PREPARED REMARKS

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For

SEC ROUNDTABLE
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It is an honor to participate in the SEC's roundtable discussion on fair value accounting – called mark-to-market accounting in most quarters. I have been such a vocal critic, it might come as a surprise to learn that I gave serious thought to mark-to-market accounting when I was Chairman of the Federal Deposit Insurance Corporation in the 1980s.

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. Mark-to-market accounting had surface appeal to me, as I thought it might force banking firms to keep the maturities of their assets and liabilities in better balance.

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

First, mark-to-market 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 would make checking and savings accounts and fixed-rate

CDs on the liability side of the balance sheet more valuable. A system that captured one change in value without picking up the other would be very misleading to investors.

Second, we believed that mark-to-market accounting would make it very difficult for banks to perform their fundamental function in our economy, which is to take relatively short-term money from depositors and convert it into relatively long-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 mark-to-market 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 were more serious than the economic problems confronting us this time around – at least until very recently. The prime rate exceeded 21%, and the economy plunged into a deep recession in 1981-82, with the agricultural sector in a depression.

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 eighth 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. Indeed, we developed a contingency plan to nationalize them.

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 estimated to be held by FDIC-insured banks and thrifts. The rest were spread among investors 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 – management greed, inept regulation, rating agency incompetency, faulty monetary policy, unregulated mortgage brokers, and too much government emphasis on creating more housing stock. My interest at this time is not in assigning blame for the problems but in identifying what caused a situation that should have been resolved easily to develop into a crisis that has spread like a cancer throughout the financial system.

I believe one of the biggest culprits is mark-to-market accounting promulgated in recent years by the Financial Accounting Standards Board and accepted by the SEC (the guidance provided under SFAS 157 has been particularly devastating). These 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 on bank balance sheets 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 as possible.

This result 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 impairment 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.

I believe it is beyond dispute that mark-to-market accounting has been extremely and needlessly destructive of bank capital in the past year and is a major cause of the current credit crisis and economic downturn. The rules have destroyed hundreds of billions of dollars of capital in our financial system, causing lending capacity to be diminished by ten times that amount.

I welcome the partial relief from mark-to-market accounting that the FASB and the SEC provided in the past couple of weeks, but it is much too little, much too late. I believe the FASB and the SEC should immediately withdraw SFAS 157. Moreover, it is my fervent hope that the SEC will recommend in its report to Congress that we abandon mark-to-market accounting altogether.

Some advocates of mark-to-market 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 mark-to-market 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 is suspended, bank management, auditors, and regulators will be charged with valuing the affected assets the same way they value all the other assets on the books of banks. They will consider the cash flows on the assets, the likelihood the assets will go into default, and the probable losses in the event of default. We will improve our valuations and disclosures, not obscure them.

C. Alternatives. I believe proponents of mark-to-market accounting have their hearts in the right place but have not thought through the issues completely and do not understand how banks operate and are regulated. Moreover, during the past year they have been in a state of denial about the utter disaster the rules have created.

As noted at the outset, the concept of mark-to-market accounting is very seductive. I believe very firmly that, over a reasonable time interval, markets are the best arbiter of values. But we frequently experience sustained periods when markets are out of kilter and do not fairly reflect the value of companies or particular assets. Moreover, mark-to-market accounting does not even purport to value the entirety of a bank's balance sheet.

Is there a way to have our cake and eat it too? Can we have a system that reflects market pricing while not eradicating earnings and masses of capital when the markets swing in one direction or another or 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 decades before we decided to experiment with mark-to-market accounting. Under historical-cost accounting, marketable assets are carried on the books of banks at

their amortized cost, and the balance sheet contains footnoted 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. This 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 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 named by the FASB's trustees through a selection process that is shrouded in mystery. The SEC has authority to overrule the FASB for public companies, but almost never does. 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. We are about 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 am not anti-accountant. Some of my best friends are from the profession. I believe we have put too much pressure on accountants by subjecting them to huge liabilities when banks and other companies fail due to market conditions and faulty business strategies. I was part of that unhealthy process when, as Chairman of the FDIC, I authorized very substantial suits against accounting firms in the wake of bank failures.

One important consequence of subjecting accountants to enormous potential liabilities is that the profession reacted by moving toward very rigid rules that leave little room for judgment and wisdom. If a rule requires that an asset be arbitrarily marked to a market or index value shown on a computer screen, there is no need for judgment and no basis to second guess the auditor in a court room. I believe we need to consider insulating auditors from liability when they are using reasonable business judgment in the process of certifying financial statements.

I also believe we urgently need to change our system of setting accounting standards to make it more accountable. I suspect others will have better ideas than I on how best to accomplish this. At a minimum, I recommend that accounting principles affecting our financial system be approved by both the Federal Reserve Board and the FDIC, which are the two agencies charged with maintaining stability and picking up the pieces when a crisis hits. I also recommend that we not cede U.S. authority over accounting standards to an international board.

Before closing, I want to bring up a subject that is not under the heading of mark-to-market accounting but is related. The SEC made what I consider a huge mistake in 1999 when it took an enforcement action against SunTrust Bank for creating excess loan

loss reserves and thereby manipulating its earnings. I believe 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 cause banks to hesitate in the creation of 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 showing higher earnings and paying out the resulting capital in dividends and stock repurchases or further leveraging their balance sheets.

The SEC's action against SunTrust is an example of the quest for theoretical accounting purity overriding safety and soundness considerations and good business judgment.

I thank you for giving me this opportunity to be heard on these very important issues. One of the things I love most about our country is our willingness to listen to dissenting views and to change what is not working.