement Relate to the FASB's Conceptual Framework**

The framework for measuring fair value considers the concepts in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* Concepts Statement 2 emphasizes that providing comparable information enables users of financial statements to identify similarities in and differences between two sets of economic events.

The definition of fair value considers the concepts relating to assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*, in the context of market participants. A fair value measurement reflects current market participant assumptions about the future inflows associated with an asset (future economic benefits) and the future outflows associated with a liability (future sacrifices of economic benefits).

This Statement incorporates aspects of the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, as clarified and/or reconsidered in this Statement. This Statement does not revise Concepts Statement 7. The Board will consider the need to revise Concepts Statement 7 in its conceptual framework project.

The expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements (present and potential investors, creditors, and others) with information that is useful in making investment, credit, and similar decisions—the first objective of financial reporting in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises.*

**How the Changes in This Statement Improve Financial Reporting**

A single definition of fair value, together with a framework for measuring fair value, should result in increased consistency and comparability in fair value measurements.

The expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period.

The amendments made by this Statement advance the Board's initiatives to simplify and codify the accounting literature, eliminating differences that have added to the complexity in GAAP.

**Costs and Benefits of Applying This Statement**

The framework for measuring fair value builds on current practice and requirements. However, some entities will need to make systems and other changes to comply with the requirements of this Statement. Some entities also might incur incremental costs in applying the requirements of this Statement. However, the benefits from increased consistency and comparability in fair value measurements and expanded disclosures about those measurements should be ongoing.

**The Effective Date of This Statement**

This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year.

The provisions of this Statement should be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except as follows. The provisions of this Statement should be applied retrospectively to the following financial instruments as of the beginning of the fiscal year in which this Statement is initially applied (a limited form of retrospective application):

a. A position in a financial instrument that trades in an active market held by a broker-dealer or investment company within the scope of the AICPA Audit and Accounting Guides for those industries that was measured at fair value using a blockage factor prior to initial application of this Statement b. A financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in footnote 3 of Issue 02-3 prior to initial application of this Statement.

c. A hybrid financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in Statement 133 (added by Statement 155) prior to initial application of this Statement.

The transition adjustment, measured as the difference between the carrying amounts and the fair values of those financial instruments at the date this Statement is initially applied, should be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for the fiscal year in which this Statement is initially applied.

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

**Attachment 3**

**News Release, "SEC Office of the Chief Accountant and FASB Staff Clarifications On Fair Value Accounting"**

**FOR IMMEDIATE RELEASE** **2008-234**

## SEC OFFICE OF THE CHIEF ACCOUNTANT AND FASB STAFF CLARIFICATIONS ON FAIR VALUE ACCOUNTING

**Washington, D.C., Sept. 30, 2008** – The current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors, and users of financial information. The SEC's Office of the Chief Accountant and the staff of the FASB have been engaged in extensive consultations with participants in the capital markets, including investors, preparers, and auditors, on the application of fair value measurements in the current market environment.

There are a number of practice issues where there is a need for immediate additional guidance. The SEC's Office of the Chief Accountant recognizes and supports the productive efforts of the FASB and the IASB on these issues, including the IASB Expert Advisory Panel's Sept. 16, 2008 draft document, the work of the FASB's Valuation Resource Group, and the IASB's upcoming meeting on the credit crisis. To provide additional guidance on these and other issues surrounding fair value measurements, the FASB is preparing to propose additional interpretative guidance on fair value measurement under U.S. GAAP later this week.

While the FASB is preparing to provide additional interpretative guidance, SEC staff and FASB staff are seeking to assist preparers and auditors by providing immediate clarifications. The clarifications SEC staff and FASB staff are jointly providing today, based on the fair value measurement guidance in FASB Statement No. 157, *Fair Value Measurements* (Statement 157), are intended to help preparers, auditors, and investors address fair value measurement questions that have been cited as most urgent in the current environment.

* * *

**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. Further, in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to available observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs. The determination of fair value often requires significant judgment. In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside

other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.

**How should the use of "market" quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?**

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

**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.

**Can transactions in an inactive market affect fair value measurements?**

Yes. A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used (generally without adjustment). Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative. If they are orderly, transactions should be considered in management's estimate of fair value. However, if prices in an inactive market do not reflect current prices for the same or similar assets, adjustments may be necessary to arrive at fair value.

A significant increase in the spread between the amount sellers are "asking" and the price that buyers are "bidding," or the presence of a relatively small number of "bidding" parties, are indicators that should be considered in determining whether a market is inactive. The determination of whether a market is active or not requires judgment.

**What factors should be considered in determining whether an investment is other than-temporarily impaired?**

In general, the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred.

Determining whether impairment is other-than-temporary is a matter that often requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment. This includes an assessment of the nature of the underlying investment (for example, whether the security is debt, equity or a hybrid) which may have an impact on a holder's ability to assess the probability of recovery.

Existing U.S. GAAP does not provide "bright lines" or "safe harbors" in making a judgment about other-than-temporary impairments. However, "rules of thumb" that consider the nature of the underlying investment can be useful tools for management and auditors in identifying securities that warrant a higher level of evaluation.

To assist in making this judgment, SAB Topic 5M[1] provides a number of factors that should be considered. These factors are not all inclusive of the potential factors that may be considered individually, or in combination with other factors, when considering whether an other-than-temporary impairment exists. Factors to consider include the following:

- The length of the time and the extent to which the market value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events, which may influence the operations of the issuer such as changes in technology that impair the earnings potential of the investment or the discontinuation of a segment of the business that may affect the future earnings potential; or
- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

All available information should be considered in estimating the anticipated recovery period.

* * *

Finally, because fair value measurements and the assessment of impairment may require significant judgments, clear and transparent disclosures are critical to providing investors with an understanding of the judgments made by management. In addition to the disclosures required under existing U.S. GAAP, including Statement 157, the SEC's Division of Corporation Finance recently issued letters in March and September that are available on the SEC's Web site to provide real-time guidance for issuers to consider in enhancing the transparency of fair value measurements to investors. Additionally, the SEC staff and the FASB staff will continue to consult with capital market participants on issues encountered in the application of fair value measurements.

# # #

[1] AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* of the PCAOB Interim Auditing Standards also provide factors to consider when evaluating whether an impairment is other-than-temporary.

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

**Attachment 4**

**FASB Staff Position No. FAS 157-3,** ***Determining the Fair Value of a Financial Asset When the Market for that Asset Is Not Active***

**FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for that Asset Is Not Active***

**FASB STAFF POSITION**

**No. FAS 157-3**

**Title:** Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active

**Date Issued: October 10, 2008**

## Objective

1. This FASB Staff Position (FSP) clarifies the application of FASB Statement No. 157, *Fair Value Measurements,* in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

## Background

2. Statement 157 was issued in September 2006, and is effective for financial assets and financial liabilities for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application was encouraged. FSP FAS 157-2, *Effective Date of FASB Statement No. 157,* amended Statement 157 to delay the effective date of Statement 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

3. 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. Statement 157 also expands disclosures about fair value measurements, thereby improving the quality of

information provided to users of financial statements. Statement 157 does not require any new fair value measurements.

4. The FASB staff obtained extensive input from various constituents, including financial statement users, preparers, and auditors, on determining fair value in accordance with Statement 157. Many of those constituents indicated that the fair value measurement framework in Statement 157 and related disclosures have improved the quality and transparency of financial information.

5. However, certain constituents expressed concerns that Statement 157 does not provide sufficient guidance on how to determine the fair value of financial assets when the market for that asset is not active. Application issues include:

a. How the reporting entity's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist
b. How available observable inputs in a market that is not active should be considered when measuring fair value
c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.

6. The Office of the Chief Accountant of the SEC and the FASB staff jointly issued a press release on September 30, 2008, that addresses similar Statement 157 application issues. That press release provides financial statement users, preparers, and auditors with additional guidance useful in dealing with those issues. The guidance included in this FSP is consistent with and amplifies the guidance contained in that press release.

All paragraphs in this FSP have equal authority.
Paragraphs in bold set out the main principles.

## FASB Staff Position

### Scope

7. **This FSP applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157.**

8. **This FSP clarifies the application of Statement 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.**

9. Key existing principles of Statement 157 illustrated in the example include:

   a. 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.
   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. For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment. Regardless of the valuation technique used, an

[1] See paragraph 7 of Statement 157.
[2] Paragraph B6 of Statement 157 describes two present value techniques for determining fair value. The present value techniques differ in how they adjust for risk and in the type of cash flows they use.

entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.

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.

10. For recurring fair value measurements using significant unobservable inputs (Level 3), paragraph 32 of Statement 157 requires an entity to reconcile the beginning and ending balances, including separately presenting changes that occurred during the period that are attributable to transfers in and/or out of Level 3. For both recurring and nonrecurring fair value measurements using significant unobservable inputs (Level 3), paragraphs 32 and 33 of Statement 157 require an entity to describe the inputs and the information used to develop those inputs.[3]

## Amendment to Add an Illustrative Example to Statement 157

11. Statement 157 is amended as follows: [Added text is underlined.]

a. Paragraphs A32A–A32F and the heading preceding them are added as follows:

*Example 11—Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*

**Note**: The conclusions reached in this example are based on the assumed facts and circumstances presented. Other approaches to determining fair value may be appropriate. Also, this example assumes that the observable transactions considered in determining fair value were not forced liquidations or distressed transactions.

A32A. On January 1, 20X8, Entity A invested in a AA-rated tranche of a collateralized debt obligation security. The underlying collateral for the collateralized debt obligation security is unguaranteed nonconforming

[3] The Board observes that the SEC's Division of Corporation Finance issued letters in March 2008 and September 2008 for issuers to consider in enhancing the transparency of disclosures relating to fair value measurements.

residential mortgage loans. Prior to June 30, 20X8, Entity A was able to determine the fair value of the collateralized debt obligation security using a market approach valuation technique based on Level 2 inputs that did not require significant adjustment. The Level 2 inputs included:

a. Quoted prices in active markets for similar collateralized debt obligation securities with insignificant adjustments for differences between the collateralized debt obligation security that Entity A holds and the similar collateralized debt obligation securities
b. Quoted prices in markets that are not active that represent current transactions for the same or similar collateralized debt obligation securities that do not require significant adjustment based on unobservable inputs.

A32B. Since June 30, 20X8, the market for collateralized debt obligation securities has become increasingly inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which collateralized debt obligation securities trade and then by a significant decrease in the volume of trades relative to historical levels as well as other relevant factors. At September 30, 20X8 (the measurement date), Entity A determines that the market for its collateralized debt obligation security is not active and that markets for similar collateralized debt obligation securities (such as higher-rated tranches within the same collateralized debt obligation security vehicle) also are not active. That determination was made considering that there are few observable transactions for the collateralized debt obligation security or similar collateralized debt obligation securities, the prices for those transactions that have occurred are not current, and the observable prices for those transactions vary substantially either over time or among market makers, thus reducing the potential relevance of those observations. Consequently, while Entity A appropriately considers those observable inputs, ultimately, Entity A's collateralized debt obligation security will be classified within Level 3 of the fair value hierarchy because Entity A determines that significant adjustments using unobservable inputs are required to determine fair value at the measurement date.

A32C. Entity A determines that an income approach valuation technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates, which would now require significant adjustments.[21a] Specifically, Entity A uses the discount rate adjustment technique described in Appendix B of Statement 157 to determine fair value.

A32D. Entity A determines that the appropriate discount rate[21b] used to discount the contractual cash flows[21c] of its collateralized debt obligation security is 22 percent after considering the following:

a. The implied rate of return at the last date on which the market was considered active for the collateralized debt obligation security was 15 percent. Based on an analysis of available observable inputs for mortgage-related debt securities, Entity A determines that market rates of return generally have increased in the marketplace since the last date on which the market was considered active for the collateralized debt obligation security. Entity A estimates that credit spreads have widened by approximately 100 basis points and liquidity risk premiums have increased during that period by approximately 400 basis points. Other risks (for example, interest rate risk) have not changed. Using this information, Entity A estimates that an indication of an appropriate rate of return for the collateralized debt obligation security is 20 percent.[21d] In making that determination, Entity A considered all available market information that could be obtained without undue cost and effort. For this collateralized debt obligation security, the available market information used in assessing the risks in the security (including nonperformance risk [for example, default risk and collateral value risk] and liquidity risk) included:
    (1) Quoted prices that are not current for the same or similar collateralized debt obligation securities
    (2) Relevant reports issued by analysts and ratings agencies
    (3) The current level of interest rates and any directional movements in relevant indexes, such as credit risk indexes
    (4) Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates
    (5) Other relevant observable inputs.
b. Two indicative quotes (that is, nonbinding quotes) for the collateralized debt obligation security from brokers imply a rate of return of 23 percent and 27 percent. The indicative quotes are based on proprietary pricing models utilizing significant unobservable inputs (that is, Level 3 inputs), rather than actual transactions.

A32E. Because Entity A has multiple indications of the appropriate rate of return that market participants would consider relevant in estimating fair value, it evaluates and weighs, as appropriate, the respective indications of the appropriate rate of return, considering the reasonableness of the range indicated by the results. Entity A concludes that 22 percent is the point within the range of relevant inputs that is most representative of fair value in the circumstances. Entity A placed more weight on the 20 percent estimated rate of return (that is, its own estimate) because (a) the indications of an appropriate rate of return provided by the broker quotes were nonbinding quotes based on the brokers' own models using significant unobservable inputs, and (b) Entity A was able to corroborate some of the inputs, such as default rates, with relevant observable

market data, which it used to make significant adjustments to the implied rate of return when the market was last considered active.

A32F. In accordance with the requirements of Statement 157, Entity A determines that the risk-adjusted discount rate appropriately reflects the reporting entity's estimate of the assumptions that market participants would use to estimate the selling price of the asset at the measurement date. Risks incorporated in the discount rate include nonperformance risk (for example, default risk and collateral value risk) and liquidity risk (that is, the compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions).

[21a] See paragraphs 20 and 21 of Statement 157.
[21b] See paragraphs B7–B11 of Statement 157.
[21c] The discount rate adjustment technique described in paragraphs B7–B11 of Statement 157 would not be appropriate when determining whether the change in fair value results in an impairment and/or necessitates a change in yield under EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," because that technique uses contractual cash flows rather than cash flows expected by market participants.
[21d] Calculated as the 15 percent implied rate of return at the last date on which the market was considered active, plus the increase in (a) credit spreads of 100 basis points (1 percent) and (b) liquidity risk premiums of 400 basis points (4 percent).

## Effective Date and Transition

12. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, *Accounting Changes and Error Corrections,* paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application.

The provisions of this FSP need not be applied to immaterial items.

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

**Attachment 5**

**News Release, "FASB Issues First of Two Proposed Staff Positions to Improve the Financial Reporting for Financial Instruments"**

## NEWS RELEASE 12/19/08

# *FASB Issues First of Two Proposed Staff Positions to Improve the Financial Reporting for Financial Instruments*

***Exposure documents are first steps in a series of short- and long-term improvements planned by the FASB***

**Norwalk, CT, December 19, 2008**—The Financial Accounting Standards Board (FASB) today issued the first of two proposed FASB Staff Positions (FSPs) intended to address concerns arising from the current financial crisis relating to accounting for financial instruments. Proposed FSP EITF 99-20-a, *Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue No. 99-20,* is available for review and comment by constituents until December 30, 2008. Additionally, proposed FSP FAS 107-a, *Disclosures about Certain Financial Instruments,* will be issued in the following week and constituents have until January 15, 2009 to review and provide comments.

The proposed FSPs represent two of four short-term projects announced by FASB Chairman Robert H. Herz at the December 15th Board meeting that are intended to improve and simplify current practices for accounting for financial instruments. Progress on the remaining projects—*Clarification of the Embedded Credit Derivative Scope Exception in Paragraph 14B of Statement 133* and *Recoveries of Other-Than-Temporary Impairments (Reversals)*—will be made in the coming weeks. In addition to these short-term efforts, Mr. Herz announced that the Board added to its technical agenda a comprehensive joint project with the International Accounting Standards Board (IASB) to address the complexity in existing standards of accounting and reporting for financial instruments. These actions were determined by the Board following extensive input received during the recent roundtables on the global financial crisis held with the IASB, and other input and discussions with constituents.

"Regaining investor confidence during this global credit crisis requires both immediate action and a plan for long-term improvement in the accounting for financial instruments," said Mr. Herz. "By issuing these proposed FSPs, the FASB is taking immediate steps to reduce complexity and make the accounting for these instruments easier to understand."

Proposed FSP EITF 99-20-a would amend the impairment guidance in EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets.* It is intended to reduce complexity and thus achieve more consistent determinations of whether other-than-temporary impairments of available-for-sale or held-to-maturity debt securities have occurred. Proposed FSP FAS 107-a would amend the disclosure requirements in FASB Statement No. 107, *Disclosures about Certain Financial Instruments,* to increase the comparability of certain financial instruments that are economically similar but have different measurement attributes.

The **proposed FSP** is available for review at **www.fasb.org**.

**About the Financial Accounting Standards Board**

Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information. For more information about the FASB, visit our website at www.fasb.org

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

**Attachment 6**

**News Release, "IASB and FASB Announce Membership of Financial Crisis Advisory Group"**

## NEWS RELEASE 12/30/08

## *IASB and FASB Announce Membership of Financial Crisis Advisory Group*

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) today announced the membership of the Financial Crisis Advisory Group (FCAG). The FCAG is the high-level advisory group set up by the boards to consider financial reporting issues arising from the global financial crisis. The group includes recognised leaders from the fields of business and government with a broad range of experience in international financial markets.

As previously announced, the FCAG will be jointly chaired by Harvey Goldschmid, former Commissioner, US Securities and Exchange Commission (US SEC), and Hans Hoogervorst, Chairman, AFM (the Netherlands Authority for the Financial Markets). Membership of the FCAG is as follows:

**John Bogle**, Founder, Vanguard, United States
**Jerry Corrigan**, Goldman Sachs and former President of the New York Federal Reserve Bank, United States
**Fermin del Valle**, former President, IFAC, Argentina
**Jane Diplock,** Chairman, IOSCO Executive Committee, New Zealand
**Raudline Etienne**, Chief Investment Officer, New York State Common Retirement Fund
**Stephen Haddrill**, Director General, Association of British Insurers, UK
**Toru Hashimoto**, former Chairman, Deutsche Securities Limited, Japan
**Nobuo Inaba**, former Executive Director, Bank of Japan, Japan
**Gene Ludwig**, former Comptroller of the Currency, United States
**Yezdi Malegam**, Board Member, National Reserve Bank of India, India
**Klaus-Peter Müller**, Chairman of the Supervisory Board, Commerzbank, Germany
**Don Nicolaisen**, former Chief Accountant, US Securities and Exchange Commission, United States
**Wiseman Nkuhlu**, Chairman of the Audit Committee, AngloGold Ashanti; former Economic Advisor to the President of the Republic of South Africa
**Tommaso Padoa-Schioppa**, former Finance Minister, Italy
**Lucas Papademos**, Vice-President, European Central Bank
**Michel Prada**, former Chairman, Autorité des marchés financiers, France

**Observers:**

**Basel Committee of Banking Supervisors**
**Committee of European Securities Regulators**
**International Association of Insurance Supervisors**
**Japan Financial Services Agency**
**US Securities and Exchange Commission**
**Nelson Carvalho, IASB SAC Chairman, Brazil**
**Dennis Chookaszian, Chairman, FASAC, United States**

Recommendations from the advisory group will be jointly considered by the two boards. Any decisions to act upon the recommendations will be subject to appropriate and thorough due process.

Commenting on the announcement, Harvey Goldschmid, joint Chairman of the FCAG said:

> I am grateful to the members of the Financial Crisis Advisory Group for agreeing to participate in this critically important initiative. There is much to be considered and we will proceed as quickly as possible with an understanding these are complex issues with large public policy stakes and many interdependencies. There are likely to be few quick fixes.

Hans Hoogervorst, joint Chairman of the FCAG said:

The Financial Crisis Advisory Group has an important role to play in assisting the two boards with their deliberations. The diversity and seniority of the group will help to ensure that any enhancements to financial reporting are considered in the context of the broader financial system and measured against a benchmark of enhancing investor confidence.

**END**

**Press inquiries:**

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***Notes for editors***

**About the IASB**

The IASB was established in 2001 and is the standard-setting body of the International Accounting Standards Committee (IASC) Foundation, an independent private sector, not-for profit organisation. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that provide high quality transparent and comparable information in general purpose financial statements. In pursuit of this objective the IASB conducts extensive public consultations and seeks the co-operation of international and national bodies around the world. Its 14 members (12 of whom are full-time) are drawn from nine countries and have a variety of professional backgrounds. They are appointed by and accountable to the Trustees of the IASC Foundation, who are required to select the best available combination of technical expertise and diversity of international business and market experience.

**About the Financial Accounting Standards Board**

Since 1973, the US Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information. For more information about the FASB, visit its Website at www.fasb.org.

**Overview of the Financial Crisis Advisory Group**

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have a long-standing commitment to work together in an internationally coordinated manner on improving financial reporting standards. As part of that commitment, accounting issues emerging from the global crisis will be considered by both boards. The boards have established this advisory group comprising senior leaders with broad international experience of financial markets to assist in that important process.

The primary function of the advisory group is to advise the boards about standard-setting implications of (1) the global financial crisis and (2) potential changes to the global regulatory environment. The group will conclude its activities within approximately six months (or less) and will conduct advisory meetings during that time.

**Areas within the Advisory Group's purview**

The advisory group will consider how improvements in financial reporting could help enhance investor confidence in financial markets. It also will help identify significant accounting issues that require urgent and immediate attention by the boards, as well as issues for longer-term consideration.

In providing that advice, the advisory group will draw upon work already underway in various jurisdictions on accounting and the credit crisis, as well as information gathered from the public round tables—one each in Asia, Europe, and North America—that the boards hosted in November and December.

The advisory group is invited to discuss, among other issues, the following:

Areas where financial reporting helped identify issues of concern during the credit crisis.
Areas where financial reporting standards could have provided more transparency to help either anticipate the crisis or respond to the crisis more quickly.
Whether priorities for the IASB and the FASB should be reconsidered in light of the credit crisis.
Potential areas that require future attention of the IASB and the FASB in order to avoid future market disruption.
The implications of the credit crisis for the interaction between general purpose financial reporting requirements for capital markets and the regulatory reporting, particularly for financial institutions.
The relationship between fair value and off balance sheet accounting and the current crisis, both during and leading up to the crisis.
The findings and relevance of conclusions of various studies underway, including the US Securities and Exchange Commission's study under the Emergency Economic Stabilization Act of 2008.
The need for due process for accounting standard-setters and its implications on resolving emergency issues on a timely and inclusive basis.
The independence of accounting standard-setters and governmental actions to the global financial crisis.

**Advisory Group Structure and Meetings**

The advisory group is chaired jointly by two co-chairs—one from each of Europe and North America. The advisory group comprises senior leaders with broad experience of international financial markets and an interest in the transparency of financial reporting information. Depending on the needs of the advisory group, subcommittees may be formed to consider various issues.

In order to provide the boards and others in the financial reporting system with the benefits of its advice, the advisory group will generally meet in public sessions, with Webcasting facilities available to all interested parties. The advisory meetings also may involve private sessions, at the discretion of the co-chairs.

The advisory group meetings will be held in London and New York on a rotating basis. The first meeting will be in January 2009. Staff support for the advisory group is provided by the IASB and FASB. Also, advisory members are entitled to be reimbursed for actual out-of-pocket travel expenses incurred in connection with advisory group meetings as they may request if it is their employer's policy not to provide reimbursement for such costs.

**Conduct of its activities**

Advisory group meetings are the primary mechanism that will be used to provide input to the IASB and FASB. The advisory group's role is not to reach a consensus or to vote on the issues that it considers at its meetings. For that reason, it is important to convene the advisory members as a group so that the boards can hear the individual members' views and members can hear and respond to each other's views.

The IASB and the FASB will provide the staff to document and communicate the input from the advisory group.

**Testimony of**

**Robert H. Herz**

**Chairman**

**Financial Accounting Standards Board**

**before the**

**U.S. House of Representatives Financial Services Subcommittee**

**On Capital Markets, Insurance, and Government Sponsored Entities**

**March 12, 2009**

**Attachment 7**

**News Release, "FASB Initiates Projects to Improve Measurement and Disclosure of Fair Value Estimates"**

## NEWS RELEASE 02/18/09

## *FASB Initiates Projects to Improve Measurement and Disclosure of Fair Value Estimates*

**Norwalk, CT, February 18, 2009**—Robert H. Herz, Chairman of the Financial Accounting Standards Board (FASB), today announced the addition of new FASB agenda projects intended to improve (1) the application guidance used to determine fair values and (2) disclosure of fair value estimates. The projects were added in response to recommendations contained in the Securities and Exchange Commission's (SEC) recent study on mark-to-market accounting, as well as input provided by the FASB's Valuation Resource Group, a group of valuation and accounting professionals who provide the FASB staff and Board with information on implementation issues surrounding fair value measurements used for financial statement reporting purposes.

"The SEC expressed continued support of fair value accounting in its study, but recommended consideration of potential improvements in the guidance surrounding the application of fair value principles," stated Chairman Herz. "We agree with the SEC and with our Valuation Resource Group that more application guidance to determine fair values is needed in current market conditions. Additionally, investors have asked for more information and disclosure about fair value estimates. Therefore, the FASB is immediately embarking on projects that directly address areas that constituents have told us are challenging in the current environment, and which will improve disclosures in financial reports."

The fair value projects address both application and disclosure guidance:

> The projects on application guidance will address determining when a market for an asset or a liability is active or inactive; determining when a transaction is distressed; and applying fair value to interests in alternative investments, such as hedge funds and private equity funds.
> The project on improving disclosures about fair value measurements will consider requiring additional disclosures on such matters as sensitivities of measurements to key inputs and transfers of items between the fair value measurement levels.

The FASB anticipates completing projects on application guidance by the end of the second quarter of 2009, and the project on improving disclosures in time for year-end financial reporting. The FASB has also recently proposed enhanced disclosures in interim reports relating to the fair values of financial instruments. (Proposed FASB Staff Position (FSP) FAS 107-b and APB 28-a is available at **http://www.fasb.org/fasb_staff_positions/prop_fsp_fas107-b&apb28-a.pdf**).

As previously announced, the FASB has also commenced work with the International Accounting Standards Board (IASB) on a more comprehensive project to improve, simplify, and converge the accounting for financial instruments. The Boards are obtaining input on that project from a number of sources, including the senior-level Financial Crisis Advisory Group that has been formed to assist the FASB and the IASB in evaluating financial reporting issues emanating from the global financial crisis.

The SEC study, entitled *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, was issued to Congress by the SEC's Office of the Chief Accountant and Division of Corporate Finance on December 30, 2008, as mandated by the Emergency Economic Stabilization Act of 2008. The 211-page report recommended against suspension of fair value accounting standards, and instead recommended specific improvements to existing practice. The report reaffirms that investors generally believe fair value accounting increases financial reporting transparency, and that the information it provides helps result in better investment decision-making. (The report is available at **http://www.sec.gov/news/studies/2008/marktomarket123008.pdf**.)

The FASB Valuation Resource Group met on February 5, 2009 to provide input on fair value issues to the Board. The group was formed in June 2007, as a result of feedback received from constituents calling for

the Board to address issues relating to valuation for financial reporting. More information about the VRG and its members is available at **http://www.fasb.org/project/valuation_resource_group.shtml#background**.

**About the Financial Accounting Standards Board**

Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information. For more information about the FASB, visit our website at www.fasb.org.

# TESTIMONY

**of**

**WILLIAM M. ISAAC**

**CHAIRMAN, THE SECURA GROUP OF LECG**
**FORMER CHAIRMAN,**
**FEDERAL DEPOSIT INSURANCE CORPORATION**

**before the**

**SUBCOMMITTEE ON CAPITAL MARKETS,**
**INSURANCE, AND GOVERNMENT**
**SPONSORED ENTERPRISES**

**U.S. HOUSE OF REPRESENTATIVES**
**COMMITTEE ON FINANCIAL SERVICES**
**WASHINGTON, DC**

**March 12, 2009**

Thank you Chairman Kanjorski, Ranking Member Garrett, and Members of the Committee for conducting this very important hearing on mark-to-market (MTM) accounting.

I use the term "mark to market accounting," rather than "fair value accounting." Everyone's goal is a fair and descriptive accounting system. There is nothing "fair" about the misleading and destructive accounting regime promoted by the Securities and Exchange Commission and the Financial Accounting Standards Board under the rubric "fair value accounting."

MTM accounting has destroyed well over $500 billion of capital in our financial system. Because banks are able to lend up to ten times their capital, MTM accounting has also destroyed over $5 trillion of lending capacity, contributing significantly to a severe credit contraction and an economic downturn that has cost millions of jobs and wiped out vast amounts of retirement savings on which millions of people were counting.

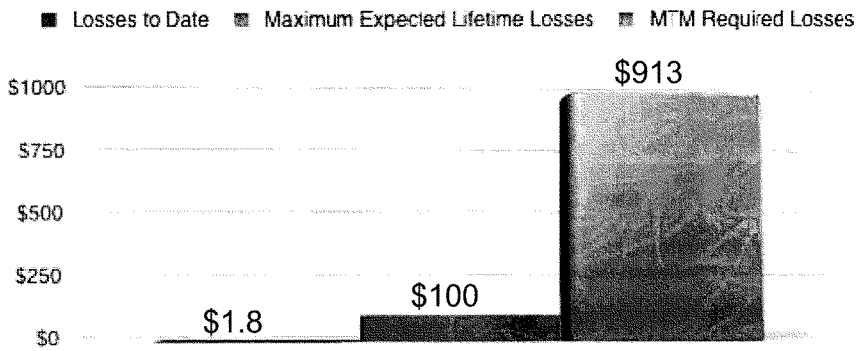
Taxpayers have been called upon to invest in our financial institutions to help repair the damage caused by MTM accounting. Congress has authorized $700 billion, and the FDIC is now asking for up to $500 billion more.

We should not be misled by those who argue that MTM is having little impact. The chart on the next page shows quite graphically the severe negative impact MTM accounting is having – nearly a billion dollars of capital was destroyed ***in just one mortgage backed security pool held in just one bank***.

# Mark to Market Accounting
# Expected Losses vs. Mark to Market Write-downs

Below is an example of the distortion that occurs when using mark to market (MTM) accounting. This example involves an actual case study from an anonymous bank that made loans and securitized them as a mortgage backed security (MBS). Expected losses and expected cash flows for the MBS differ dramatically from MTM write downs. ***The Bank is required to record MTM losses of $913 million as opposed to the maximum expected lifetime losses of $100 million, resulting in a significant overstatement of losses and having a negative impact on tangible common equity.***

**Losses on MBS Held By Bank**
(In Millions)




MBS description:

- The Bank holds a pool of MBS totaling $3.65 billion as of December 31, 2008.
- The underlying loans are not sub-prime and are generally quality loans (average of approximately 17 months of seasoning, original FICO scores of 749, and original loan-to-value ratio of 73%).

Losses based on MTM:

- The MBS has subordinated collateral of $172 million. ***The amount of subordinated collateral exceeds the worst-case loss projections, which means the Bank does not expect to incur any losses on its senior MBS positions (positions that MTM rules have required be written down by $913 million).***
- The MTM write-down required on this pool is more than nine times the maximum estimated lifetime losses.

As you might know, I opposed enactment of the $700 billion Troubled Asset Relief Program (TARP) enacted last fall. I did not believe the purchase of troubled assets from the banks would work, and I believed the program would cost taxpayers dearly if implemented.

Beyond my skepticism about the efficacy of purchasing toxic assets from banks, I felt we should first attempt to resolve the problems in our financial system in ways that would not require massive outlays by taxpayers. Immediate suspension of a MTM accounting rule known as SFAS 157 was my highest priority, as we needed to stop the senseless destruction of bank capital. I believe firmly that if the SEC and FASB had suspended this MTM rule nine months ago – in favor of marking these assets to their true economic valued based on actual and projected cash flows – our financial system and economy would not be in anywhere near the crisis that they are in today. Anyone who doubts this conclusion should study the chart on the previous page more closely. While it is way late to be effecting these changes in MTM, late is much better than never as many more MTM write-downs remain to be taken.

I was Chairman of the FDIC during the banking crisis of the 1980s. The problems in the U.S. financial system in the 1980s, despite what we are hearing from some government leaders and the media, were more serious than we are facing thus far today.

**A. Background.** One of the many problems we faced during the 1980s was the massive insolvency of thrift institutions (*i.e.,* savings banks insured by the FDIC and S&Ls insured by the former Federal Savings & Loan Insurance Corporation) due to their holdings of long-term, fixed-rate mortgages and bonds during a time of very high interest

rates. Ironically, MTM accounting had surface appeal to me during this period, as I thought it might in the future force banks and thrifts to keep the maturities of their assets and liabilities in better balance.

I asked the FDIC staff to consider whether we should push for MTM accounting, and we solicited comments and studied the issue for the better part of a year. We rejected MTM accounting for three principal reasons.

First, MTM accounting could be implemented on only a portion of the asset side of the balance sheet (*i.e.,* marketable securities) – it was daunting to even contemplate how to mark to market the liability side. We could not see a significant benefit in marking to market only a portion of one side of bank balance sheets – and to attempt to do so would produce very misleading results. For example, an increase in interest rates would drive down the value of government bonds on the asset side. But that same increase in rates could well make floating rate loans more profitable and would make checking and savings accounts and fixed-rate CDs on the liability side of the balance sheet more valuable funding sources. A system that captured one change in value without picking up the other would be very misleading to investors. Moreover, MTM accounting does not even purport to measure operating results in business units.

Second, we believed that MTM accounting would make it very difficult for banks to perform their fundamental function in our economy, which is to convert relatively short-term money from depositors into longer-term loans for businesses and consumers. Banks necessarily have some mismatch in the maturities of their assets and liabilities -- it is up to bank management, regulators, and investors to make sure the mismatch is not

excessive. Accounting rules made to influence behavior are no substitute for good judgment and can interfere with appropriate business conduct.

Third, we felt that MTM accounting would be pro-cyclical (which is never a good thing in bank regulation) and would make it very difficult for regulators to manage future banking crises. In order to better understand this concern, it is useful to consider the economic climate and banking problems of the 1980s.

The underlying economic problems of the 1980s in the U.S. were more serious than the economic problems confronting us this time around – at least so far. The prime rate exceeded 21%, and the economy plunged into a deep recession in 1981-82, with the agricultural sector in a depression. Unemployment approached 11%.

These economic problems led to massive problems in the banking and thrift industries. The savings bank industry was more than $100 billion insolvent if we had valued it on a market basis, and the S&L industry was in similar condition. A bubble burst in the energy sector, and a rolling real estate recession hit one region after another. Continental Illinois (the seventh largest bank) failed, many of the large regional banks went down (including nine of the ten largest banks in Texas), and hundreds of farm banks failed, as did an even larger number of thrifts. Three thousand banks and thrifts failed from 1980 through 1991, and many others went out of business through mergers.

It could have been much worse. The money center banks were loaded up with third world debt that was valued in the markets at cents on the dollar. If we had marked those loans to market prices, virtually every one of our money center banks would have been insolvent. We instead marked them to our estimate of their true economic value.

**B. Today's problems.** At the outset of the current crisis in the financial and credit markets, we had no serious economic problems. Inflation was under control, economic growth was good, unemployment was low, and there were no major credit problems in the banking system.

The dark cloud on the horizon was about $1.2 trillion of subprime mortgages (most had been securitized), about $200 billion to $300 billion of which were believed to be held by FDIC-insured banks and thrifts. The rest were spread throughout the world.

The likely losses on these assets were estimated by regulators to be roughly 20%. Losses of this magnitude would have caused pain for banks that held the assets, but would have been quite manageable, particularly for an industry that had after-tax earnings of roughly $150 billion in 2006 and had capital of $1.4 trillion.

How did we let this serious but manageable situation get so far out of hand – to the point where several of our most respected American financial companies have been put out of business, sometimes involving massive government bailouts?

People are assigning blame for the underlying problems – greed, inept regulation, rating agency incompetency, faulty monetary policy, unregulated mortgage brokers, and too much government emphasis on creating housing stock, particularly for lower income borrowers.

I believe one of the biggest culprits is MTM accounting. MTM rules dictate that financial institutions holding financial instruments available for sale (such as mortgage-backed securities, preferred stock, and bonds) must mark those assets to market. That

might sound reasonable if you ignore every other moving part in bank financial statements and the fundamental nature of the banking business.

What do we do when the markets for those assets, which might be thin in the best of times, freeze up and only a handful of sales occur at extremely depressed prices? The answer until recently from the SEC and FASB has been: mark the assets to market even though there is no meaningful market. The accounting profession, scarred by decades of costly litigation, keeps forcing banks to mark down the assets as fast and far as possible.

This is contrary to everything we know about bank regulation. When there are temporary impairments of asset values due to economic and marketplace turmoil, regulators must give institutions an opportunity to survive the temporary impairment. Permanent impairments should be recognized, but assets should not be marked to unrealistic fire-sale prices. Regulators must evaluate the assets on the basis of their true economic value over a reasonable time horizon.

If we had followed today's approach during the 1980s, we would have nationalized nearly all of the largest banks in the country and thousands of additional banks and thrifts would have failed. I have little doubt that the country would have gone from a serious recession into a depression.

Some advocates of MTM accounting gasp at the thought of suspending the rules. They assume it would result in a loss of transparency and an overstatement of values.

Quite to the contrary, it is the use of MTM accounting, when markets are not functioning properly, that has produced terribly misleading accounting and disclosures that value assets well below their true economic value.

If SFAS 157 were suspended, bank management, auditors, and regulators should be charged with valuing the affected assets the same way they value all the other assets on the books of banks. They should consider the cash flows on the assets, the likelihood the assets will go into default, and the probable losses in the event of default. This analysis will improve our valuations and disclosures, not obscure them. The markets are terribly confused about values today because no one – not the accountants, not the regulators, and not the rating agencies – is providing serious analysis of the true economic value of the assets. Instead, the assets are being marked down to whatever the computer screen says is their value, based on what short sellers and other speculators would like the value to be.

**C. Alternatives.** Can we have a system that reflects market pricing without eradicating earnings and masses of capital when the markets are in disarray? I believe the historical-cost accounting model, which is the cornerstone of Generally Accepted Accounting Principles, accomplished these objectives exceptionally well for many decades before we decided to experiment with MTM accounting.

Under historical-cost accounting, marketable assets are carried on the books of banks at their amortized cost, and the balance sheet contains tables showing the current market value of those portfolios. This gives investors the information they need to evaluate the adequacy of a bank's capital and its future earnings power. If a decline in market value is significant in relationship to capital and if the investor/rating agency believes the situation is not likely to reverse itself any time soon, they will discount the bank's future earnings, credit ratings, and stock and bond prices.

The historical-cost system does not run the market depreciation through the profit and loss statement and does not deplete capital (unless the diminution in value is considered permanent). Moreover, this system does not value one portion of the balance sheet without regard to the rest of the balance sheet. In short, it presents a far more accurate and holistic financial picture of a bank than today's destructive and misleading system of accounting.

**D. Who Makes the Rules?** The current world-wide crisis in the financial system demonstrates conclusively that major principles of accounting are much too important to be left solely to accountants. Accounting standards today are set by the FASB, a five-member board that is shrouded in mystery. The SEC has authority to overrule the FASB for public companies, but almost never does – at least not publicly. The result is a system of accounting that is not accountable.

The rule making process is cumbersome, often slow, and incapable of responding to rapidly changing marketplace and economic conditions. The SEC proposes to make a bad system even worse by putting our fate in the hands of an international accounting standards board that will be even less accountable and more cumbersome.

I believe we urgently need to change our system of setting accounting standards. I note that H.R. 1349 would grant authority for setting accounting standards to a five-member board (Public Accounting Oversight Board) consisting of the Chairs of the Federal Reserve, the SEC, the FDIC, and the PCAOB plus the Secretary of the Treasury. This approach has much to commend it, as it would involve directly the agencies that have primary responsibility for maintaining a sound economy and financial system.

You will no doubt hear from the SEC and FASB that you should not politicize the process of setting accounting standards. I agree with that general proposition, although it is difficult to resist political action when the SEC and FASB are sitting on their hands in the midst of a world-wide financial crisis they played such a large role in creating. I believe a Board along the lines suggested in H.R. 1349 will ensure that not only will we approach accounting standards with objectivity, we will bring to bear the vast experience of those who are charged with maintaining a strong economy and financial system.

We would not have gone down the destructive path of MTM accounting had something like this Board been in place in the early 1990s when the SEC and FASB were first considering their experiment with MTM accounting. The Secretary of the Treasury and the Chairmen of the Federal Reserve and FDIC wrote letters urging against adoption of MTM accounting. They cited the experience in the Great Depression when bank regulators were requiring MTM accounting on bank investment portfolios. In 1938, the Secretary of the Treasury, under the direction of President Roosevelt, worked with bank regulators to abandon MTM accounting in order to encourage banks to resume lending and help lead us out of the Depression. They concluded that the pro-cyclical nature of MTM accounting had kept our nation in a downward economic spiral for eight years.

Secretary of the Treasury Nicholas Brady was particularly prescient in his March 24, 1992 letter to the Chairman of the FASB: "[MTM] could . . . result in more intense and frequent credit crunches, since a temporary dip in asset prices would result in immediate reductions in bank capital and an inevitable retrenchment in bank lending capacity. Finally, it is inappropriate to apply [MTM] accounting to only a portion of a

bank's balance sheet, as would the FASB proposal. . . . This . . . could exacerbate the public's perception of systemic financial instability even when the industry's underlying businesses are solid."

Before closing, I want to bring up two subjects that are not under the heading of MTM accounting. The SEC made what I consider a huge mistake in 1999 when it took an enforcement action against SunTrust Bank for what the SEC believed to be the creation of excess loan loss reserves, thereby manipulating earnings. It is extremely important that bank regulation be counter-cyclical, not pro-cyclical. The time for banks to create reserves for losses is when the sun is shining, not in the middle of a hurricane.

It is not sound public policy to discourage banks from creating reserves during good times when they can best afford the hit to earnings. I certainly wish our banks had been encouraged to build more reserves over the past decade rather than reporting higher earnings. If H.R. 1349 is enacted, I hope the new Board will change this pro-cyclical and unsound reserving policy.

Finally, I want to mention the Uptick Rule, which the SEC repealed in 2007 and has refused to reinstate despite many calls for it to do so. The Uptick Rule was put in place in 1938 by the first Chairman of the SEC, Joseph P. Kennedy. The Rule provides that a short sale may be made only at a price higher than the previous transaction in that security. The purpose of the Rule is to make it more difficult for short sellers to gang up on a stock and beat it down to unreasonably low levels. There is no question in my mind that the absence of this and other regulations on short sellers has caused widespread

destruction of the values of securities and undermined confidence in our financial system. I believe Congress should require the SEC to reinstate the Uptick Rule immediately.

I thank you for giving me this opportunity to be heard on these very important issues.

# TESTIMONY
# OF

**JAMES KROEKER, ACTING CHIEF ACCOUNTANT**
**U.S. SECURITIES AND COMMISSION**

**CONCERNING**

# MARK–TO-MARKET ACCOUNTING: PRACTICES AND IMPLICATIONS

**BEFORE THE**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**COMMITTEE ON FINANCIAL SERVICES**

**U.S. HOUSE OF REPRESENTATIVES**

**March 12, 2009**

**U.S. Securities and Exchange Commission**
**100 F Street, NE**
**Washington, D.C. 20549**

**Testimony Concerning Mark-to-Market Accounting: Practices and Implications**

*James L. Kroeker*
*Acting Chief Accountant*
*U.S. Securities and Exchange Commission*

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the House Committee on Financial Services

March 12, 2009

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee:

I am Jim Kroeker, Acting Chief Accountant in the Office of the Chief Accountant (OCA), which advises the Commission on accounting and auditing matters. Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission (Commission) on mark-to-market accounting practices and implications.

**The Focus of Financial Reporting**

Our financial reporting system has long been considered world class and a major asset of our capital markets. This world class reputation was earned through our system's ongoing commitment to provide investors with the transparent financial information they need to make better capital allocation decisions.

Our system's reputation continues to be enhanced as investors and other capital market participants reap the benefits of transparency provided by accounting standards that focus on investors as the consumers of financial reports. This reputation should be safeguarded by those charged with stewardship of our capital markets by continuing to hold the needs of investors paramount. Interruptions to financial stability caused by real economic factors should not lure us into suspending the transparency, and accompanying clear financial picture and investor confidence, on which our capital markets depend.

The federal securities laws set forth the Commission's broad authority and responsibility to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed under those laws, as well as its responsibility to ensure that investors are furnished with other information necessary for investment decisions.[1] As part of its fulfillment of this responsibility, the Commission has recognized the role of the Financial Accounting Standards Board (FASB) and the importance of the FASB's independence.[2]

An independent standard setter is best positioned to promulgate financial reporting standards for all private industries free from undue influence. It is important to note that the accounting standards that are the subject of this hearing – those related to fair value – are used not just by financial institutions, but by all industries. Of course, open due process, including thoughtfully considering the input and views of investors and the many

others who participate and play a role in our capital markets, is also critical to the FASB fulfilling its mission of establishing and improving financial reporting.

