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**TESTIMONY OF**  
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**OFFICE OF THE COMPTROLLER OF THE CURRENCY**

**before the**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND  
GOVERNMENT SPONSORED ENTERPRISES**

**of the**

**COMMITTEE ON FINANCIAL SERVICES**

**of the**

**UNITED STATES HOUSE OF REPRESENTATIVES**

**MARCH 12, 2009**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

## **I. Introduction**

Chairman Kanjorski, Congressman Garrett, and members of the Subcommittee, my name is Kevin Bailey, and I am the Deputy Comptroller for Regulatory Policy at the Office of the Comptroller of the Currency (OCC). I appreciate the opportunity to discuss the use of mark-to-market accounting in the current environment, and the implications that has on regulatory capital requirements and bank supervision. I applaud your timely focus on this important issue.

In my testimony today, I will provide relevant background on the accounting requirements under U.S. generally accepted accounting principles (GAAP) for financial instruments that are marked-to-market, the regulatory capital requirements established by the federal banking agencies in this area, and the practical challenges faced by banks and supervisors in the implementation of these requirements.

The unprecedented disruption in world-wide financial markets over the past eighteen months has fostered considerable debate on the costs and benefits of fair value measurement, including the appropriate use of fair value in financial reporting, bank regulatory capital, and macro-prudential assessments, such as pro-cyclicality and the effects on the real economy. The OCC believes that this debate has identified a number of legitimate issues regarding the current application of fair value accounting, and we are actively working with the Securities and Exchange Commission (SEC), accounting standard setters, the Basel Committee on Banking Supervision, the Financial Stability Forum, and other interested parties to address these challenging questions. In order to advance those discussions in an open and expeditious manner, I describe below the fundamental principles underlying the OCC position in these discussions:

- Fair value measurement provides critical information on the value of financial instruments to investors, supervisors, and other users of financial statements. For many types of financial instruments, especially trading assets, fair value represents the best estimate of value as of the measurement date. While additional steps can and should be taken to enhance existing standards, the OCC believes that it is inappropriate to suspend current fair value measurement. In

view of the concerns identified, however, additional analysis is needed before consideration is given to expanding fair value measurement to other financial instruments.

- Additional measures should be taken to improve the application of existing fair value requirements. We support current efforts of the SEC, standard setters, the Basel Committee, and other groups to enhance current practices, especially as it relates to the application of fair value measurement in illiquid markets and the treatment of assets whose value is impaired on a more permanent basis.
- In assessing the application of GAAP-based requirements in regulatory capital, the banking agencies should continue to consider the critical need for risk sensitivity in regulatory capital while seeking to limit volatility that is temporary in nature from resulting capital requirements. In that process, the agencies should continue to evaluate relevant supervisory, financial reporting, and macro-prudential considerations.

## **II. Background on Fair Value Accounting**

Mark-to-market or fair value accounting has been an essential element of accounting standards in the United States and elsewhere, for decades. For assets and liabilities subject to fair value requirements, firms must report the fair value of the positions they hold on their balance sheet and the periodic changes in their fair value on either the income statement or in a separate component of equity. For U.S. firms, GAAP, administered by the Financial Accounting Standards Board (FASB), determines the extent to which assets and liabilities are measured at fair value and the extent to which these changes in fair value are recognized in earnings. In this determination, FASB and international standard setters employ the so-called “mixed attributes” model, in which different valuation criteria are applied to different types of assets and liabilities depending on their characteristics and on how the firm intends to use the financial instrument. In addition, accounting standard setters have established other valuation requirements for financial instruments that are not required to reflect periodic changes in fair value in income, requiring that such financial instruments be assessed for impairment. Each of these valuation concepts are described more fully below.

