

**Statement of Thomas Bailey
President and CEO, Brentwood Bank**

On Behalf of

**The Pennsylvania Association of Community Bankers
And
The Independent Community Bankers of America**

**Subcommittee on Capital Markets, Insurance, and Government Sponsored
Enterprises, House Financial Services Committee**

**Mark-to-Market Accounting:
Practices and Implications**

March 12, 2009

Chairman Kanjorski, Ranking member Garrett and members of the Subcommittee. I appreciate the opportunity to come before you today to provide a community banker perspective on the current application of mark-to-market accounting. My name is Thomas Bailey and I currently serve as Chairman of the Pennsylvania Association of Community Bankers (PACB). PACB is the oldest state banking trade association in the nation dating back to 1876, consisting of 150 community banks with combined assets exceeding \$90 billion and employing over 30,000 men and women. I am also testifying today on behalf of the Independent Community Bankers of America¹.

I am also the President and CEO of Brentwood Bank. Brentwood Bank serves the South Hills of Pittsburgh. Since putting its roots down more than 86 years ago, Brentwood Bank has been fulfilling the financial needs of individuals, businesses, families and the community we serve. With assets of approximately \$450 million and capital of \$25 million (equity \$37 million less FASB 115 adjustment of \$12 million), Brentwood Bank was able to generate approximately \$70 million in business, mortgage and consumer loans in its last fiscal year with no repossessed assets and less than ¼ % of assets in delinquent loans. Through the nine months ending December 31, 2008 Brentwood Bank has granted more than \$64 million in loans (commercial \$38 million, mortgage \$15 million and consumer \$11 million). We achieved all this while continuing to maintain a delinquent loan to asset ratio of less than ¼ of 1%.

Chairman Kanjorski, PACB and ICBA salute your leadership in calling this important hearing. The bank presidents who lead PACB have watched and listened to the debates regarding fair value accounting, mark-to-market and other than temporary impairment (OTTI). We understand the day-to-day effects that these accounting standards have upon Main Street banking. We have first hand experience on how these rules are an exacerbating factor in this financial crisis.

PACB took the unusual step of forming a committee to explore the issues surrounding fair value accounting. The committee's mandate was to describe the problem in simple and easy to understand terms and make related recommendations to correct the problem on a short term and long-term basis. The recommendations I present today reflects the work of PACB's committee.

The issues before this subcommittee today strike at the heart of how community bankers will serve their marketplaces in the months to come. In the case of Brentwood Bank, we have taken approximately \$2 million in OTTI charges. That \$2 million in charges represent lost opportunity cost to finance an additional \$20 million in loans based on a 10% equity requirement. This represents 30 percent of the loans we have made in the past 9 months. It has also made the Bank a bit more conservative as it looks at new lending opportunities.

¹ The Independent Community Bankers of America, the nation's voice for community banks, represents 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold \$1 trillion in assets, \$800 billion in deposits, and \$700 billion in loans to consumers, small businesses and the agricultural community.

With all the economic crises facing this country right now, the application of these rigid accounting rules, in these times, is much like throwing gasoline on a raging inferno. Those who serve on the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) that oversees the FASB must be held to account. This hearing will be an important step in bringing full public disclosure to the actions of the SEC and FASB and to get a clear understanding of how they can assure the public that action will be taken.

The application of mark-to-market in frozen markets is the heart of the problem. When these rules were developed, this unprecedented situation could not have been imagined. If FASB does not take action quickly, the problem will get worse. The close of the first quarter is only a few weeks away, and the second quarter 3 months after that. The FASB does not seem to realize the urgency of the situation. While the total suspension of market-to-market accounting is very appealing, we know that many have concerns about how the capital markets may respond to that and suspension may not be possible. Thus we offer an alternative that would address only OTTI recognition. I address our proposed solution later in my statement but now would like to explain why the rules need to be changed.

Current OTTI rules present a distorted financial picture of Fair Value.

PACB and ICBA support transparency of financial statements. Current mark-to-market accounting rules hinder transparency and distort the true condition of financial institutions holding mortgage backed securities (in particular private label mortgage backed securities), asset backed securities (including consumer loan-backed and student loan backed securities targeted by the Treasury for support) and other debt securities. This, in turn, has a highly negative impact in trying to get credit flowing in these important sectors of the capital markets.

Under U.S. GAAP (see attachment 1 for a description of current rules) a company must evaluate its investment securities portfolio to determine whether fair value is lower than book value. OTTI results when the collection of all contractual cash flows are not deemed probable. In addition, some auditors have insisted on OTTI write-downs simply because current market values were very depressed, even if the institution did not reasonably expect to lose any principal or interest.

If the company determines that it does not expect to collect all of the contractual amounts due on an investment security over the life of that security, the company must mark the investment security down from its carrying value to its current fair value, even if it intends to hold the investment security until recovery.