We continue to support the FASB in its role as our independent accounting standard setter, and investors in our capital markets have and continue to benefit from their expertise and careful judgment. We also continue to believe the FASB must be responsive to the needs of capital market participants, particularly investors. To be responsive, the FASB must continue, on a timely basis, to enhance the tools available to assist preparers and auditors when making difficult judgments. We believe that responsiveness is enhanced by collaboration among investors, preparers, auditors, regulators, and independent accounting standard setters, and we will take all prudent actions to continue to encourage such collaboration.

**The History of Fair Value Accounting**

Previous generations, after considering the causes of financial crises experienced during their times, concluded that fair value accounting was an important tool to communicate investment values to capital market participants. In particular, fair value was chosen after careful consideration, including consideration of the causes of previous financial crises and the tools that would best equip future generations when crises reemerged, such as we find ourselves in today.[3]

Although the use of fair value dates back many decades, the use of fair value measurement expanded significantly in 1975 due to concerns about the appropriate measurement attribute for securities. This expansion of the use of fair value measurements was precipitated by the financial crisis of the early 1970s when the accounting literature was inconsistent, resulting in diversity in practice, specifically with respect to marketable securities. Accounting practices at that time included recording such securities at cost, at market, and, in some cases, a combination of both measurements for different classes of securities.

The banking and savings and loan crisis of the 1980s further exposed challenges to the historic cost model of accounting for financial institutions. Specifically, savings and loan institutions accepted short-term deposits and used these deposits to fund long-term fixed-rate (e.g., 30-year) mortgage loans, their primary asset. In the late 1970s and early 1980s, interest rates were driven up by high inflation. As a result, the "current value" of assets in many cases was significantly less than the value of many reported liabilities, and these institutions were economically insolvent. However, under the historic cost accounting model, these losses were often not reflected in financial statements, which reduced transparency about their solvency.

Moreover, this also caused a moral hazard problem whereby the management of economically less solvent institutions had an incentive to take on more risky investments in the hope that they could trade their way out of their current economically less solvent position. In effect, the historical-cost-based financial statements obscured underlying economic losses and allowed troubled financial institutions to go undetected.

The experience gained by navigating these crises led to various calls for the expanded use of fair value measurements by financial institutions.[4] These calls for action, which were predicated on the experience of those that led this country during those crises, ultimately led to the fair value accounting standards we have today.

Further, it should be noted that FASB Statement No. 157, *Fair Value Measurements* (FAS 157), issued in 2006, does not itself require mark-to-market or fair value accounting. Rather, other accounting standards in various ways have required what is more broadly known as "fair value" accounting, of which mark-to-market accounting is a subset. FAS 157 was adopted to improve existing accounting requirements, because before its adoption, there was no common framework for measuring fair value, which led to inconsistent application. FAS 157 defines fair value, establishes a framework for measuring fair value, and requires expanded disclosures and transparency about fair value measurements.

As more fully described in the Commission staff's study on mark-to-market accounting, the scope of fair value accounting's use is important to appreciate when considering the issue of fair value measurements.[5] Financial institutions apply mark-to-market accounting (that is, they report changes in the fair value directly in earnings) in only limited cases. In fact, many more assets are currently recognized with changes in value not reported in earnings but rather reported directly in equity, or are currently carried at amortized cost. Loans held for investment purposes, for example, are not generally subject to mark-to-market accounting.

When mark-to-market accounting is not applied, unrealized investment losses are only recognized if the value of the investment is impaired. For debt securities that will be held to maturity, such impairment is generally only recognized if it is probable the investor will fail to recoup the investment's contractual cash flows – that is, when a credit loss has occurred.

**Efforts to Improve Fair Value Accounting**

On December 30, 2008, the Commission delivered its staff study on mark-to-market accounting to Congress. In this study, the staff did not recommend a suspension of fair value accounting standards. Rather, as discussed further below, we recommended improving existing fair value accounting standards and related guidance. However, our efforts to improve the standards began before the current extent of the financial crisis was fully known, and continue today.

For example, in March and September of 2008, the Commission's Division of Corporation Finance (Division) issued illustrative letters to large financial institutions concerning fair value disclosure practices. These letters highlighted best practices in transparent disclosure of fair value accounting garnered from the Division's ongoing review of public companies' financial reporting. The Division highlighted these disclosures and encouraged companies to incorporate them into their financial reporting.

As pointed out earlier, we steadfastly believe that financial reporting and transparency is improved by all capital market participants collaborating on the most difficult financial reporting issues. Consistent with this view, in the summer and fall of 2008, the SEC hosted three public roundtables on the topic of fair value accounting. At these roundtables, leaders representing preparers, auditors, investors, regulators, valuation experts and independent accounting standard setters exchanged views about the benefits and challenges of fair value accounting. Most participants at these roundtables expressed a belief that fair value accounting provides useful information to users of financial reporting. However, participants also expressed the desire for accounting standard setters to continue to address accounting issues arising out of the financial crisis, including improvements to the guidance on the measurement of fair value, particularly in inactive or illiquid markets.

In part due to the calls for additional guidance heard at the public roundtables, on September 30, 2008, the Commission staff and FASB staff issued a joint public statement clarifying the application of existing fair value accounting guidance, including the guidance in FAS 157. Among its clarifications, that statement pointed out that it is acceptable for management to use estimates of future cash flows that incorporate current market participant assumptions, and include appropriate risk premiums, as a part of the total mix of information used to measure fair value in certain circumstances. The clarifications also made clear that disorderly transactions are not determinative when measuring fair value, and that distressed or forced liquidation sales are not orderly transactions.

FASB Chairman Herz will likely discuss his Board's efforts in more detail, but closely following the joint public statement, the FASB issued additional guidance on how to measure fair value in inactive or illiquid markets, thereby supplementing, in near real time, the clarifications included in the joint public statement. The timely responsiveness of the FASB to this situation should be commended.

Although the guidance issued by the FASB relates to U.S. generally accepted accounting principles (U.S. GAAP), the International Accounting Standards Board (IASB) publicly expressed its support for the Commission staff and FASB efforts. The IASB's support is critical to the world-wide financial markets because fair value measurement is clearly a global issue.

As a global issue, work is ongoing internationally to develop better fair value measurement guidance. For instance, in October 2008, an expert advisory panel sponsored by the IASB issued information and educational guidance for measuring and disclosing fair value.

The FASB and IASB have also formed a Financial Crisis Advisory Group (FCAG) to help consider how improvements in financial reporting could help enhance investor confidence. OCA participates as an observer on FCAG, which began meeting monthly in January 2009. We expect the FASB to carefully consider the work of this body as it considers improvements to the guidance available in the U.S.

To address the assessment of security impairment, in our September 30, 2008 joint public statement, the Commission and FASB staffs also clarified that no bright-line thresholds exist for determining when an investment is impaired and also emphasized the need for judgment in this area. To further provide clarity to the issue of investment impairment, in October 2008, OCA, in consultation with the FASB staff, provided additional guidance for assessing perpetual preferred security impairments to address an acute practice issue that had arisen for those investments. Additionally, OCA requested that the FASB move expeditiously to address changes in the existing impairment accounting models, including the calculation and presentation of impairments, which I am glad to report they are doing.

OCA will continue to work with the FASB to further clarify the assessment of investment impairment when mark-to-market accounting is not applied. We supported the FASB's efforts in January 2009 to stream-line the guidance on impairments through harmonization of the impairment models used for different types of securities. We also support the FASB as it considers additional improvements to the impairment model for all investments, and we will continue to encourage the FASB to prioritize these improvements either through their own projects or on a joint basis with the IASB, as appropriate.

**Congressional Mark-to-Market Study**

As previously mentioned, the Commission delivered its staff study on mark-to-market accounting to Congress on December 30, 2008. In this comprehensive study, conducted in consultation with the Department of Treasury and the Federal Reserve, the Commission staff did not recommend a suspension of fair value accounting standards. Rather, we recommend improving existing fair value accounting standards and related guidance.

Our report includes eight recommendations that, if adopted, we believe will further enhance the already world class reputation of our financial reporting system. While I will outline the individual recommendations in a moment, it is worthwhile to first highlight their consistent theme: fair value accounting provides transparent financial information to investors, and better guidance can and should be provided to assist those responsible for making fair value measurement judgments.

The events leading up to the Congressional call for this study illustrated the need for identifying and understanding the linkages that exist between fair value accounting standards and the usefulness of information provided by financial institutions. In the months preceding passage of the Emergency Economic Stabilization Act of 2008 (Act), some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under FAS 157, contributed to instability in our financial markets. According to these critics, fair value accounting did so by requiring what some believed were potentially inappropriate write-downs in the value of investments held by financial institutions, most notably due to concerns that such write-downs were the result of inactive, illiquid, or irrational markets that resulted in values that did not reflect the underlying economics of the securities. These voices pointed out the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions, highlighting that this correlation could lead to the failure of financial institutions if

sufficient additional capital is unavailable to offset investment write-downs. Further, they believed the need to raise additional capital, the effect of failures, and the reporting of large write-downs would have broader negative impact on markets and prices, leading to further write-downs and financial instability, or so-called pro-cyclicality.

Just as vocal were other market participants, particularly investors, who stated that fair value accounting serves to enhance the transparency of financial information provided to the public. These participants indicated that fair value information is vital in times of stress, and a suspension of this information would weaken investor confidence and result in further instability in the markets. They pointed to what they believe are the potential causes of the crisis, namely poor lending decisions and inadequate risk management, combined with needed improvements in the current approach to supervision and regulation, rather than accounting.

Suspending the use of fair value accounting, these participants warned, would be akin to "shooting the messenger" and hiding from capital providers the economic condition of a financial institution. These participants noted that they were aware of the arguments about the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions. However, they pointed out that adjustments to the calculation of regulatory capital can be made to reduce this correlation where appropriate for prudential purposes. For example, today adjustments are made for "available-for-sale" securities, which are carried on the balance sheet by financial institutions at fair value with changes directly reported in equity subject to impairment assessments.

As mandated by the Act, our study addressed six key issues and provided recommendations on these issues. We studied these issues using a combination of techniques. Where practicable, we analyzed data empirically from a broad-based population that included a cross-section of financial institutions. For issues that did not lend themselves to empirical analysis, we undertook alternative methods, including research of public records, analysis of public comment letters received regarding this study, and the hosting of the three previously mentioned public roundtables to obtain a wide range of views and perspectives from all parties. Careful attention was given to maximize the opportunities to hear from all sides about the use fair value measurements.

The six issues mandated for study by the Act included:

1) The effect of fair value accounting standards on financial institutions' balance sheets;
2) The impact of fair value accounting on bank failures in 2008;
3) The impact of fair value accounting standards on the quality of financial information available to investors;
4) The process used by the FASB in developing accounting standards;
5) Alternative accounting standards to those provided in FAS 157; and
6) The advisability and feasibility of modifications to fair value accounting standards.

Among the study's findings, we found that investors generally believe fair value accounting increases financial reporting transparency and facilitates better investment decision making. In addition, after careful study of the factors that led to bank failures occurring in 2008, fair value accounting did not appear to play a meaningful role. Rather, we found that the failures appeared to be the result of growing credit losses, concerns about asset quality, and in certain cases, the erosion of investor confidence.

We also observed, as noted above, that fair value and mark-to-market accounting have been in place for years. That being the case, we concluded that their abrupt removal would erode investor confidence, further exacerbating instability in our financial markets.

Based on the findings of the study, we made the following eight recommendations:

1. FAS 157 should be improved, but not suspended;
2. Existing fair value and mark-to-market requirements should not be suspended;
3. Additional measures should be taken to improve the application and practice related to existing fair value requirements;
4. The accounting for financial asset impairments should be readdressed;
5. Further guidance to foster the use of sound judgment should be implemented;
6. Accounting standards should continue to be established to meet the needs of investors;
7. Additional formal measures to address the operation of existing accounting standards in practice should be established; and
8. The accounting for investments in financial assets should be simplified.

A full description of each of these recommendations is included in our study, and action has already been taken on some of its key recommendations. For instance, in his testimony, FASB Chairman Herz will likely address the FASB's recent agenda decisions to provide guidance on the measurement of securities in inactive or illiquid markets and better disclosure of fair value measurements. We will work closely with the FASB and others to implement the remaining recommendations in due course.

**Conclusion**

We should not forget that transparent financial information and investor confidence are at the heart of market efficiency and capital formation. Transparency increases financial stability by increasing investor confidence, and serving the needs of investors should continue to be the primary focus of financial reporting. As transparency is critical to the Commission fulfilling its mission of investor protection, we remain committed to enhancing it.

We continue to encourage collaboration among all capital market participants on financial reporting issues, including fair value measurement issues. The FASB is well-positioned to neutrally consider the input of all interested parties, while also safeguarding the financial reporting needs of investors.

The staff is working closely with the FASB and others to adopt the recommendations included in our study on mark-to-market accounting. We understand the urgency and gravity of the matter as companies continue to cope with the economic crisis. We look forward to the continued dialogue on the important issue of fair value measurements, and we will continue in the Commission's mission to protect investors and the capital formation process.

Thank you for the opportunity to appear today, and I would be pleased to respond to any questions.

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[1] See, e.g., sections 7, 19(a) and Schedule A, items (25) and (26) of the Securities Act of 1933, 15 U.S.C. 77g, 77s(a), 77aa(25) and (26); sections 3(b), 12(b) and 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(b), 78l(b) and 78m(b); sections 5(b), 14, 15 and 20 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79e(b), 79n, 79o and 79t; and sections 8, 30(e), 31 and 38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-8, 80a-29(e), 80a-30 and 80a-37(a).

[2] Policy Statement Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003) [68 FR 23333 (May 1, 2003)].

[3] For instance, see FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, Appendix A, Background Information and Basis for Conclusions.

[4] See, e.g., Edward J. Kane, The Gathering Crisis in Federal Deposit Insurance (1985); Lawrence J. White, On Measurement of Bank Capital, 13 Journal of Retail Banking 2 (1991), at 27-34; and George Benston, Market Value Accounting: Benefits, Costs and Incentives, Proceedings of the Conference on Bank Structure and Competition, Chicago: Federal Reserve Bank of Chicago (1989), at 547-563.

[5] Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, available at: http://www.sec.gov/news/studies/2008/marktomarket123008.pdf.

**Testimony of**

**Jeffrey P. Mahoney**

**General Counsel**

**Council of Institutional Investors**

**before the**

**Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises**

**of the**

**Committee on Financial Services**

**March 12, 2009**

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**March 12, 2009**

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**March 12, 2009**

**Prepared Statement**

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee:

Good morning. I am Jeff Mahoney, general counsel of the Council of Institutional Investors ("Council"). I am pleased to appear before you today on behalf of the Council. I have brief prepared remarks and would respectfully request that the full text of my statement and all supporting materials be entered into the public record.

The Council is a not-for-profit association of more than 130 public, corporate, and labor pension funds with assets exceeding $3 trillion. Our members are obviously quite diverse and include the Pennsylvania State Employees' Retirement System, Johnson & Johnson, and the IUE-CWA Pension Fund.

Council members are generally long term shareowners responsible for safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States ("US"). Since the average Council member invests approximately 60 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance, including issues relating to financial accounting and reporting, are of great interest to our members.

As an initial matter, the Council's policies reflect our members' views that:

(1) The goal of financial accounting and reporting and accounting standard setters should be to satisfy the information needs of investors—the key consumers of financial reports; and

(2) The needs of investors are most likely to be met if the responsibility to promulgate accounting standards resides with an independent private sector organization that employs a thorough public due process that actively solicits and gives preeminence to the views of investors.

Although we believe that the current US accounting standard setting structure and process can, and should be, further improved, we would strongly oppose any legislative or regulatory effort that would diminish the independence of accounting standard setting and provide certain industries with direct or indirect control over the outcome of the process. In our opinion, we must avoid changes to accounting standard setting that may cater to the short term self-interests of a particular industry to the detriment of the short and long-term interests of investors and other market participants.

Second, we generally agree with the findings of the United States Securities and Exchange Commission's ("Commission") recent report and recommendations to Congress on "Mark-to-Market Accounting." More specifically, we agree with the Commission's findings that existing fair value accounting standards for financial instruments increases the quality of information provided to investors about those contracts by better reflecting current economic reality.

We note that the Commission's findings are generally supported by a July 2008 Council-commissioned White Paper, entitled "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch" ("White Paper"). The White Paper is included as an attachment to the full text of my testimony for your information and review.

Consistent with the Commission's findings, the White Paper concludes that because of its timeliness and relevance, fair value accounting reduces uncertainty over time much more quickly than other existing accounting measurement approaches. As a result, fair value accounting has the ability to assist in mitigating the duration of a financial crisis. Many financial experts agree that Japan's failure to embrace fair value accounting for the financial assets of its troubled financial institutions in the 1990's unnecessarily exacerbated that country's economic woes for an entire decade.

Finally, we believe that the most appropriate approach to addressing concerns about the pro-cyclical effects of fair value accounting is not to change accounting standards, but instead to encourage the US financial institution regulators to exercise their authority, which they have done on a number of occasions in the past, to modify, if they deem necessary, fair value accounting for regulatory capital purposes. That approach allows the regulators to appropriately address their responsibilities to foster safety and soundness and financial stability of US financial institutions without further lowering investor confidence by denying investors the information they need to make economic decisions.

When I receive my quarterly 401(k) statement, I see current economic reality. Those who invest in US financial institutions and other US companies deserve to see the same economic reality. Fair value accounting for financial instruments gets investors closer to that goal.

In closing, we look forward to continuing to work cooperatively with the FASB, the SEC, this Subcommittee, and other interested parties to further improve financial accounting and reporting. Our aim is always to provide constructive input and support to ensure that financial reporting continues to evolve to better serve the needs and demands of US investors, the US capital markets, and the US economy.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

**Testimony of**
**Jeffrey P. Mahoney**
**General Counsel**
**Council of Institutional Investors**
**before the**
**Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises**
**of the**
**Committee on Financial Services**
**March 12, 2009**

**Full Text of Statement**

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee:

Good morning. I am Jeffrey P. Mahoney, general counsel of the Council of Institutional Investors ("Council"). I am pleased to appear before you today on behalf of the Council. My testimony includes a brief overview of the Council and a discussion of the Council's policies, including our policy supporting independent accounting standard setting. The remainder of my testimony includes our views on two specific issues you asked to be addressed in our testimony: (1) How fair value accounting affects investors and the broader economy; and (2) Potential proposals for regulators and accounting standard setters relating to fair value accounting.[1]

***The Council***[2]

The Council is a not-for-profit association of more than 130 public, corporate, and labor pension funds with assets exceeding $3 trillion. Our members are obviously quite diverse and include the Pennsylvania State Employees Retirement System, Johnson & Johnson, and the IUE-CWA Pension Fund.[3]

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[1] *See* Letter from Chairman Paul E. Kanjorski & Ranking Member Scott Garrett to Jeff Mahoney 1 (Mar. 5, 2009) (on file with Council).
[2] For more information about the Council of Institutional Investors ("Council"), see the Council's website at http://www.cii.org/about.
[3] See Attachment 1 for a listing of the general members of the Council.

Council members are responsible for investing and safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States ("US"). Since the average Council member invests approximately 60 percent of its entire pension portfolio in US stocks and bonds,[4] issues relating to US corporate governance, including issues relating to US financial accounting and reporting, are of great interest to our members.

***Council Corporate Governance Policies***[5]

An important part of the Council's activities involves the development of corporate governance policies. The policies set standards or recommended practices that the Council members believe companies should adopt. The policies are a living document that is constantly reviewed and updated.

The Council's policies neither bind members nor corporations. The policies are designed to provide guidelines that the Council has found to be appropriate in most situations.

Council staff uses the policies to determine whether and how the Council can respond to certain issues, including rules proposed by the US Securities and Exchange Commission ("SEC" or "Commission") and accounting standards proposed by the standard setting bodies. Council staff may without additional approval, take action on an issue that is within its policies and also within budgetary limits, subject to oversight of those actions by the Council's board.

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[4] *See* Council, Asset Allocation Survey 2 (2008) (on file with Council).
[5] For complete copies of the Council's existing policies, see the Council's website at http://www.cii.org/policies.

The nine non-officers on the Council's board of directors make up the policies committee and suggest subjects for policies, review staff policy drafts and decide which policies should be submitted to the full board.[6] All general members of the Council are invited to submit ideas for policies to Council staff or Council directors.

The full board votes on whether to approve a proposed policy. Once approved by the board, the policy is either subject to a vote by the full membership at the next meeting or by mail ballot if the board believes time is of the essence.

*Independence of Accounting and Auditing Standard Setters*[7]

Last fall, after months of research and deliberations by the Council's staff, policies committee, and board, the Council's general members approved an update to our policy on the independence of accounting and auditing standard setting ("Policy"). The Policy continues to reflect our long-held views that:

- The responsibility to promulgate accounting standards should reside with independent private sector organizations that provide for a thorough public due process;
- The technical decisions and judgments of the private sector accounting standard setter should be respected and should not be overridden by government officials or bodies;

[6] See Attachment 2 for a list of the Council's board of directors and officers.
[7] See Attachment 3 for a copy of the Council's policy on "Independence of Accounting and Auditing Standard Setters."

- High quality accounting standards are those that produce comparable, reliable, timely, transparent and understandable financial information that meets the needs of investors and other consumers of financial reports; and

- The goal of financial accounting and reporting and accounting standard setters should be to satisfy, in a timely manner, the information needs of investors and other consumers of financial reports.[8]

As we, and the Center for Audit Quality, the Consumer Federation of America, the CFA Institute, and the Investment Management Association explained in a recent joint letter to the Commission:

> If reported financial information is going to be believed, trusted, and used by investors and the business community, it is critical that the standards used to prepare that information are set by bodies that are truly **independent**.
>
> An independent standard setter makes it more likely that accounting standards will serve the needs of those who read and review financial reports, not those that are responsible for creating them. Those responsible for creating financial reports may recommend accounting rules that, intentionally or unintentionally, obfuscate an objective reporting of the real performance and condition of a company at the expense of outside shareowners. Accounting standards should be promulgated to serve the interests of investors and the capital markets.

[8] Attachment 3, at 1. We note that the United States Securities and Exchange Commission continues to share our support for independent standard setting as "best positioned to develop unbiased financial reporting standards that foster investor confidence and financial transparency . . . ." Letter from Conrad Hewitt, Chief Accountant, United States Securities and Exchange Commission to Ms. Cindy Fornelli, Executive Director, Center for Audit Quality 2 (Nov. 26, 2008) [See Attachment 5].

> In adopting the Sarbanes-Oxley Act of 2002, Congress recognized the benefits of having accounting standards set by an independent and adequately funded body, and wisely endorsed the current standards-setting process. Further political invention by Congress or the Commission runs the risk of impeding the FASB's ability to promulgate and issue standards for financial reporting, which serves investors and the capital markets of the United States. Accounting standards must faithfully represent the economic substance of business transactions and provide information that meets the needs of investors in a neutral manner to all financial market participants.[9]

Although we believe, and have publicly commented, that the US accounting standard setting structure and process can, and should, be improved,[10] we would strongly oppose, consistent with our Policy, any changes to the existing process or structure that diminishes the independence of accounting standard setting.

More specifically, we would oppose any changes that would permit government agencies or departments, particularly the regulators of financial institutions whose mission is not focused on serving the needs of investors, to have the authority to make decisions or judgments about the substance or timing of accounting standards for the companies that we invest in.[11] We believe that such a change would ultimately reduce the quality of financial accounting and reporting, harm investor confidence, and inhibit the short and long-term prospects for US economic growth.

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[9] Letter from Cindy Fornelli, Executive Director, Center for Audit Quality to The Honorable Christopher Cox 1 (Nov. 14, 2008) [See Attachment 5] [Hereinafter Cox].

[10] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Ms. Teresa S. Polley, Chief Operating Officer, Financial Accounting Foundation 1-4 (Feb. 11, 2008) [See Attachment 5].

[11] We note that one such legislative proposal, H.R. 1349, is publicly supported by the banking industry whose members include many firms whose management and boards actively participated in creating the current crisis. Jessica Holzer, *House Bill Would Create New Board For Accounting Standards*, Dow Jones Newswires Wash. 1 (Mar. 6, 2009) (on file with author), *available at http://www.easybourse.com/bourse-actualite/american-internation/house-bill-would-create-new-board-for-accounting-standards-US0268741073-629434* (noting that American Bankers Association President Edward Yingling issued a statement hailing the introduction of the legislation).

***How Fair Value Accounting Affects Investors and the Overall Economy***

As indicated by the Commission in their recent "Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting" ("SEC Report"), the purpose of financial accounting and reporting

> is to provide transparent information to investors as they make decisions. Accordingly, the primary factor to consider when evaluating the role of fair value accounting is the impact of such accounting on the information provided to investors.[12]

The Council believes, consistent with the findings of the SEC Report, the views of most investors,[13] many auditors, consumers, and other market participants, that:

> Existing fair value accounting standards, particularly as they relate to fair value accounting for financial instruments, . . . increase[s] the quality of the information available [to investors] . . . . [F]air value provides more relevant information, reflecting current economic reality that should not be replaced by alternative accounting measures.[14]

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[12] Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, Office of the Chief Accountant, Division of Corporation Finance, United States Securities and Exchange Commission 202 (Dec. 13, 2008) (on file with Council), *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf [hereinafter SEC Report].

[13] We note that an April 2008 survey of 2006 professional investors by the CFA Institute revealed that "79 percent of respondents believe that fair value measurements improve transparency and contribute to investor understanding of financial institutions' risk and 74 percent think fair value requirements will improve market integrity." Press Release, CFA Institute, CFA Institute Centre Says Fair Value "Smoothing" Will Mask the Reality of Market Conditions and Allow Companies to Hide Risk 1-2 (Apr. 17, 2008). We also note that in his most recent letter to the shareholders of Berkshire Hathaway Inc., Warren E. Buffett, Chairman of the Board, stated "[w]e endorse mark-to-market accounting." Berkshire Hathaway Inc., Letter to Shareholders 19 (Feb. 27, 2009) (on file with Council), *available at* http://www.berkshirehathaway.com/letters/2008ltr.pdf.

[14] SEC Report, *supra* note 12, at 202; *see, e.g.,* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission 4 (Oct. 29, 2008) [See Attachment 5].

Our belief about the benefits of fair value accounting for financial instruments is also supported by a July 2008 Council-commissioned white paper, "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch" ("White Paper").[15] The White Paper, authored by Professor Stephen G. Ryan, a leading expert on fair value accounting, describes the following five reasons why most investors support fair value accounting for financial instruments:

> 1. . . . [F]air values are more accurate, timely, and comparable across different firms and positions than are alternative measurement attributes . . . .
>
> . . . .
>
> 2. . . . [W]hile the credit crunch raises issues for fair value measurements, under FAS 157 fair values need not reflect fire sale values. When level 2 inputs are driven by fire sales, firms can make the argument that level 3 model-based fair values are allowed under FAS 157. Requiring firms to make this argument provides important discipline on the accounting process.
>
> . . . .
>
> 3. Fair value accounting does not allow firms to manage their income through gains trading, because gains and losses are recognized when they occur, not when they are realized.
>
> . . . .

[15] Stephen G. Ryan, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch* (July 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/CII%20Fair%20Value%20Paper%20(final)%20%20071108.pdf [See Attachment 4] [Hereinafter Ryan].

> 4. . . . [W]hen the distributions of future cash flows are skewed, it is more informative to investors to be right on average and to incorporate the probability and significance of all possible future cash flows, as fair value accounting does, than to be right most of the time but ignore relatively low probability but highly favorable or unfavorable future cash flows. It is also important to update the distribution of future cash flows for new information on a timely basis, as fair value accounting does.
>
> . . . .
>
> 5. Fair value accounting is the best platform for mandatory and voluntary disclosure and for investors to be aware of what questions to ask management . . . .[16]

The Council White Paper also notes that the overall economy, particularly during a financial crisis, likely benefits from the use of fair value accounting.[17] The White Paper explains:

> Because of its timeliness and informational richness, fair value accounting and associated mandatory and voluntary disclosures should reduce uncertainty and information asymmetry faster over time than . . . [alternative measurement approaches] would, thereby mitigating the duration of the credit crunch.[18]

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[16] *Id.* at 16-18.

[17] *See id.* at 16.

[18] *Id.*; *see also* Editorial, *All's Fair, The Crisis and Fair Value Accounting,* Economist, Sept. 18, 2008, at 1-2 (on file with Council), *available at* http://www.economist.com/finance/displaystory.cfm?story_id=12274096 (Referring to Japan's failure to embrace fair value accounting for financial instruments during the 1990's, Yoshimi Watanabe, Japan's minister for financial services, commented that "Japanese banks exacerbated their country's economic woes by 'avoiding ever facing up to losses'").

Similarly, the SEC Report found that eliminating fair value accounting would likely increase financial instability in the economy.[19] The SEC Report explains:

> [I]nvestor confidence is reinforced by providing transparency relating to the underlying asset value of their investments, and a removal of . . . [fair value accounting] information would, in fact, lead to additional financial instability.[20]

***Potential Proposals for Regulators and Standard Setters Relating to Fair Value Accounting***

*Financial Institution Regulators*

As indicated in the SEC Report, the objective of financial reporting is to provide information useful to investors and creditors in their decision-making processes.[21] In contrast, the primary objective of the regulatory capital requirements for financial institutions is to "foster safety and soundness and financial stability."[22]

The regulatory capital requirements in the US start with financial information provided in accordance with US generally accepted accounting principles ("GAAP").[23] The financial institution regulators, however, have considerable leeway in determining whether certain adjustments should be made to US GAAP for regulatory capital purposes to reflect the differences between the objectives of US GAAP reporting and the objectives of regulatory capital requirements.[24]

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[19] SEC Report, *supra* note 12, at 202.
[20] *Id.*
[21] *Id.* at 114.
[22] *Id.*
[23] *Id.*
[24] *Id.*

In fact, in a number of circumstances, the financial institution regulators have determined that the calculation of capital should exclude items required by US GAAP or include items not required by US GAAP.[25] For example, although fair value gains or losses for some debt securities are required to be included as an addition or reduction of the reported equity of financial institutions for US GAAP purposes, the financial institution regulators generally exclude those gains and losses from regulatory capital.[26]

The Council would not oppose proposals by the financial institution regulators to make further adjustments to regulatory capital for the effects of fair value accounting standards if they believe those adjustments are necessary to foster safety and soundness and financial stability, but only if those adjustments do not impact the financial accounting and reporting information made available to investors. As explained in a recent article co-authored with my fellow hearing witness Cindy Fornelli:

> Critics of fair value may have some legitimate concerns. Any such concerns, however, can be addressed without suspending our best existing approach to financial instrument valuation, and without suspending our independent, thorough and public accounting standard-setting process.
>
> Some banking industry allies worry that reduced asset valuations could put some financial institutions out of compliance with government regulations requiring a minimum amount of capital. Some have suggested that banks might hoard capital to avoid such a fate—a tactic that would thwart efforts to stimulate lending.

[25] *Id.* at 114-15.
[26] *Id.* at 115.

> It's a fair point, but it misses the fact that fair-value accounting is just the first step in a two-step process. Step one involves valuing a financial instrument to reflect today's worth. Step two involves factoring that new, lower value into the bank regulators' formulas for capital requirements.
>
> Investors and regulators need to know the current values of loans and securities in order to make rational investment and policy decisions. Whether or how those new values affect the capital requirements, and whether they should result in institutions' running afoul of capital requirements, is a decision to be made by bank regulators. If there is a problem with financial institutions meeting capital requirements, the solution should focus on step two, not on denying the realistic valuation that results from step one.[27]

*Accounting Standard Setters*

The Council is aware of the recommendations included in the SEC Report that the Financial Accounting Standards Board ("FASB") should consider further "improvement to . . . the application of SFAS No. 157 to illiquid investments . . . [and] additional measures relating to the assisting in the understanding of the impact of fair value through presentation and disclosure requirements."[28]

We note that last month the FASB issued a news release indicating that they would be addressing the following fair value projects:

> - The projects on application guidance will address determining when a market for an asset or a liability is active or inactive; . . .

[27] Cindy Fornelli and Jeff Mahoney, *Opinion: The Fair Value Fallacy,* Fin. Wk., Nov. 30, 2008, at 1-2 (on file with Council), *available at* http://www.financialweek.com/apps/pbcs.dll/article?AID=/20081130/REG/811259978/1023/otherviews; *accord* Letter from Cindy Fornelli, Executive Director, Center for Audit Quality et al. to Mr. Timothy F. Geithner et al. 1-2 (Feb. 13, 2009) [See Attachment 5].
[28] SEC Report, *supra* note 12, at 202; *see also* Cox, *supra* note 9, at 2.

- The project on improving disclosures about fair value measurements will consider requiring additional disclosures on such matters as sensitivities of measurements to key inputs and transfers of items between the fair value measurement levels.[29]

We caution that as the FASB develops additional guidance in these areas, they should only do so as part of a thorough public due process that includes solicitation of investor input and careful consideration of investor views.[30]

Moreover, and also consistent with the Council Policy, additional guidance should only be issued by the FASB if it can conclude that the guidance is responsive to and satisfies investors' information needs.[31] Any other process and result would, in our view, likely only increase the complexity of financial reporting while at the same time exacerbating the instability in the capital markets by further lowering investors' confidence in the financial reporting of US companies.[32]

In closing, we look forward to continuing to work cooperatively with the FASB, the SEC, this Subcommittee, and other interested parties to continue to improve financial accounting and reporting. Our aim is to continue to provide constructive input and support to ensure that financial reporting continues to evolve to better serve the needs and demands of US investors, the US capital markets, and the US economy.

Thank you, Mr. Chairman, for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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[29] News Release, FASB Initiates Projects to Improve Measurement and Disclosure of Fair Value Estimates 1 (Feb. 18, 2009) (on file with Council), *available at* http://www.fasb.org/news/nr021809.shtml.
[30] Attachment 3, at 2.
[31] *Id.* at 1.
[32] *See* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Russell Golden, Technical Director, FASB 6 (Dec. 24, 2008) [See Attachment 5].

**Testimony of**
**Jeffrey P. Mahoney**
**General Counsel**
**Council of Institutional Investors**
**before the**
**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises**
**of the**
**Committee on Financial Services**
**March 12, 2009**

**Attachment 1**

**Council General Members**

## Council of Institutional Investors

### General Members*

**Last Updated: 2008**

AFL-CIO Pension Plan
AFSCME Employees Pension Plan
Agilent Technologies Benefit Plans
Alameda County Employees' Retirement Association
Alaska Permanent Fund
Altria Corporate Services Pension Plan
American Federation of Teachers Pension Plan
Arkansas Public Employees Retirement System
Arkansas Teacher Retirement System
Bank of America Pension Plans
BP America
Bricklayers & Trowel Trades Pension Fund
Building Trades Pension Trust Fund-Milwaukee and Vicinity
California Public Employees' Retirement System
California State Teachers' Retirement System
Campbell Soup Retirement & Pension Plans
Carpenters United Brotherhood Local Unions & Councils Pension Fund
Casey Family
CERES Defined Contribution Retirement Plan
Chevron Master Pension Trust
Coca-Cola Retirement Plan
Colgate-Palmolive Employees' Retirement Income Plan
Colorado Fire and Police Pension Association
Colorado Public Employees' Retirement Association
Communications Workers of America Pension Fund
Connecticut Retirement Plans and Trust Funds
Contra Costa County Employees' Retirement Association
CWA/ITU Negotiated Pension Plan
Dallas Employees' Retirement Fund
Delaware Public Employees Retirement System
Detroit General Retirement System
Disney (Walt)
District of Columbia Retirement Board
Eastern Illinois University Foundation
ELCA Board of Pensions
EMC

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*General membership in the Council is open to any employee benefit plan, state or local agency officially charged with the investment of plan assets, or non-profit endowment funds and non-profit foundations. General Members participate in all meetings and seminars sponsored by the Council and are the only voting members of the Council. Annual dues are $1.30 per $1 million in fund assets, but no less than $3,000 and no more than $30,000.

Fairfax County Educational Employees' Retirement System
FedEx
Florida State Board of Administration
Gap
General Mills Retirement Plan
General Motors Investment Management
Hartford Municipal Employees Retirement Fund
Hewlett-Packard
Houston Firefighters' Relief & Retirement Fund
I.A.M. National Pension Fund
IBEW Pension Benefit Fund
Idaho Public Employee Retirement System
Illinois State Board of Investment
Illinois State Universities Retirement System
Illinois Teachers' Retirement System
Iowa Municipal Fire & Police Retirement System
Iowa Public Employees Retirement System
ITT Industries Pension Fund Trust
IUE-CWA Pension Fund
Jacksonville Police and Fire Pension Fund
Jeffrey Company Pension Plan
Johnson & Johnson
Kentucky Retirement Systems
Kern County Employees' Retirement Association
KeyCorp Cash Balance Pension Plan
Laborers' Central Pension Fund
Laborers National Pension Fund
Lens Foundation for Corporate Excellence
LIUNA Staff and Affiliates Pension Fund
Los Angeles City Employees' Retirement System
Los Angeles County Employees Retirement Association
Los Angeles Fire and Police Pension System
Los Angeles Water and Power Employees' Retirement Plan
Lucent Technologies Pension Plan
Maine Public Employees Retirement System
Marin County Employees' Retirement Association
Maryland, State Retirement Agency
Massachusetts Bay Transportation Authority Retirement Fund
Massachusetts PRIM
McDonald's Employee Benefits Plan
Michigan Municipal Employees Retirement System
Microsoft
Milwaukee Employees' Retirement System
Minnesota State Board of Investment
Missouri Public School & Non-Teacher School ERS
Missouri State Employees' Retirement System
Montgomery County Employees' Retirement System
Nathan Cummings Foundation
National Education Association Employee Retirement Plan

Navy-Marine Corps Relief Society
New Hampshire Retirement System
New Jersey Division of Investment
New York City Employees' Retirement System
New York City Pension Funds
New York City Board of Education Retirement System
New York City Fire Department Pension Fund
New York City Police Pension Fund
New York City Teachers' Retirement System
New York State and Local Retirement Systems
New York State Teachers' Retirement System
New York Times Company Pension Plan
North Carolina Retirement System
North Dakota State Land Department
Ohio Police & Fire Pension Fund
Ohio Public Employees Retirement System
Ohio School Employees Retirement System
Ohio State Teachers' Retirement System
Operating Engineers Central Pension Fund
Orange County Employees Retirement System
Pennsylvania Public School Employees' Retirement System
Pennsylvania State Employees' Retirement System
Pfizer
Pitney Bowes Pension Plan
Plumbers & Pipefitters National Pension Fund
Prudential Employee Savings Plan
Sacramento County Employees' Retirement System
San Diego City Employees' Retirement System
San Francisco City & County Employees' Retirement System
San Jose City Retirement Funds
Santa Barbara County Employees' Retirement System
Sara Lee Salaried Pension Plan
Schering-Plough Employees' Savings Plan
Sealed Air Retirement Plans
SEIU Union Pension Fund
Sheet Metal Workers' Local 19 Pension Plan
Sheet Metal Workers' National Pension Fund
Sonoma County Employees' Retirement Association
South Carolina Retirement System
Sunoco
Target
Teamster Affiliates Pension Plan
Tennessee Consolidated Retirement System
Texas Employees Retirement System
Texas Municipal Retirement System
Texas Teacher Retirement System
UAW
UFCW Staff Trust Fund
ULLICO Pension Plan Trust

UNITE HERE Laundry & Dry Cleaning Workers Pension Fund
UNITE HERE National Retirement Fund
UnitedHealth Group Retirement Plans
United States Steel and Carnegie Pension Fund
Vermont Pension Investment Committee
Washington State Investment Board
West Virginia Investment Management Board
Wisconsin State Investment Board
World Bank Staff Retirement Plan
Writers Guild of America, West

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**Committee on Financial Services**
**March 12, 2009**

**Attachment 2**

**Council Board**

**Board Officers**

Joe Dear, California Public Employees' Retirement System
Board Chair
Joe Dear is chief investment officer of California Public Employees' Retirement System

D. Craig Nordlund, Agilent Technologies Benefit Plans
*Co-Chair*
D. Craig Nordlund is svp, general counsel & secretary at Agilent Technologies

Bruce Raynor, UNITE HERE National Retirement Fund
*Co-Chair*
Bruce Raynor is general president of UNITE HERE

Shelley Smith, Los Angeles City Employees' Retirement System
*Co-Chair*
Shelley Smith is vice chair of Los Angeles City Employees' Retirement System

Gail Stone, Arkansas Public Employees Retirement System
*Treasurer*
Gail Stone is executive director of Arkansas Public Employees Retirement System

Warren Mart, I.A.M. National Pension Fund
*Secretary*
Warren Mart is general secretary-treasurer of the International Association of Machinists and Aerospace Workers

**Board Members**

Lydia Beebe, Chevron Master Pension Trust
Lydia Beebe is corporate secretary & chief governance officer at Chevron

Kenneth Colombo, Sheet Metal Workers' National Pension Fund
Kenneth Colombo is fund coordinator for the Sheet Metal Workers' National Pension Fund

Gail Hanson, State of Wisconsin Investment Board
Gail Hanson is deputy executive director of State of Wisconsin Investment Board

Eric Henry, Texas Municipal Retirement System
Eric Henry is executive director and CIO of the Texas Municipal Retirement System

Richard Metcalf, LIUNA Staff and Affiliates Pension Fund
Richard Metcalf is director of the corporate affairs department at LIUNA Staff and Affiliates Pension Fund

Meredith Miller, Connecticut Retirement Plans and Trust Funds
Meredith Miller is assistant treasurer for policy at Conneticut Retirement Plans and Trust Funds

Jody Olson, Idaho Public Employees Retirement System
Jody Olson is board chair of Idaho Public Employees Retirement System

Gregory Smith, Colorado Public Employees' Retirement Association
Gregory Smith is general counsel of Colorado Public Employees' Retirement Association

Michael Travaglini, Massachusetts Pension Reserves Investment Management Board
Michael Travaglini is executive director of Massachusetts Pension Reserves Investment Management Board

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**Attachment 3**

**Council Policy on Independence of Accounting and Auditing Standard Setters**

**The Council of Institutional Investors**
**Policies on Other Governance Issues**
**Independence of Accounting and Auditing Standard Setters**

Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the wellbeing of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. The quality, comparability and reliability of that information, in turn, depends directly on the quality of the financial reporting standards that: (1) enterprises use to recognize, measure and report their economic activities and events; and (2) auditors use in providing assurance that the preparers' recognition, measurement and disclosures are free of material misstatements or omissions. The result should be timely, transparent and understandable financial reports. The Council has consistently supported the view that the responsibility to promulgate accounting and auditing standards should reside with independent private sector organizations. The globalization of financial markets has brought calls from some regulators, stock exchanges, corporations, auditing firms and other parties for the replacement of U.S. accounting and auditing standards and standard setters with international standards and standard setters. The Council supports U.S. accounting and auditing standard setters cooperatively working with their international counterparts toward a common goal of convergence to a single set of high quality standards designed to produce comparable, reliable, timely, transparent and understandable financial information that will meet the needs of institutional investors and other consumers of audited financial reports. The Council, however, does not support replacing U.S. accounting or auditing standards or standard setters with international standards or standard setters unless and until all of the following steps have been achieved:

• In the aggregate, the information that results from the application of international accounting and auditing standards is, at a minimum, of the same quality as the information resulting from U.S. accounting and auditing standards;
• The application (by U.S. companies and their auditors) and enforcement (by U.S. regulators) of the international accounting and auditing standards are at least as rigorous and consistent as the application and enforcement of U.S. accounting and auditing standards;
• The international standard setter has sufficient resources—including a secure stable source of funding that is not dependent on voluntary contributions of those subject to the standards;
• The international standard setter has a full-time standard-setting board and staff that are free of bias and possess the technical expertise necessary to fulfill their important roles;
• The international standard setter has demonstrated a clear recognition that investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs. This includes having significant, prominent and adequately balanced representation from qualified investors on the standard setter's staff, standard-setting board, oversight board and outside monitoring or advisory groups;

• The international standard setter has a thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views before issuing proposals or final standards; and
• The international standard setter has a structure and process that adequately protects the standard setter's technical decisions and judgments (including the timing of the implementation of standards) from being overridden by government officials or bodies.

(updated Oct. 7, 2008)

**Testimony of**
**Jeffrey P. Mahoney**
**General Counsel**
**Council of Institutional Investors**
**before the**
**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises**
**of the**
**Committee on Financial Services**
**March 12, 2009**

**Attachment 4**

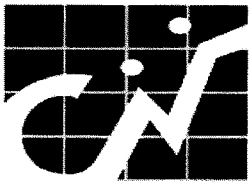
**Council White Paper, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch***

# FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

Prepared by

Stephen G. Ryan
Professor of Accounting and Peat Marwick Faculty Fellow
Stern School of Business, New York University

July 2008



COUNCIL OF
INSTITUTIONAL
INVESTORS

# FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

prepared by

Stephen G. Ryan
Professor of Accounting and Peat Marwick Faculty Fellow
Stern School of Business, New York University

for the Council of Institutional Investors*

July 2008

* This white paper was commissioned by the Council of Institutional Investors for the purpose of educating its members, policy makers and the general public about the important and timely topic of fair value accounting and its potential impact on investors. The views and opinions expressed in the paper are those of Professor Ryan and do not necessarily represent the views or opinions of the Council members, board of directors or staff. Official policy positions of the Council are determined only after an extensive due process that includes approval by a vote of the Council board and membership.

# FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

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# FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

## Executive Summary

Fair value accounting is a financial reporting approach in which companies are required or permitted to measure and report on an ongoing basis certain assets and liabilities (generally financial instruments) at estimates of the prices they would receive if they were to sell the assets or would pay if they were to be relieved of the liabilities. Under fair value accounting, companies report losses when the fair values of their assets decrease or liabilities increase. Those losses reduce companies' reported equity and may also reduce companies' reported net income.

Although fair values have played a role in U.S. generally accepted accounting principles (GAAP) for more than 50 years, accounting standards that require or permit fair value accounting have increased considerably in number and significance in recent years. In September 2006, the Financial Accounting Standards Board (FASB) issued an important and controversial new standard, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), which provides significantly more comprehensive guidance to assist companies in estimating fair values. The practical applicability of this guidance has been tested by the extreme market conditions during the ongoing credit crunch.

In response to the credit crunch, some parties (generally financial institutions) have criticized fair value accounting, including FAS 157's measurement guidance. Those criticisms have included:

- Reported losses are misleading because they are temporary and will reverse as markets return to normal
- Fair values are difficult to estimate and thus are unreliable
- Reported losses have adversely affected market prices yielding further losses and increasing the overall risk of the financial system.

While those criticisms have some validity, they also are misplaced or overstated in important respects.

The more relevant question is whether fair value accounting provides more useful information to investors than alternative accounting approaches. The answer to that question is "yes."

Some of the key reasons why fair value accounting benefits investors include:

- It requires or permits companies to report amounts that are more accurate, timely, and comparable than the amounts that would be reported under existing alternative accounting approaches, even during extreme market conditions
- It requires or permits companies to report amounts that are updated on a regular and ongoing basis
- It limits companies' ability to manipulate their net income because gains and losses on assets and liabilities are reported in the period they occur, not when they are realized as the result of a transaction
- Gains and losses resulting from changes in fair value estimates indicate economic events that companies and investors may find worthy of additional disclosures.

## I. Introduction

During the ongoing credit crunch,[1] the markets for subprime and some other asset and liability positions have been severely illiquid and disorderly in other respects. This has led various (possibly self-interested) parties to raise three main potential criticisms of fair value accounting. First, unrealized losses recognized under fair value accounting may reverse over time. Second, market illiquidity may render fair values difficult to measure and thus unreliable. Third, firms reporting unrealized losses under fair value accounting may yield adverse feedback effects that cause further deterioration of market prices and increase the overall risk of the financial system ("systemic risk"). While similar criticisms have been made periodically for as long as fair values have been used in GAAP (well over 50 years), the recent volume and political salience[2] of these criticisms is ironic given that in September 2006 the FASB issued FAS 157, *Fair Value Measurements*. This standard contains considerably more comprehensive fair value measurement guidance than previously existed. It almost seems that the credit crunch was sent to serve as FAS 157's trial by fire.

This white paper explains these potential criticisms, indicating where they are correct and where they are misplaced or overstated. It also summarizes the divergent views of parties who believe that fair value accounting benefits investors and of those who believe it hurts investors. Believing in full disclosure, the author acknowledges that he is an advocate of fair value accounting, especially for financial institutions, but not a zealot with respect to fair value measurement issues such as those raised by the credit crunch. Like any other accounting system, fair value accounting has its limitations, both conceptual and practical. The relevant questions to ask are: Does fair value accounting provide more useful information to investors than the alternatives (generally some form of amortized cost accounting)? If so, can the FASB improve FAS 157's guidance regarding fair value measurement to better cope with illiquid or otherwise disorderly markets? In the author's view, the answer to each of these questions is "yes."

Section II provides useful background information about fair value accounting, the limited alternative of amortized cost accounting, and the unsatisfying current mixed-attribute accounting model for financial instruments. This section abstracts from the difficult issues raised by the credit crunch, because investors cannot properly understand these issues and their relative importance without first understanding the more basic issues discussed in this section. Section III summarizes FAS 157's fair value measurement guidance, indicating where that guidance does not address the issues raised by the credit crunch with sufficient specificity. Section IV discusses the aforementioned potential criticisms of fair value accounting during the credit crunch and provides the author's views about these criticisms. Sections V and VI summarize the reasons why some parties believe that fair value accounting benefits investors while others believe it hurts investors.

## II. Background Information Abstracting from the Credit Crunch

### A.Fair Value Accounting

The goal of fair value measurement is for firms to estimate as best as possible the prices at which the positions they currently hold would change hands in orderly transactions based on current information and conditions. To meet this goal, firms must fully incorporate current information about future cash flows and current risk-adjusted discount rates into their fair value measurements. As discussed in more detail in Section III, when market prices for the same or similar positions are available, FAS 157 generally requires firms to use these prices in estimating fair values. The rationale for this requirement is market prices should reflect all publicly available information about future cash flows, including investors' private information that is revealed through their trading, as well as current risk-adjusted discount rates. When fair values are estimated using unadjusted or adjusted market prices, they are referred to as mark-to-market values. If market prices for the same or similar positions are not available, then firms must estimate fair values using valuation models. FAS 157 generally requires these models to be applied using observable market inputs (such as interest rates and yield curves that are observable at commonly quoted intervals) when they are available and unobservable firm-supplied inputs (such as expected cash flows developed using the firm's own data) otherwise. When fair values are estimated using valuation models, they are referred to as mark-to-model values.

Under fair value accounting, firms report the fair values of the positions they currently hold on their balance sheets. When fair value accounting is applied fully, firms also report the periodic changes in the fair value of the positions they currently hold, referred to as unrealized gains and losses, on their income statements. Unrealized gains and losses result from the arrival of new information about future cash flows and from changes in risk-adjusted discount rates during periods. As discussed in more detail in Section II.C, current GAAP requires fair value accounting to be applied in an incomplete fashion for some positions, with unrealized gains and losses being recorded in accumulated other comprehensive income, a component of owners' equity, not in net income.[3]

The main issue with fair value accounting is whether firms can and do estimate fair values accurately and without discretion. When identical positions trade in liquid markets that provide unadjusted mark-to-market values, fair value generally is the most accurate and least discretionary possible measurement attribute, although even liquid markets get values wrong on occasion. Fair values typically are less accurate and more discretionary when they are either adjusted mark-to-market values or mark-to-model values. In adjusting mark-to-market values, firms may have to make adjustments for market illiquidity or for the dissimilarity of the position being fair valued from the position for which the market price is observed. These adjustments can be large and judgmental in some circumstances. In estimating mark-to-model values, firms typically have choices about which valuation models to use and about which inputs to use in applying the chosen models. All valuation models are limited, and different models capture the value-relevant aspects of positions differently. Firms often must apply valuation models using inputs derived from historical data that predict future cash flows or correspond to risk-adjusted discount rates imperfectly. The periods firms choose to analyze historical data to determine these inputs can have very significant effects on their mark-to-model values.

This issue with fair value accounting is mitigated in practice in two significant ways. First, FAS 157 and the accounting standards governing certain specific positions (e.g., FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which governs retained interests from securitizations) require firms to disclose qualitative information about how they estimate fair values as well as quantitative information about their valuation inputs, the sensitivities of their reported fair values to those inputs, and unrealized gains and losses and other changes in the fair value of their positions. These disclosures allow investors to assess the reliability of reported fair values and to adjust or ignore them as desired. Over time, the FASB can and surely will improve these disclosures and expand them to more positions. Second, most fair value accounting standards require fair values to be re-estimated each quarter, and so past valuation errors can and should be corrected on an ongoing and timely basis.

In principle, fair value accounting should be the best possible measurement attribute for inducing firms' managements to make voluntary disclosures and for making investors aware of the critical questions to ask managements. When firms report unrealized gains and losses, their managements are motivated to explain in the Management Discussion and Analysis sections of financial reports and elsewhere what went right or wrong during the period and the nature of any fair value measurement issues. If a firm's management does not adequately explain their unrealized gains and losses, then investors at least are aware that value-relevant events occurred during the period and can prod management to explain further. Until recently, however, managements have made relatively few voluntary disclosures regarding their fair values. Fortunately, this appears to be changing as a result of the credit crunch and other factors, as illustrated by the Senior Supervisors Group's (2008) survey of recent leading-practice disclosures.

## B. The Limited Alternative of Amortized Cost Accounting

The alternative to fair value accounting generally is some form of amortized cost (often referred to over-broadly as "accrual") accounting. In its pure form, amortized cost accounting uses *historical* information about future cash flows and risk-adjusted discount rates from the inception of positions to account for them throughout their lives on firms' balance sheets and income statements. Unlike under fair value accounting, unrealized gains and losses are ignored until they are realized through the disposal, or impairment in value, of positions or the passage of time. When firms dispose of positions, they record the *cumulative* unrealized gains and losses that have developed since the inception or prior impairment of positions on their income statements.

Amortized cost accounting raises three main issues, all of which arise from its use of untimely historical information about future cash flows and risk-adjusted discount rates.

1. Income typically is persistent for as long as firms hold positions, but becomes transitory when positions mature or are disposed of and firms replace them with new positions at current market terms. This can lull investors into believing that income is more persistent than it really is.

2. Positions incepted at different times are accounted for using different historical information and discount rates, yielding inconsistent and untimely accounting for the constituent elements of firms' portfolios. This obscures the net value and risks of firms' portfolios.

3. Firms can manage their income through the selective realization of cumulative unrealized gains and losses on positions, an activity referred to as gains trading.

Issues 2 and 3 are particularly significant for financial institutions. These institutions typically hold portfolios of many positions chosen to have largely but not completely offsetting risks, so that the aggregate risks of the institutions' portfolios are within their risk management guidelines but still allow them to earn above riskless rates of return. Amortized cost accounting effectively treats financial institutions' positions as if they have no unexpected changes in value until institutions realize gains and losses on their positions. Financial institutions can easily engage in gains trading, because their positions are often quite liquid, and because one side of each of their many offsetting positions typically will have a cumulative unrealized gain while the other side will have a cumulative unrealized loss. Financial institutions can selectively dispose of the side of their offsetting positions with cumulative unrealized gains (losses), thereby raising (lowering) their net income. Because these institutions hold many offsetting positions, such gains trading can go on for many periods, possibly in the same direction.

In practice, financial report disclosures mitigate these issues with amortized cost accounting in very limited ways. For example, regarding issues 1 and 2, SEC Industry Guide 3 requires banks to disclose detailed breakdowns of their amortized cost interest revenue and expense by type of interest-earning asset and interest-paying liability. Through careful analysis of these disclosures, investors can attempt to disentangle the persistent and transitory components of amortized cost interest and to undo the inconsistent calculation of interest for different positions. This analysis can be difficult to conduct, however, because it requires investors to estimate from other information sources the average lives of banks' different types of assets and liabilities and thus when these positions likely were incepted and will mature (assuming banks do not dispose of them before maturity). Moreover, these disclosures are not required for non-banks. Regarding issue 3, all firms must disclose their realized and unrealized gains and losses on available-for-sale securities under FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, which clearly reveals gains trading for these securities. However, such disclosures are not required for most other financial assets and liabilities for which gains trading is feasible, although they could be.

Traditional bankers and other advocates of amortized cost accounting often argue that unrealized gains and losses on fixed-rate or imperfectly floating-rate positions that arise due to changes in risk-adjusted discount rates (i.e., both riskless rates and credit risk premia) are irrelevant when firms intend to hold positions to maturity, because firms will eventually receive or pay the promised cash flows on the positions. Absent issues regarding the measurement of unrealized gains and losses, this argument is clearly incorrect. Changes in risk-adjusted discount rates yield economic gains and losses to the current holders of the positions compared to the alternative of acquiring identical positions at current rates. For example, when risk-adjusted discount rates rise old assets yielding interest at lower historical rates are worth less than identical new assets yielding higher current rates. These old and new assets do not have the same values and should not be accounted for as if they do. This is true regardless of whether the firms currently holding the old assets intend to dispose of them before maturity or not.

The incorrectness of this argument is most obvious at the portfolio level, which is the right level to analyze most financial institutions. For example, if interest rates rise, then traditional banks' old assets yielding lower historical rates may have to be financed with new liabilities yielding higher current rates.

Amortized cost accounting usually is not applied in a pure fashion. Assets accounted for at amortized cost typically are subject to impairment write-downs. These write-downs can adjust the asset balance to fair value or to another measurement attribute (typically one that results in an asset balance above fair value). Depending on how impairment write-downs are measured, some or all of the fair value measurement issues discussed in Section II.A also apply to these write-downs. Moreover, additional issues arise for impairment write-downs that are recorded only if judgmental criteria are met, such as the requirement in FAS 115 and some other standards to record impairment write-downs only if the impairments are "other than temporary." Similarly, certain economic liabilities accounted for at amortized cost (e.g., most loan commitments) are subject to judgmental accruals of probable and reasonably estimable losses under FAS 5, *Accounting for Contingencies*.

## C.The Unsatisfying Mixed-Attribute Accounting Model for Financial Instruments

GAAP requires various measurement attributes to be used in accounting for financial instruments. This is referred to as the "mixed attribute" accounting model.

1. Most traditional financial instruments (e.g., banks' loans held for investment, deposits, and debt) are reported at amortized cost.

    a. As just discussed, financial assets typically are subject to (other-than-temporary) impairment write-downs. Economic financial liabilities may be subject to accrual of probable and reasonably estimable losses.

2. A few financial instruments—including trading securities under FAS 115, nonhedge and fair value hedge derivatives and fair value hedged items under FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and instruments for which the fair value option is chosen under FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*—are reported at fair value on the balance sheet with unrealized gains and losses included in net income each period.

3. Two distinct hybrids of amortized cost and fair value accounting are required for other financial instruments.

a. Available-for-sale securities under FAS 115 and cash flow hedge derivatives under FAS 133 are recorded at fair value on the balance sheet but unrealized gains and losses are recorded as they occur in accumulated other comprehensive income, a component of owners' equity, not in net income.

b. Loans held-for-sale are recorded at lower of cost or fair value under FAS 65, *Accounting for Certain Mortgage Banking Activities* (mortgages) and SOP 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) that Lend or Finance the Activities of Others* (other loans).

The mixed attribute model often allows firms to choose the measurement attribute they desire for a position through how they classify the position. For example, under FAS 115 a firm may choose to classify a security as any one of trading, available for sale, or held to maturity, and thereby obtain one of three different accounting treatments. Relatedly, the SEC (2005) states "the mixed-attribute model has prompted a significant amount of accounting-motivated transaction structures."

Similar to (and in some respects worse than) amortized cost accounting, the mixed attribute model poorly describes the net value and risks of financial institutions' portfolios of financial instruments. In particular, this model can make effective risk management by these institutions appear to be speculation, and vice-versa. For example, consider a bank that acquires fixed-rate securities that it classifies as trading and that finances those securities with fixed-rate debt with the same duration and other risk characteristics, so that the bank has no interest rate risk. If interest rates rise, then the bank's trading assets will experience an unrealized loss that is recorded in net income, while its debt will experience an unrealized gain that is not immediately recognized for any accounting purpose. Hence, this bank will appear to have been speculating on interest rate movements. Conversely, consider a bank that acquires floating-rate securities and finances those securities with the same fixed-rate debt as before, so that the bank is speculating that interest rates will rise. If interest rates do rise, then the unrealized gain on the bank's debt will not be immediately recognized for any accounting purpose and so the bank will appear to be immune to interest rate risk.

Because of these severe limitations, in the author's view consistent fair value accounting for all of financial institutions' financial instruments is clearly preferable to either the current mixed-attribute accounting model or to a pure amortized cost model.[4] Because amortized costs are useful as a check on fair values and for specific types of investment and other decisions, however, the FASB should require firms to disclose the amortized costs of financial instruments. Fair value accounting with amortized cost disclosures would be essentially the reverse of the current mixed-attribute accounting model with disclosures of the fair values under FAS 107, *Disclosures about Fair Value of Financial Instruments*.

## III.FAS 157

FAS 157 contains essentially all of the current GAAP guidance regarding how to measure fair values. FAS 157 does not require fair value accounting for any position; its guidance is relevant only when other accounting standards require or permit positions to be accounted for at fair value. While FAS 157 became effective for fiscal years beginning after November 15, 2007, most large financial institutions early adopted the standard in the first quarter of 2007, and so it has been applicable for these institutions during the entirety of the credit crunch. Not surprisingly, these institutions have reported a large portion of the losses resulting from the credit crunch.

This section describes the critical aspects of FAS 157's definition of fair value and hierarchy of fair value measurement inputs. It also indicates where this guidance does not deal with the issues raised by the credit crunch with sufficient specificity.

### A.Definition of Fair Value

FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This definition of fair value reflects an ideal "exit value" notion in which firms exit the positions they currently hold through orderly transactions with market participants at the measurement date, not through fire sales.

"At the measurement date" means that fair value should reflect the conditions that exist at the balance sheet date. For example, if markets are illiquid and credit risk premia are at unusually high levels at that date, then fair values should reflect those conditions. In particular, firms should not incorporate their expectations of market liquidity and credit risk premia returning to normal over some horizon, regardless of what historical experience, statistical models, or expert opinion indicates.

An "orderly transaction" is one that is unforced and unhurried. The firm is expected to conduct usual and customary marketing activities to identify potential purchasers of assets and assumers of liabilities, and these parties are expected to conduct usual and customary due diligence. During the credit crunch, these activities could take considerable amounts of time because of the few and noisy signals about the values of positions being generated by market transactions and because of parties' natural skepticism regarding those values. As a result, a temporal slippage arises between the "at the measurement date" and "orderly transaction" aspects of FAS 157's fair value definition that raises practical problems for preparers of financial reports. This slippage is discussed in more detail in Section III.B.

"Market participants" are knowledgeable, unrelated, and willing and able to transact. Knowledgeable parties are not just generally sophisticated and aware of market conditions; they have conducted the aforementioned due diligence and ascertained as best as possible the fair values of the positions under consideration. FAS 157 presumes that, after conducting these activities, either market participants are as knowledgeable as the firms currently holding the positions or they can price any remaining information asymmetry. The standard does not contemplate the idea that information asymmetry between the current holders of positions and potential purchasers or assumers of positions is so severe that markets break down altogether, as appears to have effectively occurred for some positions during the credit crunch.

## B. Hierarchy of Fair Value Measurement Inputs

FAS 157 creates a hierarchy of inputs into fair value measurements, from most to least reliable. Level 1 inputs are unadjusted quoted market prices in active markets for identical items. With a few narrow exceptions, FAS 157 explicitly requires firms to measure fair values using level 1 inputs whenever they are available.

Level 2 inputs are other directly or indirectly observable market data. There are two broad subclasses of these inputs. The first and generally preferable subclass is quoted market prices in active markets for similar items or in inactive markets for identical items. These inputs yield adjusted mark-to-market measurements that are less than ideal but usually still pretty reliable, depending on the nature and magnitude of the required valuation adjustments. The second subclass is other observable market inputs such as yield curves, exchange rates, empirical correlations, et cetera. These inputs yield mark-to-model measurements that are disciplined by market information, but that can only be as reliable as the models and inputs employed. In the author's view, this second subclass usually has less in common with the first subclass than with better quality level 3 measurements described below.

Level 3 inputs are unobservable, firm-supplied estimates, such as forecasts of home price depreciation and the resulting credit loss severity on mortgage-related positions. These inputs should reflect the assumptions that market participants would use, but they yield mark-to-model valuations that are largely undisciplined by market information. Due to the declining price transparency during the credit crunch, many subprime positions that firms previously fair valued using level 2 inputs inevitably had to be fair valued using level 3 inputs.

As discussed in more detail in Section IV.B, while level 2 inputs generally are preferred to level 3 inputs, FAS 157 does not necessarily require firms to use level 2 inputs over level 3 inputs. Firms should use "the assumptions that market participants would use in pricing the asset or liability." When markets are illiquid, firms can make the argument that available level 2 inputs are of such low quality that market participants would use level 3 inputs instead.

If a fair value measurement includes even one significant level 3 input, then it is viewed as a level 3 measurement. FAS 157 sensibly requires considerably expanded disclosures for level 3 fair value measurements.

## IV. Potential Criticisms of Fair Value Accounting During the Credit Crunch

This section discusses the three potential criticisms of fair value accounting during the credit crunch previously mentioned in Section I. It also indicates the guidance in FAS 157 that is most relevant to these criticisms and provides some factual observations as well as the author's views about these criticisms and guidance.

### A. Unrealized Gains and Losses Reverse[5]

This section discusses two distinct reasons why unrealized gains and losses may reverse with greater than 50% probability. First, the market prices of positions may be bubble prices that deviate from fundamental values. Second, these market prices may not correspond to the future cash flows most likely to be received or paid because the distribution of future cash flows is skewed. For example, the distribution of future cash flows on an asset may include some very low probability but very high loss severity future outcomes that reduce the fair value of the asset.

#### 1. Bubble Prices

The financial economics literature now contains considerable theory and empirical evidence that markets sometimes exhibit "bubble prices" that either are inflated by market optimism and excess liquidity or are depressed by market pessimism and illiquidity compared to fundamental values. Bubble prices can result from rational short-horizon decisions by investors in dynamically efficient markets, not just from investor irrationality or market imperfections.[6] Whether bubble prices have existed for specific types of positions during the credit crunch is debatable, but it certainly is possible.[7]

In FAS 157's hierarchy of fair value measurement inputs, market prices for the same or similar positions are the preferred type of input. If the market prices of positions currently are depressed below their fundamental values as a result of the credit crunch, then firms' unrealized losses on positions would be expected to reverse in part or whole in future periods. Concerned with this possibility, some parties have argued that it would be preferable to allow or even require firms to report amortized costs or level 3 mark-to-model fair values for positions rather than level 2 adjusted mark-to-market fair values that yield larger unrealized losses.[8]

If level 1 inputs are available, then with a few narrow exceptions FAS 157 requires firms to measure fair values at these active market prices for identical positions without any adjustments for bubble pricing. However, if only level 2 inputs are available and firms can demonstrate that these inputs reflect forced sales, then FAS 157 (implicitly) allows firms to make the argument that level 3 mark-to-model based fair values are more faithful to FAS 157's fair value definition.

The author agrees with the FASB's decision in FAS 157 that the possible existence of bubble prices in liquid markets should not affect the measurement of fair value. It is very difficult to know when bubble prices exist and, if so, when the bubbles will burst. Different firms would undoubtedly have very different views about these matters, and they likely would act in inconsistent and perhaps discretionary fashions. To be useful, accounting standards must impose a reasonably high degree of consistency in application.

It should also be noted that amortized costs reflect any bubble prices that existed when positions were incepted. In this regard, the amortized costs of subprime-mortgage-related positions incepted during the euphoria preceding the subprime crisis are far more likely to reflect bubble prices than are the current fair values of those positions.

## 2. Skewed Distributions of Future Cash Flows

Fair values should reflect the expected future cash flows based on current information as well as current risk-adjusted discount rates for positions. When a position is more likely to experience very unfavorable future cash flows than very favorable future cash flows, or vice-versa—statistically speaking, when it exhibits a skewed distribution of future cash flows—then the expected future cash flows differ from the most likely future cash flows. This implies that over time the fair value of the position will be revised in the direction of the most likely future cash flows with greater than 50% probability, possibly considerably greater. While some parties appear to equate this phenomenon with expected reversals of unrealized gains and losses such as result from bubble prices, it is not the same thing. When distributions of future cash flows are skewed, fair values will tend to be revised by relatively small amounts when they are revised in the direction of the most likely future cash flows but by relatively large amounts when they are revised in the opposite direction. Taking into account the sizes and probabilities of the possible future cash flows, the unexpected change in fair value will be zero on average.

Financial instruments that are options or that contain embedded options exhibit skewed distributions of future cash flows. Many financial instruments have embedded options, and in many cases the credit crunch has accentuated the importance of these embedded options. Super senior CDOs, which have experienced large unrealized losses during the credit crunch, are a good example. At inception, super senior CDOs are structured to be near credit riskless instruments that return their par value with accrued interest in almost all circumstances. Super senior CDOs essentially are riskless debt instruments with embedded written put options on some underlying set of assets. Super senior CDOs return their par value with accrued interest as long as the underlying assets perform above some relatively low threshold (reflecting the riskless debt instruments), but they pay increasingly less than this amount the more the underlying assets perform below that threshold (reflecting the embedded written put options). As a result of the embedded written put options, the fair values of super senior CDOs typically are slightly less than the values implied by the most likely cash flows. During the credit crunch, the underlying assets (often subprime mortgage-backed securities) performed very poorly, increasing the importance of the embedded put option and decreasing the fair value of super senior CDOs further below the value implied by the most likely outcome, which for some super seniors may still be to return the par value with accrued interest.

To illustrate this subtle statistical point, assume that the cash flows for a super senior CDO are driven by home price depreciation, and that the distribution of percentage losses is modestly skewed with relatively small probability of large losses, as indicated in the following table.

| *home price depreciation* | *probability occurs* | *estimated loss on (value of) super senior CDO as a percentage of par value* |
|---|---|---|
| <10% | 20% | 0% (100%) |
| 15% | 40% | 5% (95%) |
| 20% | 25% | 20% (80%) |
| 25% | 10% | 40% (60%) |
| 30% | 5% | 80% (20%) |

In this example, the most likely percentage loss on the super senior is 5%, which occurs 40% of the time. The expected percentage loss is a considerably larger 15%=(40%×5%) + (25%×20%) + (10%×40%) + (5%×80%), because it reflects the relatively small probabilities of large losses. The fair value of the super senior is reduced by the expected percentage loss and so is 85% of face value. Over time, this fair value will be revised upward with 60% probability, to either 95% of face value (with 40% probability) or 100% of face value (with 20% probability). The fair value will be revised downward with only 40% probability, to 80% of face value (with 25% probability) or 60% of face value (with 10% probability) or 20% of face value (with 5% probability). The expected change in fair value is zero, however, because the lower probability but larger possible fair value losses are exactly offset by the higher probability but smaller possible fair value gains. The difference between the most likely and expected change in fair value would be larger if the distribution of cash flows was more skewed.

In the author's view, it is more informative to investors for accounting to be right on average and to incorporate the probability and significance of all possible future cash flows, as fair value accounting does, than for it to be right most of the time but to ignore relatively low probability but highly unfavorable or favorable future cash flows. Relatedly, by updating the distribution of future cash flows each period, fair value accounting provides investors with timelier information about changes in the probabilities of large unfavorable or favorable future cash flows. Such updating is particularly important in periods of high and rapidly evolving uncertainty and information asymmetry, such as the credit crunch.

## B. Market Illiquidity

Together, the "orderly transaction" and "at the measurement date" elements of FAS 157's fair value definition reflect the semantics behind the "fair" in "fair value." Fair values are not necessarily the currently realizable values of positions; they are hypothetical values that reflect fair transaction prices even if current conditions do not support such transactions.

When markets are severely illiquid, as they have been during the credit crunch, this notion yields significant practical difficulties for preparers of firms' financial statements. Preparers must imagine hypothetical orderly exit transactions even though actual orderly transactions might not occur until quite distant future dates. Preparers will often want to solicit actual market participants for bids to help determine the fair values of positions, but they cannot do so when the time required exceeds that between the balance sheet and financial report filing dates. Moreover, any bids that market participants might provide would reflect market conditions at the expected transaction date, not the balance sheet date.

When level 2 inputs are driven by forced sales in illiquid markets, FAS 157 (implicitly) allows firms to use level 3 model-based fair values. For firms to be able to do this, however, their auditors and the SEC generally require them to provide convincing evidence that market prices or other market information are driven by forced sales in illiquid markets. It may be difficult for firms to do this, and if they cannot firms can expect to be required to use level 2 fair values that likely will yield larger unrealized losses.

In the author's view, the FASB can and should provide additional guidance to help firms, their auditors, and the SEC individually understand and collectively agree what constitutes convincing evidence that level 2 inputs are driven by forced sales in illiquid markets. The FASB could do this by developing indicators of market illiquidity, including sufficiently large bid-ask spreads or sufficiently low trading volumes or depths. These variables could be measured either in absolute terms or relative to normal levels for the markets involved. When firms are able to show that such indicators are present, the FASB should explicitly allow firms to report level 3 model-based fair values rather than level 2 valuations as long as they can support their level 3 model-based fair values as appropriate in theory and with adequate statistical evidence. Requiring firms to compile indicators of market illiquidity and to provide support for level 3 mark-to-model valuations provides important discipline on the accounting process and cannot be avoided.

Relatedly, the author also believes that the FASB should require firms to disclose their significant level 3 inputs and the sensitivities of the fair values to these inputs for all of their material level 3 model-based fair values. If such disclosures were required, then level 3 model-based fair values likely would be informationally richer than poor quality level 2 fair values.

## C.Adverse Feedback Effects and Systemic Risk

By recognizing unrealized gains and losses, fair value accounting moves the recognition of income and loss forward in time compared to amortized cost accounting. In addition, as discussed in Section IV.A.1 unrealized gains and losses may be overstated and thus subsequently reverse if bubble prices exist. If firms make economically suboptimal decisions or investors overreact because of reported unrealized gains and losses, then fair value accounting may yield adverse feedback effects that would not occur if amortized cost accounting were used instead. For example, some parties have argued that financial institutions' write-downs of subprime and other assets have caused further reductions of the market values of those assets and possibly even systemic risk. These parties argue that financial institutions' reporting unrealized losses has caused them to sell the affected assets to raise capital, to remove the taint from their balance sheets, or to comply with internal or regulatory investment policies.[9] These parties also argue that financial institutions' issuance of equity securities to raise capital have crowded out direct investment in the affected assets.

In the author's view, it is possible that fair value accounting-related feedback effects have contributed slightly to market illiquidity, although he is unaware of any convincing empirical evidence that this has been the case. However, it is absolutely clear that the subprime crisis that gave rise to the credit crunch was primarily caused by firms, investors, and households making bad operating, investing, and financing decisions, managing risks poorly, and in some instances committing fraud, not by accounting. The severity and persistence of market illiquidity during the credit crunch and any observed adverse feedback effects are much more plausibly explained by financial institutions' considerable risk overhang[10] of subprime and other positions and their need to raise economic capital, as well as by the continuing high uncertainty and information asymmetry regarding those positions. Financial institutions actually selling affected assets and issuing capital almost certainly has mitigated the overall severity of the credit crunch by allowing these institutions to continue to make loans. Because of its timeliness and informational richness, fair value accounting and associated mandatory and voluntary disclosures should reduce uncertainty and information asymmetry faster over time than amortized cost accounting would, thereby mitigating the duration of the credit crunch.

Moreover, even amortized cost accounting is subject to impairment write-downs of assets under various accounting standards and accrual of loss contingencies under FAS 5. Hence, any accounting-related feedback effects likely would have been similar in the absence of FAS 157 and other fair value accounting standards.

## V. Summary of Reasons Why Some Believe that Fair Value Accounting Benefits Investors

In the author's observation, the FASB and IASB, most trading-oriented financial institutions, most investor associations,[11] and most accounting academics[12] believe that overall fair value accounting benefits investors compared to accounting based on alternative measurement attributes, including amortized cost accounting. This section summarizes the benefits of fair value accounting and indicates the prior section of the paper in which these benefits are discussed.

1. Even if markets exhibit bubble prices, fair values are more accurate, timely, and comparable across different firms and positions than are alternative measurement attributes, as discussed in Section II.

    a. Fair values reflect current information about future cash flows and current risk-adjusted discount rates, as discussed in Section II.A.

        i. In contrast, amortized costs can differ dramatically from fundamental values and be very untimely for long-lived positions, as discussed in Section II.B.

ii. Amortized costs reflect any bubble prices that existed when positions were incepted. In particular, the amortized costs of subprime-mortgage-related positions incepted during the euphoria preceding the subprime crisis are far more likely to reflect bubble prices than are the current fair values of those positions.

b. Fair value accounting self-corrects over time in a timely fashion, as discussed in Section II.A.

i. This self-correcting quality is particularly important in periods of high and rapidly evolving uncertainty and information asymmetry, such as the credit crunch.

ii. In contrast, amortized cost accounting does not self-correct until gains and losses are realized, as discussed in Section II.B.

c. The comparability of the fair values of different positions is particularly important in assessing the net value and risks of financial institutions' portfolios of financial instruments, as discussed in Section II.C.

i. In contrast, amortized costs are inconsistently untimely across positions incepted at different times, as discussed in Section II.B.

2. As discussed in Section III, while the credit crunch raises issues for fair value measurements, under FAS 157 fair values need not reflect fire sale values. When level 2 inputs are driven by fire sales, firms can make the argument that level 3 model-based fair values are allowed under FAS 157. Requiring firms to make this argument provides important discipline on the accounting process.

a. One should not confuse the need for the FASB to provide additional guidance regarding how to measure fair values in illiquid markets with amortized cost accounting being preferable to fair value accounting. As discussed in Section II.B, amortized cost accounting has severe limitations even in liquid markets. These limitations become more significant in illiquid markets, because it is then that investors most need to be able to assess firms' value and risks accurately and that firms' incentives to manage their owners' equity and net income through gains trading are highest.

3. Fair value accounting does not allow firms to manage their income through gains trading, because gains and losses are recognized when they occur, not when they are realized.

a. In contrast, amortized cost accounting allows gains trading, especially by financial institutions, as discussed in Section II.B.

4. As discussed in Section IV.A.2, when the distributions of future cash flows are skewed, it is more informative to investors to be right on average and to incorporate the probability and significance of all possible future cash flows, as fair value accounting does, than to be right most of the time but ignore relatively low probability but highly favorable or unfavorable future cash flows. It is also important to update the distribution of future cash flows for new information on a timely basis, as fair value accounting does.

5. Fair value accounting is the best platform for mandatory and voluntary disclosure and for investors to be aware of what questions to ask management, as discussed in Section II.A.

    a. GAAP already mandates some useful disclosures, which the FASB can and surely will improve and extend to more positions over time.

    b. When firms report unrealized gains and losses under fair value accounting, their managements are motivated to explain what went right or wrong during the period and the nature of any fair value measurement issues.

        i. Firms have begun to make useful fair value-related voluntary disclosures, and leading-practices are developing.

    c. If managements do not provide adequate explanations, then investors at least are aware that something value-relevant happened during the period and can prod managements to explain further.

    d. In contrast, amortized cost accounting ignores unrealized gains and losses until they are realized, as discussed in Section II.B. Hence, firms typically are not required or motivated to explain economic gains and losses prior to realization. Investors may not even be aware when valuation relevant events occur during periods.

## VI. Summary of Reasons Why Some Believe that Fair Value Accounting Hurts Investors

In the author's observation, virtually all traditional banks[13] and other traditional financial institutions, most bank regulators (although this is changing with Basel II and other recent regulatory decisions),[14] and some investors and accounting academics[15] believe that fair value accounting hurts investors compared to accounting based on amortized cost or other measurement attributes, at least in some circumstances. This section catalogs the potential harms of fair value accounting and indicates the prior sections of the paper in which these potential harms are discussed. Some additional discussion of the author's views is provided regarding points not addressed in prior sections of the paper.

1. When markets are illiquid, fair value is a poorly defined notion involving hypothetical transaction prices that cannot be measured reliably, regardless of how much measurement guidance the FASB provides.

    a. In the author's view, while this point contains considerable truth as discussed in Section IV.B, it is not really a criticism of fair value accounting per se. There are many contexts in accounting where measurements are difficult to make, such as noncash exchanges and bundled sales of goods that are never sold separately as well as impairment write-downs of illiquid real and intangible assets that are otherwise accounted for at amortized cost. In these contexts, accounting measurements often involve hypothetical transactions. Hence, this point essentially boils down to the true statement that some difficult measurement settings necessarily involve hypothetical transactions. In fact, one could argue that fair value accounting for financial instruments is unusual for the opposite reason that the fair values of these instruments often can be based on actual current market transactions, not hypothetical transactions.

2. When fair values are provided by sources other than liquid markets, they are unverifiable and allow firms to engage in discretionary income management and other accounting behaviors.

    a. The comparative advantage of accounting is to provide verifiable and auditable information.

    b. In the author's view, while this point also contains considerable truth as discussed in Section II.A, it ignores the mitigation of the limitations of fair value accounting through disclosure as well as the severe limitations of amortized cost accounting discussed in Section II.B. It also ignores the fact that many amortized cost accounting estimates (e.g., goodwill impairments) are difficult to verify and audit.

3. By recognizing unrealized gains and losses, fair value accounting creates volatility in firms' owners' equity (including financial institutions' regulatory capital) and net income that need not correspond to the cash flows that will ultimately be realized.

    a. If firms are willing and able to hold positions to maturity, unrealized gains and losses resulting from changes in riskless rates and credit risk premia are meaningless because the firms will ultimately receive or pay the promised cash flows.

        i. In the author's view, this point is clearly incorrect, as discussed in Section II.B.

b. Unrealized gains and losses resulting from bubble prices or skewed distributions of future cash flows reverse with more than 50% probability over the positions' lives.

    i. In the author's view, this point is true but not a good reason to use a measurement attribute other than fair value, as discussed in Section IV.A.2.

c. Market participants' reaction to unrealized gains and losses can yield adverse feedback effects and asset prices and even systemic risk.

    i. In the author's view, this point may have some truth but it is overstated, as discussed in Section IV.C.

d. Volatility in financial institutions' regulatory capital yields systemic risk.

    i. In the author's view, this point may have some truth but it is overstated, as discussed in Section IV.C.

4. Fair value accounting mixes normal/permanent components of income, such as interest, with transitory unrealized gains and losses.

    a. In the author's view, to the extent that this issue arises in practice it is properly and easily addressed by the FASB requiring disaggregation of permanent and transitory components of income on firms' income statements. The FASB and IASB currently are addressing this issue in their joint financial statement presentation project.

    b. Moreover, this issue applies in a different and in some respects more significant fashion to amortized cost accounting. Realized gains and losses also are not permanent, and they depend on whether firms have cumulative unrealized gains and losses available to be realized and firms' discretionary choices whether or not to realize those cumulative gains and losses.

**NOTES**

[1] Ryan (2008) provides a detailed description of the causes and evolution of the subprime crisis, which began in February 2007, and the credit crunch it engendered, which began in July 2007.

[2] For example, U.S. Representative Barney Frank, the chairman of the United States House of Representatives' Financial Services Committee, has asked for fair value accounting rules to be reconsidered.

[3] More subtly, under current GAAP and accounting practices, interest revenue and expense generally are calculated on an amortized cost basis even when fair value accounting is used. As discussed in Ryan (2007, Chapter 6), this has the unfortunate effect of making unrealized gains and losses appear to reverse each period by the difference between fair value interest and amortized cost interest (i.e., the error in the measurement of interest). The FASB can and should remedy this problem by requiring interest to be calculated on a fair value basis.

[4] Whether fair value accounting is desirable for non-financial (e.g., manufacturing and retailing) firms that primarily hold tangible and intangible assets with very different risk characteristics than their primarily financial liabilities is a more complicated question that is beyond the scope of this white paper. Nissim and Penman (2008) argue that amortized cost accounting has a transaction/outcome-oriented focus that better reveals how these firms deliver on their business plans and thereby earn income over time.

[5] This section does not discuss apparent reversals of unrealized gains and losses that result from interest being calculated on an amortized cost basis even when fair value accounting is used. See footnote 3.

[6] Barlevy (2007) is a very readable discussion of asset price bubbles and the related financial economics literature.

[7] In the author's view, there is little or no reason to believe that relatively junior subprime positions have exhibited bubble pricing during the credit crunch. For example, Markit's indices for relatively junior subprime MBS positions generally have declined toward zero with no significant reversals over time, even after market liquidity improved somewhat beginning in March 2008. Moreover, the Bank of England (2008, pp. 7 and 18-20) finds these indices to be fairly close to the model-based values given reasonable loss scenarios. In contrast, there is at least some reason to believe that relatively senior subprime positions may have exhibited bubble pricing during this period. For example, Markit's indices for these positions exhibited sizeable reversals of prior losses during November-December 2007 and again in March-May 2008, although both these reversals can be explained by interventions by policymakers (the first by the Treasury Department's rescue plan for SIVs and the second by various aggressive actions taken by the Federal Reserve in March 2008). Moreover, the Bank of England concludes that these indices are considerably below modeled values even in extremely adverse loss scenarios. This could be explained by the fact the credit derivatives on which Markit's indices are based are themselves subject to illiquidity and counterparty risk.

[8] See Johnson (2008a,b) and Rummell (2008) for discussion of parties holding such views.

[9] For example, the International Monetary Fund (2008) states that "[a]ccounting standard setters will increasingly need to take into account the financial stability implications of their accounting practices and guidance" (p. xiv). Also, while "fair value accounting gives the most comprehensive picture of a firm's financial health…investment decision rules based on fair value accounting outcomes could lead to self-fulfilling forced sales and falling prices when valuations fell below important thresholds (either self-imposed by financial institutions or by regulation)" (p. 127).
[10] Gron and Winton (2001) show that financial institutions' risk overhang (i.e., risk remaining from past business decisions that cannot be eliminated due to market illiquidity) can cause them to reduce or eliminate their trading activity in positions whose risks are correlated with their risk overhang.
[11] See Center for Financial Market Integrity (2005).
[12] See American Accounting Association Financial Accounting Standards Committee (2000).
[13] See the American Banking Associations website (policy positions index, fair value accounting).
[14] See Bies (2008).
[15] See Nissim and Penman (2008).

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**Testimony of**
**Jeffrey P. Mahoney**
**General Counsel**
**Council of Institutional Investors**
**before the**
**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises**
**of the**
**Committee on Financial Services**
**March 12, 2009**

**Attachment 5**

**Council Correspondence Referenced in Full Text of Statement**

**Council Correspondence Referenced in Full Text of Statement**

1. Letter from Cindy Fornelli, Executive Director, Center for Audit Quality et al. to Mr. Timothy F. Geithner, Secretary, Department of the Treasury et al. (Feb. 13, 2009)

2. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Russell Golden, Technical Director, FASB (Dec. 24, 2008)

3. Letter from Conrad W. Hewitt, Chief Accountant, United States Securities and Exchange Commission to Ms. Cindy Fornelli, Executive Director, Center for Audit Quality et al. (Nov. 26, 2008)

4. Letter from Cindy Fornelli, Executive Director, Center for Audit Quality et al. to The Honorable Christopher Cox, Chairman, Securities and Exchange Commission (Nov. 14, 2008)

5. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission (Oct. 29, 2008) (excluding attachments)

6. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Ms. Teresa S. Polley, Chief Operating Officer, Financial Accounting Foundation (Feb. 11, 2008)

February 13, 2009

Mr. Timothy F. Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Mr. Ben S. Bernanke
Chairman
Federal Reserve Board
20th and C Streets, NW
Washington, D.C. 20551

Ms. Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Secretary Geithner, Chairman Bernanke, and Chairman Schapiro:

We are writing to applaud your efforts to restore investor confidence in the U.S. capital markets during this time of extreme uncertainty. As you seek solutions, we caution against taking action that could further undermine the confidence of investors.

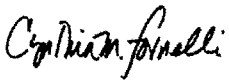
We appreciate the challenges of dealing with the financial instability resulting from the toxic assets held by banks. However, changing financial accounting standards because of valuation challenges is not the way to solve regulatory capital problems. Retreating from fair value in response to political pressure would raise suspicions that the rules were changed in order to falsely inflate asset values. We must avoid a further crisis of investor confidence in our government and the regulatory bodies overseeing those institutions.

We should not confuse the independent private sector Financial Accounting Standards Board's role to develop and improve financial accounting and reporting standards with the role and responsibilities of the regulatory bodies charged with the oversight of the safety and soundness of financial institutions. We do not believe the FASB is the body to effect capital adequacy goals for the financial institution sector.

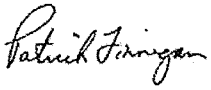
We applaud Treasury Secretary Geithner's efforts to find asset valuations that are fair, realistic, and provide the government with a good assessment of risk. However, this should not be done at the expense of fair value accounting information that best serves the interests of investors both now and over the long term.

We would be pleased to meet with you at your convenience to elaborate on our views.