### Valuation of Financial Instruments

Under the mixed attributes model, certain financial instruments are subject to fair value measurement on a mandatory basis, while other instruments are assessed using historical cost-based and impairment valuation concepts. Stated generally, the current accounting framework requires fair value measurement for financial instruments held for trading purposes, available-for-sale (AFS) assets, and all derivatives. Financial instruments that the firm determines will be held-to-maturity (HTM), most loans, and liabilities are not fair valued and are measured at amortized cost, with loans held-for-sale valued at the lower of cost or fair value. Accounting standard setters also provide firms the option to measure and report at fair value certain financial assets and liabilities that would otherwise be valued and reported at amortized cost (fair value option). As of December 31, 2008, approximately 25 percent of national banks' assets were accounted for or subject to fair value measurement.<sup>1</sup> The vast majority of these assets are either assets in banks' trading portfolios (and thus largely confined to the largest banking institutions that have active trading operations) or AFS assets.

The above paragraph provides a description of how firms reflect the value of financial instruments on their balance sheet. Equally important is how periodic changes in fair values are reported in a firm's income statement. As will be discussed later, this reporting is a key factor in determining bank regulatory capital requirements. For financial instruments carried at fair value, the period-to-period unrealized changes in fair value are either recognized through income, or are reflected in the equity section of the balance sheet in accumulated other-comprehensive-income (OCI). With respect to the national bank data noted above, approximately 12 percent of national banks' assets (primary trading assets) are accounted for at fair value with changes reflected in earnings. For the remaining 13 percent of the assets, primarily securities held as AFS, changes in fair value are reflected in OCI, unless the firm determines that the instrument has "other-

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<sup>1</sup> As reported in the bank regulatory financial reports (call reports). Banks are required to prepare call reports in accordance with US GAAP.

than-temporary” impairment (OTTI). A more detailed description of the GAAP framework is provided below.

Financial Accounting Standard No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (FAS 115), is the principal standard in accounting for debt and equity securities and was issued in 1993. There are three potential investment categories outlined in FAS 115: HTM, trading, and AFS. HTM debt securities are measured at amortized cost on the balance sheet when the bank has the positive intent and ability to hold those debt securities to maturity. Trading securities are bought and held principally for the purpose of selling in the near term and are measured at fair value with changes in fair value recorded in current period earnings. AFS securities are investments not classified as trading or as HTM and are recorded at fair value with changes in fair value flowing through OCI. Equity securities are classified as trading or AFS. As discussed more fully below, decreases in the value of AFS and HTM securities can be recognized through earnings if the firm deems such securities to be impaired on an other-than-temporary basis.

Financial Accounting Standard No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (FAS 159), issued in February 2007, allows banks to report designated financial assets and liabilities at fair value with the changes in fair value included in earnings. In general, a bank may elect the fair value option for an eligible financial asset or liability when it first recognizes the financial instrument on its balance sheet. A bank’s decision to elect the fair value option for an eligible item is irrevocable.

The accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities are set forth in Financial Accounting Standard No. 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended (FAS 133), which was issued in 1998. FAS 133 requires all derivatives to be recognized on the balance sheet as either assets or liabilities at their fair value.

As previously noted, most loans that banks hold on their balance sheets are recorded at amortized cost, with changes in their fair value generally not recognized in income. Loans that a bank holds for sale, such as those related to pending securitization activities, are measured at the lower of cost or fair value. Decreases in the fair value of loans held-for-sale below their cost are recognized in income.

#### Definition of Fair Value

FASB Statement No. 157, “Fair Value Measurements” (FAS 157), issued in September 2006, defines fair value, establishes a framework for measuring the fair value of assets and liabilities based on a three-level input measurement hierarchy, and requires disclosures about fair value measurements. Prior to this guidance, fair value was defined in multiple standards.