The following are critical points when considering how fair value accounting works today:

- Fair value is difficult to measure in an illiquid market. Fair value accounting, as currently defined under GAAP is based on an “exit price” from a market participant’s point of view. However, the today’s markets for the assets we are discussing lacks trading volume, observable inputs, reasonable bid/ask spreads, or willing buyers to support the valuation of these securities. This results in companies recording write-downs disproportionately greater than the anticipated credit or economic losses.

- When a security is deemed to be OTTI, the entire amount of OTTI loss is charged against earnings with no ability to write back up the security if the fair value recovers in the future, other than accreting the non-credit portion of the loss into income over the life of the security.²
- The entire reduction in fair market value includes both the write-downs attributable to credit losses and to losses due to liquidity. Estimates of credit losses themselves are variable and subjective, based on forecasts of how underlying loans may perform in the future – assumptions that may or may not actually come to pass.

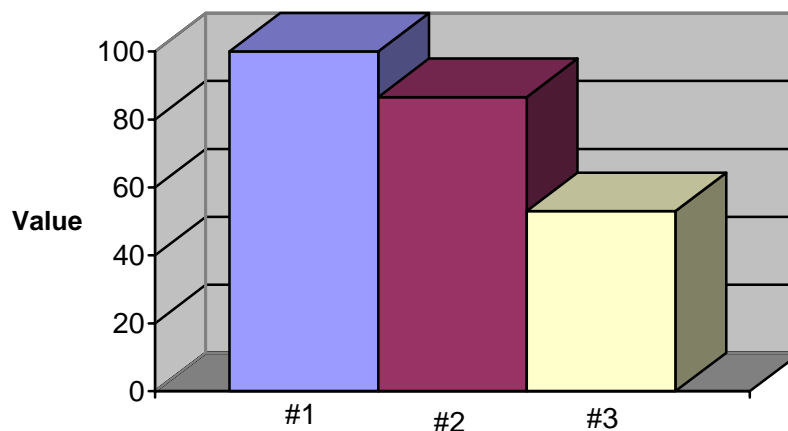
Example

I would like to move from the theoretical to the actual by presenting a real-life example about how a financial company developed an estimated credit loss and then what the resulting write-down was based on current accounting rules.

An institution holding a private label mortgage backed security (PLMBS) with an initial pre-OTTI carrying value of \$125.1 million (bar #1 in the graph below) determined through analysis that the security would suffer a future economic losses resulting in a credit loss of \$16.7 million (represented in the second bar). The analysis assumed an unemployment rate in the high teens and further assumed that 44% of the loans backing the security would go into default, including 35% of those loans that were current as of year-end. The scenario further projected a loss on the defaulted loans of 45%.

The process to arrive at this economic loss of \$16.7 million was rigorous. However, when the fair value is developed in today's illiquid markets, that institution had to take a write-down of \$58.9 million, over three times as much as the economic loss (as presented in the third bar).

This additional write-down as represented by the differences between bar #3 and bar #2 is the direct result of the application of OTTI in a dysfunctional market.



² A description of current accounting rules can be found at attachment 1.

While this is one example relating to one security, there are billions of dollars of other securities held by the nation's insured financial institutions that could meet a similar fate. According to the FDIC Statistics on Depository Institutions published as of December 31, 2008, there are more than \$2 trillion of debt securities held by the banking industry. Approximately \$1.8 trillion are classified "Available-for-Sale" and more than \$230 billion are classified "Held-to-Maturity". There are \$280 billion of PLMBS and \$130 billion of other asset-backed securities. These statistics don't include debt securities held in other financial service businesses such as the insurance industry.

Many of the markets for these assets on the books of banks are simply not functioning today.

Negative Impact of Current Accounting Rules

Current accounting rules are hurting the market's ability to revive and establish market-driven pricing. Financial institutions are not willing to risk purchasing assets that could result in a future material write-down if an immaterial credit loss may occur many years in the future. The number of transactions continues to decline and the already weak market becomes nearly invisible. The current financial reporting requirements create a self-fulfilling downward spiral for the prices of MBS, other asset-backed securities, and other debt securities.

For those financial institutions that carry PLMBS and other asset backed securities on their books, OTTI rules raise the specter of future write-downs that could further weaken capital positions. This could contribute to the hoarding of capital at many banks. This prudent reaction to guard against future accounting-driven losses likely inhibits the flow of badly needed credit.

In addition, the rules make it undesirable to sell these assets, even if an institution wanted to at prices that reflect economic losses embedded in the securities. Many investors do not want to sell an asset in this illiquid market at fire sale prices causing the seller to lock in a severe loss and give up future expected income accruing from that asset. This further freezes this market and only makes matters worse.

Another point to consider is that FHLBank stock is a big investment for community banks across America. OTTI accounting write-downs have caused FHLBanks to reduce or suspend dividends to member financial institutions which means some FHLBank member institutions are carrying a non-earning asset. In addition the negative news about FHLBank earnings which are so impacted by these misleading accounting rules have raised the cost of funds for thousands of banks and savings institutions that borrow from the Home Loan Bank System.