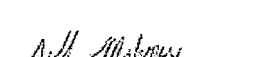
Sincerely,



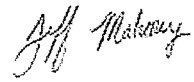
Cindy Fornelli
Executive Director
Center for Audit Quality



Patrick Finnegan
Director, Financial Reporting Policy Group
CFA Institute Centre for Financial Market Integrity



Barbara Roper
Director of Investor Protection
Consumer Federation of America



Jeff Mahoney
General Counsel
Council of Institutional Investors

cc:
Kathleen L. Casey, Commissioner, SEC
Elisse B. Walter, Commissioner, SEC
Luis A. Aguilar, Commissioner, SEC
Troy A. Paredes, Commissioner, SEC
Mark W. Olson, Chairman, PCAOB
Robert H. Herz, Chairman, FASB
Honorable Christopher J. Dodd
Honorable Richard C. Shelby
Representative Barney Frank
Representative Spencer Bachus

# COUNCIL OF INSTITUTIONAL INVESTORS

Suite 500 • 888 17th Street, NW • Washington, DC 20006 • (202) 822-0800 • Fax (202) 822-0801 • www.cii.org

Via Email

December 24, 2008

Russell Golden
Technical Director
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference: Proposed FSP EITF 99-20-a

Dear Mr. Golden:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 140 public, corporate and union pension funds with combined assets of over $3 trillion.[1] As a leading voice for long-term, patient capital, we appreciate the opportunity to provide comments in response to the proposed Financial Accounting Standards Board ("FASB") Staff Position ("FSP") 99-20-a to amend Emerging Issues Task Force ("EITF") Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets" ("Proposal").[2]

At our October 7, 2008 meeting, the Council's general membership approved an update to our policy on independence of accounting and auditing standard setting ("Policy").[3] The Policy continues to reflect our long-held view that the quality, comparability, and reliability of financial information contained in financial statements and related disclosures depends directly on the quality of financial reporting standards and the standard setters that develop those standards.[4]

The following two criteria contained in the Policy appear particularly relevant to the Proposal:

- The . . . standard setter has demonstrated a clear recognition that investors are the key customer of audited financial reports and, therefore, the primary role of . . . financial reports should be to satisfy in a timely manner investors' information needs. . . .[5]

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[1] For more information about the Council of Institutional Investors ("Council") and its members, visit our website at http://www.cii.org/.

[2] *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, Proposed FSP on EITF Issue 99-20 (Fin. Accounting Standards Bd. Proposed FSP 99-20-a Dec. 2008), http://www.fasb.org/fasb_staff_positions/prop_fsp_eitf99-20-a.pdf [hereinafter Proposal].

[3] The Council of Institutional Investors, Policies on Other Governance Issues, Independence of Accounting and Auditing Standard Setters (Updated Oct. 7, 2008), http://www.cii.org/UserFiles/file/council%20policies/CII%20Policies%20on%20Accounting%20and%20Auditing%2010-7-08(1).pdf [Hereinafter Policy]. For more information about the Council's policies, visit our website at http://www.cii.org/policies.

[4] *See* Policy, *supra*, at 1.

[5] *Id.* Of note, this criterion is consistent with Recommendation 2.1 of the August 1, 2008, Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission which states, in part, "***investor perspectives should be given pre-eminence by all parties involved in standards-setting***" (footnote omitted), http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.

- The . . . standard setter has a thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views before issuing proposals or final standards . . . .[6]

Consistent with the Policy, and the view of many other investors, accountants, auditors, and other market participants, we generally believe that:

> In the specific case of fair value reporting, investors require an accounting standard that reports a relevant and useful value of financial instruments regardless of the direction of the markets. Fair value accounting with robust disclosures provides more reliable, timely, and comparable information than amounts that would be reported under other alternative accounting approaches.[7]

Our belief about the benefits of fair value accounting for financial instruments is also supported by a July 2008 Council-commissioned white paper, "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch."[8] The attached white paper, authored by Professor Stephen G. Ryan, a leading expert on fair value accounting, provides the following insightful comments on fair value accounting and the ongoing credit crisis:

> [I]t is absolutely clear that the subprime crisis that gave rise to the credit crunch was primarily caused by . . . bad operating, investing, and financing decisions, managing risks poorly, and in some instances committing fraud, not by accounting. . . . Because of its timeliness and informational richness, fair value accounting and associated mandatory and voluntary disclosures should reduce uncertainty and information asymmetry faster over time than amortized cost accounting would, thereby mitigating the duration of the credit crunch.[9]

The Council, therefore, cannot support the Proposal for at least two fundamental reasons: (1) We do not believe the Proposal is consistent with the needs of investors; and (2) We do not believe an eleven day comment period (which includes significant ethnic, religious, and national holidays) constitutes a thorough public due process.

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[6] Policy, *supra*, at 1.
[7] Letter from Cindy Fornelli et al. to The Honorable Christopher Cox 1-2 (Nov. 14, 2008), http://www.sec.gov/comments/4-573/4573-175.pdf; *accord* Letter from Jeff Mahoney to Ms. Florence E. Harmon 4 (Oct. 29, 2008), http://www.sec.gov/comments/4-573/4573-95.pdf ("We believe that fair value accounting for financial instruments, complemented by robust disclosures, is superior to other accounting alternatives in (1) providing investors clear and accurate information, and (2) restoring the free flow of money and credit to the U.S. and global capital markets").
[8] Stephen G. Ryan, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch* (July 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/CII%20Fair%20Value%20Paper%20(final)%20%20071108.pdf [hereinafter Attachment].
[9] *Id.* at 16.

The Proposal Does Not Meet the Needs of Investors

As indicated, the Council agrees with many other investors, accountants, auditors, and other market participants that the needs of investors and other consumers of financial reports are best satisfied by requiring that all financial instruments be accounted for at fair value accompanied by robust disclosures. We note that such an approach would eliminate the need for the Proposal because other-than-temporary impairment ("OTTI") models would not be necessary if all financial instruments were reported at fair value.

We also share FASB Chairman Herz's doubts about the usefulness of OTTI models to investors generally.[10] Chairman Herz recently commented:

> I think all of this impairment stuff is voodoo . . . . I see a lot of utility for understanding what's happening to particular instruments, market values, cash flows currently and projected. I don't see a lot of value to some of these calculations that get done now *under any of the impairment models. . . . For those who believe impairment is an important element of the accounting model, I invite them to try to persuade me.*[11]

Notwithstanding the questionable usefulness of current impairment models, until the goal of reporting all financial instruments at fair value is achieved, we would not necessarily oppose any effort by the FASB to align disparate OTTI models for instruments with similar economics at least to the extent that that alignment is directionally consistent with the ultimate goal.[12] The Proposal, however, clearly fails in that regard.[13]

More specifically, the Proposal moves further away from fair value reporting by proposing to replace the OTTI model of EITF Issue No. 99-20 ("99-20") based on "market participant assumptions regarding future cash flows," with the FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("FAS 115"), OTTI model permitting "management judgment of the probability that the holder will be unable to collect the amounts due."[14] We generally agree with the following analysis of this proposed change authored by accounting & valuation experts Sarah Deans and Dane Mott of J.P. Morgan:

> 1. Moving from the 99-20 [OTTI model] . . . to the weaker FAS 115 [OTTI model] . . . actually moves the measure of these assets further away from fair value and makes their OTTI determinations more subject to gaming, in our view.

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[10] Tammy Whitehouse, *FASB Racing Through Impairment Revisions*, Compliance Wk. 1 (Dec. 23, 2008), http://www.complianceweek.com/article/5196/fasb-racing-through-impairment-revisions.
[11] *Id.* at 1 (emphasis added).
[12] *See* Proposal, *supra*, ¶5.
[13] *See, e.g.*, Sarah Deans & Dane Mott, *Accounting Issues—Financial Instrument Proposals: Standard Setters Ditch Normal Due Process*, J.P. Morgan Global Equity Res. 6 (Dec. 19, 2008) (on file with the Council) [hereinafter Deans & Mott].
[14] Proposal, *supra*, ¶4.

> 2. Even though the 99-20 [OTTI model] . . . is inconsistent with FAS 115 [OTTI model], there are numerous inconsistencies in the OTTI models throughout GAAP. If the FASB is sharply focused on the objective of providing the most useful information possible to investors, how exactly does this change accomplish this mission especially if . . . a large contingent of investors have indicated that fair value measures are more relevant to investors? This seems to be a waste of valuable board time and resources that could be used more effectively elsewhere, in our view.[15]

We also note that at the November 11, 2008, meeting of the FASB's own Investors Technical Advisory Committee ("ITAC"), ITAC members voiced strong opposition to the FASB pursuing any project—like the Proposal—designed to amend the existing OTTI guidance for financial instruments.[16] Views expressed by various ITAC members explaining their opposition to the Proposal include the following:

> ITAC does not believe any changes are necessary to the other-than-temporary impairment guidance. . . . ITAC supports measuring financial instruments at fair value, which would make impairment testing unnecessary.
>
> ITAC does not see any reason for an other-than-temporary impairment project at this time. . . . ITAC thinks that those who are encouraging the Boards to add an other-than-temporary impairment project may be looking to minimize losses that are real, which is not in the best interests of investors. . . . [C]hanging US GAAP in [this] . . . area actually would put US GAAP companies at a disadvantage because the cost of capital would increase and investors would be fearful that companies have real losses that have not been recognized. . . . [A] project to revisit the other-than-temporary guidance should not be a high priority for the Board. . . . [A] more desirable project would be one that involves measuring all financial instruments at fair value and developing more robust disclosures about how fair value changes evolve over time. . . . [C]oncerns about other-than-temporary impairment are influenced by concerns over regulatory capital requirements. Those concerns should not result in changes to accounting standards that would decrease the transparency of information for investors and can be addressed through other means.[17]

We generally share ITAC's views on this issue.

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[15] Deans & Mott, *supra,* at 6.
[16] Minutes of Meeting, FASB Investors Technical Advisory Committee ¶¶ 7-9 (Nov. 1, 2008), http://www.fasb.org/investors_technical_advisory_committee/itac_11-11-08.pdf.
[17] *Id.* ¶¶ 7-8.

The Comment Period Is Inadequate

The FASB's rules of procedure require that the "FASB will expose all proposed Statements of Financial Accounting Standards for public comment for at least 60 days, unless a shorter period (not less than 30 days) is considered appropriate by the FASB."[18] Similarly, with respect to proposed interpretations that "clarify, explain, or elaborate on a pronouncement as an aid to its understanding," FASB's rules of procedure require exposure for public comment "for at least 30 days."[19] Finally, with respect to "Technical Bulletins" designed to provide guidance for applying standards that is, among other factors, "not expected to cause a major change in accounting practice for a significant number of entities," FASB's rules of procedure require exposure for public comment of "not . . . less than 15 days."[20]

We acknowledge that on October 1, 2008, the FASB approved the following resolutions temporarily modifying the FASB's rules of procedure to potentially shorten the required public comment periods ("Resolutions"):

> RESOLVED, that effective immediately, and solely in respect to technical standard-setting activities of the FASB . . . that address and/or are responsive to the current spectrum of severe instability in the U.S. and global financial and capital markets, the FASB shall, to the extent and as determined by a majority of the FASB Members on a case-by-case basis to be necessary or advisable, have authority to accelerate FASB's normal due process practices and procedures for . . . receiving public . . . comments on, the FASB's and/or its staff's issuance of, any and all forms of FASB pronouncements . . . .
>
> RESOLVED, that, absent a re-vote to extend the term of the limited modifications to the FASB's standards-setting processes permitted by the foregoing resolution, the foregoing resolution shall expire and be of no further force or effect on January 1, 2009.[21]

Although not explicitly discussed in the Proposal, it appears that the FASB is relying on the Resolutions to accelerate the Proposal's required comment period from not less than fifteen days to only eleven days. Of note, this scrooge-like comment period includes the following ethnic and religious holidays: Boxing Day, Hanukkah, Kwanzaa, Las Posadas, Christmas Eve, and Christmas Day—a national holiday.[22]

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[18] Rules of Procedure 14 (Fin Accounting Standards Bd. Amended & Restated Dec. 1, 2002) (on file with Council).
[19] *Id.* at 15-16.
[20] *Id.* at 16-17.
[21] *Authorization of Limited and Temporary Modifications to Standards-setting Processes* (Fin Accounting Standards Bd. Oct. 1, 2008) (on file with Council) [hereinafter Resolutions].
[22] KU Medical Center, *Ethnic and Religious Cultural Holidays, Celebrations, and Festivals* 5, http://www3.kumc.edu/diversity/ethnic_relig/ethnic.html (last visited Dec. 23, 2008); *see also* Deans & Mott, *supra,* at 7 ("The fact that it is a 10-day comment period over a period when a considerable amount of stakeholders will be on a holiday and have limited opportunities to respond when, in our view, one of the key deficiencies of this project is that inadequate due diligence has been performed is of concern to us").

Notwithstanding our policy supporting a thorough public due process, we generally would not object to the FASB accelerating its due process in truly extreme and unusual circumstances in which a statement, interpretation, or other guidance was necessary to "address and/or . . . respon[d] [to] . . . severe instability in the U.S. global financial and capital markets."[23] There is, however, no evidence that we are aware of contained in, or outside, the Proposal indicating that aligning the impairment models of 99-20 with Statement 115 before year end is necessary or appropriate to address or respond to "severe instability" in the capital markets.[24]

In contrast, we believe the more supportable and far better view is that if the Proposal is adopted by the FASB before year end, it is likely, if anything, to exacerbate instability in the capital markets by further lowering investors' confidence in (1) the reporting by companies, and (2) the related independence of the accounting standard-setting process.[25] On this point, we generally agree with the following critique of the Proposal's due process by expert accountant/analyst Jack Ciesielski:

> So – should there be such a rush? No. Understandably, there are year end consequences. But the FASB looks pretty bad in rushing this project through – it's almost as if they're racing the IASB to find ways to screw up due process. The FASB takes years and years to complete projects – or not complete them – then rushes through something like this. It trivializes the importance of independent standard-setting.[26]

In summary, we strongly oppose the Proposal. We, however, appreciate the opportunity to provide our comments thereon.

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[23] Resolutions, *supra.*

[24] *See, e.g.,* Attachment, *supra,* at 16.

[25] *See, e.g.,* Bob Herz, *Lessons Learned, Relearned, and Relearned Again from the Global Financial Crisis—Accounting and Beyond*, Remarks before the AICPA National Conference on Current SEC & PCAOB Developments 18 (Dec. 8, 2008), http://www.fasb.org/articles&reports/12-08-08_herz_speech.pdf ("[A]ccounting and financial reporting are meant to inform investors and the capital markets and that straying from that objective or subordinating that objective to any other corporate, industry, social or economic objective other than sound and transparent reporting, can also cause financial instability due to loss of investor confidence in the reporting by companies").

[26] Jack Ciesielski, *Like a Train In the Night*, AAO Weblog (Private) (Dec. 18, 2008) (on file with Council); *accord* Deans & Mott, *supra,* at 6 ("We fear that this project could be another example of the FASB and IASB succumbing to political pressure that overrides their long-established system of due process. We believe the regulatory capture of the accounting standard setting process is becoming a real threat based on recent political concessions made by both the IASB and FASB in recent months").

Please feel free to contact me at 202.261.7081 or jeff@cii.org with any questions or if any additional information about the Council's views on the Proposal or related matters would be helpful to your redeliberations.

Sincerely,

Jeff Mahoney
General Counsel
Council of Institutional Investors

Attachment

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

November 26, 2008

Ms. Cindy Fornelli
Executive Director
Center for Audit Quality
601 13th Street NW
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Washington, DC 20005

Mr. Jeffery J. Diermeier, CFA
President & Chief Executive Officer
CFA Institute
560 Ray C. Hunt Dr.
Charlottesville, VA 22903

Ms. Barbara Roper
Direction of Investor Protection
Consumer Federation of America
1620 I Street NW – Suite 200
Washington, DC 20006

Mr. Jeff Mahoney
General Counsel
Council of Institutional Investors
888 17th Street, NW – Suite 500
Washington, DC 20006

Ms. Liz Murall
Director of Corporate Governance and Reporting
Investment Management Association
65 Kingsway
London WC2B 6TD
United Kingdom

Dear Ms. Fornelli et al:

Thank you for your letter dated November 14, 2008.

As you point out, issues encountered in the current crisis, particularly related to fair value accounting, have garnered national and international political attention. The credit crisis also has resulted in a renewed focus on the independence of those entrusted to develop accounting standards. The Commission has long supported the importance of independent standard setting, and I have been clear in my own support for the role of the

FASB and IASB. Their efforts to address current issues on a real-time basis, including mark-to-market accounting, fair value measurements, and other-than-temporary impairments, are essential. Equally as essential is the need for that process to be free from interference.

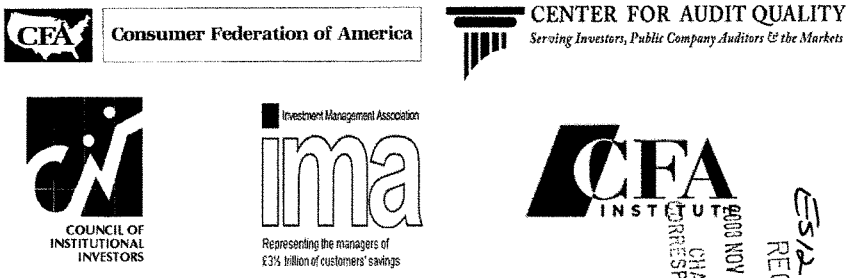
Like you, I believe that independent accounting standard setting has been integral in fostering a financial reporting system that remains robust and responsive to the needs of investors. Of course, open due process, including thoughtfully considering the input and views of your organization's constituents and the many others who participate and play a role in our capital markets, is also critical to the FASB and IASB fulfilling their mission of establishing and improving financial accounting and reporting standards.

Investors in our capital markets have benefited in the past, and will continue to benefit from in the future, both FASB and IASB expertise and careful judgment. We will need to draw upon this expertise as we continue to consider the important reporting issues arising from the global economic crisis. An independent standard setter is best positioned to develop unbiased financial reporting standards that foster investor confidence and financial transparency, and I look forward to their continued work.

Sincerely,

Conrad W. Hewitt

Conrad Hewitt
Chief Accountant

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CHAIRMAN'S CORRESPONDENCE UNIT
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November 14, 2008

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, Mail Stop 1070
Washington, DC 20549

Dear Chairman Cox:

Over the past several months there have been requests of the Securities and Exchange Commission to suspend or revise accounting standards issued by the Financial Accounting Standards Board (FASB). Such requests imply that the current economic crisis can be alleviated by simply de-recognizing economic events from financial statements. We recognize that the global financial system is experiencing levels of stress unprecedented since the Great Depression. The great insight and wisdom shown by Congress in creating the SEC during that time of severe economic distress lies in the Commission's mission of protecting investors, and maintaining fair, orderly, and efficient markets through full disclosure of the information that materially affects investment decisions. That mission has our strong and undivided support, and we hope it will be reflected in the Congressionally-mandated study of mark-to-market accounting.

If reported financial information is going to be believed, trusted, and used by investors and the business community, it is critical that the standards used to prepare that information are set by bodies that are **truly independent.**

An independent standard setter makes it more likely that accounting standards will serve the needs of those who read and review financial reports, not those that are responsible for creating them. Those responsible for creating financial reports may recommend accounting rules that, intentionally or unintentionally, obfuscate an objective reporting of the real performance and condition of a company at the expense of outside shareowners. Accounting standards should be promulgated to serve the interests of investors and the capital markets.

In adopting the Sarbanes-Oxley Act of 2002, Congress recognized the benefits of having accounting standards set by an independent and adequately funded body, and wisely endorsed the current standards-setting process. Further political intervention by Congress or the Commission runs the risk of impeding the FASB's ability to promulgate and issue standards for financial reporting, which serves investors and the capital markets of the United States. Accounting standards must faithfully represent the economic substance of business transactions and provide information that meets the needs of investors in a neutral manner to all financial market participants.

**In the specific case of fair value reporting, investors require an accounting standard that reports a relevant and useful value of financial instruments regardless of the direction of markets. Fair**

**value accounting with robust disclosures provides more reliable, timely, and comparable information than amounts that would be reported under other alternative accounting approaches.**

We acknowledge that disclosures about the application of fair value reporting may be improved, particularly with respect to the absence of liquid markets for a broad cross section of securities. Making those improvements, however, will require a partnership among standard setters, common shareowners, other investors, preparers and regulators, to bring full transparency and the highest integrity to the standards, as well as to the processes by which those standards are developed. Those goals can be achieved only through your steadfast support of investor interests. We look forward to working with you as you complete your study.

Sincerely,

/s/
Cindy Fornelli
Executive Director, Center for Audit Quality

/s/
Jeff Diermeier, CFA
President and CEO, CFA Institute

/s/
Barbara Roper
Director of Investor Protection, Consumer Federation of America

/s/
Jeff Mahoney
General Counsel, Council of Institutional Investors

/s/
Liz Murall
Director of Corporate Governance and Reporting, Investment Management Association

Cc:

- Hon. Harry Reid, U.S. Senate Majority Leader
- Hon. Christopher Dodd, Chairman, U.S. Senate Committee on Banking, Housing and Urban Affairs
- Hon. Charles Schumer, U.S. Senate Committee on Banking, Housing and Urban Affairs
- Hon. Barney Frank, Chairman, U.S. House Committee on Financial Services
- Hon. Richard Shelby, Ranking Member, U.S. U.S. Senate Committee on Banking, Housing and Urban Affairs
- Henry Paulson, U.S. Treasury Secretary
- Guido Mantega, Brazil Minister of Finance
- Henrique Meirelles, Governor of the Brazil Central Bank
- Luis Aguilar, U.S. Securities and Exchange Commission
- Kathleen Casey, U.S. Securities and Exchange Commission
- Conrad Hewitt, U.S. Securities and Exchange Commission
- Troy Paredes, U.S. Securities and Exchange Commission
- Elisse Walter, U.S. Securities and Exchange Commission

# COUNCIL OF INSTITUTIONAL INVESTORS

Suite 500 • 888 17th Street, NW • Washington, DC 20006 • (202) 822-0800 • Fax (202) 822-0801 • www.cii.org

Via Email

October 29, 2008

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number 4-573

Dear Ms. Harmon:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 140 public, corporate and union pension funds with combined assets of over $3 trillion.[1] As the leading voice for long-term, patient capital, we appreciate the opportunity to provide comments to the Securities and Exchange Commission ("Commission" or "SEC") related to the study to be conducted by the Commission under the Emergency Economic Stabilization Act of 2008 of "mark-to-market" accounting applicable to financial institutions, including depositary institutions ("Study").[2]

At our October 7, 2008 meeting, the Council's general membership approved an update to our policy on independence of accounting and auditing standard setting [See Attachment I].[3] That policy encompasses the following Council views that we believe are relevant to the Study:

- The responsibility to promulgate accounting standards should reside with independent private sector organizations that have a thorough public due process,
- The technical decisions and judgments of the private sector accounting standard setter that have been reached after a thorough public due process should be respected and not be overridden by government officials or bodies,
- High quality accounting standards are those that produce comparable, reliable, timely, transparent and understandable financial information that meets the needs of investors and other consumers of financial reports, and

[1] For more information about the Council of Institutional Investors ("Council") and its members, visit our website at http://www.cii.org/.
[2] SEC Study of Mark to Market Accounting, Securities Act Release No. 8975, Exchange Act Release No. 58,747 (Oct. 8, 2008), http://www.sec.gov/rules/other/2008/33-8975.pdf.
[3] The Council of Institutional Investors, Policies on Other Governance Issues, 1. Independence of Accounting and Auditing Standard Setting 1 (Updated Oct. 7, 2008), http://www.cii.org/UserFiles/file/council%20policies/CII%20Policies%20on%20Accounting%20and%20Auditing%2010-7-08.pdf [hereinafter Independence Policy] [See Attachment I]. For more information about the Council's policies, visit our website at http://www.cii.org/policies.

- The goal of financial accounting and reporting and accounting standard setters should be to satisfy, in a timely manner, the information needs of investors and other consumers of financial reports.[4]

Consistent with the Council's policy, we do not support the self-serving views of the bank lobby and some other special interest groups that the Commission or the U.S. Congress should suspend, replace, or otherwise modify the requirements of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("Statement 157").[5] As indicated in our recent joint letter to the Commission with the Center for Audit Quality, the CFA Institute, and the Consumer Federation of America [See Attachment II], we believe that such a move "would be a disservice to the capital markets, would be inconsistent with the views of investors, and would harm the credibility and independence of the standards setting process . . . ."[6]

We note that Statement 157 was the result of an extensive public due process that occurred over a period of more than three years.[7] That process involved the issuance of two documents for public comment, the receipt and consideration of the views expressed in approximately 125 comment letters, public board meetings and roundtable meetings with respondents to address issues raised in the comment letters, and input from the Valuation Resource Group, the Financial Accounting Standards Advisory Council, the User Advisory Council, members of the Investor Task Forces, and other interested parties.[8]

We believe the Financial Accounting Standards Board's ("FASB") public due process with respect to Statement 157 should be respected and supported. We, therefore, would generally oppose any further changes to Statement 157 without the FASB first conducting a thorough public due process in which the views of investors are actively solicited and carefully considered.

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[4] *See* Independence Policy, *supra* note 3, at 1. We note that our policy's focus on the needs of investors is generally consistent with Recommendation 2.1 of the United States Securities and Exchange Commission's ("Commission") Advisory Committee on Improvements to Financial Reporting ("Advisory Committee") 10 (Aug. 1, 2008), http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf ("investor perspectives should be given pre-eminence by all parties involved in standards-setting (footnote omitted)"). We also note that our policy's support for keeping the responsibility for promulgating accounting standard setting with independent private sector organizations rather than with the federal government is generally consistent with Recommendation 2.4 of the Advisory Committee. *Id.* at 11 ("the SEC should only issue broadly applicable interpretive implementation guidance in limited situations"). We are hopeful that the Commission, including the Office of the Chief Accountant, will soon adopt those elements of Recommendations 2.1 & 2.4 that are consistent with our policy.

[5] Fair Value Measurements, Statement of Fin. Accounting Standards No. 157 (Fin. Accounting Standards Bd. Sept. 2006), http://www.fasb.org/pdf/aop_FAS157.pdf [hereinafter Statement 157].

[6] Letter from Center for Audit Quality, CFA Institute, Consumer Federation of America, & Council of Institutional Investors, to Mr. Christopher Cox, Chairman, U.S. Securities and Exchange Commission 1 (Oct. 15, 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/10-10-08%20SEC%20joint%20letter-FINAL.pdf [See Attachment II].

[7] Statement 157, *supra* note 5, ¶ C5.

[8] *Id.* ¶¶ C6-C7.

In addition, we would again[9] like to bring to the attention of the Commission our July 2008 white paper entitled "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch" [See Attachment III].[10] The white paper, prepared by Stephen G. Ryan, Professor of Accounting and Peat Marwick Faculty Fellow, Stern School of Business, New York University, analyzes a number of issues that are pertinent to the Study.[11] For example, the following three conclusions contained in Professor Ryan's white paper are especially noteworthy and should be reflected in the final report that results from the Study:

1. There is no "convincing empirical evidence" that Statement 157 or fair value accounting contributed to the current credit crisis. The crisis is primarily the result of bad operating, investing, and financing decisions, poor risk management, and in some instances fraud.[12]

2. Fair value accounting for all of financial institutions' financial instruments provides investors with more informative reporting, particularly during a credit crisis, than other alternative accounting approaches.[13]

3. Fair value accounting for financial instruments, accompanied by robust disclosures, reduces uncertainty and information asymmetry faster over time than other alternative accounting approaches and, thereby, mitigates the duration of a credit crisis.[14]

We also note that Professor Ryan recommended that the FASB provide additional guidance for Statement 157 clarifying when firms may "report level 3 model-based fair values rather than level 2 valuations . . . ."[15] In our view, the FASB Staff Position issued on October 10, 2008, is largely responsive to that recommendation.[16]

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[9] *See, e.g.,* Letter from Paul Simenauer, Analyst, Council of Institutional Investors, to The Honorable Christopher Cox, Chairman, United States Securities and Exchange Commission 1 (Sept. 25, 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/Fair%20Value%20Accounting%20Letter%20to%20SEC%20doc%20(final)(1).pdf.

[10] Stephen G. Ryan, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch* (July 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/CII%20Fair%20Value%20Paper%20(final)%20%20071108.pdf [hereinafter Professor Ryan] [See Attachment III].

[11] *Id.*

[12] *See id.* at 16.

[13] *Id.* at 8; 14.

[14] *Id.* at 16; *see also* Editorial, *All's Fair, The Crisis and Fair Value Accounting,* Economist, Sept. 18, 2008, at 1-2, http://www.economist.com/finance/displaystory.cfm?story_id=12274096 (Referring to Japan's failure to embrace fair value accounting for financial instruments during the 1990's, Yoshimi Watanabe, Japan's minister for financial services, commented that "Japanese banks exacerbated their country's economic woes by 'avoiding ever facing up to losses'").

[15] Professor Ryan, *supra* note 10, at 15.

[16] Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, FASB Staff Position No. FAS 157-3 (Fin. Accounting Standards Bd. Oct. 10, 2008), http://www.fasb.org/pdf/fsp_fas157-3.pdf.

Finally, we strongly support and agree with the following statement of SEC Chairman Cox appearing recently in an op-ed in the New York Times:

> Transparency is a powerful antidote for what ails our capital markets. When investors have clear and accurate information, and when they can make informed decisions about where to put their resources, money and credit will begin to flow again.[17]

We believe that fair value accounting for financial instruments, complemented by robust disclosures, is superior to other accounting alternatives in (1) providing investors clear and accurate information, and (2) restoring the free flow of money and credit to the U.S. and global capital markets.

We again would like to thank the Commission for granting investors the opportunity to provide input on this important matter. Please feel free to contact me at 202.261.7081 or jeff@cii.org with any comments or questions regarding this letter or the related attached materials.

Sincerely,

Jeff Mahoney
General Counsel

Attachments

[17] Christopher Cox, Op-Ed., *Swapping Secrecy for Transparency,* N.Y. Times, Oct. 19, 2008, at 12.

**COUNCIL OF INSTITUTIONAL INVESTORS**

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Via Email

February 11, 2008

Ms. Teresa S. Polley
Chief Operating Officer
Financial Accounting Foundation
401 Merritt 7
Norwalk, CT 06856-5116

Re: Request for Comments on Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB[1]

Dear Ms. Polley:

The Council of Institutional Investors ("Council") appreciates the opportunity to provide our input on the Financial Accounting Foundation's ("FAF") Request for Comments on Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB ("RFC"). The Council is an association of more than 130 U.S. public, corporate and union pension funds with combined assets of over $3 trillion.

As a leading voice for long-term patient capital, the Council strongly believes that independent private sector accounting standard setting is critical to the integrity of the capital markets. Last year, after months of research and deliberations by the Council's staff, policies committee, and board of directors, the Council's general members unanimously approved the following policy regarding the independence of accounting and auditing standard setting:

> . . . [F]inancial statements and their related disclosures are a critical source of information to institutional investors making investment decisions. The well-being of the financial markets—and the investors who entrust their financial present and future to those markets—depends directly on the quality of the information audited financial statements and disclosures provide. The quality of that information, in turn, depends directly on the quality of the standards that: (1) preparers use to recognize and measure their economic activities and events . . . . The result should be accurate, transparent, and understandable financial reporting.

[1] Financial Accounting Foundation ("FAF"), Request for Comments on Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB (2008), http://www.fasb.org/FAF%20Proposed%20Changes.pdf.

> The responsibility to issue and develop accounting . . . standards should reside with independent private sector organizations with an appropriate level of government input and oversight. Those organizations should possess adequate resources and the technical expertise necessary to fulfill this important role. Those organizations should also include significant representation from investors and other users of audited financial reports on the organizations' boards and advisory groups. Finally, those organizations should employ a thorough public due process that includes solicitation of public input on proposals and consideration of user views before issuing final standards. The United States Congress, the Securities and Exchange Commission ("SEC"), and other federal agencies and departments should respect and support the independence of the designated accounting . . . standard setting organizations and refrain from interfering with or overriding the decisions and judgments of those bodies.[2]

Consistent with the Council's conclusion that high quality accounting standards can best be achieved by an independent private sector organization, we would like to offer the following specific comments in response to several of the proposed actions raised in the RFC:

***Proposed Action*: *Expand the breadth of individuals and organizations that are invited to submit nominations for the FAF Board of Trustees with the understanding that final authority for all appointments rests solely with the Board of Trustees.***

As indicated by the Council's policy, we believe that having significant investor representation in the private sector accounting standard setting process is critical to producing high quality accounting standards.[3] We, therefore, generally support reducing reliance on the non-user Financial Nominating Organizations ("FNOs") and Governmental Nominating Organizations ("GNOs") as the main source of nominations for the FAF Board of Trustees.

It is our understanding that the origin of the FNOs and GNOs involvement in the selection of the Board of Trustees appears to have been based, in part, on a commitment by those organizations to participate in the raising of funds required for the operation of the Financial Accounting Standards Board ("FASB") and the Governmental Accounting Standards Board ("GASB"), respectively.[4] That purpose is now less relevant (at least for the FASB) as a result of the accounting support fee requirements included in the Sarbanes-Oxley Act of 2002.[5]

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[2] Council of Institutional Investors ("Council") Policies, Pension Fund Issues, I. Independence of Accounting and Auditing Standard Setting (Mar. 20, 2007), http://www.cii.org/policies/Redesigned%20CII%20Policies%20on%20Other%20Governance%20Issues%201-29-08.pdf.

[3] Of note, the Council's policy supporting significant representation from investors and other users of financial reports on the boards and advisory groups of the organizations that establish accounting standards appears to have been adopted by the Advisory Committee on Improvements to Financial Reporting ("CIFiR"). CIFiR, Progress Report 37-38 (draft Feb. 11, 2008), http://www.sec.gov/about/offices/oca/acifr/acifr-dpr-021108.pdf.

[4] *See* American Institute of Certified Public Accountants ("AICPA"), Report of the Study on Establishment of Accounting Principles, Establishing Financial Accounting Standards 9 (Mar. 1972) (on file with the Council) (The original financial nomination organizations were the Financial Executives Institute, the National Association of Accountants, the Financial Analysts Federation, and the American Accounting Association).

[5] *See* Sarbanes-Oxley Act of 2002, Section 109(e) (2002), http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf.

Our general support for the proposed action, however, is contingent on the expansion focusing on increasing the investor representation on the FAF. As the key customers of financial accounting and reporting, qualified investors should be offered a much greater role in the boards and advisory groups of those organizations that establish accounting standards.

***Proposed Action*: *Reduce the size of the FASB from seven members to five.***

The Council generally does not support reducing the size of the FASB from seven members to five. We note that the RFC suggests that the proposed action will make the FASB "more nimble and responsive to domestic and global demands," and "more effective and efficient."[6] We are not convinced.

We believe that the better argument is that reducing the size of the FASB from seven members to five will make the Board *less* nimble and responsive and *less* effective and efficient for at least two reasons: (1) there will be fewer Board members available to take leadership roles on standard setting projects and related research and technical activities, and (2) there will be fewer Board members to engage in external communications and dialogue with investors and other interested parties—important elements of a high quality standard setting process.

Finally, we understand that in March 2002 the FAF considered a nearly identical proposal to reduce the size of the FASB from seven to five members to improve "the FASB's efficiency."[7] On that occasion the reaction from preparers, auditors, and users of financial reports was generally negative.[8] In response to those comments the FAF decided to retain a seven-member Board.[9] In our opinion, the RFC provides no basis for why a different conclusion is now appropriate.

***Proposed Action*: *Realign the FASB composition.***

The Council generally supports realignment of the FASB composition. Our support, however, is contingent on the realignment resulting in an increase in the number of qualified investor representatives on the seven-member FASB Board. More specifically, we believe that, consistent with the view expressed in 1992 by then U.S. Securities and Exchange Commission ("SEC") Chairman Richard C. Breeden, at least two of the seven members of the FASB should be qualified investors or other qualified users of financial reports.[10]

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[6] FAF, *supra* note 1, at 5.
[7] News Release, Financial Accounting Standards Board ("FASB"), Financial Accounting Foundation Considers Changes to Streamline FASB Process; Emphasizes Need for Independent Accounting Standard Setter (Mar. 14, 2002), http://72.3.243.42/news/nr031402.shtml.
[8] *See, e.g.*, Letter from Richard J. Swift, Chairman, Financial Accounting Standards Advisory Council, to Joseph S. LaGambina, Executive Vice President, FAF 1 (Apr. 1, 2002) (on file with the Council) ("The general consensus of the FASAC members is that a reduction in the number of FASB members is not advisable, and they have asked me to express this concern to you.").
[9] News Release, FASB, Financial Accounting Foundation Changes Financial Accounting Standards Board's Voting to Increase Efficiency (Apr. 24, 2002), http://72.3.243.42/news/nr042402b.shtml.
[10] Letter from Richard C. Breeden, Chairman, Securities and Exchange Commission, to Shaun O'Malley, President, FAF (Oct. 22, 1992). We also note that CIFiR has expressed support for "at least two investors" on the FASB Board if the FASB maintains a seven-member Board. CIFiR, *supra* note 3, at 39.

***Proposed Action*: Provide the FASB Chair with decision-making authority to set the FASB technical agenda.**

The Council generally does not support providing the FASB Chair with the decision-making authority to set the FASB technical agenda. It is our understanding that the proposed action would result in a significant structural change to the FASB's standard setting process. That process was originally designed, in part, to broaden the base and variety of skills involved in standard setting decisions.[11] The original design is reflected in the FASB's current rules of procedure which require that the technical agenda be approved by the FASB Board.[12]

We are troubled by the fact that the proposed action would appear to provide the FASB Chair the authority to remove a project from the FASB's agenda even if the project was supported by all of the other Board members or by all investors. Our concern is heightened by the numerous public reports over the past year of efforts by the SEC to exert more control over the FASB.[13]

We, therefore, believe the existing agenda decision-making process should be maintained. We understand that that process includes solicitation of input from investors and other users of financial reports, and requires a majority vote of the Board to add or drop a project from the agenda. In our view, the existing thorough and public agenda process lessens the potential risk that FASB's independence might be impaired by the efforts of self interested special interest groups to the likely detriment of investors and the capital markets.

***Proposed Action*: Secure a stable mandatory funding source for the GASB.**

As indicated by the Council's policy, we believe that independent private sector accounting standard setting organizations should have adequate resources to fulfill their important missions. We, therefore, generally support a stable mandatory funding source for the GASB. Such a funding source, if properly structured, would contribute to the GASB's independence and likely enhance the quality of its standards.

**Proposed Action*: Retain the current size, term length, and composition of the GASB.***

The Council generally supports retaining the current size, term length, and composition of the GASB. To the extent, however, that additional funding sources become available, we generally would support, consistent with the Council's policy, seven full time members of the GASB.

***Proposed Action*: Provide the GASB Chair with decision-making authority to set the GASB technical agenda.**

The Council generally opposes providing the GASB Chair with decision-making authority to set the GASB technical agenda for the same reasons we generally oppose providing such authority to the FASB Chair.

* * * *

[11] AICPA, *supra* note 4, at 10-11.
[12] FASB, Rules of Procedure 51 (amended and restated through Dec. 1, 2002).
[13] *See, e.g.*, Marie Leone & Alan Rappeport, SEC Said No to FASB Raises, CFO.com (Apr. 2, 2007), http://www.cfo.com/article.cfm/8952913.

The Council appreciates the opportunity to express its views on the RFC. Please do not hesitate to contact me if you have any questions or would like any additional information.

Sincerely,

Jeff Mahoney
General Counsel
Council of Institutional Investors

Statement of

**Robert McTeer, Ph.D.**

Distinguished Fellow

National Center for Policy Analysis

on

# MARK-TO-MARKET ACCOUNTING:

## Practices and Implications

Financial Services Subcommittee on Capital Markets, Insurance, and

Government Sponsored Enterprises

United States House of Representatives

March 12, 2009

*Dallas Headquarters*: 12770 Coit Road, Suite 800 ▪ Dallas, Texas 75251 ▪ 972-386-6272 ▪ Fax: 972-386-0924 ▪ www.ncpa.org
*Washington Office*: 601 Pennsylvania Ave. NW, Ste 900, South Bldg ▪ Washington, D.C. 20004 ▪ 202-220-3082 ▪ Fax: 202-220-3096

Mr. Chairman and members of the committee, thank you for the opportunity to testify.

When I moved to Texas in 1991, someone gave me a little book of Texas wisdom titled, "Don't Squat with Your Spurs On." Among its nuggets of wisdom was this one: "No matter who says what, if it don't make sense, don't believe it." What's been going on with mark-to-market accounting doesn't make sense to me.

Much of our recent wealth destruction has resulted from slavish adherence to an accounting dogma that never should have applied to banks and other regulated financial intermediaries in the first place.

Thousands of banks, thrifts, insurance companies and credit unions who had absolutely nothing to do with making or securitizing subprime loans are victims, not villains. They purchased mortgage-backed securities because they thought they were safe and liquid, as indicated by their AAA rating.

When sub-prime mortgages in the pools began defaulting at a higher rate, the market for the bonds dried up. Yet, the rigid application of mark-to-market rules enforced by regulators and gun-shy internal and external auditors, forced drastic write-downs even when their owners were both willing and able to hold them until the market improved or hold them to maturity if necessary. Even though the bonds weren't trading, most of the underlying mortgages were still generating income, and most still are.

The tragedy comes not from the write-downs per se, but from the resulting decline—dollar for dollar— in regulatory capital. Hypothetical or potential losses in securities resulted in actual or real losses of capital if the securities were in an account labeled securities for sale rather than securities held to maturity. It would be a simple matter to change the labels, but the accounting rules don't allow it. Fixing that would be an easy interim step.

A closely related question is whether the impairment in individual mortgages is classified as "temporary" or "other than temporary," in which case they must be written off. Logic would suggest, at least, that any excess of capital written off that way could be added back to capital, or "accreted," if the original judgment is proven too pessimistic.

It's my understanding that most of the regulators concur with this, but are hesitant to allow it because of uncertainty over Congressional intent and reaction, and possibly the reaction of the SEC and FASB. Reassurance on that score from you would be helpful. They have the authority; they just need the nudge, or encouragement.

I've heard it said that mark-to-market was considered fine for banks until the market turned against them. This is not entirely true. Chairman Greenspan wrote a 4-page, single-spaced letter to the SEC urging them not to apply mark-to-market to commercial banks because their business

model is not that of a trader, but involves holding assets on their balance sheet. His letter is dated November 1, 1990.[1]

A little later Treasury Secretary Brady wrote a similar letter to the SEC.

Now fast-forward to 2009, when Paul Volcker, speaking as Chairman of The Group of 30 Experts, released the results of their study of the financial crisis.

His recommendation #12 on Fair Value Accounting says:[2]

a. Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments in distressed markets.

b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business models of these institutions…

If a mortgage in a pool collateralizing a security becomes impaired, the negative impact is multiplied. For example, if a bank buys a bond with 1000 underlying mortgages, and a few of these mortgages become "other than temporarily impaired," the bank has to write down and lose regulatory capital on the whole bond— not just on the impaired mortgages.

You can't unscramble an egg, but, if the bank had the same 1000 mortgages on its books individually, the write-downs would be much more modest.

While the original markdowns may not be justified, they can be self-fulfilling. The resulting loss of capital may attract increased supervisory attention, which, perversely, may lead to higher capital requirements just as capital is becoming scarcer.

The bank's worsened condition may bring higher FDIC deposit insurance as well. Restrictions on growth may then follow so the "weakened" bank can't try to grow out of its problems. The motive here is to preserve the insurance fund. As this process is multiplied across the banking system deposit insurance premiums may be raised across the board.

The banks after being restricted in their accumulation of capital reserves during the good times have their requirements increased when they can afford it least. The FDIC, after having to keep its premiums low during the good times has to raise them during the bad times. In the present case, an alternative needs to be found.

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[1] Alan Greenspan, "Letter to Hon. Richard C. Breeden," Federal Reserve, November 1, 1990. Available at http://www.bob-mcteer-blog.com/wp-content/plugins/uploads/Greenspan%20letter%20to%20SEC%20November%201990.pdf.

[2] Group of 30, "Financial Reform: A Framework for Financial Stability," Working Group on Financial Reform, January 15, 2009, page 14. Available at: http://www.group30.org/pubs/recommendations.pdf.

This whole perverse pro-cyclical sequence of events started in my example with unnecessarily rigid application of mark-to-market accounting.

I heard Chairman Frank acknowledge the pro-cyclical nature of mark-to-market accounting on television. I hope this committee will be able to do something about it.

One more point about pro-cyclicality. The uptick rule needs to be restored and the ban on naked shorts should be enforced.

It makes me sound naïve, I know, but it's never seemed quite right to me that people are allowed to sell things they don't own. When they can sell stocks they don't even have to borrow, they can sell more than the total number of stocks outstanding. How fair is that?

Thank you.

*Frank Keating*
*President & Chief Executive Officer*
*(202) 624-2300 t (202) 572-4840 f*
*FrankKeating@acli.com*

March 12, 2009

The Honorable Paul E. Kanjorski
Chairman
Subcommittee on Capital Markets
U.S. House of Representatives
Washington, DC 20515

The Honorable Scott Garrett
Ranking Member
Subcommittee on Capital Markets
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Kanjorski and Ranking Member Garrett:

The American Council of Life Insurers (ACLI) appreciates the opportunity to submit the following comments in regard to the March 12th Subcommittee Hearing titled, "Mark-to-Market Accounting: Practices and Implications." ACLI is a Washington, D.C.-based trade association whose 340 member companies account for 93 percent of the life insurance industry's total assets in the United States, 94 percent of life insurance premiums and 94 percent of annuity considerations.

Our members are long-term investors, with assets totaling $5.1 trillion at the end of 2007. We are the single largest source of corporate bond financing in the U.S., holding approximately 18% of total U.S. corporate bonds. As a result of our long-term outlook, mark-to-market accounting is not appropriate for our business model nor for the benefit of our policyholders. This accounting rule is counter productive and does not align with the true economic values of assets but rather blindly follows market activity.

The use of fair values in financial reporting is limited to the ability of investors to understand liquidity needs and sources for an organization. When fair values are used for performance reporting, risk analysis and regulatory capital, what results is a pro-cyclical decision making process distorted by market overreactions.

