

**Statement of John von Seggern,  
President and CEO, Council of Federal Home Loan Banks  
Subcommittee on Capital Markets, Insurance, and  
Government Sponsored Enterprises,  
House Financial Services Committee**

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Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee, I am John von Seggern, the President and CEO of the Council of Federal Home Loan Banks, a trade association whose members include all 12 Federal Home Loan Banks (FHLBanks). On behalf of the Council I want to thank you for giving me the opportunity to submit a statement for the record.

The primary purpose of the FHLBanks is to provide their more than 8,000 member financial institutions with a reliable and steady source of funding for the extension of vital housing, community and economic development credit and financial services to their communities. The FHLBanks collectively also serve as the largest supplier of affordable housing grant funds in the United States by providing 10 percent of their net income for this purpose.

As cooperatives, the FHLBanks seek to maintain a balance between their public policy mission and their obligation to provide adequate returns on the capital supplied by members. The FHLBanks achieve this balance by delivering low cost financing, and providing members a viable alternative to the secondary mortgage market via the mortgage loan programs, while paying a dividend when appropriate. Without FHLBanks, most community depository institutions (a bank or company which holds funds or securities deposited by others, and where exchanges of these securities take place) would not have access to medium-and long-term sources of funding.

We appreciate your holding this hearing on an issue that is of major significance to the FHLBanks as well as many other financial institutions and companies. While the matter of U.S. GAAP principles for Fair Value Accounting (FVA) and other-than-temporary-impairment (OTTI) may appear to be of interest only to those in the accounting profession, let me assure you that the subject matter of this hearing has a direct impact on communities throughout the country by affecting the capacity of financial institutions to provide necessary credit and services.

Fair Value Accounting principles are designed with the intention of providing investors and users of financial statements with current information about the financial condition and value of a company's assets. Generally FVA does provide accurate and transparent information, however the current market conditions have exposed flaws in certain principles within FVA. Current interpretation and application of OTTI rules can distort the true condition of certain assets, particularly private label mortgage backed securities (MBS), held by financial institutions and other companies. As a result, while current accounting for OTTI should only provide accurate and transparent financial information, it has become a market factor and has distorted the real value of certain assets.

### **What is OTTI and when is it applied?**

U.S. GAAP's FAS 115 "Accounting for Certain Investments in Debt and Equity Securities" requires that individual investment securities classified as available-for-sale or held-to-maturity be evaluated to determine whether a decline in fair value below a security's carrying value is other-than-temporary. If the company determines that it does not expect to collect all of its scheduled contractual cash flows, the company must mark the investment security down from its carrying value to its current fair value, even if the company intends to hold the investment security to maturity.

U.S. GAAP does not provide "bright lines" or "safe harbors" in making judgments about OTTI. The impairment must be evaluated based on specific factors including the nature and

extent of the probable decrease in fair value of the asset below cost to determine if the impairment is other-than-temporary. And, if an other-than-temporary-impairment is determined the amount of the write-down is the difference between the carrying value and the fair value of the investment. The investment security's fair value becomes its new cost basis, and a realized loss is recognized, which results in an immediate adverse impact on retained earnings, thereby reducing the company's capital.

While the criteria for recognizing if other-than-temporary-impairments exists for both loans and mortgage backed securities are nearly identical, the manner in which fair value is then determined for OTTI is very different. OTTI is recognized for loans by requiring a write down to fair value based on the expected probable economic losses of the assets. In the case of MBS once OTTI is recognized fair value must be determined based on current market valuations with the determined fair value becoming the new cost basis of the asset, any subsequent recoveries in fair value are not recognized.

### **Current OTTI rules and application are flawed.**

Generally FVA provides accurate and transparent financial information. However, when financial markets become illiquid and non-functioning, inherent fair value and market price begin to diverge. The unique current market dislocations have exposed a flaw in the U.S. GAAP Fair Value Accounting for OTTI, particularly regarding held-to-maturity investment assets.

Current interpretation and application of U.S. GAAP rules applicable to OTTI can present a distorted financial picture despite its goal of increased transparency. Although managerial judgment is permitted in determining fair value when there are illiquid or non-functioning markets, outside auditors and regulators generally have taken a more conservative view requiring market-based mark to market valuation for held-to-maturity (HTM) assets. Without a functioning market, "real" market value cannot be determined in many cases, which results in accounting mandated asset write downs far in excess of the probable economic impairments.

Fair Value Accounting, as currently defined under U.S. GAAP and interpreted by the accounting firms, is based on an "exit price" from a market participant's point of view. This concept presumes the existence of a referenceable market to provide price discovery. However, the private label MBS market currently lacks trading volume, observable inputs, reasonable bid/ask spreads, or willing sellers to support the valuation of these securities. This results in companies recording write-downs disproportionately greater than the probable credit or economic losses.