Under FAS 157, fair value is defined as “the price that would be received to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date.”<sup>2</sup> That standard also articulates a hierarchy of input preferences for the measurement of fair value. The highest priority, or Level 1, is given to quoted prices in active markets for identical assets or liabilities, such as widely traded investment securities. Level 2 inputs to valuation are those based on quoted prices other than those included within Level 1 that are observable for the asset or liability, either directly or indirectly. Finally, if Level 1 and Level 2 inputs are unavailable, then Level 3 inputs are used. Level 3 inputs are unobservable inputs for the asset or liability that reflect the firm’s own assumptions regarding valuation. As defined, therefore, application of fair value measurement does not require the presence of liquid markets. The fair value of financial instruments can be estimated when a market for that instrument does not exist, either through the use of valuation models developed by the firm or through independent brokers, such as consensus pricing services. Based on information from a recent study on mark-to-market accounting, the SEC has provided information on the current

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<sup>2</sup> FAS No. 157, paragraph 5.

classification of assets in the fair value hierarchy.<sup>3</sup> As it relates to the banks included in the study, 82 percent of assets measured at fair value were measured using Level 2 inputs, followed by 11 percent using Level 1, and 7 percent using Level 3.

### Impairment

Even if a financial asset is not subject to fair value measurement, fair value concepts may become relevant if the asset is considered to be impaired. Under GAAP, there are multiple sets of impairment rules for financial instruments, depending on the characteristics, form, and intended use of the asset. For example, for most loans, impairment is based on bank management's estimate of incurred credit losses and is accounted for in the allowance for loan and lease losses. For AFS debt and equity securities and HTM debt securities, impairment occurs when the fair value of a security is less than its (amortized) cost basis. If impairment is judged to be OTTI, the individual security is written down to fair value and the amount of the write-down reduces current earnings.

There are no bright lines in discerning whether a decline in the value of a financial instrument is other than temporary. Rather, this is a judgmental determination of the individual firm considering various factors, including:

- The length of time and the extent to which the fair value has been less than its carrying amount;
- The financial condition and near-term prospects of the issuer; and
- The intent and ability of the firm to retain its investment in the issuer for a period of time sufficient to allow for an anticipated recovery in fair value.

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<sup>3</sup> *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting*, United States Securities and Exchange Commission (SEC Fair Value Study).

### **III. Background on Capital**

An important intersection between fair value accounting and prudential regulation and supervision occurs in the realm of bank regulatory capital requirements. However, before turning to the interaction between fair value accounting and regulatory capital, it is useful to provide a short, high-level description of the regulatory capital framework.

For over two decades, U.S. banks have been subject to risk-based capital requirements. These requirements, which are based on the international framework established by the Basel Committee on Banking Supervision (Basel I Framework), define regulatory Tier 1 and total capital, and specify how bank assets are to be risk-weighted under this regime. Tier 1 capital is defined to include common stock and retained earnings, as well as certain perpetual preferred stock. Total capital includes all capital elements included in Tier 1 and also includes instruments that are junior to depositors but not as equity-like, such as subordinated debt.

Under the Basel I Framework, each balance sheet asset generally is assigned to one of a handful of risk-weight buckets. Assets such as cash and U.S. Treasuries require no risk-based capital, while commercial loans and most consumer loans, which comprise the largest portion of most banks' assets, are assigned a capital charge of 8 percent. In other words, corporate loans must have \$8 of capital set aside for every \$100 in loan amount. The risk-based capital standards also take into account derivatives and other off-balance sheet exposures such as loan commitments and letters of credit. Banks must hold capital against these off-balance sheet items based on various risk factors, including for example, counterparty credit risk and the length of the commitment.

The OCC's risk-based capital rules require banks to have a minimum of \$4 of Tier 1 capital and \$8 of total capital for every \$100 of risk-weighted assets. It is important to note, however, that these are minimum levels, and banks are expected to hold capital above that level, commensurate with the level and nature of all of their risks.



In 2007, the federal banking agencies adopted the Basel II advanced approaches framework (Basel II Framework) which certain large, internationally active banks are expected to begin using no later than April 1, 2011. The Basel II Framework is designed to be significantly more risk sensitive than the risk-bucket approach used in the Basel I Framework. For example, under the Basel II Framework, rather than assigning all corporate loans the same risk weight, the risk weight will vary based on a bank's internal assessment and knowledge of the borrower and the nature of collateral provided.