The lessons from the current financial crisis show that financial statements should reflect economic value and the role of market values should be limited to disclosure.

It is imperative that legislators and regulators modify mark-to-market accounting in favor of a return to conservative cash flow based accounting. These principles of accounting have worked for many years and provide consistent accounting results through both "bubble" periods and during periods of volatile market failures such as today. This consistency will result in less pro-cyclical risk taking and capital raising activities.

Our hope is that this hearing will help make the necessary adjustments to accounting treatment and guidance so that our economic recovery is not impaired by the application of flawed rules. We thank you for your leadership and stand ready to work with you and all willing participants to bring about this goal in a rational and expeditious manner.

Sincerely,

Frank Keating

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ACLI
Financial Security For Life.

## Mark-to-Market Accounting: Current Rules A Poor Fit for Insurers

The Financial Accounting Standards Board, under the auspices of the Securities and Exchange Commission, instituted mark-to-market accounting with the goal of improving transparency to investors of a company's net worth. It requires companies to value their holdings, including corporate bonds, based on current market conditions; that is, on the fair-market price if the bonds were sold today. It does not matter whether a given company has any intention of selling its bonds under current market conditions.

### Life insurer corporate bond investments

Life insurers are major investors in high-grade corporate bonds. Life insurer corporate bond holdings reflect the long-term nature of their obligations to policy and annuity owners. The average maturity of all corporate bond holdings is 17 years. The goal is to assure that life insurers have assets to pay claims as they are filed. The day-to-day, even year-to-year, fluctuations in the financial markets are less important than maintaining a good match of assets to expected liabilities.

### Matching assets to liabilities

Life insurers have developed sophisticated mathematical tools to estimate when claims are likely to arise on groups of policies written today. For example, if a life insurer writes $500,000 face-value whole life insurance policies on 100 30-year-old males in 2008, the insurer can predict with a high degree of precision how many claims on those polices will be filed in five years, 10 years, 15 years, 20 years, and beyond. The premiums received on these policies will be invested in securities, including corporate bonds, carefully selected to match the expected claims payment schedule. Some 42 percent of life insurer corporate bond holdings had a maturity date of 20 years or more at the time of purchase.

### Mark-to-market: Current rules a poor fit for life insurers

Because life insurers purchase bonds to match expected claims, often with the intention of holding those bonds until they mature, mark-to-market accounting may provide a misleading profile of a company's true financial strength because of short-term fluctuations in the markets. Indeed, insurance regulators and Nationally Recognized Statistical Rating Organizations disregard market values in determining a company's financial strength. Thus, mark-to-market accounting, with its emphasis on transparency for investors, may not be the best template to apply to life insurer bond holdings, which emphasize matching assets to expected payouts, especially given today's unprecedented market conditions.

### Working towards a resolution

The American Council of Life Insurers and its member companies are working with the Financial Accounting Standards Board and the Securities and Exchange Commission for relief from mark-to-market accounting requirements.

*March 12, 2009*

Statement for the Record

*On Behalf of the*

AMERICAN **BANKERS** ASSOCIATION

*Before the*

Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

**Statement for the Record**
**On Behalf of the**
**American Bankers Association**
**Before the**
**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises**
**Committee on Financial Services**
**United States House of Representatives**
**March 12, 2009**

Chairman Kanjorski, Ranking Member Garrett and members of the Subcommittee, the American Bankers Association (ABA) appreciates the opportunity to submit a statement on the issues surrounding mark to market accounting. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.9 trillion in assets and employ over 2 million men and women.

The problems that exist in today's financial markets can be traced to many different factors. One key factor that is recognized as having exacerbated these problems is fair value accounting, also known as mark to marketing accounting.

Current accounting is resulting in financial statements for banks that are not transparent and are misleading to users of financial statements. ABA unequivocally supports transparency in financial reporting, both as preparers of financial statements and users of others' financial statements. Therefore, we believe it is critical to make improvements to financial reporting – in this case, improvements to fair value accounting. Recording credit losses is an important part of this process. However, current mark to market accounting requires that ***additional losses be reported***. This

accounting has a pro-cyclical impact on the securities involved, as market uncertainty increases with such accounting and the downward spiral of market values continues.

Detailed descriptions of the problems and our recommended solutions are outlined below.

- Mark to market accounting is broken and is causing havoc in the markets.
- Accounting guidance provided to financial statement preparers and auditors regarding mark to market accounting have either been insufficient or non-existent.
- Immediate changes are necessary and can be made to provide more accurate, reliable, and transparent information to users of financial statements.

## I. Mark to market accounting is broken and is causing havoc in the markets

Mark to market accounting (MTM) has been extremely controversial for many years. Under MTM, certain assets and liabilities are recorded in financial statements at their market values. Therefore, when the market swings, so do financial statements – often ignoring the underlying economics. The current market environment has demonstrated the pro-cyclicality and other flaws related to mark to market accounting.

MTM is required in a number of areas for commercial banks. Investment securities use MTM, whether they are in trading portfolios or designated as "available for sale" (AFS). Derivatives used by banks and mortgage servicing rights also use MTM. Under a relatively new accounting standard, all assets and liabilities, whether they are financial assets and liabilities or not, are marked to market during a business acquisition. All securities classified as "other than temporarily impaired" (also known

as OTTI) are marked to market, whether the security is available for sale or being held to maturity. There are many other areas in the accounting literature that require MTM, thus, a broad suspension of MTM is not what we believe is the appropriate solution.

In some cases, MTM changes are recorded only in capital (such as AFS securities), and in other cases, the changes in market values are recorded in earnings and capital (such as trading portfolios, most derivatives, and OTTI). In any event, MTM accounting can be pervasive at a bank and it can have a significant impact on publicly reported capital.

Current market conditions have brought to light two major areas in the MTM accounting literature that are broken and need to be repaired: (1) the definition of fair value, and (2) the definition of OTTI.

***The definition of fair value needs repair.***

In 2006, FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157), changing the definition of fair value to require that "exit price" be used. The new guidance, however, does not provide an adequate framework for applying MTM when markets become illiquid. Typical sellers are not selling in these markets and typical buyers are not buying in meaningful volumes. Many holders of assets are, thus, restrained from selling, because they know the economic values of their assets are greater than the infrequent and/or distressed sale values they are seeing in the marketplace. Thus, there is no true "fair value." The use of "exit price" in an illiquid market results in an unrealistic downward bias, which reduces transparency and can have serious public policy implications.

***The definition of "Other Than Temporary Impairment" needs repair.***

Recording OTTI that is based on credit impairment is non-controversial in the banking industry – banking institutions fully understand and support the need to record such impairment. However, there is much controversy with recording losses that are based on the ***market's perception of value*** (MTM), which often results in recognizing losses that exceed credit losses or, even worse, recording losses for instruments ***that have experienced no credit problems and are fully performing in accordance with their terms.*** The erosion of earnings and capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.

In today's illiquid market, the results of improper OTTI rules can be severe: capital is artificially eroded despite solid fundamental credit performance, and the lending capability of a bank is needlessly reduced. This amplifies the pro-cyclical nature of MTM – reduced lending slows economic activity, which puts mortgage and other borrowers at risk, and puts further pressure on mortgage-backed and other asset-backed security prices. The cycle builds on itself. Therefore, misleading information is contributing to the uncertainty in the markets and further constriction of credit in investment markets. The resulting credit squeeze has an impact on individuals, their savings and investments, and their spending decisions. Even in good times, this pro-cyclical effect introduces significant volatility, and, therefore, uncertainty related to financial information.

Recommendations by the Group of 30, Federal Reserve Chairman Ben Bernanke, and others call for a review of mark to market accounting in light of its inherent pro-cyclical structure.

In some cases, MTM changes are recorded only in capital (such as AFS securities), and in other cases, the changes in market values are recorded in earnings and capital (such as trading portfolios, most derivatives, and OTTI). In any event,

MTM accounting can be pervasive at a bank and it can have a significant impact on publicly reported capital.

**II. Accounting guidance provided to financial statement preparers and auditors regarding mark to market accounting has either been insufficient or non-existent.**

The Securities and Exchange Commission (SEC) and the FASB have issued various clarifications on fair value accounting to help companies assign value to illiquid assets. However, this guidance has been insufficient. For example, the guidance still does not address how to determine when markets are sufficiently "distressed" in order to use modeling for estimating fair values. There has also been no further attempt to improve the OTTI rules in this environment, even though on October 14, 2008, SEC wrote to the FASB requesting that a review of OTTI be done "expeditiously." Moreover, even though many believe that auditors may be applying the accounting rules in a way that was never intended, there has been no guidance from the Public Company Accounting Oversight Board (PCAOB) provided to auditors to assist them in their audits.

The adverse affect of MTM almost always results in OTTI for banks, which directly reduces earnings and capital. This lack of timely guidance, then, on MTM is frustrating for banks, especially as it relates to OTTI.

In the U.S., OTTI is triggered based on market values. If any OTTI exists, the asset must be written down to market value through earnings. That is, if an asset's market value is below the value on the books, it should be evaluated to determine whether it has OTTI. If OTTI exists, then the asset must be written down to market value, and the loss is reported in both earnings and capital.

As just noted, some areas of the current market are now so uncertain that the market "bid" offering prices are significantly lower than the expected cash flows to be received. An example of this follows.

A bank holds a mortgage security in its "held to maturity" portfolio. Based on the credit profile of the mortgages in the security, the bank may expect to collect 90 percent of the cash flows, so the security may have an economic value of 90 cents on the dollar. However, the bid price is only 50 cents on the dollar. Under the current application of OTTI rules, even if the cash flows are performing at 90 cents on the dollar and the entity holding the security has ***both the intent and ability*** to hold the security until it matures, the entity must write down the security through earnings to 50 cents. This write-down is ***permanent***, and there is no subsequent reversal of the loss, ***even if the asset recovers its market value***. Going forward, since interest received is applied to the written down asset, the reported yield on this investment is disproportionately high. Users of the financial statements will be thoroughly confused about the true financial condition of the security, and may make decisions about other similar securities based on this bad information.

By way of comparison, international accounting standards are very different from those in the U.S. OTTI for debt securities that are held to maturity (including mortgage securities) is based on ***credit impairment rather than market value.*** In our example above, the security would be marked down to 90 cents for international accounting purposes, rather than 50 cents. Additionally, for international purposes, if the impairment recovers, then the amount written down can be reversed through earnings. Therefore, the U.S. rules generally result in higher losses for banks than their international competitors and less transparency as to the economic condition of their securities portfolios.

**III. Immediate changes are necessary and can be made to provide more accurate, reliable, and transparent information to users of financial statements.**

The current illiquid market we are experiencing has brought to light two major areas in MTM that need to be repaired: (1) the definition of fair value, and (2) the definition of OTTI. Some have suggested that these repairs be made to regulatory capital rules; however, ABA believes that the first priority should be to ensure that the publicly reported information is improved as soon as possible. Even banks that are well capitalized after recording OTTI are concerned that merely reporting an unnecessary loss can undercut the confidence that depositors and others have in our institutions.

With this in mind, ABA recommends the following[1]:

1. The definition of "fair value" should be improved to replace "exit" price with the price "between a willing buyer and a willing seller in an arm's length transaction that is not a forced sale." This would give a more representative estimate of fair value.

2. The U.S. model for OTTI should be based on an improved version of the international standards. The trigger for OTTI should be credit impairment (probable economic loss), and the securities – whether held to maturity or available for sale – should be written down for ***economic loss rather than market loss***. Additionally, if OTTI recovers, the write-downs ***previously taken through earnings should be reversed through earnings***. This would provide a more accurate and transparent estimate of economic loss.

[1] Attached is ABA's letter to SEC, dated November 13, 2008, which is in response to SEC's request for its Congressionally mandated study on MTM. The letter provides additional details about the history of the issue and the ABA's recommendations for solving the problems.

3. MTM (fair value) should not be the model used to account for all financial instruments, and the current efforts already underway to do so should be abandoned. Further consideration of MTM should be made based on a review performed as per recommendations by the Group of 30, Chairman Bernanke, and others.

**Conclusion**

All bankers want – and critically need – financial information that fairly presents financial condition and is transparent. Credit losses ***must be recognized***, and the reporting of losses ***must be credible***. Unfortunately, current mark to market accounting rules, including those used in the application of recording other than temporary impairment, provide neither the most relevant nor the most reliable information to any users of bank financial statements. Our recommended changes will help improve financial reporting by providing users – whether they are long term investors, depositors, or regulators – with more reliable and transparent information.

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November 13, 2008

Mr. Jim Kroeker
Deputy Chief Accountant
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File Number 4-573 – SEC Study of Mark to Market Accounting

Dear Mr. Kroeker:

The American Bankers Association (ABA)[1] supports providing users of financial statements with relevant, reliable, and useful information. As our industry is built on trust, transparent financial information is critical to our foundation. We want to make it clear that we support the use of mark to market in certain circumstances, where it is a reliable and relevant model; however, in other circumstances – painfully demonstrated in today's environment – it can be terribly misleading to investors and other users of financial statements. We also want to clarify that we do not support an immediate suspension of all forms of fair value, because it would result in confusion for both preparers and investors.[2] Instead, we believe that (1) improvements must be made to existing rules prior to December 31, 2008, year-end reporting, (2) any further moves to require fair value for all financial instruments should be abandoned.

The problems that exist in today's financial markets can be traced to many different factors. One key factor that is recognized as having exacerbated these problems is fair value accounting. It simply has not worked properly. Our descriptions of the problems and our recommended solutions are described below.

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[1] ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

[2] ABA's primary concern with an immediate suspension of all fair value is the lack of accounting guidance that would be available along with such a suspension. For example, fair value is used in many different accounting standards (SFAS 115, SFAS 107, SFAS 133, the Derivatives Implementation Group decisions, the "other than temporary impairment rules, etc.). For preparers, who are responsible for reporting in accordance with GAAP, this would result in confusion. We strongly believe that a longer term project to take a fresh look at the various places in the accounting literature that require fair value should be undertaken.

## IMPROVEMENTS TO EXISTING RULES

SFAS 157

As we indicated in our letters to the Financial Accounting Standards Board (FASB), the federal banking agencies, and the Securities and Exchange Commission (SEC),[3] we believe that Statement of Financial Accounting Standards No. 157, *Fair Value Measurement* (SFAS 157), and certain other related accounting literature are flawed because they do not provide a framework to guide preparers of financial statements and auditors in applying their fundamental concepts when markets become illiquid. As financial markets thin out or even seize up, as trades become fewer and more volatile, and in general as trading values become increasingly unreliable, it is daily more apparent that for many assets, especially under current conditions, there is not a true "fair value". Although SFAS 157 defines fair value for accounting purposes, it does not adequately describe how to estimate fair value in an environment with far fewer than normal buyers and only distressed (or liquidating) sellers. Typical sellers are not selling and typical buyers are not buying in meaningful volumes. Many holders of assets are restrained from selling, because they know the economic values of their assets are greater than the distressed sale values they are seeing in the marketplace. Both buyers *and* sellers are "market participants", yet they are not participating, and there are either no trades or insufficient trades in order to estimate fair value under SFAS 157 and other literature.

During the exposure period for the FASB's FSP 157-3, we believe the FASB had the opportunity to work within the current standard to clarify the definition of fair value. However, as ABA expressed in its letter to Chairman Cox on October 13,[4] the standard fell short of providing the guidance that was needed. This inability to recognize how to amend the standard within its current framework leads us to believe that the framework itself must be amended. Mark to market based on exit price in an illiquid market results in an unrealistic downward bias, which reduces transparency and can have serious public policy implications.[5]

SFAS 157 should be amended to relieve the downward bias it creates in illiquid markets. It is fairly clear that the use of fair value is still not understood in the marketplace, and there is much confusion over what is the "real" market price. An exit price is not necessarily the fair value of a financial instrument, as it is currently being implemented. A more logical route would be to follow the former definition of fair value (which was generally viewed as a willing buyer and willing seller in an

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[3] See ABA letter to FASB dated August 7, 2008; ABA letter to the four federal banking agencies dated May 12, 2008; ABA letter to SEC dated September 11, 2008; ABA letter to SEC dated September 23, 2008.

[4] See ABA letter to SEC dated October 13, 2008.

[5] See ABA letter to FASB dated October 9, 2008; ABA letter to FASB dated August 7, 2008; ABA letter to Federal Reserve dated May 12, 2008.

arm's length transaction that is not a forced sale), which seemed to be well understood. It would also represent a more likely estimate of fair value.[6]

OTTI

Other than temporary impairment (OTTI) has been controversial for many years, especially subsequent to the implementation in 1994 of Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115). Recording OTTI that is based on credit impairment is non-controversial in the banking industry – financial institutions fully understand and support the need to record such impairment. However, there has been and continues to be much controversy over recording losses that are based on the market's perception of value (fair value), which often results in recognizing losses that exceed credit losses or recording losses for instruments that have experienced no credit problems and are fully performing in accordance with their terms. The erosion of earnings and capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.

The ABA was pleased to read the letter from the SEC to the FASB, dated October 14, 2008, which included a request that the FASB "expeditiously address issues that have arisen in the application of the OTTI model in Statement 115",[7] and we have strongly encouraged the FASB to resolve the OTTI issues prior to December 31, 2008, as described in our letter to the FASB on November 13, 2008.[8]

Fair value accounting influences the recognition of OTTI. In today's illiquid market the results can be severe: (1) capital is artificially eroded despite solid fundamental credit performance, (2) the lending capability of a bank is reduced as much as $13 for every $1 of needless OTTI, and (3) the accounting formula is driving economic outcomes – including reduced availability of consumer and small business credit, with a negative impact on the health of individual institutions – and does not reflect economic reality.

Inasmuch as the current OTTI model is based on fair value estimates – from an often hypothetical market participant's perspective – with impairment recognized when the decline in fair value is considered other than temporary, it results in distortions, unnecessary complexity, and reduced transparency – and it suppresses economic activity. For example, the ABA met on September 25, 2008, with the SEC and other interested parties to discuss our concerns about how OTTI concepts were

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[6] Also see ABA letter to FASB dated November 12, 2008, which called for a deferral of the effective date (delayed application) of SFAS 157 for non-financial assets and non-financial liabilities. The current effective date (delayed application) is fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

[7] See SEC letter to FASB dated October 14, 2008.

[8] See ABA letter to FASB dated November 13, 2008.

being applied, primarily for instruments that are fully performing.[9] Over the years there have been proposals and practices by accounting firms that utilized "bright lines" based on the severity and duration of declines in fair value. Those bright lines – or even not so bright lines – often result in permanent write-downs of fully performing assets or assets that subsequently recover value, but whose subsequent increases in value can only be recognized over the remaining life of the financial instrument, which can be many years. Additionally, the OTTI write-downs for non-credit related matters (without writing instruments up when liquidity improves) subsequently results in an artificially high yield ratio as the assets – debased in fair value estimates – continue to perform as originally contracted. In such a case, neither the write-down nor the resulting yield/income to maturity or sale is reflective of actual company "performance" or the result of operational decisions made by management. This results in volatility, particularly in today's markets, that is inaccurate for these instruments, is misleading to the users of financial statements, reduces transparency and comparability against peers, and introduces unwarranted uncertainty in the performance measurement of individual financial institutions. The resulting misleading information is contributing to the uncertainty in the markets and the freezing of investment.

There is and has been much confusion over what OTTI is and what it means. For example, is OTTI permanent? If not, is it closer to permanent than a pure fair value concept? If closer to permanent, then why are the short durations for recovery (such as 12 months) used by some of the accounting firms? If closer to pure fair value, should OTTI really result in impairment losses that cannot be reversed? What is the impact of an uncertain market on OTTI (that is, the lack of typical buyers and sellers, the definition of "exit price" in illiquid markets, the application of Emerging Issues Task Force Issue 99-20)? Should "bright lines" or other guidelines be used for severity, duration, or recovery? How should "market participants" be defined? How does one identify the assumptions a market participant would use when there are reduced numbers and types of market participants for an asset class? How is an illiquid transaction or market defined?

The intersection of two accounting concepts has introduced a negative bias into accounting for available for sale (AFS) securities. Those concepts are: (1) valuation of assets based on "exit price," regardless of market conditions (SFAS 157); and (2) evaluation of assets for OTTI based on cash flow and other assumptions that a hypothetical "market participant" would use (Emerging Issues Task Force Issue 99-20). While these concepts may have been intended to enhance objectivity by forcing third party data to be considered, they have had the unintended consequence of creating accounting results that are often not based on reasonable assumptions and that are so negative that the results are truly <u>not</u> objective. Further, these concepts have driven companies and their auditors to spend huge amounts of time and money attempting to find or extrapolate third party support or market-based data for assumptions, when in fact such third party sources do not exist. Thus, the best estimate of fair value lacks the appropriate level of reliability that is needed for sound financial reporting purposes.

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[9] See ABA letter to the SEC dated September 11, 2008.

Preparers of financial statements and their auditors have continuously faced the following problems with the existing OTTI rules:

1. Determining whether or not an impairment loss must be recorded. Some auditors' views (along with the rules-based approach of the FASB's Emerging Issues Task Force Issue 99-20) suggest that a significant decline in fair value must be OTTI, even if there is no credit loss. In such a case, performing assets that have no credit losses are written down as impaired, with the result being a sort of "lower of cost or market" (LOCOM) approach reported in earnings.

2. Determining the amount of impairment to record. The loss recorded on impaired securities is the difference between book value and fair value. Thus, instruments that have any amount of credit loss – even small amounts – must be written down to fair value, sometimes necessitating larger write-downs than the credit loss entails.

3. Requiring that AFS securities not be sold. During the analysis of whether OTTI exists, it is sometimes determined that OTTI does not exist and that the reporting entity has the intent and ability to hold the instrument until a recovery of value. Unfortunately, this also has the contorted result of prohibiting sales of securities from AFS even though sound portfolio management strategies might suggest otherwise at a date preceding the estimated recovery.

After encountering these problems and recording instruments in accordance with the above, the resulting financial statements are misleading.

To help cure this situation, we recommend that the FASB adopt an OTTI model that is similar to that of the International Accounting Standards Board (IASB), but with some changes.[10] [11] The approach would be that for Held to Maturity (HTM) and AFS OTTI recognition in earnings:

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[10] Because the IASB's standard (IAS 39, *Financial Instruments: Recognition and Measurement*) is based largely on U.S. GAAP, there are also shortcomings with that model that need to be overcome.

[11] Our understanding of the IAS 39 approach is that it focuses on loss events that provide objective evidence of impairment, and, if impaired:

- Held to maturity securities – the amount of impairment is determined by comparing the carrying amount of the instrument with the present value of future cash flows (excluding future credit losses that have not been incurred), discounted at the financial asset's original effective interest rate), essentially the credit impairment. If impairment loss subsequently decreases, the amount can be reversed through earnings.
- Equity securities carried at cost (unquoted equities or derivatives linked to unquoted equities) – the amount of impairment is determined by comparing the carrying amount and the present value of future cash flows discounted at the current market rate of return for a similar financial asset. If impairment loss subsequently decreases, the amount cannot be reversed.

- OTTI would exist if loss events provide objective evidence of credit impairment.[12]

- The amount of impairment would be determined by comparing the carrying amount of the instrument with the present value of estimated future cash flows (excluding future credit losses that have not been incurred), discounted at the financial asset's original effective interest rate.

- If impairment loss subsequently decreases, that amount would be reversed through earnings.

Under our recommended approach, HTM and AFS would continue to be reported as described in the current accounting literature (SFAS 115), with HTM reported at amortized cost and AFS at fair value (with changes in fair value reported in other comprehensive income) and with the existing robust disclosures. Under this model, just as in a fair value model, the need for rigorous, objective analysis must also involve reasoned judgment.[13]

We note that this approach may be difficult to apply for some smaller institutions and may be difficult to apply for all banks for all instruments by December 31, 2008 (due to the need for systems changes, etc.). However, it is very important that the new model be available. Thus, entities should be given the option of following the current U.S. accounting rules for OTTI or the new model for OTTI and should have the option of applying the new model to individual instruments. We believe there are precedents for this (Statement of Financial Accounting Standards No. 159, *Fair Value Option*), and it would result in improved information for users of financial statements.

Basing OTTI on credit risk would result in more logical financial statements. For example, under SFAS 115, a financial institution must identify instruments that are "available for sale". However, under current practice relating to OTTI, the financial institution is also required to ascertain that it has the intent and ability to hold the

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- Available for sale – the amount of impairment is the cumulative loss that has been recognized in other comprehensive income, and is reclassified from equity to earnings. The amount that is reclassified is the difference between amortized cost and fair value, less any impairment loss previously recognized in earnings. If impairment loss subsequently decreases: (1) for equity securities, the amount cannot be reversed through earnings, (2) for debt securities, the amount can be reversed through earnings.

[12] We anticipate that for most classes of securities that most banks are permitted to own there should not be a need for extensive documentation to support the lack of recognition of OTTI.

[13] The purpose of this section is to address OTTI and not whether other parts of SFAS 115 may need to be amended. Thus, this letter assumes that SFAS 115 continues to be the basis for investment securities.

instrument until recovery if OTTI is not recorded. Thus, the same instrument that is labeled as "available for sale" is also labeled with the "intent to hold", which are contradictory. This is extremely illogical to financial institution preparers and cannot possibly be logical to investors and other users of financial statements. This new model for OTTI would help remedy that situation.

The U.S. GAAP model for OTTI simply has not worked well and has not served investors well. We strongly encourage the SEC to ensure that a proposal is issued quickly that would utilize credit risk rather than fair value to determine OTTI. Fair value fluctuations – as demonstrated in today's market – generally do not provide either a true fair value or economic value.

SFAS 141(R)

We are also concerned about additional accounting projects in the pipeline that, if finalized, could ignite new disruptions in the market place.[14] In our October 13, 2008, letter to the Commission, we recommended that any new fair value standards projects be suspended pending Congressional review of the fair value study mandated by the Emergency Economic Stabilization Act of 2008 (EESA).

In our November 12, 2008, letter to the FASB,[15] we expressed continued concern about fair value projects that are highly controversial with respect to whether or not they improve the accounting literature. We recommended that the FASB take into consideration the importance of the study being conducted by the Commission by delaying the effective date for fair value guidance that has been issued but has not yet been implemented. Our most immediate concern is fair value for business combinations, which is required by Statement of Financial Accounting Standards No. 141(R), *Business Combinations* (SFAS 141(R). The current effective date is for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

During the SEC Roundtable on mark to market on October 29, 2008, two banking industry participants noted that the combination of SFAS 157 and SFAS 141(R) have prevented acquisitions of financial institutions from occurring during 2008. Other ABA members have had this same experience. Prior to SFAS 141(R) and SFAS 157, assets and liabilities were required to be marked to market under the purchase accounting rules. However, SFAS 141(R) requires new fair value for loans, and SFAS 157 defines fair value in such a way that it tends to result in lower fair values.

The current approach in accounting for business combinations (purchase accounting) has assumed that when a company is acquired, the acquisition is based on the fair values of individual assets and liabilities. This fair value primarily included fair value adjustments for interest rate effects and minor credit adjustments.

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[14] See ABA letter to SEC dated September 23, 2008.

[15] See ABA letter to FASB dated November 12, 2008, which requested a deferral of the effective date for both SFAS 141(R) and non-financial assets and liabilities in SFAS 157.

Under the new standards (SFAS 141(R) and SFAS 157), acquired loans must be recorded at a different fair value. That fair value is defined under the new definition in SFAS 157, *which is based on exit price*, and includes discounts for liquidity and credit risk that exceed the previous definition of fair value and the accrued losses currently recognized under GAAP for loans. Although the acquirer may not expect to realize these estimates of market losses on the loans, it must write the loans down, which reduces capital at acquisition. Over time, that loss will be accreted back into income. However, the liquidity and credit spread discount on the fair value of the loans can be so severe that such effects as higher goodwill levels, potentially higher capital needs, etc., make acquisitions undesirable under conditions of market stress. The result in 2008 has been the nearly total disappearance of mergers as a means of resolving troubled financial institutions at the very time when this important tool would be of significant value to regulators and to the financial system as a whole. That is to say, that a crucial tool in reducing systemic risk has been taken off the table by the effect of these fair value rules.

An additional complication with the use of fair value in SFAS 141(R) is the increased complexity in accounting for loans. Loans typically represent a significant portion of the assets of financial institutions. Historically, the allowance for loan and lease losses (ALLL) related to the acquired entity's loans and leases has been carried over from the acquired institution's books to the acquirer's books. Thus, the loans are displayed on the balance sheet at the loan balance along with the corresponding ALLL contra-account. This makes it clear to readers of financial statements the amount of credit losses accrued against the loans. However, under 141(R) the acquired loans are required to be recorded at fair value at acquisition, and the ALLL is only recorded if losses are incurred subsequent to acquisition. This results in a mixture for the newly combined entity of some loans being reported at the fair value as of the acquisition date with no ALLL, some reported at the fair value as of the acquisition date with ALLL, and other loans being reported at current balances with ALLL. The use of fair value in SFAS 141(R) also results in inconsistency in the treatment of loans on an institution's books, systems problems for tracking the various accounting methods for loans, and difficulty in measuring or understanding credit risk both for regulators and management. Understanding credit risk is paramount, especially in the current environment. This accounting will make financial institutions' financial statements more difficult to understand for investors and other users of financial statements.

The effective date of SFAS 141(R)should be delayed indefinitely and should be re-established only after a thorough analysis of the significant issues involving fair value accounting, including such questions as to whether the proposed standards are clearly to the benefit of users of financial statements, whether fair value is pro-cyclical, whether the impact of the proposals on the marketplace has been adequately taken into account and provided for, and whether entities of all sizes have the ability to prepare their own financial statements without undue cost burdens. At the time when the restoration of stability in the financial services industry may be greatly promoted—and financial failures avoided— through appropriate consolidations, implementing a new standard that is based on such a controversial model seems counterproductive.

## FURTHER MOVES TOWARD FAIR VALUE

There has been a long history of controversy over whether mark to market accounting should be used by financial institutions. Some examples are:

- In July, 1938, the Comptroller of the Currency provided a revision of its bank examination procedures[16] to move from the use of market value to intrinsic value.

  > Under the new designations, the principle is clearly recognized that in making loans, whether for working capital or fixed capital purposes, the banks should be encouraged to place the emphasis upon intrinsic value rather than upon liquidity or quick maturity.
  >
  > Similarly, the reviews examination procedure recognizes the principle that bank investments should be considered in the light of inherent soundness rather than on a basis of day to day market fluctuations. It is based on the view that the soundness of the banking system depends in the last analysis upon the soundness of the country's business and industrial enterprises, and should not be measured by the precarious yardstick of current market quotations which often reflect speculative and not true appraisals of intrinsic worth.

- On March 19, 1990, the federal banking regulators submitted a report to Congress on market value accounting by banks for the sovereign debt of highly indebted countries. In this report (*Study of the Merits of Market Value Accounting for Certain International Debt Exposures),* they concluded that moving from existing generally accepted accounting principles (GAAP) to market value was not an improvement in reporting and it "would likely result in volatility in banks' reported financial position and earnings. This could make judgments by the banking agencies, as well as investors and depositors, much more difficult."[17] Also, "...market value accounting could have a significant adverse effect on the safety and soundness of the banking system."

- In June 1990, the ABA provided to the FASB a white paper entitled, *Market Value Accounting.*[18] Its summary of conclusions still holds true today:

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[16] Revision in Bank Examination Procedure and in the Investment Securities Regulation of the Comptroller of the Currency, Pages 563-564, July, 1938, Federal Reserve Bulletin.

[17] *Study of the Merits of Market Value Accounting for Certain International Debt Exposures,* March 19, 1990, Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Report to Congress.

[18] *Market Value Accounting,* June, 1990, pages 1-2, American Bankers Association.

- Users of financial statements are many and varied. Market value financial statements are designed to meet the needs of a very limited group of users – those interested in an estimate of liquidation value – while ignoring the needs of all other users.
- The existing historical cost accounting model is practical and understandable. Historical cost information, supported by appropriate reliable market value disclosures, adequately meets the needs of all users.
- The market value accounting model is based primarily on constantly changing interest rates, together with subjective secondary market information, and involves significant estimation processes. This will cause market value financial statements to be very subjective, volatile, and unreliable. Small changes in interest rates will have a dramatic impact on reported earnings and capital, causing those key elements of information to be volatile and potentially misleading.
- The cost/benefit of market value accounting to the banking industry would be negative. Banks would incur significantly higher costs for an end product that, at best, has little value and, at worst, could be misleading. The tremendous difficulty in implementing a reporting system that would not be totally misleading should not be underestimated.
- The historical perspective on market value accounting is relevant. Over the last five decades, there have been numerous discussions about various aspects of market value accounting. The consistent result of these discussions and related studies, including the FASB's Conceptual Framework Project, has been the retention of the present reporting basis. Additionally, studies conducted by the banking industry, and more recently by banking regulators, have reached these same conclusions specifically with respect to bank financial statements and certain specific assets in those financial statements. That work and the related conclusions are still applicable today.
- The effect of market value accounting on the deposit insurance system would not be beneficial. Adoption of market value accounting for bank financial statements would have no positive impact on the deposit insurance system, and could very possibly have a negative impact. This is because the subjectivity, volatility, and unreliable nature of market value financial statements could severely impede regulatory monitoring of capital adequacy by masking significant, permanent problems. Also, the uncertainty of the earnings results would constrain the ability of banks to raise capital, weakening the banking system and thereby creating more risk to the insurance funds.

During 1999, the Joint Working Group of Standards Setters (JWGSS), an international group that included the FASB, and the Joint Working Group of Banking Associations (JWGBA), which was an international group of banking

associations including the ABA, exchanged views. In an October 1999 paper[19], the JWGBA concluded that:

- A full fair value system does not provide a sound basis for predicting banking book net cash flows and lacks relevance.
- Banking book income is earned on an ongoing basis over time and not from taking advantage of short term fluctuations in prices; the accruals accounting method provides a dynamic and faithful representation of both this earning process and the manner in which a bank's management operates. It, therefore, provides a more relevant and reliable representation of this earning process. A notional fair value snapshot taken at a historic balance sheet date fails to achieve this.
- Fair values for a banking operation are significantly more subjective than values derived under the mixed measurement accounting model and this would reduce both the reliability and comparability of financial statements.
- Financial statements prepared using the mixed measurement method of accounting are well understood by users who have developed sound and extensive financial management processes that rely on this information as a basis for economic decision-making. A move to a full fair value measurement basis would represent a radical change to those analytical processes. This should not be undertaken as the case for such a radical change has not been made with sufficient conceptual justification.
- Within any given accounting measurement model, it is not possible to encapsulate in a single measure everything that an investor needs to know. Both fair value and historical cost accounting need to be supplemented by appropriate risk-based and other disclosures in order to provide investors with a complete picture.

More recently, the FASB and IASB issued a controversial document for exposure and comment, *Reducing Complexity in Reporting Financial Instruments.*

- In its October 17, 2008 comment letter on the IASB/FASB document, the following comments were made by the four U.S. federal banking agencies:[20]
  - ...we continue to have concerns about the wider use of fair value accounting for financial instruments.
  - ...we continue to strongly oppose an expansion of the required use of fair value accounting in the primary financial statements beyond where it is currently required or permitted, particularly for non-traded, illiquid financial instruments whose fair value cannot be reliably measured.
  - We believe that measurement should reflect the way in which instruments are used to generate earnings and cash flows, regardless of whether active markets for the instruments in question typically exist. For example, we agree that fair value accounting through earnings is appropriate for trading activities where cash flows are generated by active

[19] See JWGBA paper dated October 1999.

[20] See letter from four federal banking agencies to FASB dated October 17, 2008.

buying and selling. However, most financial institutions in the United States do not manage their business on a fair value basis.

- Broader use of fair value accounting would increase the complexity of application of financial instrument accounting standards for these financial institutions – especially medium-sized and smaller institutions, which represent the overwhelming majority of preparers by number – which in general do not use fair values to manage their exposures.
- Notwithstanding the recent issuances by the FASB and the Securities and Exchange Commission concerning fair value, the market turbulence during the past year has emphasized a number of lessons, including:
  - There are important unresolved conceptual and practical issues surrounding the definition and meaning of "fair value" when markets are illiquid.
  - In illiquid markets, measurement of fair values can be very difficult, involve considerable subjective judgment, and require a high level of technical sophistication.
  - Disclosures concerning measurement methods and measurement uncertainty are in need of further improvement.

  We strongly encourage the FASB to work on these issues as they relate to existing fair value measurement and disclosure requirements.
- *The current market turmoil has increased instances where the range of uncertainty regarding certain fair value estimates is material in relation to the overall balance sheets of financial institutions.* (Emphasis added.)

The International Banking Federation (IBFed),[21] on which the ABA actively participates and is a founding member, wrote two comment letters to the IASB/FASB on the joint project mentioned above. In the first comment letter,[22] the IBFed concluded that:

- Fair value measurement provides an appropriate accounting base for financial instruments held for trading purposes or if the business model is based on fair value. However, applying fair value measurement to financial instruments held to maturity within the banking book would overstate the extent to which instruments are held for trading or managed on a fair value basis within the business and the extent to which deep and liquid markets exist. These are highly significant factors in determining the relevance of fair value in financial reporting.
- A mixed measurement model provides investors with better information for evaluating financial institutions. It requires fair value measurement

[21] The International Banking Federation (IBFed) is the organization of the banking trade associations of the leading financial nations. The members of the IBFed include the American Bankers Association, the Australian Bankers Association, the Canadian Bankers Association, the China Banking Association, the European Banking Federation, the Indian Banks Association, and the Japanese Bankers Association. The objectives of IBFed include increasing the effectiveness of the financial services industry's response to multilateral and national government issues affecting their common interests.

[22] See IBFed paper dated April 2008.

for assets and liabilities managed on a fair value basis and recognizes that not all financial instruments – let alone non-financial assets and liabilities – are managed on a fair value basis or are even capable of reliable fair value measurement. If an entity's business model is not on a fair value basis, amortized cost is the more appropriate way to estimate future cash flows. Fair value information is already disclosed in footnotes, which are an integral part of financial statements, and is a more suitable format for providing the information to investors.

- Reality is more complex than can be communicated in a fair value model. Relevant performance reporting will never be achieved if the framework for financial reporting sticks rigidly to either a historical cost model or a fair value model. A mixed measurement model represents a principles-based approach to measurement by acknowledging that an entity's business model may determine that more than one measurement basis is relevant. Instead of the IASB determining that one approach offers a superior model to that of others, the aim should be for accounting standards to accommodate the various business models and circumstances in which financial instruments are used. As widely recognized at the IASB Roundtables on measurement, a mixed model is more likely to result in useful reporting.

In its second comment letter to the IASB,[23] the IBFed stated the following: "We do not support, and do not accept, that the long term solution is fair value for all financial instruments." The IBFed further noted that the August 2008 Final Report of the Advisory Committee on Improvements to Financial Reporting to the SEC expresses reservations about expanding the use of fair value in financial reporting. IBFed states that the Advisory Committee Report:

- observes that a full fair value approach may be simpler and more meaningful for some investors, but adds that "a full fair value approach would diminish the reliability of some reported amounts (while increasing the effort required to prepare them) because they cannot be based on observable prices."
- notes that some fair values would need to be estimated on the basis of model inputs that are also unobservable and that such estimates would be highly subjective.
- expresses concern about the variance in quality, skill, and reports of valuation specialists and the fact that there is no comprehensive mechanism for ensuring the ongoing quality, training and oversight of valuation specialists for the purpose of financial reporting.
- adds that this leads some to conclude that "a wholesale transition to fair value would reduce the reliability of financial reports to an unacceptable degree".

According to the FASB's Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises:*

[23] See IBFed letter to IASB dated September 19, 2008.

> Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.
>
> Financial accounting is not designed to measure directly the value of a business enterprise, but the information it provides may be helpful to those who wish to estimate its value.

The ancillary costs of implementing fair value are also significant. For example, personnel must be trained, accounting systems need to be re-written, software providers need to be educated, etc. Additionally, the ABA's June 1990 white paper included the following: "An additional major cost to the banking industry would be the uncertainty and confusion that is expected among financial statement users – including bank management." This is now being experienced, not only among users and management but also by auditing firms.

## CONCLUSIONS

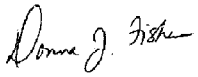
ABA supports the use of fair value for instruments that are traded or if an entity's business model is based on fair value. In many other comment letters not quoted in this letter (including those relating to SFAS 115, SFAS 133, etc.), the ABA has continuously opposed the FASB's efforts to move to fair value for financial instruments if the entity's business model is not based on fair value. We urge that any further moves toward the fair value model be abandoned in favor of a more useful model. Whether or not fair value is used for financial instruments, the resulting model will continue to be a mixed model. The current practical mixed model is more appropriate that the more complex mixed model that would be used with fair value for all financial instruments.

We recommend the following:

1. Current problems relating to fair value must be addressed for December 31, 2008, financial reporting, including: improving the definition of fair value in SFAS 157, improving the accounting rules for OTTI, and delaying the implementation date for SFAS 141(R) as well as the remaining items (those with a delayed effective date) in SFAS 157.
2. Mark to market (fair value) should not be the model for all financial instruments, and the current efforts to do so should be abandoned.

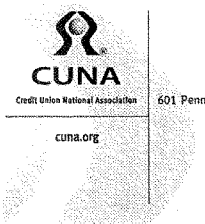
We appreciate the effort that the SEC is undertaking and would be glad to provide additional information. Please feel free to contact me.

Sincerely,



Donna Fisher

Enclosures



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**Statement of the**
**Credit Union National Association**

**Mark-to-Market Accounting: Practices and Implications**

House Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
March 12, 2009

Mr. Chairman, on behalf of the Credit Union National Association, thank you very much for the opportunity to submit this statement for the record of the hearing on Mark-to-Market accounting. This issue is critical to achieving stability in the financial marketplace, and we appreciate your calling this hearing to review mark-to-market rules and consider whether there is a need for changes to the standard. CUNA represents nearly 90% of America's 8,000 credit unions and 92 million credit union members.

Like other financial institutions, federally insured credit unions over $10 million in assets are required to follow U.S. Generally Accepted Accounting Principles (GAAP). Also like other financial institutions, credit unions have been both directly and indirectly affected by the application of mark-to-market accounting in this current dislocated market. While natural person (or retail) credit unions are restricted in what they can invest in and as a result do not directly hold many assets required to be marked to market, corporate (or wholesale) credit unions have broader authority to invest directly in certain available-for-sale securities that must be valued using mark-to-market accounting. Due to the cooperative structure of credit unions, the financial strain experienced by the corporate sector is felt throughout the entire credit union network, including the National Credit Union Share Insurance Fund.

Mark-to-market accounting requires assets be valued at current market prices. Many critics of the accounting method argue that it forces assets to be marked down to artificially low prices due to the current absence of a market for many asset classes, such as mortgage-backed securities (MBS). Furthermore, these critics claim that basing the value of an asset on the price it could currently fetch in the open market is inappropriate in instances where the owner has the intent and ability to hold onto the asset past the current reporting period.

Conversely, proponents of mark-to-market feel that disclosure of an asset's underlying qualities is paramount and in order to maintain investor confidence the accounting standard must remain intact.

Whether one is for or against mark-to-market, most agree that when it was developed its drafters did not consider its application in markets such as the current illiquid one. This standard, originally intended to enhance accuracy of publicly-disclosed financial information, is having the opposite effect in the present economic environment when applied to certain instruments.

Just two days ago, at the Council on Foreign Relations, Federal Reserve Chairman Ben Bernanke stated that:

> [D]etermining appropriate valuation methods for illiquid or idiosyncratic assets can be very difficult, to put it mildly. As a result, further review of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency.

Chairman Bernanke's statement echoes the concerns felt by much of the financial services industry, including credit unions.

While credit unions are not asking Congress to set accounting standards, we are asking that it direct the appropriate standard-setting body—whether the Financial Accounting Standards Board (FASB) or the Securities and Exchange Commission (SEC)—to address the problems these standards have created and to develop an approach that will promote greater accuracy in financial statements in light of the current market. This can be achieved by focusing on how investments such as MBS should be reported in the current economic environment.

The SEC recently conducted a study on the effects of mark-to-market and the FASB has since issued guidance on applying Statement of Financial Accounting Standards No. 157, Fair Value Measurements. However, the SEC's recommendations and the FASB's guidance do not go far enough in addressing the fundamental problem of applying mark-to-market accounting in an illiquid market. The FASB has announced several upcoming projects that will address some of the issues; however, any results will not be seen until late this summer or early fall. This problem cannot wait, and we urge Congress to address these matters with the SEC and the FASB now.

We understand that the subcommittee intends to focus today on the issue of whether impairment of an asset due to credit losses could be separated out from losses due to liquidity. We believe that such separation would be immensely beneficial and have supported this approach in our comment letters on this issue. From an investor perspective, it would provide a more accurate depiction of how the underlying credit portion of the asset is performing; for holders of such assets, it would more closely reflect the asset's true economic worth.

In addition, mark-to-market impacts the application of accounting standards to assets that must be treated as other-than-temporarily impaired (OTTI), such as MBS. This is because GAAP requires OTTI assets to be written down for the entire difference between their original cost and their fair market value. Because of the current illiquid market conditions, the difference in these values can be substantial and result in charges to earnings that represent unnecessary and overstated capital reductions. We urge Congress to direct the SEC and the FASB to again address OTTI and to recognize the differences between credit losses and liquidity losses due to inactive markets.

