Testimony Concerning Exploring the Balance Between Increased Credit Availability and Prudent Lending Standards

James L. Kroeker
Acting Chief Accountant
U.S. Securities and Exchange Commission

House Committee on Financial Services

March 25, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee:

I am Jim Kroeker, Acting Chief Accountant in the Office of the Chief Accountant (OCA), which advises the Commission on accounting and auditing matters. I am pleased to testify today on behalf of the Securities and Exchange Commission (Commission).

Your invitation to this hearing included a number of important questions that are appropriately the province of my fellow regulators here today. One area you did inquire about related to fair value accounting. I am happy to provide you with an update on this topic.

Recent Efforts to Improve Fair Value Accounting

Two weeks ago, on March 12, this Committee's Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on the critical topic of fair value accounting, at which I also testified. I believe that the hearing helped to further crystallize and advance the objective sought by market participants for improved guidance on the measurement of fair value and accounting for impairments.

There can be no doubt, and we at the Commission fully understand, the gravity and urgency of these issues as we all work in the public interest to address the global economic crisis. The hearing on March 12 underscored our own efforts for swift consideration and appropriate action, including action to address and, as appropriate, implement the critical recommendations the Commission staff identified in our Congressional study on mark-to-market accounting, which we conducted in consultation with the Department of the Treasury and the Federal Reserve.

Consistent with the sentiments we have clearly heard from many members of this Committee, I believe swift action must be taken to address the accounting for investment impairments and to improve the measurement guidance for illiquid assets for first quarter 2009 reporting. We are therefore pleased that the FASB has acted diligently and responsively to use their expertise as an independent standard-setter and expose amendments to the measurement of securities in inactive markets and the recognition of "other-than-temporary" security impairments. Following the FASB due process procedures, the proposed amendments were deliberated fully at an open public meeting of the full Board, were approved by a majority vote, and are now subject to public comment.

On March 17, the FASB's amendments were made available for a 15-day public comment period ending April 1.

The FASB's proposed amendments seek to directly address two of the recommendations in the Commission staff's December 30, 2008 study on mark-to-market accounting. First, these proposed amendments seek to provide additional guidance on determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurements. Generally, if the market is not active, then a valuation technique other than one that uses the quoted price shall be used. For example, the reporting entity could use an income approach (that is, a present value technique based on estimated cash flows) to estimate fair value based on an orderly transaction between willing market participants. This amended ability to use cash flows to measure securities in inactive markets seeks to address concerns about using distressed, forced or disorderly sales as the basis for estimating fair value.

Second, the FASB's proposed amendments seek to provide a clearer benchmark for when an other-than-temporary impairment exists and needs to be recorded on securities held outside of a company's trading book, and to transparently disclose the amount of the impairment directly associated with probable cash flow declines. These proposed amendments seek to provide greater clarity than exists today about the nature of losses. Under these proposed amendments, the probable losses in cash flow would be recorded in earnings, and the loss attributable to all other factors (e.g., liquidity and changes in interest rates) would be transparently reported as a component of "other comprehensive income" (OCI). To be clear, securities available for sale would continue to be reported at fair value on the balance sheet.

To illustrate how the FASB's proposed amendments would seek to improve the accounting for other-than-temporary impairments, consider their proposed application to a mortgage-backed security (MBS) comprised entirely of a large portfolio of residential mortgage loans. Under the existing guidance for other-than-temporary impairments, if it becomes probable that the MBS investor will suffer even a minor loss of expected cash flow, instead of recording the minor loss in earnings, the loss is based upon the MBS's current fair value. The FASB proposal would seek to provide additional information to the investor by reporting the minor loss of expected cash flow in earnings with other changes in value recognized in equity (i.e., OCI) until a decision to sell the security, and realize the loss, was made. That is, such a model would appear to help bridge the gap between the current fair value and the value expected from holding investment positions until markets return to normal liquidity levels.

