TESTIMONY

of

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before the

SUBCOMMITTEE ON CAPITAL MARKETS,
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Thank you Chairman Kanjorski, Ranking Member Garrett, and Members of the Committee for conducting this very important hearing on mark-to-market (MTM) accounting.

I use the term “mark to market accounting,” rather than “fair value accounting.” Everyone’s goal is a fair and descriptive accounting system. There is nothing “fair” about the misleading and destructive accounting regime promoted by the Securities and Exchange Commission and the Financial Accounting Standards Board under the rubric “fair value accounting.”

MTM accounting has destroyed well over $500 billion of capital in our financial system. Because banks are able to lend up to ten times their capital, MTM accounting has also destroyed over $5 trillion of lending capacity, contributing significantly to a severe credit contraction and an economic downturn that has cost millions of jobs and wiped out vast amounts of retirement savings on which millions of people were counting.

Taxpayers have been called upon to invest in our financial institutions to help repair the damage caused by MTM accounting. Congress has authorized $700 billion, and the FDIC is now asking for up to $500 billion more.

We should not be misled by those who argue that MTM is having little impact. The chart on the next page shows quite graphically the severe negative impact MTM accounting is having – nearly a billion dollars of capital was destroyed ***in just one mortgage backed security pool held in just one bank***.

Mark to Market Accounting
Expected Losses vs. Mark to Market Write-downs

Below is an example of the distortion that occurs when using mark to market (MTM) accounting. This example involves an actual case study from an anonymous bank that made loans and securitized them as a mortgage backed security (MBS). Expected losses and expected cash flows for the MBS differ dramatically from MTM write downs. ***The Bank is required to record MTM losses of $913 million as opposed to the maximum expected lifetime losses of $100 million, resulting in a significant overstatement of losses and having a negative impact on tangible common equity.***

Losses on MBS Held By Bank
(In Millions)

<u>MBS description:</u>

- The Bank holds a pool of MBS totaling $3.65 billion as of December 31, 2008.
- The underlying loans are not sub-prime and are generally quality loans (average of approximately 17 months of seasoning, original FICO scores of 749, and original loan-to-value ratio of 73%).

<u>Losses based on MTM:</u>

- The MBS has subordinated collateral of $172 million. ***The amount of subordinated collateral exceeds the worst-case loss projections, which means the Bank does not expect to incur any losses on its senior MBS positions (positions that MTM rules have required be written down by $913 million).***
- The MTM write-down required on this pool is more than nine times the maximum estimated lifetime losses.

As you might know, I opposed enactment of the $700 billion Troubled Asset Relief Program (TARP) enacted last fall. I did not believe the purchase of troubled assets from the banks would work, and I believed the program would cost taxpayers dearly if implemented.

Beyond my skepticism about the efficacy of purchasing toxic assets from banks, I felt we should first attempt to resolve the problems in our financial system in ways that would not require massive outlays by taxpayers. Immediate suspension of a MTM accounting rule known as SFAS 157 was my highest priority, as we needed to stop the senseless destruction of bank capital. I believe firmly that if the SEC and FASB had suspended this MTM rule nine months ago – in favor of marking these assets to their true economic valued based on actual and projected cash flows – our financial system and economy would not be in anywhere near the crisis that they are in today. Anyone who doubts this conclusion should study the chart on the previous page more closely. While it is way late to be effecting these changes in MTM, late is much better than never as many more MTM write-downs remain to be taken.

I was Chairman of the FDIC during the banking crisis of the 1980s. The problems in the U.S. financial system in the 1980s, despite what we are hearing from some government leaders and the media, were more serious than we are facing thus far today.

A. Background. One of the many problems we faced during the 1980s was the massive insolvency of thrift institutions (*i.e.*, savings banks insured by the FDIC and S&Ls insured by the former Federal Savings & Loan Insurance Corporation) due to their holdings of long-term, fixed-rate mortgages and bonds during a time of very high interest rates. Ironically, MTM accounting had surface appeal to me during this period, as I thought it might in the future force banks and thrifts to keep the maturities of their assets and liabilities in better balance.

I asked the FDIC staff to consider whether we should push for MTM accounting, and we solicited comments and studied the issue for the better part of a year. We rejected MTM accounting for three principal reasons.