Under U.S. GAAP, the entire reduction in fair market value is recognized in the income statement, both the write-downs attributable to credit or economic loss and liquidity. Finally, this OTTI-derived loss is charged against earnings with no ability to recoup any future increase in fair value. Some of the consequences of these flawed rules are that mortgage markets become more unstable, credit availability is further contracted, and affected companies' capital is further depleted increasing the risk of institution failures.

The 2008 earnings of the FHLBanks provide an example. As reported recently by the Office of Finance, of the 11 FHLBanks reporting there was a cumulative recognition of \$166 million in estimated probable economic losses which resulted in an OTTI write down to fair value of approximately \$1.8 billion. The write downs were 10 times the estimated economic losses.

### **Accounting rules are helping to drive down the market for private label MBS.**

The current economic trend has shown that there is a highly illiquid market for private label MBS, few investors are willing to make a bid for these assets and virtually no holders of these securities are willing to accept the bids that may be proffered. Further exacerbating the current mortgage market crisis is the application of current OTTI accounting standards which serve as an additional deterrent to any prospective market participants who might see the economic value in mortgages but are fearful of future OTTI required write downs.

The current application and interpretation of U.S. GAAP OTTI principles has become a market factor, rather than an accurate and transparent statement of financial condition creating a self-fulfilling downward spiral for MBS prices. Left unchanged the extension of residential mortgages will continue to decline and the already weak market in MBS will become nearly invisible.

### **OTTI charges adversely affect the nation's banking system.**

The U.S. GAAP rules and interpretations for OTTI have had and will continue to have a dramatic negative effect on U.S. financial institutions, creating regulatory capital challenges during an ongoing economic crisis. In many cases, the most egregious impact is on HTM assets of financial institutions that were purchased as such and can continue to be held-to-maturity. While the performance and fulfillment of the HTM MBS obligations are virtually the same as similar loans held in portfolio, the accounting treatment under U.S. GAAP is significantly different. Under U.S. GAAP, loans held in portfolio that are subject to impairment are accounted for under FAS 114 "Accounting by Creditors for Impairment of a Loan" through the discounted cash flow guidance, which means that while MBS treatment requires a write down to market price, loans held in portfolio only require recognition of the anticipated cash flow impairment which is generally much less.

Current OTTI accounting charges have caused the FHLBanks to reduce their capital positions, reduce dividends to member institutions, and raise the cost of funds for thousands of banks and savings institutions that borrow from their FHLBank. This further impedes the Nation's community banks' ability to lend.

For all financial institutions that carry private label MBS on their books, OTTI rules raise the specter of future write-downs that could weaken capital positions further. This may be one of the key factors to the retention of existing and new capital at many banks. This prudent reaction to guard against future accounting-driven losses inhibits the flow of badly needed credit to communities and small businesses.

## **Current application of OTTI will hurt home ownership and affordable housing opportunities**

In part because of the unintended consequences of OTTI application the private label MBS market has become nearly nonexistent, shifting virtually all of the mortgage origination to the agency markets drying up critical funds needed for mortgage liquidity.

In addition, funding sources for affordable housing are being negatively impacted. The FHLBank System has been the single largest provider of affordable housing grants, contributing 10% of its net income for affordable housing and economic development programs. OTTI accounting rules that require write downs on assets that are far in excess of the estimated probable economic losses are significantly reducing otherwise available affordable housing funds. The FHLBanks' fourth quarter financial reports will result in an approximate reduction of more than \$100 million in Affordable Housing Program funding as a direct result of OTTI liquidity losses.

### **Correcting the OTTI flaw.**

The solution is not to abandon or suspend appropriate consideration of fair value principles but rather to immediately seek a better principles-based balance between the investors' need for accurate and useful financial information and the business model of the regulated financial institutions. OTTI rules for entities that have demonstrated the ability and intent to hold securities until maturity should be the same as if the securities were debt instruments. To be more precise, instruments which require other-than-temporary-impairment charges based on appropriately robust cash flow analysis of the loan agreements based on sufficient loan level data.

In addition, the classification of an impairment as an other-than-temporary-impairment should be based on a material probable impairment rather than first dollar or de minimis probable impairment. Economic and credit losses should be reported through earnings and liquidity losses if any should be reported through other comprehensive income.

Quick action by the SEC and FASB to address these concerns would result in a far more accurate presentation of the true economic condition of financial institutions such as the FHLBanks under the highly distorted current conditions in the marketplace.

Thank you again for the opportunity to submit this statement.