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MARK-TO-MARKET ACCOUNTING:

PRACTICES AND IMPLICATIONS

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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

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C O N T E N T S

WITNESSES
Thursday, March 12, 2009

APPENDIX

Additional Material Submitted for the Record

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 profound 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 non-functioning 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 economic 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 different 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 addition, 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 re-addressed. 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 maturity, 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-market. 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 officially 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 because 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 recommendations 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 opportunities 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 additional 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 under-capitalized 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 acknowledged 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 accounting 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 re-evaluated 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 accounting. 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 invite 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 impression 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 stand-by 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

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