First, MTM accounting could be implemented on only a portion of the asset side of the balance sheet (*i.e.,* marketable securities) – it was daunting to even contemplate how to mark to market the liability side. We could not see a significant benefit in marking to market only a portion of one side of bank balance sheets – and to attempt to do so would produce very misleading results. For example, an increase in interest rates would drive down the value of government bonds on the asset side. But that same increase in rates could well make floating rate loans more profitable and would make checking and savings accounts and fixed-rate CDs on the liability side of the balance sheet more valuable funding sources. A system that captured one change in value without picking up the other would be very misleading to investors. Moreover, MTM accounting does not even purport to measure operating results in business units.

Second, we believed that MTM accounting would make it very difficult for banks to perform their fundamental function in our economy, which is to convert relatively short-term money from depositors into longer-term loans for businesses and consumers. Banks necessarily have some mismatch in the maturities of their assets and liabilities – it is up to bank management, regulators, and investors to make sure the mismatch is not excessive. Accounting rules made to influence behavior are no substitute for good judgment and can interfere with appropriate business conduct.

Third, we felt that MTM accounting would be pro-cyclical (which is never a good thing in bank regulation) and would make it very difficult for regulators to manage future banking crises. In order to better understand this concern, it is useful to consider the economic climate and banking problems of the 1980s.

The underlying economic problems of the 1980s in the U.S. were more serious than the economic problems confronting us this time around – at least so far. The prime rate exceeded 21%, and the economy plunged into a deep recession in 1981-82, with the agricultural sector in a depression. Unemployment approached 11%.

These economic problems led to massive problems in the banking and thrift industries. The savings bank industry was more than $100 billion insolvent if we had valued it on a market basis, and the S&L industry was in similar condition. A bubble burst in the energy sector, and a rolling real estate recession hit one region after another. Continental Illinois (the seventh largest bank) failed, many of the large regional banks went down (including nine of the ten largest banks in Texas), and hundreds of farm banks failed, as did an even larger number of thrifts. Three thousand banks and thrifts failed from 1980 through 1991, and many others went out of business through mergers.

It could have been much worse. The money center banks were loaded up with third world debt that was valued in the markets at cents on the dollar. If we had marked those loans to market prices, virtually every one of our money center banks would have been insolvent. We instead marked them to our estimate of their true economic value.

B. Today's problems. At the outset of the current crisis in the financial and credit markets, we had no serious economic problems. Inflation was under control, economic growth was good, unemployment was low, and there were no major credit problems in the banking system.

The dark cloud on the horizon was about $1.2 trillion of subprime mortgages (most had been securitized), about $200 billion to $300 billion of which were believed to be held by FDIC-insured banks and thrifts. The rest were spread throughout the world.

The likely losses on these assets were estimated by regulators to be roughly 20%. Losses of this magnitude would have caused pain for banks that held the assets, but would have been quite manageable, particularly for an industry that had after-tax earnings of roughly $150 billion in 2006 and had capital of $1.4 trillion.

How did we let this serious but manageable situation get so far out of hand – to the point where several of our most respected American financial companies have been put out of business, sometimes involving massive government bailouts?

People are assigning blame for the underlying problems – greed, inept regulation, rating agency incompetency, faulty monetary policy, unregulated mortgage brokers, and too much government emphasis on creating housing stock, particularly for lower income borrowers.

I believe one of the biggest culprits is MTM accounting. MTM rules dictate that financial institutions holding financial instruments available for sale (such as mortgage-backed securities, preferred stock, and bonds) must mark those assets to market. That might sound reasonable if you ignore every other moving part in bank financial statements and the fundamental nature of the banking business.

What do we do when the markets for those assets, which might be thin in the best of times, freeze up and only a handful of sales occur at extremely depressed prices? The answer until recently from the SEC and FASB has been: mark the assets to market even though there is no meaningful market. The accounting profession, scarred by decades of costly litigation, keeps forcing banks to mark down the assets as fast and far as possible.

This is contrary to everything we know about bank regulation. When there are temporary impairments of asset values due to economic and marketplace turmoil, regulators must give institutions an opportunity to survive the temporary impairment. Permanent impairments should be recognized, but assets should not be marked to unrealistic fire-sale prices. Regulators must evaluate the assets on the basis of their true economic value over a reasonable time horizon.

If we had followed today's approach during the 1980s, we would have nationalized nearly all of the largest banks in the country and thousands of additional banks and thrifts would have failed. I have little doubt that the country would have gone from a serious recession into a depression.

Some advocates of MTM accounting gasp at the thought of suspending the rules. They assume it would result in a loss of transparency and an overstatement of values.