We understand that the FASB's current plan is for its proposed amendments to be finalized by the first week of April in time for first quarter 2009 reporting. First quarter 2009 reporting would represent a timely response to our study's recommendations, and we are encouraged that the FASB has taken advantage of this earliest opportunity to act.

These proposed amendments are now in an important exposure period. As Representative Kanjorski aptly described at the March 12 hearing, there are strongly held views on all sides of these issues. It is critical that all those affected carefully consider the proposed amendments and whether they properly address the most pressing practice issues in the measurement of fair value and assessment of security impairment while also enhancing the information available to investors.

We also are actively taking steps to advance these issues. This has been and remains my number one priority. We have been proactively reaching out to investor groups, the accounting profession, fellow regulators, and representatives from those industries that would be most affected by the FASB's proposed amendments. And of course we are, as we always are, in constant contact with the FASB, and we understand that they have likewise engaged in active dialogue with capital market participants.

As I have testified before, we continue to believe the FASB must be responsive to the needs of capital market participants. While the Commission has broad authority and responsibility to prescribe accounting standards,[1] it has long relied on the FASB as a private sector standard-setter and recognized the importance of the FASB's independence.[2] The FASB, in turn, is obliged to consider, in adopting accounting principles, the need to keep standards current in order to reflect emerging accounting issues and changing business practices.[3]

I am hopeful that the FASB will continue, on a timely basis, to enhance the tools available to assist preparers and auditors when making these difficult judgments. As I testified on March 12, as the principal advisor to the Commission on accounting and auditing issues, I and my office remain ready to assist the Commission in any way it deems necessary.
I am also hopeful that the FASB will continue its efforts to comprehensively reconsider the accounting for all financial instruments, which was also a recommendation in the staff's mark-to-market study. We will be working closely with the FASB in the near future as they continue that undertaking, including closely monitoring their efforts to harmonize the accounting for loans and securities and to choose a measurement objective that meets the needs of investors.

Interaction between Regulatory Capital and U.S. GAAP

As you are aware, the Commission and my office are not responsible for monitoring the availability of credit, nor are we responsible for assessing financial institutions' lending practices. These aspects of regulation are already best addressed by others here today.

However, my office is responsible for establishing and enforcing accounting policy to enhance the transparency and relevancy of financial reporting in fulfilling the Commission's separate and mission of investor protection, market efficiency and capital formation, a mission that is at the heart of our privately financed economy. As part of our fulfillment of this responsibility and mission, we oversee the activities of the FASB. As part of our oversight, we remain cognizant of the primary objective of U.S. GAAP reporting and how that primary objective interacts with the separate objectives of others, including regulatory capital reporting, and we engage in regular and meaningful dialogue, interaction, and consultation with banking regulators.

As we discuss in our December 30 study on mark-to-market accounting, the primary objective of financial reporting is, and should be, to provide information useful to investors and creditors in their decision-making processes. The primary objective of prudential banking oversight has been to foster safety and soundness and financial stability.

When considering these often complementary, yet different, objectives, it is also important to recall two points. First, investors generally can, and do, make decisions on a current basis, necessitating relevant and reliable current information about financial values and prospects on a timely basis. While an individual entity may have a long term horizon, the capital allocation decisions of investors depend on their own individual circumstances.

For example, working Americans are faced with daily decisions about which investment to purchase and hold in an IRA or 401(k). The historical cost of an asset (that is, the price the reporting entity bought the asset years ago) may in many cases provide little relevance to an investor making a current capital allocation decision. Rather, information about the current values and the financial prospects of the reporting entity may be extremely important to the investor when determining which investment to purchase.

The full Commission and I believe that confidence in our markets begins with the quality and transparency of the financial information available to help investors decide whether, when, and where to invest their hard-earned dollars. The goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting provides necessary confidence in the fairness of the markets and plays a fundamental role in contributing to make our markets the most efficient, liquid and resilient in the world.