In addition to these risk-based capital requirements, banks are also required to meet a leverage ratio requirement. The leverage ratio serves as a complementary and relatively simple measure of capital adequacy. The leverage capital requirement is calculated as Tier 1 capital, as described earlier, divided by adjusted total assets, which generally approximate total assets reported under GAAP. Banks are required to maintain a leverage ratio of at least 4 percent – or 3 percent if they are considered to be operating in a very low risk manner.

Regulatory capital rules are a cornerstone of our supervisory regime, incorporated directly into various rules, such as those used to determine the amount banks can lend to one borrower, invest for community development purposes, and lend to an affiliate. In addition, the Prompt Corrective Action regime imposes increasingly severe supervisory limitations when bank capital ratios falls below specified levels, such as restrictions on asset growth, expansionary proposals, and dividends issuance.

#### **IV. Interplay Between Fair Value Accounting and Capital**

While the federal banking agencies use GAAP as a starting point in determining inputs to the regulatory capital rules, there are many important deviations that arise from the different goals of financial reporting and prudential regulatory capital requirements. As noted above, for example, the risk-based ratios include not only GAAP-based balance sheet assets, but also measures for counterparty credit risk for derivative contracts and risks related to off-balance sheet exposures in the form of letters of credit and loan commitments. Additionally, while recognized as an asset under GAAP, goodwill is

deducted from banks' calculations of Tier 1 and total capital due to its difficulty in being realized separate and apart from the rest of the bank's assets and ongoing operations. Below, I describe how the regulatory capital rules align with, and deviate from, the accounting rules as they relate to fair valued assets. Broadly speaking, all of the regulatory capital regimes – Basel I risk-based, Basel II risk-based, and the leverage ratio – deal with fair-valued assets similarly. Therefore, the discussion below will not distinguish between these frameworks, but speak of them in a more comprehensive manner.

In general, regulatory capital requirements include any changes in fair value of exposures where those unrealized gains or losses flow through earnings.<sup>4</sup> In other words, unrealized gains and losses in the fair values of exposures such as trading book exposures and exposures that are measured using the fair value option (FAS 159) are generally included in regulatory capital calculations. Because many of these assets are held with the intent to trade or sell them over a relatively short time horizon —at which time changes in their value will be realized as a gain or loss —using their fair values in regulatory capital calculations is an appropriate reflection of their effect on a bank's current financial and economic position.

In contrast, changes in unrealized fair value gains and losses that do not flow through to earnings are generally not included in regulatory capital calculations. For such fair valued instruments, the unrealized gains and losses flow through OCI, rather than through earnings. This treatment neutralizes the effect of unrealized fair value gains and losses in AFS debt securities for purposes of evaluating regulatory capital adequacy. The basis for this treatment is that these unrealized gains and losses are more temporary in nature, since the bank is not holding the securities for short-term trading purposes. This treatment avoids introducing excessive volatility into regulatory capital measures for

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<sup>4</sup> One exception to the inclusion in regulatory capital of unrealized gains and losses that flow through earnings relates to a bank's own liabilities. The banking agencies expect banks to neutralize or reverse from regulatory capital any unrealized fair value gains and losses on their liabilities that are attributable to changes in the bank's own creditworthiness. Adjusting regulatory capital in this manner keeps a bank from recognizing any benefit in its capital position resulting from its own credit deterioration.

changes in market values that might prove to be short lived. Without this treatment, temporary changes in a security's market value due to movements in interest rates could result in regulatory capital changes that would affect its capacity to lend and could trigger more permanent regulatory sanctions, including Prompt Corrective Action restrictions and penalties.