Quite to the contrary, it is the use of MTM accounting, when markets are not functioning properly, that has produced terribly misleading accounting and disclosures that value assets well below their true economic value.

If SFAS 157 were suspended, bank management, auditors, and regulators should be charged with valuing the affected assets the same way they value all the other assets on the books of banks. They should consider the cash flows on the assets, the likelihood the assets will go into default, and the probable losses in the event of default. This analysis will improve our valuations and disclosures, not obscure them. The markets are terribly confused about values today because no one – not the accountants, not the regulators, and not the rating agencies – is providing serious analysis of the true economic value of the assets. Instead, the assets are being marked down to whatever the computer screen says is their value, based on what short sellers and other speculators would like the value to be.

C. Alternatives. Can we have a system that reflects market pricing without eradicating earnings and masses of capital when the markets are in disarray? I believe the historical-cost accounting model, which is the cornerstone of Generally Accepted Accounting Principles, accomplished these objectives exceptionally well for many decades before we decided to experiment with MTM accounting.

Under historical-cost accounting, marketable assets are carried on the books of banks at their amortized cost, and the balance sheet contains tables showing the current market value of those portfolios. This gives investors the information they need to evaluate the adequacy of a bank's capital and its future earnings power. If a decline in market value is significant in relationship to capital and if the investor/rating agency believes the situation is not likely to reverse itself any time soon, they will discount the bank's future earnings, credit ratings, and stock and bond prices.

The historical-cost system does not run the market depreciation through the profit and loss statement and does not deplete capital (unless the diminution in value is considered permanent). Moreover, this system does not value one portion of the balance sheet without regard to the rest of the balance sheet. In short, it presents a far more accurate and holistic financial picture of a bank than today's destructive and misleading system of accounting.

D. Who Makes the Rules? The current world-wide crisis in the financial system demonstrates conclusively that major principles of accounting are much too important to be left solely to accountants. Accounting standards today are set by the FASB, a five-member board that is shrouded in mystery. The SEC has authority to overrule the FASB for public companies, but almost never does – at least not publicly. The result is a system of accounting that is not accountable.

The rule making process is cumbersome, often slow, and incapable of responding to rapidly changing marketplace and economic conditions. The SEC proposes to make a bad system even worse by putting our fate in the hands of an international accounting standards board that will be even less accountable and more cumbersome.

I believe we urgently need to change our system of setting accounting standards. I note that H.R. 1349 would grant authority for setting accounting standards to a five-member board (Public Accounting Oversight Board) consisting of the Chairs of the Federal Reserve, the SEC, the FDIC, and the PCAOB plus the Secretary of the Treasury. This approach has much to commend it, as it would involve directly the agencies that have primary responsibility for maintaining a sound economy and financial system.

You will no doubt hear from the SEC and FASB that you should not politicize the process of setting accounting standards. I agree with that general proposition, although it is difficult to resist political action when the SEC and FASB are sitting on their hands in the midst of a world-wide financial crisis they played such a large role in creating. I believe a Board along the lines suggested in H.R. 1349 will ensure that not only will we approach accounting standards with objectivity, we will bring to bear the vast experience of those who are charged with maintaining a strong economy and financial system.

We would not have gone down the destructive path of MTM accounting had something like this Board been in place in the early 1990s when the SEC and FASB were first considering their experiment with MTM accounting. The Secretary of the Treasury and the Chairmen of the Federal Reserve and FDIC wrote letters urging against adoption of MTM accounting. They cited the experience in the Great Depression when bank regulators were requiring MTM accounting on bank investment portfolios. In 1938, the Secretary of the Treasury, under the direction of President Roosevelt, worked with bank regulators to abandon MTM accounting in order to encourage banks to resume lending and help lead us out of the Depression. They concluded that the pro-cyclical nature of MTM accounting had kept our nation in a downward economic spiral for eight years.

Secretary of the Treasury Nicholas Brady was particularly prescient in his March 24, 1992 letter to the Chairman of the FASB: "[MTM] could . . . result in more intense and frequent credit crunches, since a temporary dip in asset prices would result in immediate reductions in bank capital and an inevitable retrenchment in bank lending capacity. Finally, it is inappropriate to apply [MTM] accounting to only a portion of a bank's balance sheet, as would the FASB proposal. . . . This . . . could exacerbate the public's perception of systemic financial instability even when the industry's underlying businesses are solid."