Second, investors generally may not have the ability to otherwise obtain information in a format specific for their own use. Therefore, in evaluating their investment decisions, investors are dependent on the financial reporting provided by management and as guided by the Commission. However, unlike investors, banking regulators have the ability to prescribe the format of information provided to them, including the ability to adjust U.S. GAAP reporting, or require additional information for purposes of their own analysis and, as I describe further below, have exercised that ability in many cases.

As we noted in our study, regulatory capital requirements for banks in the U.S. currently start with financial information provided in accordance with U.S. GAAP. Section 121 of FDICIA requires that the accounting principles used in the reports and statements filed with banking regulators by insured depository institutions be no less stringent than U.S. GAAP.[4] The banking regulations for preparing balance sheet and income statement reports filed with regulators are consistent with FDICIA.

There are, however, instances in which the prudential banking regulators have determined that adjustments should be made to U.S. GAAP accounting results for regulatory capital purposes, thereby reflecting the important differences between the objectives of U.S.

GAAP reporting and the objectives of regulatory capital requirements. We understand that these adjustments are intended to reflect the solvency and safety and soundness of the financial institutions on an ongoing basis. This can be done, for instance, by seeking to limit volatility that is temporary in nature.

For example, consistent with the safety and soundness objective, losses on assets that are reflected in income and retained earnings in accordance with U.S. GAAP are generally recognized in regulatory capital. However, while equity, as presented under U.S. GAAP, is the starting point for the banking regulators' regulatory capital calculations, the regulatory capital standards and their instructions for calculating regulatory capital include several adjustments from U.S. GAAP-based equity. An example in this area is that unrealized gains and losses for available-for-sale (AFS) debt securities generally do not impact regulatory capital calculations, even though these unrealized gains and losses are reported in U.S. GAAP-based equity (as part of accumulated other comprehensive income). Losses that are realized by a financial institution, either by sale of the debt security or determination that the decline in the fair value of the debt security is other-than-temporary, are reflected in regulatory capital.

In 1995, the Office of Thrift Supervision (OTS), as well as the other banking regulators (collectively, the Agencies), issued a final rule to exclude unrealized gains and losses for available-for-sale debt securities recognized under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) from regulatory capital. In its final rule, the OTS stated:

> After considering all the comments received, the OTS, in consultation with the other Agencies, has decided not to adopt its proposal to include the FAS 115 equity component in computing regulatory capital. …Based on the comment letters received, the OTS determined that adoption of the proposal could potentially have an inappropriate impact on associations' regulatory capital and result in an inaccurate picture of their capital positions. For example, fluctuations in interest rates could cause temporary changes in regulatory capital levels, which in turn could trigger more permanent regulatory intervention and inappropriately affect industry profitability. …The OTS considered the comments received regarding FDICIA's requirement that regulatory accounting policy be no less stringent than GAAP. Section 121 of FDICIA requires that policies applicable to reports and statements filed with the Federal banking agencies generally conform to GAAP. The section, however, does not require the calculation of an institution's regulatory capital or the components of regulatory capital to conform to GAAP, and the legislative history of the section indicates that was not necessarily the intent of Congress.[5]

In addition to making adjustments to exclude from regulatory capital certain amounts reported under U.S. GAAP in accumulated OCI, the regulatory calculation of capital also includes adjustments to certain assets that are recognized and included in equity under U.S. GAAP.[6] For example, goodwill[7] is deducted from regulatory capital and the inclusion in regulatory capital of certain servicing rights recognized as assets under U.S.

GAAP is limited. As a result, fair value measurements that adjust the carrying amount of items excluded from regulatory capital, while reducing U.S. GAAP-based equity, may not have an impact on regulatory capital.