Furthermore, we encourage this subcommittee to include in its discussion a review of auditor practices under fair value accounting. Our concern is that auditors have shown little flexibility in how assets may be reflected under fair value and mark-to-market principles. In some instances auditors have encouraged institutions to be more conservative in the process by which they value these assets in their financial statements. More accurate financial statements demand greater auditor consistency.

Finally, we are encouraged by and welcome the introduction of H.R. 1349 by Representatives Perlmutter and Lucas. This legislation would establish the Federal Accounting Oversight Board. We hope Congress will thoroughly consider this legislation. However, in light of the magnitude of the crisis we face, we believe that in order to best address the complex principles of fair value accounting and mark-to-market, an expert panel should be established with the exclusive purpose of examining these issues.

On February 26, CUNA sent a letter to President Obama urging him to form a Presidential Task Force on Fair Value Accounting. Such a task force would bring together the accounting profession, government policy makers, and representatives of credit unions and others in the financial sector to develop feasible recommendations to enhance financial statement accuracy through more appropriate recognition of the present uncertain market. We strongly believe that a task force with the narrow directive to address the issues presented in this statement is vital to resolving the current economic strains on many of our nation's financial institutions.

Time is critical in resolving these issues, and we strongly urge this subcommittee and the House Financial Services Committee to expedite its review and quickly put into place the pieces that are necessary to bring about a timely resolution.

Mr. Chairman, thank you very much for calling this hearing and providing us the opportunity to submit this statement for the record.

March 11, 2009

The Honorable Paul Kanjorski
Chairman
Subcommittee on Capital Markets,
Insurance and Government
Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Scott Garrett
Ranking Member
Subcommittee on Capital Markets,
Insurance and Government
Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Kanjorski and Ranking Member Garrett:

The undersigned business organizations and institutions, which represent entities from across a broad spectrum of the economy and all areas of the financial services industry, thank you for holding this very important hearing tomorrow on mark-to-market accounting practices.

The United States and the global economy have undergone a period of almost unprecedented strain and challenge. The falling prices of real estate related assets have ground the securitization markets to a halt, dried up liquidity, and frozen credit availability. The resulting illiquid and non-functioning markets and related impacts have cascaded throughout the economy, causing severe market dislocations and job losses.

While there are many causes for this crisis, the procyclical impacts of certain mark-to-market accounting principles have exacerbated the situation. Accounting rules did not cause this crisis. However, the inability of businesses, investors, and government to properly value assets in disorderly markets has created uncertainty and a loss of confidence that has led to a self-reinforcing cycle of write-downs and further economic contractions.

We recognize that accounting standards should be developed and governed by the appropriate bodies. Further, we believe the appropriate course is not the wholesale abandonment of appropriate application of fair value accounting principles, but rather the immediate correction to better principles-based financial reporting. Each of our organizations has jointly or individually proposed short-term and long-term solutions to the unintended consequences that have arisen from the application of mark-to-market accounting standards. While the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") have taken some incremental action to facilitate the use of mark-to-market accounting in disorderly markets, the scope of the changes has not been adequate, nor has the pace been consistent with the crisis conditions that exist.

With the upcoming subcommittee hearing on mark-to-market accounting, we write to you today to express our concerns for the need to correct the unintended consequences of mark-to-market accounting. We do not ask that Congress write accounting rules. Rather, it is incumbent that the appropriate bodies understand that a pace of business-as-usual is unacceptable. Let us be clear, real economic losses should be recognized and are necessary for orderly markets. However, the recognition of losses that do not have a basis in economic reality is unsustainable in any environment. Appropriate changes in mark-to-market accounting should not wait until

mid-year or year-end. That will only allow the spiral of accounting driven financial losses to continue.

Our hope is that these hearings ask the tough questions and stimulate immediate action that makes necessary adjustments in both the accounting treatment and guidance so that economic recovery is not impaired by the application of flawed rules. We stand ready to work with all willing participants to bring about this goal in a rational and expeditious manner.

Sincerely,

American Bankers Association
American Council of Life Insurers (ACLI)
American Financial Services Association
Certified Commercial Investment Member Institute
Commercial Mortgage Securities Association
NAIOP, the Commercial Real Estate Development Association
The Council of Federal Home Loan Banks
Financial Services Roundtable
Group of North American Insurance Enterprises
Independent Community Bankers of America
Institute of Real Estate Management
International Council of Shopping Centers
Mortgage Bankers Association
National Association of Home Builders
National Association of Realtors
Pennsylvania Association of Community Bankers
Property Casualty Insurers Association of America
The Real Estate Roundtable
The U.S. Chamber of Commerce
Federal Home Loan Bank of Atlanta
Federal Home Loan Bank of Boston
Federal Home Loan Bank of Chicago
Federal Home Loan Bank of Cincinnati
Federal Home Loan Bank of Dallas
Federal Home Loan Bank of Des Moines
Federal Home Loan Bank of Indianapolis
Federal Home Loan Bank of New York
Federal Home Loan Bank of Pittsburgh
Federal Home Loan Bank of San Francisco
Federal Home Loan Bank of Seattle
Federal Home Loan Bank of Topeka

Cc: The Members of the House Committee on Financial Services

March 10, 2009

**Executive Chair**
Jerry M. de St. Paer

**Douglas Wm. Barnert**
Executive Director

The Honorable Barney Frank
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Frank and Ranking Member Bachus:

The Group of North American Insurance Enterprises ("GNAIE")[1] would like to thank you for the opportunity to provide written testimony to the U.S. House financial services subcommittee hearing on mark-to-market (or fair value) accounting rules.

We provide this testimony against a back-drop of a continuing crisis of confidence in our nations' most storied financial institutions, soaring unemployment, and an unprecedented level of government intervention into the free market mechanisms that propelled the growth and prosperity of the United States and our partners over the last century.

As described by the Securities and Exchange Commission in its *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* ("Report"), fair value accounting is used to measure roughly one-third of bank assets and nearly three quarters of insurance company assets. For financial institutions that measure assets at fair value on the balance sheet and do not elect the fair value option or designate a trading strategy, which is the predominant practice for banks and insurers, periodic changes in the fair value of assets are recognized in equity as opposed to net income.

In light of the preceding, any debate about the insignificant impact of fair value accounting on earnings, misses the critical issue which is the catastrophic impact of fair value accounting on the equity, and therefore the financial strength and stability, of our nations' financial institutions that lie at the heart and fuel the engine of commerce and economic activity.

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GNAIE is a trade organization comprised of 18 leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations, and all are major participants in the US markets.

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Financial institutions such as banks and insurance companies represent some of the largest and most important investors in debt securities issued by all levels of government, corporations, and other entities. Together these institutions operate within a complex interdependent framework that forms the most efficient and powerful engine of commerce the world has ever known. Financial institutions typically utilize a business model that includes a capital buffer, similar to an individual's savings account, to protect against unanticipated losses that may occur, including those associated with investments in debt securities. It is the equity capital of financial institutions (banks and insurers) that has been most severely weakened by the application of fair value measurements to debt securities associated with inactive, illiquid markets.

The engine of commerce has stalled, and as a result over twelve million Americans are out of work, and those that remain employed are faced with the continued uncertainty of whether their job will be the next to be eliminated as businesses around the world rapidly reduce their workforces to coincide with the dramatic reduction in demand for products and services.
In times of crisis, it is important to understand the underlying factors that caused the crisis as well as those that facilitated its proliferation. The goal is to ensure that factors that may be continuing to act as accelerants (e.g., fair value measurements in inactive, illiquid markets) are quickly neutralized and that remedies are developed that appropriately address the root causes of the crisis.

The on-going debate about fair value measurement has unfortunately been filled with misinformation that has further confused an inherently complex topic. The critical issue is whether fair value measurement is possible, or appropriate, when markets are inactive, illiquid, and unstable. In contrast, there is no opposition to the use of fair value measurements where active, liquid and stable markets exist.

Prior to FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157") the notion of fair value, as applied to an asset, was the amount expected to be received in ***a transaction between a willing buyer and seller***. SFAS 157 modified the notion of fair value to the price that would be received to sell the asset in ***a transaction between actual or hypothetical market participants;*** thereby transforming the notion of fair value from a completed transaction based measure to a mere aspirational goal.

As a result of the substitution of the term "willing buyer and seller" with "hypothetical market participant", when markets for certain structured credit products at the epicenter of the worldwide credit crisis became inactive, illiquid and unstable in mid to late 2007, SFAS 157 nonetheless required financial institutions to "fair value" those assets at the price "a hypothetical market participant would transact". Valuation of those securities proved problematic in late 2007 and the problems continue today as insufficient transparent market observable data exists from which a hypothetical transaction value for hypothetical market participants can be constructed.

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The difficulty in deriving reliable, transparent values for the above mentioned securities is supported by the fact that even the U.S. Government has not been able to estimate a value for these securities as it contemplates various assistance programs. At the same time, reporting entities continue to be forced to calibrate fair value estimates to erratic sales activity as well as activity in over the counter derivative markets, neither of which possess any modicum of transparency; and in fact are currently being investigated for evidence of manipulation.

The preceding situation led to our observation that while fair value measurements did not cause the worldwide credit crisis, they served as a powerful accelerant that aided the systematic catastrophic erosion of the value of trillions of dollars of structured securities below their true economic value which in turn severely weakened, or completely eliminated, the equity capital of some of the worlds largest financial institutions. Moreover, as fair values began to decline in the face of inactive, illiquid and unstable markets, the erosion of equity caused certain financial institutions to be downgraded which triggered liquidity needs due to customer withdrawals and surrenders and the posting of collateral on certain contracts. Addressing liquidity needs typically required the sale of securities, which put further downward pressure on security prices, thereby accelerating the vicious cycle.

Interestingly, while the self-reinforcing fair value firestorm was allowed to rage completely out of control until it crippled many of the world's largest and most important financial markets, a relatively minor amount of actual losses were incurred on the assets at the epicenter of the crisis. Of course, losses have since increased, however, it remains unclear what portion of those losses are attributable to the bursting of the pre-existing real estate bubble versus the catastrophic economic destruction caused by the fair value firestorm.

As you preside over these hearings amidst the severely weakened remains of what once was the most admired financial system ever constructed, you must remain steadfast in your conviction to eradicate the accelerant (i.e., fair value measurement in inactive, illiquid and unstable markets) that allowed what was a large but containable fire to rage completely out of control and spread across the globe to the point where it will erode the standard of living of individuals around the world as well as future generations.

While irreparable harm has already been caused to the worlds financial markets, action must triumph over continued inaction; your constituents are dependent on your actions to provide a catalyst to reverse the effects of the fair value induced self-reinforcing downward spiral. That catalyst is putting an end to the application of SFAS 157 when markets are illiquid and inactive. In those situations accounting measurements must rely on the only relevant, reliable, and transparent information that exists – that is, ***amortized cost adjusted for actual incurred losses***. See specifics of GNAIE's alternative measurement proposal on pages 3 and 4 of attached letter to Mr. James Kroeker, Deputy Chief Accountant, Securities and Exchange Commission dated December 4, 2008.

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Our proposal would cost taxpayers nothing to implement, and contrary to plethora of misinformation about the relevance and transparency of fair value measurements, even in inactive and illiquid markets, this proposal would achieve a vastly superior level of transparency and would also be impervious to manipulation by "shadow" over-the-counter markets. Moreover, if liquidity returns and the markets once again become active we support moving from our proposed temporary measurement guidance back to fair value.

We encourage the committee to act both thoughtfully and expeditiously, all the while keeping in mind the fragile state of the world's financial markets, the fragile condition of your constituents, as well as the risk posed to the standard of living of generations to come.

Respectfully,

Kevin Spataro

Kevin Spataro
Chairman, Accounting Convergence Committee
Group of North American Insurance Enterprises

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Encl.

cc: Rep. Paul E. Kanjorski
Rep. Scott Garrett

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Sun Life Financial Inc.

D. Keith Bell
Senior VP, Corporate Finance
Travelers Companies, Inc.

Brian Nocco
CFO
XL Capital Ltd.

**Douglas Wm. Barnert**
Executive Director

December 4, 2008

Mr. Jim Kroeker
Deputy Chief Accountant
U.S. Securities and Exchange Commission
100 F Street NE Washington, DC 20549

Re: File Number 4-573 – SEC Study of Mark-to-Market ("MTM") Accounting

Dear Mr. Kroeker:

The Group of North American Insurance Enterprises ("GNAIE")[1], would like to thank you for the opportunity to participate in the MTM Roundtable on November 21, 2008.

We would like to again state very clearly that GNAIE fully supports the use of fair value as a measurement basis for financial instruments whenever active, liquid, orderly markets exist from which transparent and consistent market observable data ("MOD") is available to validate prices either directly or indirectly. We believe this situation fulfills the basic requirements of the qualitative characteristics of financial information (i.e., relevance, reliability, comparability, and understandability).

Moreover, while we do not believe fair value measurements caused the Worldwide Credit Crisis ("WCC"); once it emerged, and an inactive, illiquid, and disorderly market ensued for certain securities; unreliable and non-transparent fair value measurements of those securities served as a powerful accelerant[2].

GNAIE believes the fundamental shortcoming of FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157") relates to its application to certain illiquid securities including structured credit products ("SCP's") held in certificated form which are at the epicenter of the WCC. More specifically, we believe SFAS 157

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1 GNAIE is a trade organization comprised of 18 leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations, and all are major participants in the US markets.

2 This assertion rests on the notion that levered financial institutions (e.g., broker-dealers, banks, and life insurers), historically a primary investor group for securitized debt instruments with loan related collateral, all but stopped making incremental investments in those instruments when they experienced a significant decline in fair value (largely attributable to liquidity spreads that increased to unprecedented levels) and previously active, liquid, and orderly markets for the instruments became inactive, illiquid, and disorderly. The unprecedented increase in liquidity spreads, price volatility, and corresponding decrease in fair value caused these asset types to become significantly out of favor, and despite seemingly attractive prices, there is little trading activity as financial institutions have avoided selling existing investments below internal estimates of economic value and adding to existing positions is not a viable alternative due to the volatile impacts on equity and solvency measures.

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was pushed beyond its limitations as it does not produce reliable measurements representative of fair value (in the traditional sense of a willing buyer/willing seller) when markets are inactive, illiquid, and disorderly.

An example of the fundamental shortcoming with SFAS 157 involves situations where the condition of a market migrates from active, liquid, and orderly to inactive, illiquid, and disorderly, resulting in the unavailability of sufficient data to support reliable fair value measurements either on a direct or indirect basis. In these situations, applying the existing guidance in SFAS 157, using data from inactive, illiquid markets, results in measurements that we believe are more representative of *liquidation values* than fair value. The issue with these values is that they are fundamentally incompatible with financial statements presented on a going-concern basis, and with a reporting entity's intent and ability to hold such securities for the foreseeable future; which is typically the case with insurance companies.

We believe the severity of the current situation is largely attributable to SFAS 157's replacement of the basic notion of a "*willing buyer/willing seller in an arm's length transaction other than a forced or liquidation sale*" with the "*price received to sell an asset or paid to transfer a liability in an orderly transaction at the measurement date (i.e., exit value)*". In addition, the asset sale or liability transfer under SFAS 157 is a *hypothetical transaction*, not an actual transaction at the measurement date from perspective of market participant ("MP"). Accordingly:

- The SFAS 157 continuum is virtually infinite as it was intentionally designed to produce fair value measurements whenever required without the burden of a "willing buyer/willing seller" requirement; just a requirement to simulate a *hypothetical transaction* with all available information;
- While SFAS 157 includes the notion of an "orderly transaction", it refers specifically to *hypothetical as opposed to actual transactions*, as such there is no requirement for an orderly market or sustained, transparent, "market" activity to determine fair value; rather, just a need to develop a MP's view of exit value given all available information;
- In the current environment, certain SCP's are out of favor with investors (including a historical primary investor group – financial institutions such as banks, broker-dealers, and life insurers) as evidenced by liquidity spreads that have widened to unprecedented levels. Despite severe declines in market activity for certain SCP's, a MP estimate of exit value can nonetheless be determined as it represents a hypothetical transaction based on all available information. The question posed by GNAIE, however, is not whether a number can be assigned to exit value using the SFAS 157 paradigm, but rather whether the number assigned is:
  - **Relevant**: i.e., if the measurement represents a liquidation value, we believe it would be inconsistent with financial statements prepared on a going concern basis;
  - **Reliable**: i.e., if the MP view is derived from limited MOD its reliability may be difficult to independently validate;
  - **Comparable**: i.e., assuming limited MOD is available to directly or indirectly support an exit value measurement there is likely more variability, dispersion, and less consensus between estimates derived by unrelated MP's.

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**GNAIE's Proposed Solution**

GNAIE's proposal is one we believe can be implemented using existing mechanisms within US GAAP and can produce results that are sustainable in the longer term. More specifically, where markets for SCP's are no longer active, liquid, or orderly, thereby making it less likely that reliable fair values can be consistently derived on a direct or indirect basis, a "screen" would be added to SFAS 157. The screen would redirect SCP's held in certificated form, from the scope of SFAS 157 to other existing authoritative guidance applicable to the underlying collateral contained in the SCP's (which is often mortgage related but can also be consumer, auto, or other loan related products). Our basic proposal is thus to migrate from a fair value measurement under SFAS 157, *but only in situations where markets are not active, liquid, or orderly*, to an amortized cost/incurred loss measurement paradigm applied to identical loans outside the SCP's that are not held in securitized (or certificated) form. Notwithstanding our proposal to modify the measurement attribute from fair value to amortized cost, reporting fair values for affected securities would remain a footnote disclosure requirement for the benefit of financial statement users who wish to obtain the information regardless of its reliability.

**Specifics of GNAIE's Alternative Measurement Proposal**

- SCP's associated with markets that are not active, liquid, or orderly, would be accounted for using existing authoritative accounting standards applicable to the SCP's underlying loans as if they were held in an un-securitized (i.e., whole loan) form by originators;
- Financial statement users would benefit from the alignment of the measurement attribute for loans held in securitized (or certificated) form when markets for the securitized (or certificated) assets are illiquid, inactive, or otherwise not orderly, with the existing measurement paradigm(s) applied to identical assets held in non-securitized (or non-certificated) form;
- Collateral supporting SCP's held in securitized (or certificated) form for which markets are no longer active, liquid, or orderly is typically loans (e.g., mortgage, consumer, etc.). The measurement attribute for loans in existing US GAAP is typically amortized cost. Underlying collateral would be aggregated and reported net of a valuation allowance determined under FASB Statement No. 5, *Accounting for Contingencies* ("SFAS 5") and impairment would be determined under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* ("SFAS 114") or other applicable standards;
- GNAIE's proposal would require essential amendments to SFAS 157, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS 115") and other relevant standards to redirect securities associated with markets that become inactive, illiquid, or disorderly to other existing measurement standards applicable to the underlying collateral when not held in securitized (or certificated) form.
- GNAIE's proposal would require development of a qualitative and/or quantitative guide to promote conformity around decisions of when markets migrate from being active, liquid, and orderly to inactive, illiquid and disorderly and back again;
- For SCP's held in securitized (or certificated) form, the investor would be required to provide a positive assertion as to its intent and ability to hold a security whose measurement attribute is

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changed from fair value to amortized cost "for the foreseeable future" to eliminate any potential concerns about the non-recognition of unrealized losses;

- Transfers of SCP's from a SFAS 115 available-for-sale ("AFS") designation to an amortized cost paradigm outside SFAS 115 would be accounted for using the guidance in paragraph 15(d) of SFAS 115. As a result, any difference between fair value and amortized cost included as an adjustment of other comprehensive income ("OCI") would be reversed over the remaining life of the security through the securities' effective yield;
- Fair value would remain a footnote disclosure requirement for SCP's whose measurement attribute is modified from fair value to amortized cost for the benefit of financial statement users who desire this information regardless of its reliability;
- Securities would be redirected back to SFAS 115 and 157 and measured at fair value if liquidity, activity, and order returns to the market. *This is consistent with GNAIE's support for the use of fair value as a measurement basis when markets are active, liquid, and orderly*;
- A transfer back to AFS from amortized cost would be at the then existing fair value and AFS mechanics would resume.

**GNAIE Views on Alternative Proposals and Other Considerations**

***Separation of Credit, Liquidity, and Interest Components of Fair Value***

We are aware of alternative proposals that would attempt to decompose market value changes into basic interest, credit, and liquidity components and have only the credit component recognized in the income statement with the other components affecting only OCI to the extent the reporting entity has the intent and ability to hold the affected securities to full recovery or maturity. We believe attempts to reliably separate the periodic changes in fair value associated with credit and liquidity would be severely challenged and do not believe that any such separation would be reliable or comparable between reporting entities.

To address the challenge of decomposing periodic fair value changes between credit, liquidity, and interest, some have suggested that the value assigned to credit be measured using a SFAS 5 incurred loss model. While we do support use of a SFAS 5 incurred loss model in situations where markets for SCP's become inactive, illiquid, and disorderly, we would not support its use as a proxy for a periodic fair value change attributable to credit as we believe this would create an entirely new type of mixed attribute accounting model where fair value and amortized cost would be combined in such a way as to produce assets whose carrying value would become a new hybrid of fair value or amortized cost.

Notwithstanding our skepticism as to whether periodic changes in fair value can be reliably separated between credit, liquidity, and interest, there is also the fundamental issue that continuing to report securities at values that may be more akin to liquidation values than fair value would allow the highly corrosive impacts to shareholder's equity to continue. We believe if this fundamental issue is not addressed, *and it is not addressed in this bifurcation proposal*, any further widening of

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liquidity spreads and corresponding decreases in fair value would further weaken already weak financial services companies' equity capital and could be a catalyst for additional corporate failures.

***Introduce a Loan & Receivable Category to SFAS 115***

Some have suggested seeking better alignment between SFAS 115 and International Accounting Standard No. 39, *Financial Instruments: Recognition and Measurement* by introducing a Loan and Receivable category to SFAS 115 and then allowing reclassifications from SFAS 115 AFS to Loans and Receivables in situations where markets for SCP's with underlying loan collateral become inactive, illiquid, or disorderly. While we believe this could potentially produce results similar to GNAIE's proposal, we believe the proposal would be more difficult to introduce in the near term as its scope would need to be very carefully and narrowly defined and its interaction with other existing US GAAP standards that apply to un-securitized loans would need to be clarified.

***Transparency***

Throughout this intense debate, those who support the continuation of fair value measurements, *even in situations where markets are inactive, illiquid, and disorderly*, do so under the basic pretense that such information is *relevant* and provides the greatest degree of *transparency* to financial statement users. GNAIE believes the notion of transparency is being inappropriately referenced inasmuch as we do not understand how measurements derived from data obtained from inactive, illiquid, or disorderly markets can in any way be considered "transparent". Stated differently, assuming limited if any transparency into the limited transactions occurring in these markets that are inactive, illiquid, and disorderly, we do not understand how using the attributes of those "non-transparent" transactions as inputs in a SFAS 157 hypothetical transaction model can produce values that could, in any way, be described as transparent.

***The Purpose of Financial Reporting***

A separate but related topic that continues to influence the larger debate about the use of fair value as a measurement attribute relates to the basic purpose of financial reporting. GNAIE continues to believe the primary purpose of financial reporting is to provide financial statement users with relevant, reliable, comparable, and understandable information upon which they can make rational economic decisions about a reporting entity (i.e., whether to buy or sell common stock issued by the entity, to make a loan to the entity, or to engage in some other economic relationship). Accordingly, we believe financial statement users should be provided financial statements that have predictive value in terms of providing a reliable basis for decision making, which is fundamentally different than an objective of providing financial statement users with financial statements that are in and of themselves hypothetical predictions. In the current debate, the preceding is best illustrated by the difference between GNAIE's proposal to use amortized cost and an incurred loss model to value SCP's associated with markets that are no longer active, liquid, or orderly as opposed to estimating the exit value of such instruments by reference to a hypothetical transaction with inputs aligned to transactions where little transparency exists into how the prices were derived or the underlying transaction terms.

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**Recommendation**

Given the severity of the existing economic environment, we believe it is essential that regulators and standard setters work together to identify and implement practical solutions that will be effective as of December 31, 2008. Moreover, we believe the GNAIE proposal is one that is practical, easily implementable (as most of the necessary accounting and financial reporting infrastructure already exists), aligns with the direction the IASB appears to be headed on this issue, and is also conceptually sound. Given the critical importance of this issue, coupled with our belief that we have identified the most practical and implementable proposal, we offer our time and assistance to discuss the content of this letter or other issues or alternatives that may assist the Commissioners and Staff in indentifying and implementing a solution to the existing issues with SFAS 157 that would be effective as of December 31, 2008.

Sincerely,

Kevin Spataro

Kevin Spataro
Chairman, Accounting Convergence Committee
Group of North American Insurance Enterprises, Inc.

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**Statement of John A. Courson**

**President and Chief Executive Officer**

**Mortgage Bankers Association**

**for the Record of the**

**Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises**

**Committee on Financial Services**

**United States House of Representatives**

**Hearing on**

**"Mark-to-Market Accounting: Practices and Implications"**

**March 12, 2009**

Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee, thank you for holding this very important hearing on the impact of fair value accounting on the current financial crisis. As you consider policy responses to this issue, the Mortgage Bankers Association[1] (MBA) believes that you should consider a number of key points outlined below.

Fair value accounting, as defined in various pronouncements 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 may have resulted in a pro-cyclical impact in the current credit market crisis. Further, the present rules in Statement of Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), require enterprises to take write-downs guised as other-than-temporary impairments (OTTI) that include factors such as the currently high liquidity risk in the market, which is cyclical and therefore not other-than-temporary. This too may be having a pro-cyclical impact. Finally, the Financial Accounting Standards Board (FASB) should reconsider its long-term objective of reporting all financial assets at fair value.

There are at least three major problems with fair value as presently practiced. The first two should be immediately addressed and the third relates to the proposed longer-term use of fair value.

**OTTI Guidance Needs Immediate Change** – FAS 115 requires a full fair value write-down based upon the first dollar of credit impairment that shows up.

The following example highlights the problems that this provision is causing in the current inactive markets:

> Bank ABC has a private label mortgage-backed security on its books at $5 million. The fair value based upon the most recent sale of a similar security is $3.2 million, or a discount of $1.8 million from current carrying value. The credit losses expected to impact the cash flows of the security are estimated to be $200,000, and the remainder of the discount relates to a liquidity risk discount currently assigned by the market for this asset. Bank ABC does its periodic OTTI test and determines that an other-than-temporary loss exists related to the

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 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.

> $200,000 of estimated credit losses. Under the guidance in FAS 115, the $200,000 estimated credit losses triggers recognition of the entire fair value loss of $1.8 million through profit and loss, even though the vast majority of that loss is due to conditions in the market, which are likely to be temporary in nature. Further, as market conditions improve, Bank ABC is precluded from reversing that write down.

MBA proposes the following principle to guide OTTI:

> OTTI losses recognized should be based solely on factors affecting value that will likely have a permanent impact on the value of a financial asset or liability. This will generally include only instrument-specific credit risk for most debt securities.

**Measurement of Fair Value in Inactive Markets** – MBA believes that the guidance that the SEC and FASB provided in the joint press release on September 30, 2008, 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. However, MBA believes that the characteristics that are currently considered to determine if the market for a particular security is inactive are not adequately robust. In fixing the short-term problems in fair value accounting, FASB should provide additional guidance that expands the list of "symptoms" of an inactive market to include:

- significant widening of "bid ask" spreads;
- significant reduction from the normal number of transactions in a market;
- trades occurring primarily by sellers who are financially troubled;
- buyers that are not the traditional market participants, but rather are opportunistic players looking for a bargain; and
- non-distressed sellers sitting on the sidelines, unwilling to sell in the current market at the prices being offered.

FASB's example in the FSP does not appear to allow a company to entirely exclude the assumed 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 consideration 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.

MBA recommends the following principle:

> In an inactive market, liquidity discount should be ignored in calculating fair value.

**Inconsistency with Typical Financial Institution Business Model –** FAS 157 articulates a fair value standard that attempts to measure the price at which financial assets could be sold at the balance sheet date. This appears to provide information desired by investors. However, most banks and thrifts are not managed as trading portfolios. 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. Management of these companies increasingly believe 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. Further, the current hybrid reporting of certain financial assets at fair value and few financial liabilities at fair value ignores the purposeful duration matching of assets and liabilities. It is for these reasons that many preparers 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 on the last minute, of the last hour, on the last day of the reporting period. The concept of using an "exit price" as a fair value measure appears to be inconsistent with an asset that will not be sold in the near term.

MBA, however, recognizes that users of financial statements believe that fair value measures are essential for their understanding of an enterprise's financial position. Accordingly, MBA recognizes the need for comprehensive fair value information for all financial assets and liabilities.

MBA, therefore, believes it is time for accounting policymakers to think "outside the box" to adopt a financial presentation model that will capture the business strategies related to financial asset/liability management while still providing investors with the value that they are intent on having.

MBA appreciates the opportunity to present the above principles for your consideration and we look forward to working with you as you evaluate and implement policy responses.

March 11, 2009

The Honorable Paul Kanjorski
Chairman
Subcommittee on Capital Markets,
Insurance and Government
Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Scott Garrett
Ranking Member
Subcommittee on Capital Markets,
Insurance and Government
Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Kanjorski and Ranking Member Garrett:

The undersigned organizations commend your scrutiny of mark-to-market accounting rules and their impact on the economy.

As you are aware, the current state of the financial markets has resulted in a sharp reduction in liquidity and credit availability, making it challenging for to find reasonable financing for affordable housing and community development initiatives. At the same time, the real world effects of these market conditions are increasing the demand for such projects. Mark-to-market accounting rules seem to be exacerbating this situation, with a non-functioning market leading to cyclical write-downs of assets.

In addition, other funding sources for affordable housing are being negatively impacted, such as the FHLBank System which has been the single largest provider of affordable housing grants, contributing 10% of its net income for affordable housing development. Other-than-temporary-impairment (OTTI) accounting rules that require write downs on assets that are far in excess of the probable economic losses are significantly reducing otherwise available affordable housing funds. The FHLBanks' unaudited fourth quarter 2008 financial reports suggest an approximate reduction of $140 million in Affordable Housing Program (AHP) funding as a direct result of OTTI liquidity losses.

As you prepare for the upcoming hearing, we urge you to examine the unintended consequences of mark-to-market accounting on the supply of funds for affordable housing and community development.

Thank you,

National Alliance of Community Economic Development Associations
National Association for County Community and Economic Development
National Association of Housing and Redevelopment Officials

National Association of Local Housing Finance Agencies
National Association of Towns and Townships
National Community Development Association
National Council of State Housing Agencies
National League of Cities
Pennsylvania Housing Alliance
United States Conference of Mayors

Cc: Members of the House Financial Services Committee

**Statement of John von Seggern,**
**President and CEO, Council of Federal Home Loan Banks**
**Subcommittee on Capital Markets, Insurance, and**
**Government Sponsored Enterprises,**
**House Financial Services Committee**

**March 12, 2009**

Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee, I am John von Seggern, the President and CEO of the Council of Federal Home Loan Banks, a trade association whose members include all 12 Federal Home Loan Banks (FHLBanks). On behalf of the Council I want to thank you for giving me the opportunity to submit a statement for the record.

The primary purpose of the FHLBanks is to provide their more than 8,000 member financial institutions with a reliable and steady source of funding for the extension of vital housing, community and economic development credit and financial services to their communities. The FHLBanks collectively also serve as the largest supplier of affordable housing grant funds in the United States by providing 10 percent of their net income for this purpose.

As cooperatives, the FHLBanks seek to maintain a balance between their public policy mission and their obligation to provide adequate returns on the capital supplied by members. The FHLBanks achieve this balance by delivering low cost financing, and providing members a viable alternative to the secondary mortgage market via the mortgage loan programs, while paying a dividend when appropriate. Without FHLBanks, most community depository institutions (a bank or company which holds funds or securities deposited by others, and where exchanges of these securities take place) would not have access to medium-and long-term sources of funding.

We appreciate your holding this hearing on an issue that is of major significance to the FHLBanks as well as many other financial institutions and companies. While the matter of U.S. GAAP principles for Fair Value Accounting (FVA) and other-than-temporary-impairment (OTTI) may appear to be of interest only to those in the accounting profession, let me assure you that the subject matter of this hearing has a direct impact on communities throughout the country by affecting the capacity of financial institutions to provide necessary credit and services.

Fair Value Accounting principles are designed with the intention of providing investors and users of financial statements with current information about the financial condition and value of a company's assets. Generally FVA does provide accurate and transparent information, however the current market conditions have exposed flaws in certain principles within FVA. Current interpretation and application of OTTI rules can distort the true condition of certain assets, particularly private label mortgage backed securities (MBS), held by financial institutions and other companies. As a result, while current accounting for OTTI should only provide accurate and transparent financial information, it has become a market factor and has distorted the real value of certain assets.

**What is OTTI and when is it applied?**

U.S. GAAP's FAS 115 "Accounting for Certain Investments in Debt and Equity Securities" requires that individual investment securities classified as available-for-sale or held-to-maturity be evaluated to determine whether a decline in fair value below a security's carrying value is other-than-temporary. If the company determines that it does not expect to collect all of its scheduled contractual cash flows, the company must mark the investment security down from its carrying value to its current fair value, even if the company intends to hold the investment security to maturity.

U.S. GAAP does not provide "bright lines" or "safe harbors" in making judgments about OTTI. The impairment must be evaluated based on specific factors including the nature and

extent of the probable decrease in fair value of the asset below cost to determine if the impairment is other-than-temporary. And, if an other-than-temporary-impairment is determined the amount of the write-down is the difference between the carrying value and the fair value of the investment. The investment security's fair value becomes its new cost basis, and a realized loss is recognized, which results in an immediate adverse impact on retained earnings, thereby reducing the company's capital.

While the criteria for recognizing if other-than-temporary-impairments exists for both loans and mortgage backed securities are nearly identical, the manner in which fair value is then determined for OTTI is very different. OTTI is recognized for loans by requiring a write down to fair value based on the expected probable economic losses of the assets. In the case of MBS once OTTI is recognized fair value must be determined based on current market valuations with the determined fair value becoming the new cost basis of the asset, any subsequent recoveries in fair value are not recognized.

**Current OTTI rules and application are flawed.**

Generally FVA provides accurate and transparent financial information. However, when financial markets become illiquid and non-functioning, inherent fair value and market price begin to diverge. The unique current market dislocations have exposed a flaw in the U.S. GAAP Fair Value Accounting for OTTI, particularly regarding held-to-maturity investment assets.

Current interpretation and application of U.S. GAAP rules applicable to OTTI can present a distorted financial picture despite its goal of increased transparency. Although managerial judgment is permitted in determining fair value when there are illiquid or non-functioning markets, outside auditors and regulators generally have taken a more conservative view requiring market-based mark to market valuation for held-to-maturity (HTM) assets. Without a functioning market, "real" market value cannot be determined in many cases, which results in accounting mandated asset write downs far in excess of the probable economic impairments.

Fair Value Accounting, as currently defined under U.S. GAAP and interpreted by the accounting firms, is based on an "exit price" from a market participant's point of view. This concept presumes the existence of a referenceable market to provide price discovery. However, the private label MBS market currently lacks trading volume, observable inputs, reasonable bid/ask spreads, or willing sellers to support the valuation of these securities. This results in companies recording write-downs disproportionately greater than the probable credit or economic losses.

Under U.S. GAAP, the entire reduction in fair market value is recognized in the income statement, both the write-downs attributable to credit or economic loss and liquidity. Finally, this OTTI-derived loss is charged against earnings with no ability to recoup any future increase in fair value. Some of the consequences of these flawed rules are that mortgage markets become more unstable, credit availability is further contracted, and affected companies' capital is further depleted increasing the risk of institution failures.

The 2008 earnings of the FHLBanks provide an example. As reported recently by the Office of Finance, of the 11 FHLBanks reporting there was a cumulative recognition of $166 million in estimated probable economic losses which resulted in an OTTI write down to fair value of approximately $1.8 billion. The write downs were 10 times the estimated economic losses.

**Accounting rules are helping to drive down the market for private label MBS.**

The current economic trend has shown that there is a highly illiquid market for private label MBS, few investors are willing to make a bid for these assets and virtually no holders of these securities are willing to accept the bids that may be proffered. Further exacerbating the current mortgage market crisis is the application of current OTTI accounting standards which serve as an additional deterrent to any prospective market participants who might see the economic value in mortgages but are fearful of future OTTI required write downs.

The current application and interpretation of U.S. GAAP OTTI principles has become a market factor, rather than an accurate and transparent statement of financial condition creating a self-fulfilling downward spiral for MBS prices. Left unchanged the extension of residential mortgages will continue to decline and the already weak market in MBS will become nearly invisible.

**OTTI charges adversely affect the nation's banking system.**

The U.S. GAAP rules and interpretations for OTTI have had and will continue to have a dramatic negative effect on U.S. financial institutions, creating regulatory capital challenges during an ongoing economic crisis. In many cases, the most egregious impact is on HTM assets of financial institutions that were purchased as such and can continue to be held-to-maturity. While the performance and fulfillment of the HTM MBS obligations are virtually the same as similar loans held in portfolio, the accounting treatment under U.S. GAAP is significantly different. Under U.S. GAAP, loans held in portfolio that are subject to impairment are accounted for under FAS 114 "Accounting by Creditors for Impairment of a Loan" through the discounted cash flow guidance, which means that while MBS treatment requires a write down to market price, loans held in portfolio only require recognition of the anticipated cash flow impairment which is generally much less.

Current OTTI accounting charges have caused the FHLBanks to reduce their capital positions, reduce dividends to member institutions, and raise the cost of funds for thousands of banks and savings institutions that borrow from their FHLBank. This further impedes the Nation's community banks' ability to lend.

For all financial institutions that carry private label MBS on their books, OTTI rules raise the specter of future write-downs that could weaken capital positions further. This may be one of the key factors to the retention of existing and new capital at many banks. This prudent reaction to guard against future accounting-driven losses inhibits the flow of badly needed credit to communities and small businesses.

**Current application of OTTI will hurt home ownership and affordable housing opportunities**

In part because of the unintended consequences of OTTI application the private label MBS market has become nearly nonexistent, shifting virtually all of the mortgage origination to the agency markets drying up critical funds needed for mortgage liquidity.

In addition, funding sources for affordable housing are being negatively impacted. The FHLBank System has been the single largest provider of affordable housing grants, contributing 10% of its net income for affordable housing and economic development programs. OTTI accounting rules that require write downs on assets that are far in excess of the estimated probable economic losses are significantly reducing otherwise available affordable housing funds. The FHLBanks' fourth quarter financial reports will result in an approximate reduction of more than $100 million in Affordable Housing Program funding as a direct result of OTTI liquidity losses.

**Correcting the OTTI flaw.**

The solution is not to abandon or suspend appropriate consideration of fair value principles but rather to immediately seek a better principles-based balance between the investors' need for accurate and useful financial information and the business model of the regulated financial institutions. OTTI rules for entities that have demonstrated the ability and intent to hold securities until maturity should be the same as if the securities were debt instruments. To be more precise, instruments which require other-than-temporary-impairment charges based on appropriately robust cash flow analysis of the loan agreements based on sufficient loan level data.

In addition, the classification of an impairment as an other-than-temporary-impairment should be based on a material probable impairment rather than first dollar or de minimis probable impairment. Economic and credit losses should be reported through earnings and liquidity losses if any should be reported through other comprehensive income.

Quick action by the SEC and FASB to address these concerns would result in a far more accurate presentation of the true economic condition of financial institutions such as the FHLBanks under the highly distorted current conditions in the marketplace.

Thank you again for the opportunity to submit this statement.

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Fred R. Becker, Jr.
*President and CEO*

March 11, 2009

The Honorable Paul Kanjorski
Chairman
House Financial Services
Subcommittee on Capital Markets,
Insurance and GSE's
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Scott Garrett
Ranking Member
House Financial Services
Subcommittee on Capital Markets,
Insurance and GSE's
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Kanjorski and Ranking Member Garrett: Mr. Chairman

I am writing on behalf of the National Association of Federal Credit Unions (NAFCU) the only trade organization exclusively representing the interests of our nation's federal credit unions, regarding the hearing "Mark-to-Market Accounting: Practices and Implications." NAFCU welcomes this important hearing and would like to offer the following comments.

NAFCU applauds the Chairman for taking up such a prevalent issue at a time when we face one of the most serious economic downturns our country has experienced in decades. As the Chairman has noted, "illiquid markets have resulted in great difficulty in valuing sizable assets … (and) … it is important, within the existing independent standard-setting structure – to still provide investors with the information needed to make effective decisions without continuing to impose undue burdens on financial institutions."

NAFCU believes that the transparency and disclosure of information provided by mark-to-market accounting has helped maintain and strengthen the reputation of the American marketplace. Armed with the proper information, investors worldwide have been able to make confident investment decisions regarding American businesses.

The current situation regarding certain securities held by major American financial institutions has, however, led some to call into question mark-to-market accounting. Many financial institutions find themselves having to devalue sizable assets held on balance sheets that do not have a liquid market.

NAFCU believes that financial reporting should be a transparent process. Accordingly, we support the increase of comparability of information about financial assets that have related economic characteristics but have different reporting measurement attributes by requiring entities to disclose information regarding the measurement attributes for debt securities classified as held-to-maturity, debt securities classified as available-for-sale, and certain loans and long

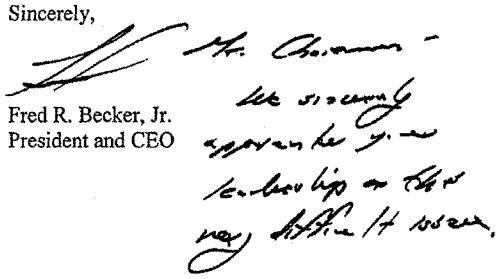
term receivables. For these financial assets, entities would be required to provide, in tabular format, the assets' measurement attributes (1) as reported in the statement of financial position; (2) at fair value; and (3) at the incurred loss amount. Requiring disclosures of different reporting measurement attributes for the debt securities and loans covered would improve the quality of information available to users of financial statements and be beneficial given that financial assets covered in the proposal have related characteristics. While there will be an apparent increase in burden for preparers, we are convinced that the benefits arising from having increased comparability information easily outweigh the increased burden.

While NAFCU supports the proposed changes to increase comparability, we also support the Private Company Financial Reporting Committee's recommendation to limit the application of the requirements to entities where the disclosures are needed.

NAFCU urges the Chairman and the Committee to responsibly consider ways to find common ground that would benefit investors and financial institutions alike by finding acceptable changes in the current system that can provide relief to financial institutions in the short term, while not creating long-term unintended consequences. It is with that in mind that we support your efforts to find relief that can work in the current system.

We look forward to working with the Committee to help find solutions benefiting all parties and applaud the Chairman's efforts in tackling this important issue. Please do not hesitate to contact me at 703-522-4770 with any questions or concerns that you may have.

Sincerely,



Fred R. Becker, Jr.
President and CEO

cc: Subcommittee Members
The Honorable Barney Frank
The Honorable Spencer Bachus

Chairman Ben S. Bernanke
At the Council on Foreign Relations, Washington, D.C.
March 10, 2009
Financial Reform to Address Systemic Risk

The world is suffering through the worst financial crisis since the 1930s, a crisis that has precipitated a sharp downturn in the global economy. Its fundamental causes remain in dispute. In my view, however, it is impossible to understand this crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990s. In the simplest terms, these imbalances reflected a chronic lack of saving relative to investment in the United States and some other industrial countries, combined with an extraordinary increase in saving relative to investment in many emerging market nations. The increase in excess saving in the emerging world resulted in turn from factors such as rapid economic growth in high-saving East Asian economies accompanied, outside of China, by reduced investment rates; large buildups in foreign exchange reserves in a number of emerging markets; and substantial increases in revenues received by exporters of oil and other commodities. Like water seeking its level, saving flowed from where it was abundant to where it was deficient, with the result that the United States and some other advanced countries experienced large capital inflows for more than a decade, even as real long-term interest rates remained low.

The global imbalances were the joint responsibility of the United States and our trading partners, and although the topic was a perennial one at international conferences, we collectively did not do enough to reduce those imbalances. However, the responsibility to use the resulting capital inflows effectively fell primarily on the receiving countries, particularly the United States. The details of the story are complex, but, broadly speaking, the risk-management systems of the private sector and government oversight of the financial sector in the United States and some other industrial countries failed to ensure that the inrush of capital was prudently invested, a failure that has led to a powerful reversal in investor sentiment and a seizing up of credit markets. In certain respects, our experience parallels that of some emerging-market countries in the 1990s, whose financial sectors and regulatory regimes likewise proved inadequate for efficiently investing large inflows of saving from abroad. When those failures became evident, investors lost confidence and crises ensued. A clear and highly consequential difference, however, is that the crises of the 1990s were regional, whereas the current crisis has become global.