Before closing, I want to bring up two subjects that are not under the heading of MTM accounting. The SEC made what I consider a huge mistake in 1999 when it took an enforcement action against SunTrust Bank for what the SEC believed to be the creation of excess loan loss reserves, thereby manipulating earnings. It is extremely important that bank regulation be counter-cyclical, not pro-cyclical. The time for banks to create reserves for losses is when the sun is shining, not in the middle of a hurricane.

It is not sound public policy to discourage banks from creating reserves during good times when they can best afford the hit to earnings. I certainly wish our banks had been encouraged to build more reserves over the past decade rather than reporting higher earnings. If H.R. 1349 is enacted, I hope the new Board will change this pro-cyclical and unsound reserving policy.

Finally, I want to mention the Uptick Rule, which the SEC repealed in 2007 and has refused to reinstate despite many calls for it to do so. The Uptick Rule was put in place in 1938 by the first Chairman of the SEC, Joseph P. Kennedy. The Rule provides that a short sale may be made only at a price higher than the previous transaction in that security. The purpose of the Rule is to make it more difficult for short sellers to gang up on a stock and beat it down to unreasonably low levels. There is no question in my mind that the absence of this and other regulations on short sellers has caused widespread destruction of the values of securities and undermined confidence in our financial system. I believe Congress should require the SEC to reinstate the Uptick Rule immediately.

I thank you for giving me this opportunity to be heard on these very important issues.

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PROFESSIONAL EXPERIENCE:

The Secura Group of LECG **1986 – Present**
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Mr. Isaac is Chairman of The Secura Group, a leading financial institutions consulting firm, operating as a division of LECG. The Secura Group provides financial advisory services, strategic planning, regulatory counseling, risk-management services, strategic studies, and general management consulting for financial institutions. LECG, of which Mr. Isaac is a Managing Director, is one of the world's leading expert services firm with 1,300 professionals serving Global Fortune 500 firms from offices in 13 countries. Mr. Isaac also serves as Chairman of various Isaac family real estate development companies. Mr. Isaac writes for *The American Banker, Wall Street Journal, Washington Post, New York Times,* and other publications and is a frequent speaker before banking groups. He is also a founding member of the American Bankers Council.

Arnold & Porter **1986 – 1993**
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Senior Partner in the largest law firm in Washington, DC and one of the largest in the nation. Arnold & Porter was a founding partner of Secura. Mr. Isaac left the firm in 1993 when Secura purchased Arnold & Porter's interest in the firm.

Federal Deposit Insurance Corporation **1978 – 1985**
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Chairman

Mr. Isaac served as Chairman of the Federal Deposit Insurance Corporation from 1981 through 1985, the most tumultuous period in U.S. banking since the Great Depression. He was appointed by President Carter to the three-member board of directors of the FDIC, and confirmed by the Senate, in 1978. While Mr. Isaac was at the FDIC, it had 7,000 employees operating from over 100 offices, an annual administrative budget exceeding $550 million, revenues exceeding $3 billion, and it handled hundreds of bank failures including some of the largest in U.S. history. Chairman, Federal Financial Institutions Examination Council (1983-85). Member, Depository Institutions Deregulation Committee (1981-85). Mr. Isaac served as a member, the Vice President's Task Group on Regulation of Financial Services (1984).

First Kentucky National Corporation **1974 – 1978**
Louisville, Kentucky

Vice President, General Counsel & Secretary

Mr. Isaac served as Vice President, General Counsel & Secretary of First Kentucky National Corporation and its subsidiaries, including First National Bank of Louisville and First Kentucky Trust Company. Responsible for: legal department; corporate secretary's functions, including director and shareholder meetings and regulatory reporting; investor relations, including all shareholder relations and financial reports and presentations; governmental relations and affairs; and economics department.

Foley & Lardner **1969 – 1974**
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Attorney

Attorney with Foley & Lardner, one of the largest law firms in the country. Mr. Isaac practiced general corporate law specializing in banking law (primarily regulatory affairs, including securities matters, acquisitions and branching) and antitrust law.

EDUCATION:

LL.D. (Honorary), 1984
Miami University, Oxford, Ohio

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Member, Board of Directors of MPS Group, Inc.
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Former Member, Board of Directors of Amex Bank.
Member, Board of Directors of The Associates prior to its sale to CitiGroup.
Member, The Bretton Woods Committee.
Member, Center for Positive Living, Sarasota, Florida.
Member, Board of Directors, and Chairman-elect, Goodwill Industries, Sarasota, Florida.
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