Certain other fair-valued exposures such as pension assets and liabilities are treated similarly to AFS debt securities, with unrealized gains and losses flowing through OCI. A different approach is used for AFS equity securities where unrealized losses, but not unrealized gains, are included in Tier 1 capital. The unrealized gains are allowed to be included in total capital, but only after a significant hair cut or discount. This more conservative approach for AFS equity securities reflects the fact that, unlike AFS debt securities, AFS equity securities have no maturity date, and unrealized losses on AFS equity securities may not necessarily be recouped when equity securities are sold and unrealized gains may be temporary.

While the regulatory capital rules neutralize the effect of *temporary* fluctuations in AFS debt securities and pension accounts, the rules do incorporate more *permanent* decreases in value. This is accomplished through the recognition of impairment in value of financial instruments that are deemed OTTI. As noted earlier, write-downs for OTTI are taken through earnings, and these write-downs also flow through to regulatory capital for both AFS securities and for held-to-maturity securities. Table 1 summarizes the interplay between accounting and regulatory capital for certain financial instruments. In summary, bank regulatory capital rules use GAAP as a starting point for assessing capital adequacy and, generally, fair value changes that are recognized in a bank's income statement are incorporated in a bank's regulatory capital levels.

**Table 1**  
**Accounting and Capital Treatment for Bank Assets**

<b>Asset Type</b>	<b>Balance Sheet Valuation Criteria</b>	<b>Effect of Changes in Fair Value in Financial Reporting under GAAP</b>	<b>Effect of Changes in Fair Value on Tier 1 Regulatory Capital</b>
<b>Equity Investments</b>			
Trading	Fair Value	Changes recognized in earnings.	Changes recognized in capital through earnings.
Available for Sale	Fair Value	Changes reflected in OCI. No affect on earnings until sold or OTTI.	Unrealized losses recognized in capital; unrealized gains excluded until sold.
<b>Debt Investments</b>			
Trading	Fair Value	Changes recognized in earnings.	Changes recognized in capital through earnings.
Available for Sale	Fair Value	Changes reflected in OCI. No effect on earnings until sold or OTTI.	Changes not recognized until sold or OTTI.
Held to Maturity	Amortized Cost	Changes in fair value not recognized unless OTTI.	Changes not recognized unless OTTI.
<b>Direct Investment in Loans</b>			
Held for Sale	Lower-of-cost-or-fair value	Declines below cost recognized in earnings.	Declines below cost recognized in capital.
Held for Investment	Amortized Cost	Changes in fair value are not reflected. Impairment is recognized through earnings based on incurred credit losses.	Changes in fair value are not reflected. Impairment is recognized in capital through earnings based on incurred credit losses.

## V. Challenges Faced by Bank and Supervisors

The unprecedented disruption that we have seen in the financial markets over the past eighteen months have fostered considerable debate on the costs and benefits of fair value measurement, including the appropriate use of fair value in financial reporting, bank regulatory capital, and macro-prudential assessments, such as pro-cyclicality.<sup>5</sup> The OCC believes that this debate has identified a number of legitimate issues about the current application of fair value and we are actively working with the SEC, accounting standard setters, the Basel Committee, the Financial Stability Forum, and other interested parties to address these challenging questions. As I noted previously, the fundamental principles underlying the OCC position in these discussions are:

- Fair value measurement provides critical information on the value of financial instruments to investors, supervisors and other users of financial statements. For

<sup>5</sup> See, e.g., *The Global Financial Stability Report*, International Monetary Fund, Chapter 3 (October 2008)

many types of financial instruments, especially trading assets, fair value represents the best estimate of value as of the measurement date. While additional steps can and should be taken to enhance existing standards, the OCC believes that it is inappropriate to suspend current fair value measurement. In view of the concerns identified, however, additional analysis is needed before consideration is given to expanding fair value measurement to other financial instruments.

- Additional measures should be taken to improve the application of existing fair value requirements. We support current efforts of the SEC, standard setters, the Basel Committee and other groups to enhance current practices, especially as it relates to the application of fair value measurement in illiquid markets and the treatment of impairment for OTTI assets.
- In assessing the application of GAAP-based requirements in regulatory capital, the banking agencies should continue to consider the critical need for risk sensitivity in regulatory capital while seeking to limit volatility that is temporary in nature from resulting capital requirements. In that process, the agencies should continue to evaluate relevant supervisory, financial reporting, and macro-prudential considerations.

