



Statement of John A. Courson
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for the Record of the
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
Hearing on
“Mark-to-Market Accounting: Practices and Implications”
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Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee, thank you for holding this very important hearing on the impact of fair value accounting on the current financial crisis. As you consider policy responses to this issue, the Mortgage Bankers Association¹ (MBA) believes that you should consider a number of key points outlined below.

Fair value accounting, as defined in various pronouncements and updated in Statement of Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), was never “test driven” in an inactive or illiquid market environment. MBA believes that interpretations for the use of fair value in inactive markets may have resulted in a pro-cyclical impact in the current credit market crisis. Further, the present rules in Statement of Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), require enterprises to take write-downs guised as other-than-temporary impairments (OTTI) that include factors such as the currently high liquidity risk in the market, which is cyclical and therefore not other-than-temporary. This too may be having a pro-cyclical impact. Finally, the Financial Accounting Standards Board (FASB) should reconsider its long-term objective of reporting all financial assets at fair value.

There are at least three major problems with fair value as presently practiced. The first two should be immediately addressed and the third relates to the proposed longer-term use of fair value.

OTTI Guidance Needs Immediate Change – FAS 115 requires a full fair value write-down based upon the first dollar of credit impairment that shows up.

The following example highlights the problems that this provision is causing in the current inactive markets:

Bank ABC has a private label mortgage-backed security on its books at \$5 million. The fair value based upon the most recent sale of a similar security is \$3.2 million, or a discount of \$1.8 million from current carrying value. The credit losses expected to impact the cash flows of the security are estimated to be \$200,000, and the remainder of the discount relates to a liquidity risk discount currently assigned by the market for this asset. Bank ABC does its periodic OTTI test and determines that an other-than-temporary loss exists related to the

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

\$200,000 of estimated credit losses. Under the guidance in FAS 115, the \$200,000 estimated credit losses triggers recognition of the entire fair value loss of \$1.8 million through profit and loss, even though the vast majority of that loss is due to conditions in the market, which are likely to be temporary in nature. Further, as market conditions improve, Bank ABC is precluded from reversing that write down.

MBA proposes the following principle to guide OTTI:

OTTI losses recognized should be based solely on factors affecting value that will likely have a permanent impact on the value of a financial asset or liability. This will generally include only instrument-specific credit risk for most debt securities.

Measurement of Fair Value in Inactive Markets – MBA believes that the guidance that the SEC and FASB provided in the joint press release on September 30, 2008, and that FASB provided in its subsequent FSP FAS 157-3 – *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP) – were a good starting point to guide enterprises on how management’s internal assumptions should be considered when measuring fair value when relevant observable data does not exist. However, MBA believes that the characteristics that are currently considered to determine if the market for a particular security is inactive are not adequately robust. In fixing the short-term problems in fair value accounting, FASB should provide additional guidance that expands the list of “symptoms” of an inactive market to include:

- significant widening of “bid ask” spreads;
- significant reduction from the normal number of transactions in a market;
- trades occurring primarily by sellers who are financially troubled;
- buyers that are not the traditional market participants, but rather are opportunistic players looking for a bargain; and
- non-distressed sellers sitting on the sidelines, unwilling to sell in the current market at the prices being offered.

FASB’s example in the FSP does not appear to allow a company to entirely exclude the assumed liquidity risk factor based upon recent sales in an inactive market. This appears to be having a “circular” impact. On the one hand, FASB is guiding toward use of future cash flow models in an inactive market but, on the other hand, requiring the consideration of a liquidity factor from infrequent, observable sales that may be distressed. The results of such cash flow models are similar to using the distressed sale results themselves. MBA believes that this will further the pro-cyclicality impact.

MBA recommends the following principle:

In an inactive market, liquidity discount should be ignored in calculating fair value.

Inconsistency with Typical Financial Institution Business Model – FAS 157

articulates a fair value standard that attempts to measure the price at which financial assets could be sold at the balance sheet date. This appears to provide information desired by investors. However, most banks and thrifts are not managed as trading portfolios. Rather, most assets will not be sold in the near term, but will be realized upon maturity, prepayment by the obligor, or, in some cases, future sales. Management of these companies increasingly believe that such accounting in certain cases is short-sighted and does not take into account the way management runs the business – which is a longer term view of managing the duration risks and credit risks of assets and liabilities to optimize cash flows on a longer term basis. Further, the current hybrid reporting of certain financial assets at fair value and few financial liabilities at fair value ignores the purposeful duration matching of assets and liabilities. It is for these reasons that many preparers of financial institutions complain that fair market value accounting does not present fairly the results of operations. Rather, operating results are based upon where the market lands on the last minute, of the last hour, on the last day of the reporting period. The concept of using an “exit price” as a fair value measure appears to be inconsistent with an asset that will not be sold in the near term.

MBA, however, recognizes that users of financial statements believe that fair value measures are essential for their understanding of an enterprise’s financial position. Accordingly, MBA recognizes the need for comprehensive fair value information for all financial assets and liabilities.

MBA, therefore, believes it is time for accounting policymakers to think “outside the box” to adopt a financial presentation model that will capture the business strategies related to financial asset/liability management while still providing investors with the value that they are intent on having.

MBA appreciates the opportunity to present the above principles for your consideration and we look forward to working with you as you evaluate and implement policy responses.