In certain circumstances, the regulatory calculation of capital also includes items not reported in equity under U.S. GAAP. In 2005, the Federal Reserve issued a final rule addressing the definition of regulatory capital in which it stated:

> A change in the GAAP accounting for a capital instrument does not necessarily change the regulatory capital treatment of that instrument. Although GAAP informs the definition of regulatory capital, the [Federal Reserve] is not bound to use GAAP accounting concepts in its definition of [T]ier 1 or [T]ier 2 capital because regulatory capital requirements are regulatory constructs designed to ensure the safety and soundness of banking organizations, not accounting designations established to ensure the transparency of financial statements. In this regard, the definition of [T]ier 1 capital since the [Federal Reserve] adopted its risk-based capital rule in 1989 has differed from GAAP equity in a number of ways. The [Federal Reserve] has determined that these differences are consistent with its responsibility for ensuring the soundness of the capital bases of banking organizations under its supervision. These differences are not differences between regulatory reporting and GAAP accounting requirements, but rather are differences only between the definition of equity for purposes of GAAP and the definition of [T]ier 1 capital for purposes of the Board's regulatory capital requirements for banking organizations.[8]

In sum, while financial reporting may serve as a starting point for other users, such as banking regulators, it should continue to be developed by the FASB to primarily satisfy the needs of private sector investors and other users that may not have the ability to otherwise obtain information in a format specific for their own use. As I testified two weeks ago, the full Commission and I continue to believe the FASB is best positioned to promulgate neutral financial reporting standards. As previously described, if they deem necessary, the banking regulators have the ability to adjust financial reporting or require additional information for purposes of their own analysis and have exercised that ability as they deem appropriate.

Conclusion

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. We support the FASB's swift and responsive actions to propose amendments that seek to address the recommendations included in the SEC staff's study. We will continue to solicit input from all parties affected by this issue. My office and I are assisting the Commission, by advising them on the FASB's recent actions. We stand ready to provide support to Commission and the FASB, in any way the Commission deems appropriate, to help ensure that FASB timely consider and address the recommendations for improvements included in our study, and to ensure information available to investors in these economic conditions is as accurate, timely and useful as possible. This remains my number one priority during these challenging economic times.

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

---

[1] See, e.g., sections 7, 19(a) and Schedule A, items (25) and (26) of the Securities Act of 1933, 15 U.S.C. 77g, 77s(a), 77aa(25) and (26); sections 3(b), 12(b) and 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(b), 78l(b) and 78m(b); and sections 8, 30(e), 31 and 38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-8, 80a-29(e), 80a-30 and 80a-37(a).

[2] Policy Statement Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003) [68 FR 23333 (May 1, 2003)] ("2003 Policy Statement").

[3] See section 19(b) of the Securities Act of 1933, 15 U.S.C. 77s(b), as amended by the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201 et seq. Further, in the 2003 Policy Statement, the Commission stated its belief that the FASB "should provide timely guidance to public companies, accounting firms, regulators and others on accounting issues that the Commission considers to be of immediate significance to investors." Further, the Commission stated that: "We expect that the Commission staff will refer issues to the FASB or one of its affiliated organizations when those issues may warrant new, amendments to, or formal interpretations of, accounting standards. We also expect that the FASB will address such issues in a timely manner." Id. (footnotes omitted)

[4] See 12 U.S.C. 1831n.

[5] Regulatory Capital: Common Stockholders' Equity, OTS Release No. 95-151 (August 3, 1995) [60 FR 42025 (August 15, 1995)].

[6] See "Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)," last updated December 2008 as provided on the FFIEC website, for a description of the assets reported under U.S. GAAP that are not eligible to be included in Schedule RC-R – Regulatory Capital. (available at http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_041_200812_i.pdf).

[7] In December, the Agencies jointly issued a final rule allowing goodwill, which must be deducted from Tier 1 capital, to be reduced by the amount of any associated deferred tax liability. See Minimum Capital Ratios; Capital Adequacy Guidelines; Capital Maintenance; Capital; Deduction of Goodwill Net of Associated Deferred Tax Liability, Docket No. OTS-2008-0019 (December 15, 2008) [73 FR 79602 (December 30, 2008)].

[8] Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital, Docket No. R-1193 (March 10, 2005) [70 FR 11827 (March 10, 2005)].