In the sections below, I discuss the application of these broad principles in the context of the most significant fair valuation implementation issues faced by banks and bank supervisors – the treatment of financial instruments deemed to be OTTI and the valuation of financial instruments for reporting and capital purposes. For OTTI, the issue is when and whether, in the current constrained markets, a decline in the value of a debt security should be considered other-than-temporary. With regard to valuation, a critical issue has been the appropriateness and methods by which banks ascertain the fair value of an asset when the markets for such assets are highly illiquid or non-existent.

## OTTI

As noted earlier, under GAAP, a security is considered impaired when its fair value is less than its carrying value. If a bank determines that the impairment is other-than-temporary, the individual security is deemed OTTI and its carrying value on the balance sheet is written down to its fair value, with the amount of the write-down reducing current earnings. The OTTI decision for a given asset is a judgmental decision of the bank, considering various factors related to the depth and duration of the decrease in the value of the asset. Because OTTI reflects a more permanent decrease in the value of the security, the OTTI write-down is reflected in regulatory capital.

We believe that the treatment of OTTI in our current capital rules has struck an appropriate balance between risk sensitivity and the concern over excessive capital volatility. While introducing some additional volatility, recognizing the change in value of the OTTI asset serves to better reflect the current risk profile of the institution in regulatory capital. Such early recognition of troubled assets within the capital regime can spur action by bank management and advances critical supervisory objectives, especially the agencies' Prompt Corrective Action regulations.

In light of that current treatment, the OCC believes that standard setters should continue consideration of enhancements to OTTI requirements that could improve both financial reporting and regulatory capital. One such possible enhancement was identified in the recommendations in the SEC's Fair Value Study. Under the proposed enhancement, the OTTI model could be revised to recognize in income only that portion of OTTI related to credit losses. The remaining decline in fair value, the non-credit loss portion (such as a liquidity discount) would be recognized in OCI. Such a change would reduce volatility, while still reflecting credit-related losses in earnings and regulatory capital. In the Fair Value Study report, the SEC indicated that "this model has the potential to provide investors with both fair value information as well as transparent information regarding the cash flows management expects to receive by holding investments, rather than through accessing the market currently. 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.”<sup>6</sup> While there are operational challenges with delineating credit from non-credit impairment for a given financial instrument, the OCC believes that this is an idea worth pursuing.

### Valuation

As noted above, GAAP establishes a hierarchy of input preferences for the measurement of fair value. While the clear preference is for quoted prices in active markets for identical assets or liabilities, the existence of such active, liquid markets is not required for the application of fair value measurement, and, more importantly, such markets are currently not the norm. As noted previously, the SEC’s Fair Value Study, indicates that 82 percent of the assets measured at fair value in banks were measured using Level 2 inputs. The study also indicated that for many Level 2 assets, it appeared that banks generally used an alternative pricing method that did not rely on observable quoted prices for a given asset, but rather, used quoted prices for similar assets or a combination of Level 2 inputs. In this environment, price discovery is particularly difficult for complex financial instruments, due to the complexity of the payoff structures, and the links between valuations and the underlying risk factors. Even the most sophisticated institutions are challenged in this environment to determine fair values, as evidenced by the increasing volume of Level 3 exposures.

Community and mid-sized banking institutions face a similar problem, albeit one which affects debt securities in AFS and HTM accounts, and which can have a greater proportional impact on their regulatory capital. Lacking the resources of the larger firms, community banks face a difficult challenge in determining the fair value of their AFS and HTM securities, as their investment portfolios have become more complex over time. In particular, valuations for various private mortgage-backed securities and other forms of structured mortgage and corporate debt have proven to be very difficult to value in the current market environment.

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<sup>6</sup> SEC Fair Value Study, page 205.