OTTI rules also may be thwarting inadvertently the extraordinary and expensive efforts of the Congress, the Treasury Department, the Federal Reserve and the Federal Deposit Insurance Corporation to improve the current situation and driving up the costs of these efforts. Unprecedented amounts of funds are pouring into the financial services industry to replenish the capital lost as a direct result of this accounting rule. This is a "paper loss" and does not reflect reality.

We do not believe the American taxpayers want their tax dollars used to cover up a “paper loss.” We also know, as do you, that the American public wants these dollars to be put to work in communities across America, but our accounting rules make this more difficult.

Proposed Solution

Chairman, Kanjorski, your letter of invitation asked that we address whether current rules can be revised going forward. We do not believe Congress should be writing accounting standards. However, when markets cease to function as we have experienced over the past several months, continued application of an accounting standard based on valuations derived from a dysfunctional market only serves to compound the problem.

Congress must hold FASB accountable for allowing this situation to exist and to encourage FASB to rectify this situation by providing OTTI guidance that will improve financial reporting in these unique market circumstances. Congress should ask the SEC and FASB to apply existing accounting rules that apply to loans held in portfolio to asset backed securities and other debt securities for which the institution has the intent and ability to hold.

The determination of whether OTTI exists as well as the magnitude of loss recorded should be based on a rigorous credit analysis appropriate to the characteristics of the securities, taking into account the nature of any credit enhancements. Any OTTI should reflect the true economic loss (i.e., probable credit losses). If economic losses change, such changes would be recognized immediately through earnings. To accommodate the existing GAAP fair value framework and provide transparency as to the recorded amounts, the OTTI loss on held-to-maturity (HTM) debt securities should be separated and reported in two components: (1) through earnings for probable credit losses and (2) through the footnotes to financial statements to disclose the fair value of the securities.

This proposed solution would also work for Available-For-Sale securities that the institution intends to hold until recovery. The OTTI loss should be (1) recognized through earnings for probable credit losses and (2) all other portions of the loss (such as from liquidity discounts) will remain in accumulated other comprehensive income (loss) in stockholders’ equity until the security is sold or matures.

It is worth noting that this change would not hinder transparency and would actually improve comparability and consistency. All institutions have, for many years, reported the fair value of all financial assets in their financial statement notes annually. FASB recently increased the frequency of that reporting requirement to quarterly.

This is similar to International Accounting Standards (IASB) rules that apply FAS 5/FAS 114-like treatment for the OTTI of MBS and permit the recognition of future gains against the recorded OTTI loss.

Mr. Chairman and members of the Subcommittee, thank you again for your attention today and I would be happy to answer any questions you might have.

Current Accounting Rules

U.S. GAAP has three classifications for investment securities and the related accounting for each is summarized below:

Trading Securities – are marked to market (fair value) through the income statement.

Available for Sale Securities - are marked to market (fair value) through the equity section of the balance sheet entitled Accumulated Other Comprehensive Income. These securities must be evaluated for OTTI on a quarterly basis. If they are deemed to be OTTI, which generally means there is some level of expected credit losses embedded in the security sometime in the future, then it's write-down to fair value is currently recognized in the income statement.

Held to Maturity Securities – are recorded at cost on the balance sheet and their fair value is disclosed in the footnotes to the financial statements. The financial institution that owns these securities must have both the ability and intent to hold them to maturity; in fact, U.S. GAAP does not permit their sale except under rare instances. These securities need to be evaluated quarterly for OTTI, and if so deemed, then they must be written down to fair value through the income statement.

Given the current market conditions, there is a large difference between the expected credit losses in these securities and the fair market values. The difference between the credit loss and the fair market value is recognized from an accounting prospective as additional yield on the security over its remaining estimated life. The security may not be written back up if the fair value recovers.

Current U.S. GAAP for the recognition and measurement of impairment losses differs for loans and asset-backed held to maturity securities even though the securities are comprised of a pool of loans.

GAAP treatment for loans: GAAP for recognition and measurement of impairment for loans held by creditors, such as mortgage loans held as investments by banks, follows “the loan impairment model”. This results in loans reported at amortized cost less an allowance for loan losses computed based on incurred credit losses. Credit losses or economic losses are generally computed as the present value of expected future cash flows on the loans.

- The loan impairment model provides for recognized reserves (equal to estimated incurred credit losses only) with future changes in the required level of reserves affecting earnings in future periods.

GAAP Treatment for Securities: GAAP for recognizing and measuring OTTI for investments in securities – even assuming the investor has the ability and intent to hold the

debt security to maturity (HTM); requires the use of fair values as defined by GAAP (FAS 157). This guidance defines fair value as the “exit price” which would take into account estimated credit losses and a discount for market participants’ assumptions about illiquidity, interest rate risk, etc.

- The entire amount of the OTTI loss on HTM investments is charged against earnings with no adjustments allowed in future periods for any recoveries if fair value increases.