In the near term, governments around the world must continue to take forceful and, when appropriate, coordinated actions to restore financial market functioning and the flow of credit. I have spoken on a number of occasions about the steps that the U.S. government, and particularly the Federal Reserve, is taking along these lines.2 Until we stabilize the financial system, a sustainable economic recovery will remain out of reach. In particular, the continued viability of systemically important financial institutions is vital to this effort. In that regard, the Federal Reserve, other federal regulators, and the Treasury Department have stated that they will take any necessary and appropriate steps to ensure that our banking institutions have the capital and liquidity necessary to function well in even a severe economic downturn. Moreover, we have reiterated the U.S. government's determination to ensure that systemically important financial institutions continue to be able to meet their commitments.

At the same time that we are addressing such immediate challenges, it is not too soon for policymakers to begin thinking about the reforms to the financial architecture, broadly conceived, that could help prevent a similar crisis from developing in the future. We must have a strategy that regulates the financial system as a whole, in a holistic way, not just its individual components. In particular, strong and effective regulation and supervision of banking institutions, although necessary for reducing systemic risk, are not sufficient by themselves to achieve this aim.

Today, I would like to talk about four key elements of such a strategy. First, we must address the problem of financial institutions that are deemed too big--or perhaps too interconnected--to fail. Second, we must strengthen what I will call the financial infrastructure--the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets--to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality--that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing. My discussion today will focus on the principles that should guide regulatory reform, leaving aside important questions concerning how the current regulatory structure might be reworked to reduce balkanization and overlap and increase effectiveness. I also will not say much about the international dimensions of the

issue but will take as self-evident that, in light of the global nature of financial institutions and markets, the reform of financial regulation and supervision should be coordinated internationally to the greatest extent possible.

**Too Big to Fail**

In a crisis, the authorities have strong incentives to prevent the failure of a large, highly interconnected financial firm, because of the risks such a failure would pose to the financial system and the broader economy. However, the belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.

In the midst of this crisis, given the highly fragile state of financial markets and the global economy, government assistance to avoid the failures of major financial institutions has been necessary to avoid a further serious destabilization of the financial system, and our commitment to avoiding such a failure remains firm. Looking to the future, however, it is imperative that policymakers address this issue by better supervising systemically critical firms to prevent excessive risk-taking and by strengthening the resilience of the financial system to minimize the consequences when a large firm must be unwound.

Achieving more effective supervision of large and complex financial firms will require a number of actions. First, supervisors need to move vigorously--as we are already doing--to address the weaknesses at major financial institutions in capital adequacy, liquidity management, and risk management that have been revealed by the crisis. In particular, policymakers must insist that the large financial firms that they supervise be capable of monitoring and managing their risks in a timely manner and on an enterprise-wide basis. In that regard, the Federal Reserve has been looking carefully at risk-management practices at systemically important institutions to identify best practices, assess firms' performance, and require improvement where deficiencies are identified.3 Any firm whose failure would pose a systemic risk must receive especially close supervisory oversight of its risk-taking, risk management, and financial condition, and be held to high capital and liquidity standards.4 In light of the global reach and diversified operations of many large financial firms, international supervisors of banks, securities firms, and other financial institutions must collaborate and cooperate on these efforts.

Second, we must ensure a robust framework--both in law and practice--for consolidated supervision of all systemically important financial firms organized as holding companies. The consolidated supervisors must have clear authority to monitor and address safety and soundness concerns in all parts of the organization, not just the holding company. Broad-based application of the principle of consolidated supervision would also serve to eliminate gaps in oversight that would otherwise allow risk-taking to migrate from more-regulated to less-regulated sectors.

Third, looking beyond the current crisis, the United States also needs improved tools to allow the orderly resolution of a systemically important nonbank financial firm, including a mechanism to cover the costs of the resolution. In most cases, federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, this framework does not sufficiently protect the public's strong interest in ensuring the orderly resolution of nondepository financial institutions when a failure would pose substantial systemic risks. Improved resolution procedures for these firms would help reduce the too-big-to-fail problem by narrowing the range of circumstances that might be expected to prompt government intervention to keep the firm operating.

Developing appropriate resolution procedures for potentially systemic financial firms, including bank holding companies, is a complex and challenging task. Models do exist, though, including the process currently in place under the Federal Deposit Insurance Act (FDIA) for dealing with failing insured depository institutions and the framework established for Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008. Both models allow a government agency to take control of a failing institution's operations and management, act as conservator or receiver for the institution, and establish a "bridge" institution to facilitate an orderly sale or liquidation of the firm. The authority to "bridge" a failing institution through a receivership to a new entity reduces the potential for market disruption while limiting moral hazard and mitigating any adverse impact of government intervention on market discipline.

The new resolution regime would need to be carefully crafted. For example, clear guidelines must define which firms could be subject to the alternative regime and the process for invoking that regime, analogous perhaps to the procedures for invoking the so-called systemic risk exception under the FDIA. In addition, given the global operations of many large and complex financial firms and the complex regulatory structures under which they operate, any new regime must be structured to work as seamlessly as possible with other domestic or foreign insolvency regimes that might apply to one or more parts of the consolidated organization.

**Strengthening the Financial Infrastructure**

The first element of my proposed reform agenda covers systemically important institutions considered individually. The second element focuses on interactions among firms as mediated by what I have called the financial infrastructure, or the financial plumbing if you will: the institutions that support trading, payments, clearing, and settlement. Here the aim should be not only to help make the financial system as a whole better able to withstand future shocks, but also to mitigate moral hazard and the problem of too big to fail by reducing the range of circumstances in which systemic stability concerns might prompt government intervention. I'll give several examples.

Since September 2005, the Federal Reserve Bank of New York has been leading a major joint initiative by the public and private sectors to improve arrangements for clearing and settling credit default swaps (CDS) and other over-the-counter (OTC) derivatives. As a result, the accuracy and timeliness of trade information has improved significantly. However, the infrastructure for managing these derivatives is still not as efficient or transparent as that for more mature instruments. The Federal Reserve Bank of New York, in conjunction with other domestic and foreign supervisors, will continue to work toward establishing increasingly stringent targets and performance standards for market participants. To help alleviate counterparty credit concerns, regulators are also encouraging the development of well-regulated and prudently managed central clearing counterparties for OTC trades.5 Just last week, we approved the application for membership in the Federal Reserve System of ICE Trust, a trust company that proposes to operate as a central counterparty and clearinghouse for CDS transactions.

The Federal Reserve and other authorities also are focusing on enhancing the resilience of the triparty repurchase agreement (repo) market, in which the primary dealers and other major banks and broker-dealers obtain very large amounts of secured financing from money market mutual funds and other short-term, risk-averse sources of funding.6 For some time, market participants have been working to develop a contingency plan for handling a loss of confidence in either of the two clearing banks that facilitate the settlement of triparty repos. Recent experience demonstrates the need for additional measures to enhance the resilience of these markets, particularly as large borrowers have experienced acute stress. The Federal Reserve's Primary Dealer Credit Facility, launched in the wake of the Bear Stearns collapse and expanded in the aftermath of the Lehman Brothers bankruptcy, has stabilized this critical market, and market confidence has been maintained. However, this program was adopted under our emergency powers to address unusual and exigent circumstances. Therefore, more-permanent reforms are needed. For example, it may be worthwhile considering the costs and benefits of a central clearing system for this market, given the magnitude of exposures generated and the vital importance of the market to both dealers and investors.

More broadly, both the operational performance of key payment and settlement systems and their ability to manage counterparty and market risks in both normal and stressed environments are critical to the stability of the broader financial system. Currently, the Federal Reserve relies on a patchwork of authorities, largely derived from our role as a banking supervisor, as well as on moral suasion to help ensure that critical payment and settlement systems have the necessary procedures and controls in place to manage their risks. By contrast, many major central banks around the world have an explicit statutory basis for their oversight of these systems. Given how important robust payment and settlement systems are to financial stability, a good case can be made for granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.

Another issue that warrants attention is the potential fragility of the money market mutual fund sector. Last fall, as a result of losses on Lehman Brothers commercial paper, a prominent money market mutual fund "broke the buck"--that is, was unable to maintain a net asset value of $1 per share. Over subsequent days, fearful investors withdrew more than $250 billion from prime money market mutual funds. The magnitude of these withdrawals decreased only after the Treasury

announced a guarantee program for money market mutual fund investors and the Federal Reserve established a new lending program to support liquidity in the asset-backed commercial paper market.

In light of the importance of money market mutual funds--and, in particular, the crucial role they play in the commercial paper market, a key source of funding for many businesses--policymakers should consider how to increase the resiliency of those funds that are susceptible to runs. One approach would be to impose tighter restrictions on the instruments in which money market mutual funds can invest, potentially requiring shorter maturities and increased liquidity. A second approach would be to develop a limited system of insurance for money market mutual funds that seek to maintain a stable net asset value. For either of these approaches or others, it would be important to consider the implications not only for the money market mutual fund industry itself, but also for the distribution of liquidity and risk in the financial system as a whole.

**Procyclicality in the Regulatory System**

It seems obvious that regulatory and supervisory policies should not themselves put unjustified pressure on financial institutions or inappropriately inhibit lending during economic downturns. However, there is some evidence that capital standards, accounting rules, and other regulations have made the financial sector excessively procyclical--that is, they lead financial institutions to ease credit in booms and tighten credit in downturns more than is justified by changes in the creditworthiness of borrowers, thereby intensifying cyclical changes.

For example, capital regulations require that banks' capital ratios meet or exceed fixed minimum standards for the bank to be considered safe and sound by regulators.7 Because banks typically find raising capital to be difficult in economic downturns or periods of financial stress, their best means of boosting their regulatory capital ratios during difficult periods may be to reduce new lending, perhaps more so than is justified by the credit environment. We should review capital regulations to ensure that they are appropriately forward-looking, and that capital is allowed to serve its intended role as a buffer--one built up during good times and drawn down during bad times in a manner consistent with safety and soundness.8 In the area of prudential supervision, we should also ensure that bank examiners appropriately balance the need for caution and the benefits of maintaining profitable lending relationships when evaluating bank loan policies.

The ongoing move by those who set accounting standards toward requirements for improved disclosure and greater transparency is a positive development that deserves full support. However, determining appropriate valuation methods for illiquid or idiosyncratic assets can be very difficult, to put it mildly. Similarly, there is considerable uncertainty regarding the appropriate levels of loan loss reserves over the cycle. As a result, further review of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency. Indeed, work is underway on these issues through the Financial Stability Forum, and the results of that work may prove useful for U.S. policymakers.9

Another potential source of procyclicality is the system for funding deposit insurance. In recognition of this fact--as well as the weak economic outlook and the current strains on banks and the financial system--the Federal Deposit Insurance Corporation recently announced plans to extend from five years to seven years the period over which it would restore the deposit insurance fund to its minimum required level. This plan, if implemented, should help reduce the costs imposed on banks at a time when capital and lending are already under pressure. Policymakers should consider additional steps to reduce the possible procyclical effects of deposit insurance costs while still ensuring that riskier banks pay higher premiums than safer banks. One possibility would be to raise the level to which the designated reserve ratio may grow in benign economic environments, so that a larger buffer is available to be drawn down when economic conditions worsen and insurance losses are high.

**Systemic Risk Authority**

The policy actions I've discussed would inhibit the buildup of risks within the financial system and improve the resilience of the financial system to adverse shocks. Financial stability, however, could be further enhanced by a more explicitly macroprudential approach to financial regulation and supervision in the United States. Macroprudential policies focus on risks to the financial system as a whole. Such risks may be crosscutting, affecting a number of firms and markets, or they may be concentrated in a few key areas. A macroprudential approach would complement and build on the current regulatory and supervisory structure, in which the primary focus is the safety and soundness of individual institutions and markets.

How could macroprudential policies be better integrated into the regulatory and supervisory system? One way would be for the Congress to direct and empower a governmental authority to monitor, assess, and, if necessary, address potential systemic risks within the financial system. The elements of such an authority's mission could include, for example, (1) monitoring large or rapidly increasing exposures--such as to subprime mortgages--across firms and markets, rather than only at the level of individual firms or sectors; (2) assessing the potential for deficiencies in evolving risk-management practices, broad-based increases in financial leverage, or changes in financial markets or products to increase systemic risks; (3) analyzing possible spillovers between financial firms or between firms and markets, such as the mutual exposures of highly interconnected firms; and (4) identifying possible regulatory gaps, including gaps in the protection of consumers and investors, that pose risks for the system as a whole. Two areas of natural focus for a systemic risk authority would be the stability of systemically critical financial institutions and the systemically relevant aspects of the financial infrastructure that I discussed earlier.

Introducing a macroprudential approach to regulation would present a number of significant challenges. Most fundamentally, implementing a comprehensive systemic risk program would demand a great deal of the supervisory authority in terms of market and institutional knowledge, analytical sophistication, capacity to process large amounts of disparate information, and supervisory expertise.

Other challenges include defining the range of powers that a systemic risk authority would need to fulfill its mission and then integrating that authority into the currently decentralized system of financial regulation in the United States. On the one hand, it seems clear that any new systemic risk authority should rely on the information, assessments, and supervisory and regulatory programs of existing financial supervisors and regulators whenever possible. This approach would reduce the cost to both the private sector and the public sector and allow the systemic risk authority to leverage the expertise and knowledge of other supervisors. On the other hand, because the goal of any systemic risk authority would be to have a broader view of the financial system, simply relying on existing structures likely would be insufficient.

For example, a systemic risk authority would need broad authority to obtain information--through data collection and reports, or when necessary, examinations--from banks and key financial market participants, as well as from nonbank financial institutions that currently may not be subject to regular supervisory reporting requirements. A systemic risk authority likely would also need an appropriately calibrated ability to take measures to address identified systemic risks--in coordination with other supervisors, when possible, or independently, if necessary. The role of a systemic risk authority in setting standards for capital, liquidity, and risk-management practices for the financial sector also would need to be explored, given that these standards have both microprudential and macroprudential implications.

In general, much discussion will be needed regarding what can reasonably be expected from a macroprudential regime and how expectations, accountability, and authorities can best be aligned. Important decisions must be made about how the systemic risk regulation function should be structured and located within the government. Several existing agencies have data and expertise relevant to this task, so there are a variety of organizational options. In any structure, however, to ensure accountability, the scope of authorities and responsibilities must be clearly specified

Some commentators have proposed that the Federal Reserve take on the role of systemic risk authority; others have expressed concern that adding this responsibility would overburden the central bank. The extent to which this new responsibility might be a good match for the Federal Reserve depends a great deal on precisely how the Congress defines the role and responsibilities of the authority, as well as on how the necessary resources and expertise complement those employed by the Federal Reserve in the pursuit of its long-established core missions.

It seems to me that we should keep our minds open on these questions. We have been discussing them a good deal within the Federal Reserve System, and their importance warrants careful consideration by legislators and other policymakers. As a practical matter, however, effectively identifying and addressing systemic risks would seem to require the involvement of the Federal Reserve in some capacity, even if not in the lead role. As the central bank of the United States, the Federal Reserve has long figured prominently in the government's responses to financial crises. Indeed, the Federal Reserve was established by the Congress in 1913 largely as a means of addressing the problem of recurring financial panics. The Federal Reserve plays such a key role in part because it serves as liquidity provider of last resort, a power that has proved critical in financial crises throughout history. In addition, the Federal Reserve has broad expertise derived from its wide range of activities, including its role as umbrella supervisor for bank and financial holding companies and its active monitoring of capital markets in support of its monetary policy and financial stability objectives.

**Conclusion**

In the wake of the ongoing financial crisis, governments have moved quickly to establish a wide range of programs to support financial market functioning and foster credit flows to businesses and households. However, these necessary short-term steps must be accompanied by new policies to limit the incidence and impact of systemic risk. In my remarks today, I have emphasized the need to address the problems posed by firms that are perceived to be too big to fail, the importance of efforts to strengthen the financial infrastructure, the desirability of reducing the procyclical effects of capital regulation and accounting rules, and the potential benefits of taking a more macroprudential approach to the supervision and regulation of financial firms. Some of the policies I propose can be developed and implemented under the existing authority of financial regulators. Indeed, we are in the process of doing just that. In other cases, congressional action will be necessary to create the requisite authority and responsibility.

Financial crises will continue to occur, as they have around the world for literally hundreds of years. Even with the sorts of actions I have outlined here today, it is unrealistic to hope that financial crises can be entirely eliminated, especially while maintaining a dynamic and innovative financial system. Nonetheless, these steps should help make crises less frequent and less virulent, and so contribute to a better functioning national and global economy.

**FINANCIAL ACCOUNTING FOUNDATION**
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
Fax: 203-849-9714

October 3, 2008

The Honorable Spencer Bachus
U.S. House of Representatives
Room 2246 Rayburn House Office Building
Washington, DC 20510

Dear Representative Bachus:

Effective accounting standards are achieved only when the standard-setting process is independent and free of undue political influence. As the independent, private-sector organization responsible for oversight of the Financial Accounting Standards Board (FASB), the Financial Accounting Foundation (FAF) is deeply committed to protecting investor interests through our long-standing mission to protect the independence and integrity of the standard-setting process.

The FAF does not take positions on the FASB's standards; we leave the complex task of accounting standard setting to the experts who comprise the FASB. However, we care deeply about the integrity and independence of the standards-setting process. We are very concerned about the current efforts of some to legislate the suspension of one of the FASB's standards, Statement 157 on fair value measurements. We believe that any legislative effort to overturn a FASB standard will greatly undermine investor confidence. We believe that once Congress starts setting accounting standards through its political process, the integrity of U.S. accounting standard setting and the credibility of U.S. financial reporting will be dangerously compromised.

If Congress sends the message that special interests are able, through legislation, to overturn expert accounting judgment arrived at through an open and thorough due process, necessary and timely improvements in financial reporting will likely become impossible and the best interests of participants in the capital markets will not be served.

The FAF strongly urges Congress to reject proposals that would threaten the independent process for establishing accounting standards for investors, auditors and preparers. Any

changes to accounting standards, including Statement 157, should be made through the FASB's open due process, without political interference that could cause a loss of investor confidence in the financial reporting process.

Very truly yours,

Robert E. Denham

Chairman

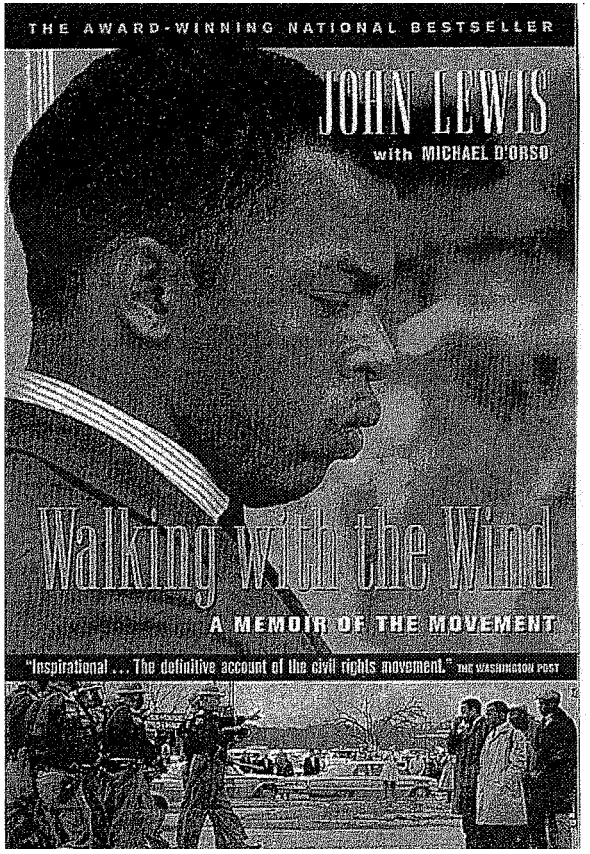
cc: The Honorable Nancy Pelosi, Speaker of the House
The Honorable Steny Hoyer, House Majority Leader
The Honorable John A. Boehner, House Minority Leader
The Honorable Roy Blunt, House Minority Whip

The Honorable Barney Frank
The Honorable Paul E. Kanjorksi
The Honorable Deborah D. Pryce

The Honorable Harry Reid, Senate Majority Leader
The Honorable Mitch McConnell, Senate Minority Leader

The Honorable Christopher Dodd, United States Senate
The Honorable Richard Shelby, United States Senate
The Honorable Jack Reed, United States Senate
The Honorable Wayne Allard, United States Senate

The Honorable Henry Paulson, Secretary, U.S. Department of the Treasury
The Honorable Christopher Cox, Chairman, Securities and Exchange Commission
The Honorable Luis A. Aguilar, Commissioner, Securities and Exchange Commission
The Honorable Kathleen L. Casey, Commissioner, Securities and Exchange Commission
The Honorable Troy A. Paredes, Commissioner, Securities and Exchange Commission
The Honorable Elisse B. Walter, Commissioner, Securities and Exchange Commission




## PROLOGUE

I want to begin this book with a little story. It has nothing to do with a national stage, or historic figures, or monumental events. It's a simple story, a true story, about a group of young children, a wood-frame house and a windstorm.

The children were my cousins: Roy Lee and Jinnie Boy, Naomi and Leslie and Willie Muriel—about a dozen of them, all told—along with my older sister Ora and my brothers Edward and Adolph. And me, John Robert.

I was four years old at the time, too young to understand there was a war going on over in Europe and out in the Pacific as well. The grownups called it a world war, but I had no idea what that meant. The only world I knew was the one I stepped out into each morning, a place of thick pine forests and white cotton fields and red clay roads winding around my family's house in our little corner of Pike County, Alabama.

We had just moved that spring onto some land my father had bought, the first land anyone in his family had ever owned—110 acres of cotton and corn and peanut fields, along with an old but sturdy three-bedroom house, a large house for that part of the county, the biggest place for miles around. It had a well in the front yard, and pecan trees out back, and muscadine grapevines growing wild in the woods all around us—our woods.

My father bought the property from a local white businessman who lived in the nearby town of Troy. The total payment was $300. Cash. That was every penny my father had to his name, money he had earned the way almost everyone we knew made what money they could in those days—by tenant farming. My father was a sharecropper, planting, raising and picking the same crops that had been grown in that soil for hundreds of years by tribes like the Choctaws and the Chickasaws and the Creeks, Native Americans who were working this land long before the place was called Alabama, long before black or white men were anywhere to be seen in those parts.

Almost every neighbor we had in those woods was a sharecropper, and most of them were our relatives. Nearly every adult I knew was an aunt or an uncle, every child my first or second cousin. That included my uncle Rabbit and aunt Seneva and their children, who lived about a half mile or so up the road from us.

On this particular afternoon—it was a Saturday, I'm almost certain—about fifteen of us children were outside my aunt Seneva's house, playing in her dirt yard. The sky began clouding over, the wind started picking up, lightning flashed far off in the distance, and suddenly I wasn't thinking about playing anymore; I was terrified. I had already seen what lightning could do. I'd seen fields catch on fire after a hit to a haystack. I'd watched trees actually explode when a bolt of lightning struck them, the sap inside rising to an instant boil, the trunk swelling until it burst its bark. The sight of those strips of pine bark snaking through the air like ribbons was both fascinating and horrifying.

Lightning terrified me, and so did thunder. My mother used to gather us around her whenever we heard thunder and she'd tell us to hush, be still now, because God was doing his work. That was what thunder was, my mother said. It was the sound of God doing his work.

But my mother wasn't with us on this particular afternoon. Aunt Seneva was the only adult around, and as the sky blackened and the wind grew stronger, she herded us all inside.

Her house was not the biggest place around, and it seemed even smaller with so many children squeezed inside. Small and surprisingly quiet. All of the shouting and laughter that had been going on earlier outside, had stopped. The wind was howling now, and the house was starting to shake. We were scared. Even Aunt Seneva was scared.

And then it got worse. Now the house was beginning to sway. The wood plank flooring beneath us began to bend. And then, a corner of the room started lifting up.

I couldn't believe what I was seeing. None of us could. This storm was actually pulling the house toward the sky. With us inside it.

That was when Aunt Seneva told us to clasp hands. Line up and hold hands, she said, and we did as we were told. Then she had us walk as a group toward the corner of the room that was rising. From the kitchen to the front of the house we walked, the wind screaming outside, sheets of rain beating on the tin roof. Then we walked back in the other direction, as another end of the house began to lift.

And so it went, back and forth, fifteen children walking with the wind, holding that trembling house down with the weight of our small bodies.

More than half a century has passed since that day, and it has struck me more than once over those many years that our society is not unlike the children in that house, rocked again and again by the winds of one storm or another, the walls around us seeming at times as if they might fly apart.



It seemed that way in the 1960s, at the height of the civil rights movement, when America itself felt as if it might burst at the seams—so much tension, so many storms. But the people of conscience never left the house. They never ran away. They stayed, they came together and they did the best they could, clasping hands and moving toward the corner of the house that was the weakest.

And then another corner would lift, and we would go there.

And eventually, inevitably, the storm would settle, and the house would still stand.

But we knew another storm would come, and we would have to do it all over again.

And we did.

And we still do, all of us. You and I.

Children holding hands, walking with the wind. That is America to me—not just the movement for civil rights but the endless struggle to respond with decency, dignity and a sense of brotherhood to all the challenges that face us as a nation, as a whole.

That is the story, in essence, of my life, of the path to which I've been committed since I turned from a boy to a man, and to which I remain committed today. It is a path that extends beyond the issue of race alone, and beyond class as well. And gender. And age. And every other distinction that tends to separate us as human beings rather than bring us together.

That path involves nothing less than the pursuit of the most precious and pure concept I have ever known, an ideal I discovered as a young man and that has guided me like a beacon ever since, a concept called the Beloved Community.

Let me tell you how I came to understand that concept, how it ushered me into the heart of the most meaningful and monumental movement of this American century, and how it might steer us all where we deserve to go in the next.

Let me tell you about my life.

## My Mark-to-Market Nightmare

I couldn't sleep at all last night. It started with a dream-nay, a nightmare-that I had taken a three-week vacation in a remote part of the world where cell phone reception was happily non existent. There were zero bars.

It was a good vacation. I came home refreshed, full of vim and vigor, and ready to re-join the rat race. All that changed when my accountant called with bad news. He said I was broke-flat broke. I thought he was kidding.

"How can that be?" I asked. "I have my portfolio of Treasury bills and notes and a few mortgage-backed securities to fall back on if necessary."

"Yes, but you've been gone three weeks, which is an eternity these days. During that time, your Treasuries declined in market value because interest rates increased, and your mortgage-backed securities became illiquid as trading in them virtually stopped. I had to mark them all down to market, which, in the case of the MBSs, was virtually zero. Sorry about that, but that's not the worst of it. Writing down the market value of your securities reduced their value by more than your net worth. So, you're now broke. You've gone from a high-net-worth individual to a no-net-worth individual."

"Wait a minute! I don't have to sell these securities now. I can wait until their prices recover. I can even hold them to maturity if I have to. There's no credit risk. The Treasuries were issued by the federal government, which could print money to pay them off if it had to, and the MBS's were issued by Fannie Mae and Freddie Mac, which are quasi-government. They are obviously too big and important for the government to let them fail."

"I'm afraid a lot happened during your vacation. Fannie and Freddie are government now; they, too, got marked to market and taken over by the government. So did AIG, the huge world-wide insurance company."

"Well, there you are. All my securities are now government securities, and, if necessary, I can hold them all to maturity. There's no need, no rationale, to mark them to market. Besides how low could they go anyway?"

"Your Treasuries are pretty short term, which is in your favor, but a flight into Treasuries still reduced their yield. Your Mortgage-backed securities took the biggest hit. Since the market for them has virtually dried up, I've had to mark them all the way down."

"All the way down?"

"Yes, all the way down."

"Well, I guess I could always sell my house."

"I've already taken the liberty of putting a for-sale sign out front."

"Thanks a lot. I'm glad I have a thoughtful accountant like you. I don't know what I would do without you."

"Thanks. I do my best. I'm actually trying to get appointed to FASB, which is the Financial Accounting Standards Board. That's the outfit that makes up these accounting rules. It would be quite an honor for me. It is the most powerful organization in the country. Even their bosses at the SEC and Treasury are afraid to mess with them."

"Do they have the power to change their rules or modify them a bit to help the country get through this housing crisis?"

"Yes, of course. Or, the SEC could direct them to do it. In its big bailout bill, Congress reaffirmed the SEC's authority to do that in order to remove any doubt. I don't know why they are defying Congress."

"Do you think it will get done eventually?"

"I doubt it. Accountants take pride in their professionalism, and it just wouldn't look right for them to modify an accounting rule just to save the financial sector and the economy."

"Speaking of that, I read on the plane that the Federal Reserve, probably the most conservative institution in America, if not the world, has been pulling out all the stops-taking unprecedented steps-to get the country through this national emergency. And I understand the Treasury has also taken extraordinary, unprecedented steps to save the economy. Am I right?"

"You are right."

"And I believe there is a provision in the Emergency Powers Act, or some such law, that gives the President the right to suspend even the Bill of Rights in a national emergency. Am I right about that too?

"I believe so."

"So the Bill of Rights may be suspended in a national emergency, but not mark to market accounting?"

"It would appear so."

About that time I woke up in a cold sweat and said a little prayer:

**"Lord, please don't ever mark me to market, especially on one of my down days."**

# Press Releases

## Bachus: Unreasonable Criticism and Factually Inaccurate Characterizations Have Created Atmosphere of Fear, Confusion

March 10, 2009

Today, Congressman Spencer Bachus (R-AL), the top Financial Services Committee Republican, issued this statement:

"Warren Buffett's recent comments that markets are confused and fearful are right on point. Contributing to the current market confusion and fear is the constant stream of inconsistent, inaccurate and exaggerated statements concerning our economy and financial institutions from both the Administration and Congress.

"While there must be open and honest debate about ideas and their merit, negative and unconstructive rhetoric does nothing to help struggling families or restore investor confidence and can become somewhat of a self-fulfilling prophecy in our credit and capital markets.

"Unreasonable criticism and factually inaccurate characterizations, such as comments about 'zombie banks' or 'walking dead financial institutions', create an atmosphere of fear and undermine confidence. This is especially harmful and counter-productive when it takes the form of unfounded speculation about the condition of particular financial institutions.

"Criticism is easy, but the hard work of constructive engagement on issues is what the voters sent us here to do. We need to tone-down the rhetoric and get to work addressing the challenges we and the American people face.

"The American people's strength, ingenuity, and spirit should serve as a reminder of who we work for and what we were sent here to accomplish. We have a long track record of coming together to overcome enormous challenges, and have emerged stronger in doing so. Right now, we are facing daunting economic turmoil, and I have no doubt that we will again emerge stronger. Working families deserve nothing less in this time of crisis than for their elected officials to come together to craft pragmatic, commonsense solutions."

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Committee on Financial Services - Republicans
B371a Rayburn House Office Building , Washington, DC 20515 Phone: (202) 225-7502

# Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting

OFFICE OF THE CHIEF ACCOUNTANT
DIVISION OF CORPORATION FINANCE

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

This is a report by the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

### 6. Advisability and Feasibility of Modifications to Fair Value Accounting Standards

This final section summarizes steps taken and underway to improve upon current accounting requirements. This section also provides recommendations on the advisability and feasibility of modifications to existing accounting standards and related financial reporting requirements, which are discussed below.

### B. Recommendations

The recommendations, and the observations leading to the related recommendations, are described in detail in the final section of this study. For ease of reference, the following table provides an executive summary of the recommendations based upon the observations of this study. To facilitate an understanding for how each recommendation was developed, each recommendation below is associated with relevant observations that indicated a need for action or improvement.

| Recommendation #1 | Observations |
|---|---|
| ***SFAS No. 157 should be improved, but not suspended.*** | • The guidance in SFAS No. 157 does not determine when fair value should be applied. SFAS No. 157 only provides a common definition of fair value and a common framework for its application.<br>• Suspending SFAS No. 157 itself would only revert practice to inconsistent and sometimes conflicting guidance on fair value measurements.<br>• Other recommendations address necessary improvements to existing standards. |
| **Recommendation #2** | **Observations** |
| ***Existing fair value and mark-to-market requirements should not be suspended.*** | • Fair value and mark-to-market accounting has been in place for years and abruptly removing it would erode investor confidence in financial statements.<br>• Fair value and mark-to-market accounting do not appear to be the "cause" of bank and other financial institution failures.<br>• Mark-to-market accounting is generally limited to investments held for trading purposes and for certain derivative instruments; for many financial institutions, these represent a minority of their total investment portfolio. |

| | |
|---|---|
| | • Over 90% of investments marked-to-market are valued based on observable inputs, such as market quotes obtained from active markets.<br>• Investors generally agree that fair value accounting provides meaningful and transparent financial information, though improvements are desirable. |
| **Recommendation #3**<br><br>***While the Staff does not recommend a suspension of existing fair value standards, additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both Level 2 and Level 3 estimates).*** | **Observations**<br><br>• Fair value requirements should be improved through development of application and best practices guidance for determining fair value in illiquid or inactive markets. This includes consideration of additional guidance regarding:<br>o How to determine when markets become inactive<br>o How to determine if a transaction or group of transactions is forced or distressed<br>o How and when illiquidity should be considered in the valuation of an asset or liability, including whether additional disclosure is warranted<br>o How the impact of a change in credit risk on the value of an asset or liability should be estimated<br>o When observable market information should be supplemented with and / or reliance placed on unobservable information in the form of management estimates<br>o How to confirm that assumptions utilized are those that would be used by market participants and not just by a specific entity<br>• Existing disclosure and presentation requirements related to the effect of fair value in the financial statements should be enhanced.<br>• FASB should assess whether the incorporation of changes in credit risk in the measurement of liabilities provides useful information to investors, including whether sufficient transparency is provided.<br>• Educational efforts to reinforce the need for management judgment in the determination of fair value estimates are needed.<br>• FASB should consider implementing changes to its Valuation Resource Group. |

| Recommendation #4 | Observations |
|---|---|
| ***The accounting for financial asset impairments should be readdressed.*** | • U.S. GAAP does not provide a uniform model for assessing impairments.<br>• The prominence of the measure "OCI," where certain impairments are disclosed, could be enhanced by requiring its display on the income statement.<br>• For many financial institutions, financial assets marked-to-market through the income statement represent a minority of their investment portfolio.<br>• A large portion of financial institutions' investment portfolios consist of AFS securities or loans, subject to challenging judgments related to impairment, which determines when such losses are reported in the income statement.<br>• Current impairment standards generally preclude income recognition when securities prices recover until investments are sold. |
| **Recommendation #5** | **Observations** |
| ***Implement further guidance to foster the use of sound judgment.*** | • SFAS No. 157 is an objectives-based accounting standard that relies on sound, reasoned judgment in its application.<br>• Sound judgment is a platform from which to foster the neutral and unbiased measures of fair value desired by investors.<br>• Requests have been made for the Commission and the Public Company Accounting Oversight Board ("PCAOB") to emphasize their support for sound judgment in the application of accounting and auditing standards. |
| **Recommendation #6** | **Observations** |
| ***Accounting standards should continue to be established to meet the needs of investors.*** | • Investors, and most others, agree that financial reporting's primary purpose is to meet the information needs of investors.<br>• Most appear to agree that fair value measurements provide useful information to investors, meeting their information needs.<br>• Beyond meeting the information needs of investors, general-purpose financial reporting has secondary uses that may be of additional |

| | |
|---|---|
| | utility to others, such as for prudential oversight.<br>• General-purpose financial reporting should not be revised to meet the needs of other parties if doing so would compromise the needs of investors. |
| **Recommendation #7**<br><br>***Additional formal measures to address the operation of existing accounting standards in practice should be established.*** | **Observations**<br><br>• While the existing FASB process works well, steps could be taken to enhance the process.<br>• After adoption of new accounting standards, unforeseen implementation issues often may arise.<br>• An independent accounting standard-setter is best equipped to address broadly effective implementation issues that arise from the adoption of a new accounting standard.<br>• Independent accounting standard-setters are well served by the input received from a broad spectrum of constituents.<br>• Critical to the success of an independent accounting standard-setter is its timely responsiveness to the information needs of investors. |
| **Recommendation #8**<br><br>***Address the need to simplify the accounting for investments in financial assets.*** | **Observations**<br><br>• The prominence of OCI could be enhanced by requiring its display on the income statement.<br>• Many investors feel that clear disclosure of the inputs and judgments made when preparing a fair value measurement is useful.<br>• While a move to require fair value measurement for all financial instruments would likely reduce the operational complexity of U.S. GAAP, the use of fair value measurements should not be significantly expanded until obstacles related to such reporting are further addressed. |

# Congress of the United States
Washington, DC 20515

March 11, 2009

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Schapiro:

As you know, we inserted the provision in the Emergency Economic Stabilization Act of 2008 (EESA) mandating that the U.S. Securities and Exchange Commission (SEC) study mark-to-market accounting standards and report its findings to Congress within 90 days. While we appreciate the SEC's timely completion and delivery of the report mandated by EESA, unfortunately, very little progress has been made toward implementing any of the report's recommendations since its transmittal to Congress last December.

Many Members of Congress share our concern that these accounting rules governing valuation and loss provisioning are making the current financial crisis worse than it otherwise might have been. We also agree with Chairman Bernanke that these accounting rules may be contributing to an unnecessary tightening of credit in today's challenging markets.

We are particularly concerned that the SEC and the Financial Accounting Standards Board (FASB) lack a sufficient sense of urgency in addressing the negative impact of mark-to-market accounting rules in the current economic environment. The failure of FASB to act or the SEC to exercise its authority under the circumstances is in no way playing it safe. In fact under the current circumstances, it continues to be a dangerous course of action.

The SEC has the power to force FASB to act or to act in their place where necessary. The time for review and study has passed and action is needed now. Therefore, we urgently request the SEC to take immediate action.

Sincerely,

Spencer Bachus
Member of Congress

Roy Blunt
Member of Congress

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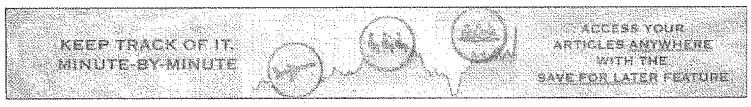


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THE WALL STREET JOURNAL.
WSJ.com

OPINION | MARCH 6, 2009

# Obama Repeats Bush's Worst Market Mistakes

*Bad accounting rules are the cause of the banking crisis.*

By STEVE FORBES

What is most astounding about President Barack Obama's radical economic recovery program isn't its breadth, but its continuation of the most destructive policies of the Bush administration. These Bush policies were in themselves repudiations of Franklin Delano Roosevelt, Mr. Obama's hero.

The most disastrous Bush policy that Mr. Obama is perpetuating is mark-to-market or "fair value" accounting for banks, insurance companies and other financial institutions. The idea seems harmless: Financial institutions should adjust their balance sheets and their capital accounts when the market value of the financial assets they hold goes up or down.

That works when you have very liquid securities, such as Treasurys, or the common stock of IBM or GE. But when the credit crisis hit in 2007, there was no market for subprime securities and other suspect assets. Yet regulators and auditors kept pressing banks and other financial firms to knock down the book value of this paper, even in cases where these obligations were being fully serviced in the payment of principal and interest. Thus, under mark-to-market, even non-suspect assets are being artificially knocked down in value for regulatory capital (the amount of capital required by regulators for industries like banks and life insurance).

Banks and life insurance companies that have positive cash flows now find themselves in a death spiral. Of the more than $700 billion that financial institutions have written off, almost all of it has been book write-downs, not actual cash losses. When banks or insurers write down the value of their assets they have to get new capital. And the need for new capital is a signal to ratings agencies that these outfits might deserve a credit-rating reduction.

So although banks have twice the amount of cash on hand that they did a year ago, they lend only under duress, or apply onerous conditions that would warm Tony Soprano's heart. This is because they know that every time they make a loan or an investment there is a risk of a book write-down, even if the loan is unimpaired.

If this rigid mark-to-market accounting had been in effect during the banking trouble in the early 1990s, almost every major commercial bank in the U.S. would have collapsed because of shaky Latin American and commercial real estate loans. We would have had a second Great Depression.

But put aside for a moment the absurdity of trying to price assets in a disrupted or non-existent market, of not distinguishing between distress prices and "normal" prices. Regulatory capital by its definition should take the long view when it comes to valuation; day-to-day fluctuations shouldn't matter. Assets should be kept on the books at the price they were obtained, as long as the assets haven't actually been impaired.

Mark-to-market accounting does just the opposite. When times are good, it artificially boosts banks' capital, thereby encouraging more investing and lending. In a downturn it sets off a devastating deflation.

Mark-to-market accounting is the principal reason why our financial system is in a meltdown. The destructiveness of mark-to-market -- which was in force before the Great Depression -- is why FDR suspended it in 1938. It was unnecessarily destroying banks.

But bad ideas never die. Mark-to-market was resurrected by the Financial Accounting Standards Board and became effective in the fall

of 2007 (FASB rule 157) to the approval of the Bush administration, its Treasury Department, and the Securities and Exchange Commission. Even as FASB 157 began to take its toll on financial institutions last year, Mr. Bush refused to kill or suspend it. When Congress voiced displeasure last fall, the administration and regulatory authorities made some cosmetic changes, but the poisonous essence remained.

Another horrific Bush policy that Mr. Obama has left untouched concerns short selling. In 1938, the SEC, created by FDR, enacted the so-called uptick rule, which held that investors could not short a stock unless it went up in price. In July 2007, the SEC, whose commissioners were handpicked by the White House, got rid of the rule. Market volatility exploded.

Compounding this lunacy was the SEC's inexplicable failure to enforce the rule against "naked" short selling. Before an investor can short a stock, he is supposed to borrow the shares and pay a broker or stockholder a fee. What sellers soon realized was that the SEC was turning a blind eye to naked short-selling, thus adding even more pressure to beleaguered bank equities. Short sellers quickly saw how mark-to-market made seemingly invincible companies vulnerable to destruction. They picked their targets and relentlessly sold financial stocks short.

If the president really takes Roosevelt's legacy seriously, he should suspend mark-to-market accounting rules, restore the uptick rule, and enforce the prohibition against naked short selling. If he doesn't, historians will look back in utter amazement at Mr. Obama's preservation of Mr. Bush's worst economic policies.

**Mr. Forbes is chairman and CEO of Forbes Inc. and editor in chief of Forbes magazine.**

Please add your comments to the Opinion Journal forum.

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The Washington Post

# Don't Blame Mark-to-Market Accounting

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By Allan Sloan
Tuesday, October 28, 2008; D02

Mark-to-market is a business rarity -- an accounting term that draws reactions from people who don't know spreadsheets from bedsheets. Mark-to-market, which we'll call MTM, evokes images of Enron's made-up profits and the other corporate scandals that marred the first years of this decade. Not pretty.

Now MTM -- which means valuing marketable securities at market prices -- is a hot item again, but for the opposite reason. This time financial companies and their allies are claiming it's too strict. They argue that marking the value of complex, illiquid securities to artificially low market prices has unnecessarily crippled the U.S. and world financial systems by creating billions of illusory losses on perfectly fine (albeit illiquid) securities, such as collateralized debt obligations linked to mortgages. Markets for these things, the argument goes, are depressed way below true economic value.

Accountants argue that MTM -- known formally as Financial Accounting Standards No. 157 -- is fine, although the Financial Accounting Standards Board has agreed to tweak it. (Don't ask me for details -- the written arguments on this are so sleep-inducing they could be marketed as an Ambien alternative.)

This week, the Securities and Exchange Commission is scheduled to hold a high-profile public meeting about MTM. The SEC, which has the power to overrule FASB, is holding the meeting because a provision in the $700 billion bailout law requires that it study MTM and report to Congress by late December.

The guy who got that provision into the bill, Rep. Spencer Bachus (R-Ala.), the ranking minority member of the House Banking Committee, told me he wasn't trying to politicize accounting. "It just says, 'Study it,' " he told me. "It doesn't say [to do] a study to repeal it. It doesn't say [to do] a study to suspend it."

But given that it's finger-pointing time both in Washington and on Wall Street, it's not going to be easy for the SEC to leave mark-to-market accounting strictly alone. In this environment, what regulator dares run the risk of being held responsible for not doing something that would supposedly mitigate the world's credit crunch? Would you want to find yourself accused of failing to act if the financial world totally melted down, as it has recently seemed about to do?

Normal accounting is being overridden to help banks in various ways. In early October, for instance, federal financial regulators jointly ruled that the $125 billion of preferred stock that the Treasury is buying from nine big banks will be treated as Tier 1 capital (the best kind), even though it normally wouldn't qualify.

Second, in a little-noted move, regulators allowed banks with losses on some Fannie Mae and Freddie Mac securities to treat the resulting tax savings as Tier 1 in their regulatory statements for the third

quarter. That's strange, given that the quarter ended Sept. 30 as usual, but legislation making this tax break usable didn't become law until Oct. 3. How often has my source for this nugget -- accounting guru Robert Willens of Robert Willens LLC -- seen such grandfathering in his 40-year career? "Never," he says.

Of course, this is more about optics than economics. As is mark-to-market, in my humble opinion. Credit markets have been frozen much of the past 15 months largely because banks haven't trusted the balance sheets of other banks and have thus been afraid to lend to them. I can't imagine that confidence problem being resolved by changing MTM.

There are problems with MTM: It's relatively new, and parts of it seem arbitrary. But its problems have been exaggerated. It's easier to blame accountants for your problems than to admit you made your institution vulnerable by overleveraging its balance sheet and buying securities you didn't understand. Ironically, many of today's whiners adopted MTM a year before they had to, partly because of an arcane provision that let them count as profit the decline in the market value of their publicly traded debt.