The OCC has actively participated in supervisory and policy initiatives to enhance valuation practices within financial institutions. These efforts were designed to identify effective and ineffective valuation practices for complex or illiquid financial instruments and to emphasize the critical importance of robust risk management and control processes around the measurement of fair values and their reliability. I want to emphasize three such initiatives as particularly relevant: (i) the Senior Supervisors Group<sup>7</sup> report *Observations on Risk Management Practices during the Recent Market Turbulence*, March 6, 2008 (SSG Report); (ii) the Basel Committee report *Fair value measurement and modeling: An assessment of challenges and lessons learned from the market stress*, June 2008 (June BCBS Report); and (iii) the Basel Committee consultative document *Supervisory guidance for assessing financial instrument fair value practices*, November 2008 (November BCBS Report).

These initiatives put forward a number of important observations and supervisory expectations relevant to the issues before this Subcommittee:

- “The Supervisors’ assessments of valuation practices have stressed the importance of consistent application of independent and rigorous valuation practices across the firm. At firms that performed better in late 2007, management had established, before the turmoil began, rigorous internal processes requiring critical judgment and discipline in the valuation of holdings of complex or potentially illiquid securities. When these firms reached decisions on values, they sought to use those values consistently across the firm, including for their own and their counterparties’ positions.” SSG Report, page 3
- “[F]irms that faced more significant challenges in late 2007 generally had not established or made rigorous use of internal processes to challenge valuations. They continued to price the super-senior tranches of [collateralized debt obligations] at or close to par despite observable deterioration in the performance

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<sup>7</sup> The Senior Supervisors Group is a group of supervisors organized at the request of the Financial Stability Forum to evaluate the effectiveness of current risk management in financial institutions. The seven supervisory agencies included within the Group are: the Office of the Comptroller of the Currency, the U.S. Securities and Exchange Commission, the Federal Reserve Board, the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, and the U.K. Financial Services Authority.



- of the underlying [residential] MBS collateral and declining market liquidity. Management did not exercise sufficient discipline over the valuation process: those firms generally lacked relevant internal valuation models and sometimes relied too passively on external views of credit risk from rating agencies and pricing services to determine values for their exposures.” SSG Report, page 3.
- “[T]he market turmoil highlighted the difficulties in estimating fair values due to the lack of liquidity in the markets, the complexity of some financial instruments, and the shift by some banks to more model-based methodologies which increased the use of unobservable inputs. . . The absence of a price from a liquid and actively traded market means that the valuation must rely on models or proxy-pricing methodologies as well as on expert judgment. The outputs of such models and processes are highly sensitive to the inputs and assumptions adopted, as well as being subject to estimation error and uncertainty. Moreover, calibration of the valuation methodologies is often complicated by the lack of readily available benchmarks. Finally, the liquidity of the markets varies over time, introducing further variability to the estimation of the fair values for financial instruments.” June BCBS Report, page 3.
  - “The relevance and reliability of valuations are directly related to the quality and reliability of the inputs. A bank is expected to consider all relevant market information and other factors likely to have a material effect on an instrument's fair value when selecting the appropriate inputs to use in the valuation process. It should maximize the use of relevant observable inputs and minimize the use of unobservable inputs when estimating fair value using a valuation technique. However, observable inputs or transactions may not be relevant, such as in a forced liquidation or distressed sale, or transactions may not be observable, such as when markets are inactive. In such cases, the observable data should be considered, but may not be determinative.” November BCBS Report, page 6.

## **VI. Conclusion**

In conclusion, the valuation of financial instruments in the illiquid markets so prevalent today, especially as it relates to complex financial instruments, is exceedingly difficult. It

is, therefore, incumbent on supervisors and standard setters to continue efforts to enhance current practices through additional guidance and consultation with representatives of the industry, investors and other interested persons. As part of that process, we will continue to assess the challenges and benefits of fair value measurement as we consider its use in financial reporting, risk management and regulatory capital.