Statement of

Kevin J. Bailey

Deputy Comptroller of the Currency

Office of the Comptroller of the Currency

Before the

Subcommittee on Capital Markets, Insurance, and

Government Sponsored Enterprises

Of the

Committee on Financial Services

United States House of Representatives

March 12, 2009

Chairman Kanjorski, ranking member Garrett, and members of the subcommittee, thank you for the opportunity to be here today to discuss fair value accounting and the practical challenges faced by banks and bank supervisors in the implementation of those standards.

The unprecedented disruption in world-wide financial markets that we have seen over the past eighteen months has raised a number of issues about mark-to-market, or fair-value accounting, including the very important question of how, or even whether, fair value concepts should be used in financial reporting and bank regulatory capital. Implementation of these standards in the context of the current crisis has also caused many to question the extent to which fair value measurement has contributed to pro-cyclicality in the broader economy.

As the primary supervisor for national banks, which hold nearly 70 percent of the nation's banking assets, the OCC has a significant interest in the impact of fair value accounting, especially its effect on capital – a key measure of a bank's health and ability to provide credit. The OCC and the other Federal banking agencies use current accounting standards as the starting point in determining inputs in regulatory capital rules, but make an independent assessment of bank risk exposures and activities in determining standards of capital adequacy.

There are two critical elements in the development of our capital adequacy standards that I wish to highlight today.

First, our capital adequacy requirements must provide an accurate and timely assessment of a bank's individual risk profile, reflecting a consideration of all material risks. Since these regulatory capital rules are the basis for much of our supervisory program, including limits on loans to one borrower and the Prompt Corrective Action early intervention program, a timely and accurate capital regime is critical.

Second, it is also important to limit excessive and unnecessary volatility in capital that could disrupt credit markets and prevent banks from effectively serving their customers.

The banking agencies have worked diligently to balance these important objectives as they relate to fair value measurement. Stated generally, and except for assets that a bank intends to trade in the short term, current risk-based capital rules neutralize the effect of temporary fluctuations in the value of financial instruments, and incorporate more permanent decreases in value in regulatory capital ratios.

We believe that this approach to fair value measurement strikes the right balance between the need for banks to recognize more permanent changes in the value of their assets in capital, while not subjecting banks to wild swings in measured capital levels. With that said, we do believe that enhancements to fair value measurement can help address a number of legitimate issues that have been raised during the current crisis.

The question in front of us is not whether banks should or should not be subject to fair value accounting. Instead, the real question is, what steps can be taken to address the issues revealed by the current crisis so as to improve the application of existing requirements and enhance current practices.

Let me identify two areas for possible enhancement. The first issue relates to the narrow question of how to evaluate assets which banks determined to be impaired on a more permanent basis. To use accounting terms, these are known as assets that are "other-than-temporarily" impaired or OTTI.

For most banks, and especially community banks, OTTI is the main issue as it relates to fair value measurement. If a bank determines that impairment of one its assets is other than temporary, the value of the asset on its balance sheet is written down to fair value, with the amount of the write-down reducing current earnings and, therefore, regulatory capital. Many commenters have described the dramatic effect such actions can have on banks and other firms and have raised legitimate questions about the appropriateness of the current application of fair value principles in this area.

As I describe in more detail in my written statement, alternative OTTI models are currently being discussed to address this issue. We believe that enhancements such as these warrant active consideration by standard setters and we are prepared to assist in that process in any way we can.

The second issue relates to the broader question of how to value financial instruments for which there is no active, liquid market. There is a clear need for additional guidance to address the numerous definitional and implementation questions that have surfaced in recent months. Such guidance would facilitate improvements in the relevance and reliability of valuations and benefit financial reporting, regulatory capital and risk management.

Mr. Chairman, as you noted in statements prior to this hearing, fair minded, incremental and achievable fixes to the issues with fair value accounting identified in recent months are needed. This hearing is an important step in that direction and I look forward to answering your questions.