The bottom line: Despite MTM's flaws, blaming it for the world's financial problems isn't the answer. Neither is shooting the messenger -- or, in this case, the accountant.

*Allan Sloan is Fortune magazine's senior editor at large. His e-mail address is asloan@fortunemail.com.*

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GARY G. MILLER
42ND DISTRICT, CALIFORNIA

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March 10, 2009

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Schapiro:

As a member of the House Financial Services Committee, I would like to congratulate you on your new position as Chairman of the Securities and Exchange Commission (SEC). I look forward to working with you to strengthen our national securities markets and to promote the well being of the U.S. financial sector. It is with these principles in mind that I write to you today to request that you take all necessary and immediate action to address ongoing issues with the fair value accounting standard and its application.

During consideration of the Emergency Economic Stabilization Act (EESA), many Members of Congress raised serious concerns that accounting standards and their application contributed, in part, to the recent instability in our financial markets. As a result of these concerns, a provision was included in the EESA that required the SEC to conduct a study, in consultation with the Federal Reserve and Treasury, on the impact that mark-to-market has had on our financial markets and report its findings to Congress.

As you are aware, in late December, the SEC issued the congressionally mandated report and declared that the current accounting standards lacked sufficient guidance for auditors and investors when valuing certain financial assets. However, despite this report and previous efforts, I believe accounting policymakers have yet to take the necessary steps to address the issues raised and to improve the fair value accounting standard and its application in all market conditions.

On February 11, 2009, during consideration of the oversight plan of the Committee on Financial Services for the 111th Congress, members unanimously approved an amendment I offered to strengthen the Committee's oversight on mark-to-market accounting. Under the adopted plan, the Committee will review the SEC report and ensure that accounting policymakers take additional steps to revisit and address the mark-to-market issues raised in the report. These concerns are consistent with the SEC findings on the need to make improvements when determining the value of assets in inactive markets.

The Committee will also consider whether viable alternatives exist to pricing distressed assets in an inactive market. The Committee intends to examine all potential options, including (1) offering clearer and more specific guidance, (2) new and additional changes to the current standard, and (3) exploring alternatives, such as allowing firms to separate "credit" and "liquidity" risk in the estimation of the fair values of assets.

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With regard to the last item, as you know, the SEC report found that within the current reporting requirements, "investors are often not provided sufficient information to fully assess whether declines in value (of an asset) are related to changes in liquidity or whether declines relate to probable credit losses." I strongly support efforts to ensure that investors have an accurate reflection of assets and the overall financial condition of companies. However, I agree that the recent non-functioning and illiquid markets have revealed a flaw in the application of the current standard. This market reality requires a re-examination by all policymakers, as is highlighted in the unanimously approved amendment in the Committee on Financial Services.

Accordingly, I strongly encourage accounting policymakers to make much needed and important improvements in the current fair value accounting standard in order to ensure the true fair value of assets in all markets and to assist in our economic recovery. I appreciate your prompt consideration and look forward to working with you during the 111th Congress to address these critical issues.

Sincerely,

GARY G. MILLER
Member of Congress

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 19, 2009

The Honorable Gabrielle Giffords
U.S. House of Representatives
Washington, D.C. 20515

Dear Congresswoman Giffords:

Thank you for submitting questions on the March 12, 2009, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing on "Mark-to-Market Accounting: Practices and Implications."

First, you asked for my comments and suggestions about mark-to-market (fair value) accounting during downward economic times. We understand the practical challenges faced by banks and supervisors in the implementation of U.S. generally accepted accounting principles (GAAP) for financial instruments that are marked-to-market. As more fully described in my written and oral testimony for the March 12, 2009 hearing,[1] the Office of the Comptroller of the Currency (OCC) believes that the mark-to-market debate has identified a number of legitimate issues regarding the current application of fair value accounting. Although we do not believe it is appropriate to suspend fair value accounting, we are actively working with the Securities and Exchange Commission (SEC), accounting standard setters, the Basel Committee on Banking Supervision, the Financial Stability Board, and other interested parties to seek improvement in its application.

There are a number of groups studying the recent market events and discussing fair value issues to help determine the role fair value has played. For example, in late 2008, the SEC delivered a report to Congress mandated by the Emergency Economic Stabilization Act of 2008 that recommended against the suspension of fair value accounting standards. The SEC recommended improvements to existing practice, including reconsidering the accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available.

Consistent with the SEC report recommendations, my testimony recommendations and the message delivered by the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises during the March 12, 2009 hearing, the Financial Accounting Standards

[1] http://www.occ.treas.gov/ftp/release/2009-22b.pdf

Board (FASB)[2] recently finalized guidance addressing many of the concerns. We believe that the recent guidance[3] better reflects the impact of the current economic environment on financial institutions' financial statements and will improve financial reporting. The changes also have the potential to positively impact regulatory capital ratios. However, we still face many challenges with respect to mark-to-market accounting and the OCC will continue to actively monitor and participate in the relevant discussions.

Second, you indicated that there is a modified European version of mark-to-market accounting that "exempts" real estate during downward economic times. We are not familiar with the model you are describing. However, the OCC has regular contact with representatives of the International Accounting Standards Board (IASB) and we will be certain to discuss the different models they may have in place for valuing real estate to determine their potential applicability in the United States.

I hope this information is helpful. If you have any questions or need further information, please contact John Hardage, Director, Congressional Liaison, at 202-874-1881.

Sincerely,

Kevin J. Bailey
Deputy Comptroller for Regulatory Policy

[2] The FASB is the designated organization in the private sector for establishing standards of financial accounting. The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies, but relies on the private sector for this function to the extent that the private sector demonstrates the ability to fulfill the responsibility in the public interest.

[3] EITF 99-20-1, "Amendments to the Impairment Guidance of EITF Issue No. 99-20"; FASB Staff Positions 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*; FASB Staff Positions 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*; FASB Staff Position 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments.*

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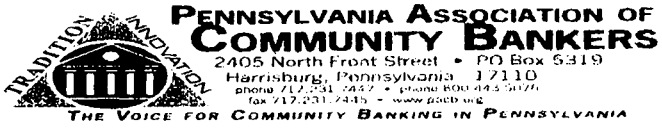



# MEMO

**To:** Committee on Financial Services
Attention: Terrie Allison (Fax 202-225-4254)

**From:** Frank A. Pinto, President/CEO

**Date:** April 29, 2009

**Re:** Responses to Representative Giffords' Questions

Below are Thomas Bailey's, Chairman of Pennsylvania Association of Community Bankers, President/CEO of Brentwood Bank, responses to the questions submitted by Representative Gifford.

Question #1.

**We believe that the mark-to-market rules, as they are currently written, cause debt security values to be written down to artificially low values when the market becomes dysfunctional and illiquid. This "paper loss" is one of the issues that is adding fuel to the current economic crisis. There are various methodologies available to correct this problem. Our association has advanced one option which would give companies the opportunity to value investments based upon expected future cash flows or the liquidation value associated with the underlying collateral that the debt security is founded upon. These rules are currently in use to value troubled debt in financial institutions and are described and defined by FAS 114 and FAS 5. The result of this proposal would be to allow for an evaluation of the fair market value of a debt security using the three standard methods of evaluation. The three methods of evaluation to be utilized will then be: *1.)* the market approach (market value), *2.)* the income approach (discounted cash flows), and *3.)* the asset approach (collateral liquidation net values). The value most representative of fair market value considering the existing circumstances is then utilized.**

Question #2.

We have not examined the European version of modified mark to market rules with regards to real estate assets. Current accounting rules do not require banks to mark to market their loans unless they have been securitized. We would be hesitant to endorse another layer of standards that may be opene to even more interpretation.

Thomas G. Duncan
General Counsel
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Re: Mark-to-Market Accounting: Practices and Implications

As requested I provide responses to the questions posed by Congresswoman Gabrielle Giffords following my testimony to the Subcommittee on Mark-to-Market Accounting on March 12, 2009.

Question #1 from Representative Giffords:
There are arguments about whether mark-to-market should be modified, temporarily suspended or even eliminated during downward economic times. Can you comment on this and offer your suggestions for how to ease the pain for our companies and banks?

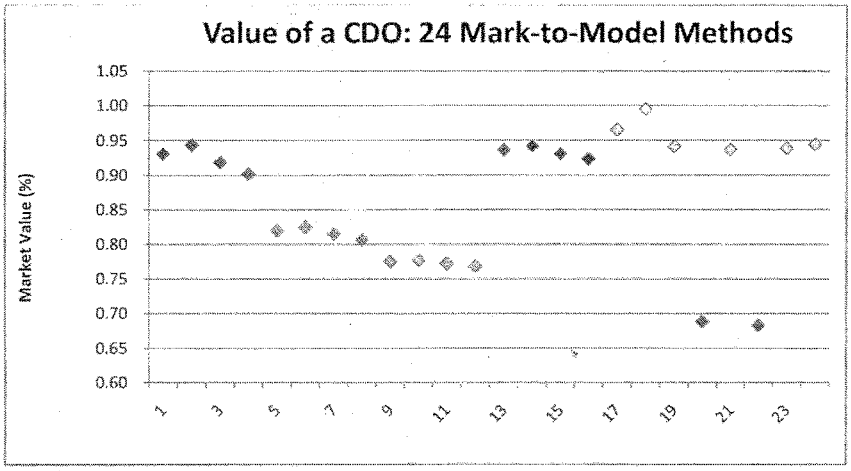
Response:
Mark to market accounting should not be thrown out. I suggest that rather than abandoning mark to market, additional measures such as mark to model from independent sources be added.

Over the past 25 years I have evaluated, advised regarding and assisted with the cleanup of numerous financial train wrecks and meltdowns including the savings & loan crises of the late 1980s, the derivatives losses of the 1990s (Orange County, Bankers Trust, David Askin's Granite Funds, CMOs, inverse floaters, kitchen sink bonds), the LTCM and currency crises in 1998, and the bursting of the credit bubble and meltdown that started in 2007. The valuation of assets played a central role in all of these. In my opinion, no single valuation technique measures fair value well across all market environments. In normal markets mark to market represents fair value well; However, in distressed markets where only fire sales are taking place, or in over-fueled markets where only over-priced sales are taking place, marking to independent, third-party models may better approximate fair value.

Recent market events do not demonstrate that Mark to Market should not be abandoned but rather that other measures should be used to a greater degree alongside. Widely-used single measures can and will be arbitraged, and certainly played a role along with too many simplifying assumptions and too much liquidity in the meltdown. In my experience the desire to simplify accounting, risk and return views – and to produce single "answers" played a significant role in numerous financial losses. This not only is true in the current financial crisis but also was true in prior financial crises.

A widespread reaction of the Enron and related scandals was to push hard to reduce flexibility in the application of accounting rules and the potential for similar deeply misleading if not fraudulent disclosures. But the present circumstances demonstrate the drawbacks of going too far in the direction of rigid application of inflexible rules, especially if misleading market valuations or gaping inconsistencies of valuation result. At the same time, all stakeholders investors, shareholders, regulators and taxpayers among others) need to be protected from any firm that "cooks tWhen mark to model is used, this can be accomplished by (i) using independent, third-party models and (ii) requiring additional disclosure so that it is clear when mark to market and mark to model produce different values and/or when different approaches are employed.

What happens when there is no market? There is little doubt that when markets function, they are competitive and effective in evaluating, combining, analyzing and disseminating information. But when markets do not function, participants must operate without mission critical information. This is the scenario that faces financial firms and investors around the world who hold trillions in credit derivatives. When a market price is not available for pricing an instrument, participants must resort to mark to model. The need for "belt and suspenders" around that mark to model process is demonstrated by the chart below. In this chart, a single collateralized debt obligation (commonly termed a "CDO") is valued under various mark-to-model approaches. The tremendous variance in results is clear with values ranging from 68% to 99% using different mark-to-model methods:




Which answer is correct? Clearly stakeholders need comfort on numerous topics – below I list six important questions to ask:

1. Are the models within the range of common market practice?
2. Are the models robust (is the math correct and is the right type of math used?)
3. Have the models been independently verified?
4. Are the models implemented properly (are simplifying assumptions appropriate, are the data correct, are inputs proper?)
5. Has the firm switched models and does this change the firm's financial results?
6. During normal markets, how do the mark-to-model values compare with actual market prices?

Also important to consider is whether a "one size fits all" approach to accounting standards reduces the diversity of market participants approach to investment and trading styles in the markets. In any given market environment differences exist among and between global banks, broker dealers, regional banks, insurance companies, pension funds and asset management firms, among others. They have varying business considerations and time frames to hold assets and different abilities to do so (due to liquidity pressures or the absence thereof) in order to realize the intended value.

Diversity supports market stability, and reduces the potential for pro-cyclical and thus financially unstable behavior. The current Mark to Market financial reporting promotes common market and risk management approaches and therefore pro-cyclical behavior. A "one size fits all" approach may lead to a "crowded response" by risk managers when markets become extremely volatile or disrupted. The negative impact of this was exemplified during the LTCM crisis in 1998. This further supports the use of a mark-to-model approach alongside mark-to-market.

Question #2 from Representative Giffords:
I am aware that the European version of modified mark-to-market "exempts" real estate from mark-to-market during downward economic times due to the fact that real estate is highly illiquid. Have you examined this model? Do you think it would be an effective tool for the United States market?

Response:
Yes I have examined this model. I do not believe it is as effective as a mark-to-model approach that better reflects possible permanent impairment of assets.

Please do not hesitate to contact me with any questions or if I can provide additional information or clarification.

Respectfully submitted,

Tanya Beder
Chairman, SBCC Group Inc.

Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises Hearing

"Mark-to-Market Accounting: Practices and Implications"

Statement and Questions Submitted for the Record
Congresswoman Gabrielle Giffords
March 12, 2009

Several businesses in my district in Southern Arizona have expressed concern to me about the impact of mark-to-market accounting in today's financial environment. In particular, they have suggested that the accounting rules that require companies and banks to write down their assets' values to market value should be significantly modified in these difficult economic times. They are concerned that these assets sometimes have significant but undetermined value and under the mark-to-market rules companies are forced to devalue these assets substantially when there is no readily available "market" for them.

1. There are arguments about whether mark-to-market should be modified, temporarily suspended or even eliminated during downward economic times. Can you comment on this and offer your suggestions for how to ease the pain for our companies and banks?

CAQ Response:

The challenges facing financial institutions, in your district and others throughout the nation, *are* a serious concern. But dealing with capital adequacy concerns by suspending or significantly altering fair value accounting only serves to obscure current realities, further undermine investor confidence, and prolong the current crisis. Investors need to know the current values of loans and securities in order to make rational investment decisions. Regulators need to know the current values in order to make rational policy decisions.

The application of fair value accounting standards can be improved. However, banking regulators have the authority to determine whether or how current valuations affect capital requirements and make adjustments accordingly. This "two-pronged approach" is the only meaningful way to address banks' liquidity concerns.

We all want swift and meaningful action to address the economic crisis. But as we respond to the crisis, we should remain true to principles of investor protection in order to support capital formation. Investor confidence in the reliability and transparency of financial reporting is critical to our financial system's long-term well being.

Please see my written testimony for a more complete response to your question.

2. I am aware that the European version of modified mark-to-market "exempts" real estate from mark-to-market during downward economic times due to the fact that real estate is highly illiquid. Have you examined this model? Do you think it be an effective tool for United States markets?

CAQ Response:

I believe you are referring to International Accounting Standard (IAS) 40 Investment Property, which prescribes the accounting treatment for investment property under IFRS as endorsed in the European Union.

IAS 40 permits enterprises to choose between a fair value model and a cost model in accounting for investment property, although the standard says that the fair value model is the preferred method. One method must be adopted for all of an entity's investment property, and when property is measured using the fair value model, that model must continue to be used – even if comparable market transactions become less frequent or market prices become less readily available. Change is permitted only if this results in more relevant information, and IAS 40 notes that this is highly unlikely to be the case for a change from the fair value model to the cost model.

Our understanding of accounting practice in the European Union is that this is an extremely rare circumstance and that investment property companies that have elected to use the fair value model are continuing the use that model during the economic downturn.

As I indicated in my testimony, the CAQ believes that the objective of fair value measurements of financial instruments is just as important to investors when markets are illiquid as in other times. Allowing exemptions would likely undermine investor confidence, thereby causing them to further withdraw capital, which could prolong the current crisis.

**FASB Responses to Questions**
**Submitted Following March 12, 2009 Congressional Hearing**

**Question #1**—Why would it not make sense to provide another election period for companies to elect into FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*?

If FASB issues additional guidance for banks, will it consider also providing guidance to Business Development Companies (BDC), one of the largest providers of credit to small and middle-market companies? Would FASB consider providing additional guidance as to whether BDCs should use the merger and acquisition (M&A) market instead of a hypothetical trading market to value assets that it intends to hold to maturity and which it enters and exits in the M&A market?

Response:
Business Development Companies are considered to be investment companies. Investment companies are required to report their investment assets at fair value, as defined by FASB Statement No. 157, *Fair Value Measurements*. However, before Statement 159, liabilities related to those investment assets could not be reported at fair value. This led to a potential mismatch due to the different measurement attributes for the investment assets and the related liabilities. Statement 159 was issued to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently.

Generally, a company may elect the fair value option at the time an asset or liability is initially recognized or at the time Statement 159 is first adopted. Electing the fair value option after initial recognition of an asset or liability permits a company to recognize gains or losses (resulting from marking the asset from its previous carrying amount to fair value) in reporting periods other than when those gains and losses occurred. However, to ensure that gains and losses reported in earnings exclude gains and losses that occurred in other periods, the Board limited a company's ability to elect the fair value option for its existing financial assets and liabilities to initial adoption or when a new liability is initially recognized.

Statement 157 and its related implementation guidance apply to all companies. That guidance is not specific to a particular industry.

We encourage all constituents to participate in our open standard-setting process. Also, we suggest that the Business Development Companies consider submitting their implementation question as a technical inquiry via our website. As part of our normal due process, the FASB works with constituents to monitor the implementation of its standards to determine if additional clarification is needed.

The FASB established the Valuation Resource Group to provide the FASB with information about implementation issues regarding fair value measurements used in financial reporting and the alternative viewpoints associated with those implementation

issues. The Valuation Resource Group is composed of a cross-section of industry representatives, including financial statement preparers, auditors, users, and valuation experts.

In December 2008, the IASB and the FASB announced a joint project, *Financial Instruments—Improvements to Recognition and Measurement*. That project will, among other objectives, (a) reconsider the recognition and measurement of financial instruments and (b) increase convergence of accounting for financial instruments. The scope of the project will also consider issues related to the fair value option. The Boards expect to issue an Exposure Draft later this year.

**Question #2**—There are arguments about whether mark-to-market should be modified, temporarily suspended or even eliminated during downward economic times. Can you comment on this and offer your suggestions for how to ease the pain for companies and banks?

Response:
The role of accounting and reporting standards is to help provide investors and the capital markets with sound, unbiased financial information on the activities, results, and financial condition of reporting enterprises. We are charged with providing investors with the best available information about the financial condition of reporting entities. The usefulness and credibility of such information depend heavily on it providing an honest and neutral portrayal and not being skewed to favor any particular company, industry, or type of transaction or being modified in times of economic stress or being purposefully biased in favor of any other regulatory, social, or economic objectives other than sound reporting to investors and the capital markets. The information needs of investors and the capital markets often differ from that of financial institution regulators, who focus on safety and soundness, capital adequacy, and financial stability. So, while financial institution regulators may base computations of regulatory capital on GAAP numbers, their decisions on capital adequacy and responses to capital impairments cannot and should not be driven solely or mechanically by balance sheet results.

As the current financial and economic crisis has deepened and broadened, there has been considerable focus on the subject of so-called mark-to-market or fair value accounting. It is important to note that fair value is not mark to any market. Rather, for assets measured at fair value, companies are required to mark those assets to their estimate of the price that would be received in a sale of the assets in orderly transactions under current market conditions.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the Act) was signed into law. Section 133 of the Act mandated that the Securities and Exchange Commission (SEC) conduct a study on mark-to-market accounting standards. The SEC provided its study, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, to the United States Congress on December 30, 2008. That report supported the continued use of fair value. In addition, that report recommended that "additional

measures should be taken [by the FASB] to improve the application and practice related to existing fair value requirements (particularly as they relate to both Level 2 and Level 3 estimates)" and that the "FASB reassess current impairment accounting models for financial instruments."

The FASB issued one staff position on impairment in January 2009. In April 2009, the FASB issued three staff positions to improve guidance and disclosures on fair value measurements and impairments. We believe that this additional guidance is responsive to the SEC recommendations.

**Question #3**—I am aware that the European version of modified mark-to-market "exempts" real estate from mark-to-market during downward economic times due to the fact that real estate is highly illiquid. Have you examined this model? Do you think it be an effective tool for United States markets?

Response:
European listed companies report under International Financial Reporting Standards (IFRS). We discussed your question with our colleagues at the International Accounting Standards Board, the accounting standards body that promulgates IFRS. Based on our discussions, we are not aware of an "exemption" from mark-to-market accounting during downward economic times for real estate assets.

IFRS requires a company to measure its property, plant, and equipment, either on a cost basis or revaluation basis (i.e., revalued at fair value periodically). If a company measures an asset based on the revaluation model, that company is required to periodically revalue the asset to fair value, regardless of how that fair value is determined (i.e., using pricing information readily available in the marketplace or estimations derived from models). The company is never "exempt" from the requirement to periodically remeasure the asset to fair value. The frequency of revaluations depends upon the change in fair value of the asset being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required.

IFRS also requires a company to measure its investment property either at cost or at fair value. If a company elects to measure its investment property at fair value, that company is required to measure that asset at fair value in an ongoing manner (i.e., as of the end of each reporting period) and must continue to do so "even if comparable market transactions become less frequent or market prices become less readily available."[1]

For assets measured on a cost basis, IFRS requires a company to test an asset for impairment when an indicator of impairment exists. IFRS requires a company to recognize an impairment loss if the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use, which is based on the discounted cash flows of expected future cash flows to be derived from the asset. When determining an asset's recoverable amount,

[1] International Accounting Standard 40, *Investment Property*, par. 55.

IFRS permits a company to measure impairment based solely on its value in use, if the company is unable to reliably estimate the fair value of the asset.

Generally accepted accounting principles in the United States (U.S. GAAP) generally require a company to measure real estate assets at cost and generally do not permit a company to measure real estate assets at fair value on an ongoing basis. For real estate assets measured on a cost basis, the primary difference in impairment guidance under U.S. GAAP compared with IFRS is that impairment is not recognized unless the carrying amount of the asset is less than the undiscounted expected cash flows to be derived from the asset.

**RESPONSES OF WILLIAM M. ISAAC
TO QUESTIONS SUBMITTED
BY CONGRESSWOMAN GABRIELLE GIFFORDS
ON MARK-TO-MARKET ACCOUNTING
PRACTICES AND IMPLICATIONS**

April 30, 2009

1. There are arguments about whether mark-to-market accounting should be modified, temporarily suspended or even eliminated during downward economic times. Can you comment on this and offer your suggestions for how to ease the pain for our companies and banks?

**I have been a strong opponent of mark-to-market (MTM) accounting for depository institutions since the mid-1980s when I was Chairman of the Federal Deposit Insurance Corporation and requested the FDIC staff to conduct an extensive study of the issue.**

**Interestingly, MTM accounting was applicable to bank investment portfolios during the 1930s. President Roosevelt and his Secretary of the Treasury determined in 1938, after meeting with bank regulatory officials, that MTM accounting was pro-cyclical, was preventing banks from resuming lending, and was keeping the economy mired in the Great Depression. They abolished MTM accounting in favor of the historical cost based accounting system that remained in place until the 1990s when the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) decided to re-impose MTM accounting.**

**This move by FASB and the SEC was opposed strongly by the FDIC, the Federal Reserve, and the Department of Treasury. Secretary of the Treasury Nicholas Brady was particularly prescient in his March 24, 1992 letter opposing re-imposition of MTM accounting. He warned that MTM accounting would create volatility in bank earnings and capital and would lead to periods of severe credit contraction.**

**I do not believe that MTM accounting played a major role in causing banks to invest in sub-quality loans, but there can be no doubt that MTM accounting has needlessly destroyed hundreds of billions of dollars of capital in our**

**financial system during the past year and has helped created a serious crisis in confidence, which has led to a serious economic downturn that has cost millions of people their jobs and homes. The cost to taxpayers is likely measured in the trillions.**

**I believe we should keep MTM accounting in place for bank trading portfolios. Beyond trading portfolios, MTM accounting should be abolished and we should return to historical cost based accounting accompanied by good footnote disclosures of the market values of bank investment portfolios. This will provide a much sounder accounting system which better reflects the true condition of financial institutions and the operating performance of their business lines.**

**These changes should been made a year ago. The longer we wait to implement these changes, the more destruction will be done to our financial system and economy.**

**Going forward, I believe Congress should enact the Perlmutter bill or something akin to it. Accounting standards are much too important to be left solely to accountants and the SEC. I believe we should involve the bank regulatory agencies in overseeing accounting standards that affect depository institutions.**

2. I am aware that the European version of modified mark-to-market "exempts real estate from mark-to-market during downward economic times due to the fact that real estate is highly liquid. Have you examined this model? Do you think it would be an effective tool for the United States markets?

**I have not studied the European version of mark-to-market but I am told that it is a better (more flexible) model than the U.S version. As explained above, I believe that, except for trading portfolios, MTM accounting is a very poor and at times highly destructive accounting system for depository institutions. Both the U.S. and Europe would be well advised to abolish it immediately.**

**Attachment**

**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing**

**"Mark-to-Market Accounting: Practices and Implications"**

**Responses to Statement and Questions Submitted for the Record by Congresswoman Gabrielle Giffords**

**Jeff Mahoney, General Counsel, Council of Institutional Investors**

**April 22, 2009**

**Several businesses in my district in Southern Arizona have expressed concern to me about the impact of mark-to-market accounting in today's financial environment. In particular, they have suggested that the accounting rules that require companies and banks to write down their assets' values to market value should be significantly modified in these difficult economic times. They are concerned that these assets sometimes have significant but undetermined value and under the mark-to-market rules companies are forced to devalue these assets substantially when there is no readily available "market" for them.**

1. **There are arguments about whether mark-to-market should be modified, temporarily suspended or even eliminated during downward economic times. Can you comment on this and offer your suggestions for how to ease the pain for our companies and banks?**

   The purpose of accounting, and its usefulness to investors, lenders, businesses, and indeed policy makers, is to report companies' economic story as it is, not as we might wish it to be. Investors and other users of financial reports depend critically on the quality, clarity, timeliness, and completeness of financial information in valuing financial investments and assessing risks. The modification, temporary suspension, or elimination of fair value accounting for financial instruments during downward economic times (or during any economic times) can obfuscate essential information that assists investors in differentiating between high-risk and low risk investments.

Most of the few legitimate concerns about fair value accounting that were raised at the Subcommittee hearing had as their basis the potential impact of fair value accounting on the ability of financial institutions to maintain compliance with government regulations requiring a minimum amount of capital. A common argument expressed by some witnesses and Members of the Subcommittee at the hearing was that those regulations were constraining banks from providing necessary loans to businesses. As indicated in my testimony, the solution to this problem is a simple one that can be taken promptly without distorting financial reporting and harming investors.

The solution is for the financial institution regulators to use their existing discretion to make adjustments to fair value amounts reported by banks to address any capital adequacy issues that may be inhibiting lending to businesses. On multiple occasions during the Subcommittee hearing, witness Kevin Bailey, Deputy Comptroller for Regulatory Policy, Office of the Comptroller of the Currency, confirmed that the regulators have the authority to take such action. It was astounding, given the fury at the hearing, that Members of the Subcommittee did not insist that such action be immediately taken.

As I concluded in my testimony, when I receive my quarterly 401(k) statement, I see economic reality. Those who invest in US financial institutions and other companies deserve to see the same economic reality. Fair value accounting for financial instruments gets investors closer to that goal.

2. **I am aware that the European version of modified mark-to-market "exempts" real estate from mark-to-market during downward economic times due to the fact that real estate is highly illiquid. Have you examined this model? Do you think it be an effective tool for United States markets?**

I am not aware of any European version of modified mark-to-market that "exempts" real estate from mark-to-market during downward economic times due to the fact that real estate is highly illiquid. I am aware that International Accounting Standard 40, entitled *Investment Property,* permits a company to elect to report all real estate that qualifies as investment property at fair value under certain circumstances.

The standard also provides that if a company chooses to report all investment property at fair value it can, under certain circumstances, for a particular property, change the reporting to cost. That change can generally only occur if there is clear evidence at the time the property is acquired that the company cannot determine the fair value of the property on a continuing basis. Once a company has measured a specific property at fair value, it must continue to measure that property at fair value even if comparable market transactions become less frequent or market prices become less readily available.

Adopting the IAS 40 model in the United States might improve the accounting for investment property in the U.S. because such property is generally required to be reported at cost. The IAS 40 model, however, would not improve the accounting for financial instruments which was the focus of the Subcommittee hearing.

In the U.S., financial instruments are generally already permitted to be reported at fair value. Moreover, the guidance for measuring fair value explicitly provides companies the tools for estimating fair value using judgment in those circumstances when the determination is difficult because fair values can not be observed on a continuing basis.

In conclusion, and as indicated in my testimony and in the Council commissioned white paper entitled "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch," fair value accounting for financial instruments, complemented by robust disclosures, is superior to other accounting alternatives in (1) providing investors clear and accurate information, and (2) restoring the free flow of money and credit to the U.S. and global capital markets.

February 18, 2008

The Honorable Gabrielle Giffords
United States House of Representatives
Washington, D.C. 20515

Dear Representative Giffords:

I am President/CEO of Alliance Bank of Arizona (Alliance Bank) which operates 11 offices in Maricopa, Pima and Coconino counties. Bruce Beach, principal director of Beach, Fleischman & Co., Tucson's largest CPA firm, is the Chairman of the Alliance Bank Board of Directors and also serves on the Board of the Southern Arizona Leadership Council. Bruce has asked me to share directly with you some of the specific challenges bankers face as we strive to continue making loans in a very tough economic environment. Specifically, Bruce has asked me to explain the impact of the "mark to market" rule on Western Alliance Bancorporation and how the imposition of that rule has directly depleted our capital position and, by extension, our capacity to lend money going forward.

A brief description of Alliance Bank and its parent company, Western Alliance Bancorporation (WAL) may be helpful to put my comments in context. Alliance Bank celebrated its 6th anniversary earlier this month. As of 12/31/08, Alliance had total assets of $867 million with just under 1% of Arizona's total deposit market share. In 2008, Alliance generated net growth in loans outstanding of $94 million, (with over 70% of those loans to businesses or for commercial purposes). Alliance is now the state's 11th largest bank out of approximately 70 doing business here, employing over 150 people with an annual payroll of $12 million.

Our parent, Western Alliance Bancorporation, operates five banking franchises in three western states (Arizona, California and Nevada). As of 12/31/08 WAL had total assets of $5.3 billion and ranked as the 100th largest public trading banking company in the United States. Bank of Nevada, WAL's largest affiliate bank, has $3.0 billion in assets and is the second largest state chartered community bank

headquartered in Nevada. WAL's application for $140 million in TARP capital was approved and funded in November, 2008. WAL put $15 million of capital in Alliance Bank in 2008 and $50 million in Bank of Nevada. All WAL affiliate banks are considered "well capitalized."

Against this backdrop, consider the recent specific application of the "mark to market" rule on the capital position of several of the affiliate banks within WAL. One of the assets WAL banks own is Bank of America's perpetual adjustable rate preferred stocks (ARPS), with a face value $50 million, but a market value of approximately $22 million.

We understand Bank of America has received a total capital infusion from the TARP program of $45 billion dollars during the last four months, as well as federal guarantees of another $118 billion of troubled securities and loans. Bank of America insists that, despite facing severe challenges, it is in sound condition and will survive. The ARPS we own are *pari passu* with TARP funds that Bank of America has received. It continues to make its interest payments on a timely basis, and we believe it will to the U.S. Treasury as well. Despite this, regulatory accounting rules require that the after-tax unrealized loss on these securities be a deduction against Tier I capital, thus curtailing WAL's ability to grow its balance sheet and make loans. As a rule of thumb, each of our banks can lend out about 10 times our capital, so this translates into a curtailment of $200 million in loan capacity going forward despite the fact that no outward evidence exists that this earning asset is going to cease to perform.

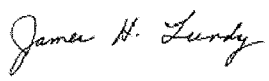
The impact of this rule on just this one block of securities in the WAL system purchased from the nation's largest bank is significant. Imagine the multiplier effect across the country as bank's large and small are forced to reduce their capital in similar ways…it translates to billions of lost capital and tens of billions of lost lending capacity at a time when Congress is trying valiantly to infuse the banking system with fresh capital to stabilize our financial system and encourage lending across all sectors of the economy to both businesses and individuals. Defenders of the mark to market rule may make theoretical accounting arguments as to why the rule makes sense….and perhaps is does in normal times when markets are operating efficiently….but it clearly isn't helpful now. And, waiver of the rule will not prevent the legitimate write down of securities that actually have no underlying value.

This "mark to market" rule lies at the heart of the dilemma of what to do with the billions of dollars of so called "toxic assets", which are made up of securitized residential mortgages. The fact is that the vast majority of U.S. mortgages, continue to be paid as agreed, but they have been mixed together through the securitization process with non-performing mortgages and thus no one can be certain how the pools of these securities backed by mortgages of widely different

quality will perform.....so the "pool value" freezes, and under mark to market there is tremendous pressure to take huge write downs for the entire pool....yet most underlying mortgages keep right on paying. Congress, the Administration, Treasury and the Financial Regulatory agencies need to work out some sensible changes to the mark to market rules and capital requirements of financial institutions that hold mortgage-backed securities where most (but not all) of the mortgages supporting those securities continue to pay.....the ones which retain significant underlying value but are illiquid can and should be treated differently from those with little or no real value and existing accounting standards and regulatory rules are already in place to make those "real world" distinctions. "Mark to market" in this unprecedented environment is a significant impediment to solving our banking problems, and by extension, our severe economic crisis.

I would be happy to meet with you to discuss this issue in more detail and answer any questions you or your staff may have about how healthy banks committed to helping the Arizona, Nevada and California economies grow are dealing with this crisis on a real world day to day basis. Similarly, I know that Robert Sarver and Dale Gibbons, the Western Alliance CEO and CFO, are also available to discuss this in more depth.

Sincerely,



James H. Lundy
President/CEO

JHL/jrm

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Testimony of

Former Speaker of the House Newt Gingrich
Emily Renwick
American Enterprise Institute

To the Subcommittee on Capital Markets, Insurance and GSEs
Committee on Financial Services
U.S. House of Representatives

March 12, 2009

"It is Time to Follow FDR and Suspend Mark-to-Market as a Destructive Regulation."

Mr. Chairman, Ranking Member Bachus, and members of the Subcommittee, thank you for providing us the opportunity to present testimony on this very important issue.

Mark-to-market ("fair value") is a major cause of the current financial disaster. It has accelerated and deepened the decline of asset values. It has crippled institutions that would have survived under a more honest and realistic accounting system.

Ironically, the flaws in mark-to-market are not new.

Since the 1930s, accountants and bank regulators have recognized the inherent weaknesses of mark-to-market accounting.

Dating back to 1938, the Federal Reserve recommended that accounting principles should be revised. President Franklin Delano Roosevelt heeded their advice, and quickly moved to repeal mark-to-market.

Despite the inherent weakness and procyclicality of mark-to-market accounting, the Financial Accounting Standards Board (FASB) capriciously reinstated mark-to-market in 2007 in effort to create more transparency. Under Financial Accounting Standard (FAS) No. 157, financial analysts are required to value an asset at the current mark rate even when there is no inherent market value.

Given the economic climate today, where stocks are selling pennies on the dollar, it is no wonder that many banks have had to take drastic write downs on their portfolios. Even if these assets continue to perform and deliver consistent cash flows, analysts still have to discount these assets to fire-sale, market prices. As a result, mark-to-market continues to cited as an exacerbating force in the current credit crisis.

Steve Forbes recently noted that if, "this rigid mark-to-market accounting had been in effect during the banking trouble in the early 1990s, almost every major commercial bank in the U.S. would have collapsed because of shaky Latin American and commercial real estate loans. We would have had a second Great Depression."[i]

William Isaac, former Chairman of Federal Deposit Insurance Corporation (FDIC), also made the same point that, "If we had followed today's approach during the 1980s, we would have nationalized all of the major banks in the country, and thousands of additional banks and thrifts would have failed. I have little doubt that the country would have gone from a serious recession into a depression."[ii]

It has become clear that FASB has not acted quickly enough to change this destructive rule.

Part of the problem rests with the nature of accounting regulation. Given that FASB sits under the Securities and Exchange Commission (SEC) which is then under the jurisdiction of Congress, the entire bureaucratic structure has become a bottleneck through which significant reform cannot escape and is permanently stifled.

For this reason, we submit this testimony in support of HR 1349, the Federal Accounting Oversight Board Act of 2009, which will create the Financial Accounting Oversight Board. Unlike the current regulatory structure, this new board will do a better job incorporating the input of all the relevant bodies in the financial communities.

By bringing together the Chairman of the Federal Reserve, the Secretary of Treasury, the Chairman of the SEC, the Chairman of the FDIC, and the Chairman of the Public Company Accounting Oversight Board (PCAOB), we will insure that accounting standards will no longer be relegated to a bureaucratic blind spot where no one has the power to change accounting rules that are destructive.

Officials from the Federal Reserve continue to voice their frustration over mark-to-market issues, but they lack the effective tools to initiate reform. In testimony in February before the Committee on Financial Services, U.S. House of Representatives, Chairman Bernanke acknowledged, in his own words, that the Fed has "heard a lot of concern about whether some assets are being mis-valued – too high or too low—based on the use of mark-to-market modeling or mark-to-market asset valuations."[iii]

In fact, the Federal Reserve has been issuing warning for at least eight years since 2002. In testimony on behalf of the Governors of the Federal Reserve in 2002, Susan S. Bies cautioned:

> "The FASB has stated that it believes that all financial instruments should be reported at fair value when the conceptual and measurement issues of fair value are resolved. ...The lack of reasonably specific standards for the estimation of fair values for non-traded, illiquid instruments could lead to problems for auditors and bank supervisors in verifying the accuracy of fair value estimates. ... Therefore, *the Federal Reserve has questioned the usefulness of comprehensive fair value accounting for all financial assets and liabilities in the primary financial statements.* (emphasis added)"[iv]

Just this week, Bernanke reiterated his concerns about mark-to-market in stating:

> "The ongoing move by those who set accounting standards toward requirements for improved disclosure and greater transparency is a positive development that deserves full support. However, determining appropriate valuation methods for illiquid or idiosyncratic assets can be very difficult, to put it mildly. As a result, further review of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency."[v]

Yet given the cumbersome bureaucratic structure, the Federal Reserve has lacked the political clout to advance a mark-to-market reform.

In order to ensure that we never allow a financial accounting rule to have such a devastating impact on our economy, we should quickly pass HR 1349. Through this legislation, members of the financial regulatory community, like the Federal Reserve, will now have legitimate power to reform accounting standards.

President Ronald Reagan was the first president to enact significant regulatory reform based on sound, rational changes. This bill follows in his footsteps, by putting forth a smart policy change that will allow more timeliness and flexibility in setting accounting standards.

Given that seventy years have passed since FDR's repeal, we should act now by finally putting an end to the destructive impact of mark-to-market accounting.

This is not an esoteric or minor issue. Every day that mark-to-market remains unreformed, jobs are killed, values are driven down and institutions are further endangered.

This is one of the most important reforms which could help turn the economy around.

Congress should pass HR 1349 as quickly as possible and recommend mark-to-market is immediately reformed.

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[i] Forbes, Steve. "Obama Repeats Bush's Worst Market Mistakes," *Wall Street Journal*, March 6, 2009,
[ii] Isaac, William, "How to Save the Financial System," *Wall Street Journal*, September 19, 2008,
[iii] Malpass, David, "Market Jumps after Bernanke Mentions Mark-to-Market and Uptick Rule," (Malpass transcription of Hearing before the Committee on Financial Services, U.S. House of Representatives, on February 25, 2009) distributed by e-mail February 25, 2009.
[iv] Bies, Susan. "Remarks by Governor Susan S. Bies: Effective Accounting and Disclosure for Financial Transactions and Financial Institutions," At the National Conference on Banks and Savings Institutions, American Institute of Certified Public Accountants, Washington, D.C., November 7, 2002.
[v] Bernanke, Ben S. "Financial Reform to Address Systemic Risk," At the Council on Foreign Relations, Washington, D.C., March 10, 2009.

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Subcommittee on Capital Markets, Insurance and GSEs
Committee on Financial Services
U.S. House of Representatives

March 12, 2009

# Reform of "Fair Value" Accounting

Mr. Chairman, Ranking Member Bachus, and members of the Subcommittee, thank you for the opportunity to present testimony on the immediate need to reform "fair value" accounting, which has made and continues to make the financial crisis worse than it needs to be. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago. I am a director of three financial services companies.

## Reform of the "Fair Value" Accounting Theory is Needed Immediately

"Fair value," also called "mark to market," is an accounting theory. We need to understand as a fundamental point that it is a theory, not a fact. It is a theory which has had enormously damaging real world unintended results.

"The mark to market mechanism is pernicious," Gene Ludwig, Comptroller of the Currency under President Clinton, has stated. Fair value accounting is "a major cause of the world-wide financial crisis," Bill Isaac, the Chairman of the FDIC during the 1980s financial crisis and a distinguished witness today, has observed. He has added that the application of fair value accounting on top of the other problems of the 1980s would have been disastrous.

"Bank investments should be considered in the light of inherent soundness… and should not be measured by the precarious yardstick of current market quotations which often reflect speculative and not true appraisals of intrinsic worth." This was the conclusion of the Federal

Reserve in 1938, as it put an end to the former mark to market practices of the day, which had helped drive the banking system down, then as now. (There are no new ideas in finance.)

What does "intrinsic value" mean? Fundamentally, it means the principal and interest that you are going to collect. If you are not going to collect it, it should of course be written off. But should you write it off when you are going to collect it, because a panicked market has put a panicked price on it? That way, which is the fair value way, creates a downward spiral in which everybody except short-sellers and vulture buyers loses.

A FASB defense of its fair value accounting theory, which has cycled into becoming the dominant accounting fashion only during the last couple of decades, claims that "fair value *reflects* losses that have been incurred, it does not *cause* losses." But in a big financial bust, with a self-reinforcing downward spiral of panic and illiquidity, this is manifestly untrue: accounting has real world effects. These include freezing funding markets, heightening uncertainty, triggering defaults on debt covenants, and changing customer and regulatory behavior. This all creates further uncertainty, which further lowers asset prices, which triggers accounting losses… and so on down.

The perverse effects of fair value accounting in a market panic are why almost all banking regulators oppose it. It is too easy for them to think of distressed situations which the banking system would not have survived if it had had to mark to market at the time.

Accounting is Always a Theory

Apologists for FASB and fair value accounting say they are only insisting on "the facts" of market prices, although they of course admit that in many cases there is no active market or no market at all, and that panicked conditions can result in fire sale prices that will be judged by later observers as irrational. Nonetheless, they say, we must not hide from "the facts."

But accounting is always a matter of theory. It never is and never can be simply facts. It is and can only be certain facts as treated according to some theory. Within the theory, it generates the projections, estimates and guesses needed to calculate what the theory defines as its results—for example, the defined concepts of "profit" and "capital." As the Institute of Chartered Accountants of England and Wales so rightly observes:

> "Financial reporting attempts to measure inherently abstract and debatable concepts such as income and net assets, and it has particular features that make it to some extent inevitably subjective."

Thus accounting theories are debated over years and decades without the ability of one side or the other to prove it is right.

What kind of a theory is fair value accounting when applied to debt instruments? It is an OK theory in a stable period when prices of debt instruments are equilibrium-seeking. But in a

period of disequilibrium and discontinuity, like a panic, it adds to the disequilibrium and makes the problems worse.

Debt instruments (unlike equities or houses) have a principal to be repaid at maturity and interest payments until then. Consider the principal and interest that is indeed going to be paid. What is the right accounting representation of these future cash flows in today's balance sheet? This is the same question as asking what discount rate should be applied to them, and how that should affect the defined concepts of profit and capital. To discount the cash flows by the exaggerated illiquidity premiums of a panicked market, and by doing so to exaggerate losses and erase capital, is both theoretically unsound and feeds the panic.

Many observers therefore say we should "suspend" fair value accounting. This seems to me to give it too much credit. I say it should not be suspended, but reformed.

The way to do this is to produce balance sheets and income statements as before the fair value days, that is, based on the principal and interest you are going to collect. This should define profit and capital. Then add a separate fair value balance sheet, completely "marked to market," using whatever market prices there are or estimates of what they might be if there were markets trading. This would give the proponents of fair value accounting all the information they desire, while not driving the financial system into the perverse downward spiral.

HR 1349

The FASB has been very slow and reluctant—even when confronted with the financial crisis—to fix what seem to be the obvious problems with fair value accounting theory. Therefore a new oversight board to govern accounting rulemaking seems like a good idea to me. With its proposed membership, I believe this new board would provide a more balanced forum to address the problems I have discussed.

But such a board needs to be promptly created, get in business, and act quickly.

Thank you again for the opportunity to share these views.