Remarks of Scott M. Polakoff, Acting Director
Office of Thrift Supervision
to the Independent Community Bankers Association
Annual Convention
Phoenix, Arizona
March 21, 2009

Good morning. Thank you, Mike (Menzies, ICBA Chairman), for your kind introduction. It's a pleasure to be with you today.

Introduction

Last year, when you had your convention, I am sure we all expected difficult challenges ahead for both the banking and thrift industries. I am also sure; however, none of us expected the extent of systemic risk or its profound impact, which continues to threaten our national economic security. Now, in hindsight, we see the consequences of over reliance on financial models, of rating agency influence on structured products, of the lack of due diligence in packaging of structured products, the weaknesses in originate-to-distribute models, and the lack of controls over third party (brokers, conduits, wholesalers) loan originators.

In today's unsettled environment, average Americans have come to understand previously unaccustomed financial terms - "TARP," "Default Swaps" and "RMBS." I haven't heard "Mark-to-Market in common parlance yet. But, as bank executives, you know the significance of the mark-to-market accounting rules, which require you to report the fair value of the positions you hold on your balance sheets and the periodic changes in their fair value on the income statement.

I intend to devote most of my time this morning to this subject – the problems that are caused by the current rule; the FASB proposal to change the rule; and what OTS believes is the proper solution.

I'll also give you my take on the "executive compensation" limitations imposed under the President's Stimulus Package. I'll wrap up with a brief discussion of the "Regulatory Restructuring" of the U.S. banking system that has come to the fore due to the current economic crisis. I believe all of these issues may have a direct, significant impact on your bank's health and viability.

Fair Value Accounting

The unprecedented disturbance in the financial markets touched off a hot debate over the pros and cons of amending the current mark-to-market accounting rules. The House held hearings last week. Your own Thomas Bailey testified in favor of changing the rules. At the hearing, FASB was pressured by Congress to change the fair value accounting standards and on March 17th FASB issued two proposals with a 15-day public comment period ending April 1, 2009. The proposals are "*Determining when a market for an asset or a liability is not active and determining when a transaction is not distressed*" and "*Other-than-temporary impairments*."

Most important to financial institutions is a change in recognizing "other-than-temporary impairments" – or (OTTI) of investment securities. OTS strongly supports amending the current accounting rules on OTTI so that only that portion of the impairment representing credit losses is reflected in earnings, and the non-credit loss piece would not reduce earnings or regulatory capital.

I want to walk you through where I believe "mark-to-market" accounting makes sense, and where I believe that it does not make sense. I will also explain how OTS believes the rule should be amended.

For loans held for sale and foreclosed real estate, when the fair value declines below cost, the loss is charged to earnings and thus reflected in regulatory capital. Accountants refer to this as "LOCOM," or "lower-of-cost-or-market" accounting. As the bank intends to sell these assets, I would say that this treatment makes sense. So, this is LOCOM. What about "mark-to-market" accounting?

Banks must use "mark-to-market" accounting for the following assets: trading securities and derivatives, as well as any eligible assets or liabilities for which the bank has voluntarily elected to report at fair value. All changes in the fair value of such assets or liabilities, whether deemed temporary or otherwise, are currently reported through earnings and therefore reflected in regulatory capital. As these assets are managed on a fair value basis, I would say that this treatment also makes sense.

However, as it turns out, most community banks do <u>not</u> have significant amounts of assets that are accounted for on a mark-to-market basis through earnings. In fact, these assets comprise less than 5% of total assets for the OTS thrift industry.

But, I'll talk about a different aspect of "mark-to-market" that is troublesome and which does greatly impact community banks.

For investment securities (that is, those classified as "available-for-sale" or "held-to-maturity"), <u>temporary</u> losses in their fair value are <u>not</u> reflected in GAAP earnings. For debt securities, temporary losses do not reduce regulatory capital. However, for debt securities where the decline in fair value is deemed to be "other-than-temporary," the fair value losses <u>are</u> recognized in earnings and thus in regulatory capital. In contrast, temporary losses for equity securities reduce regulatory capital.

The accountants tell me that "other-than-temporary" does <u>not</u> mean <u>permanent</u>. However, the current treatment afforded an

OTTI impairment suggests that it is permanent, in that the entire unrealized loss is charged to earnings, which reduces regulatory capital. I use the term "unrealized" here to emphasize that the loss is not the result of any sale transaction.

As you might expect, assessing OTTI is a complex, significant judgment call. The measurement of fair value in illiquid markets poses additional challenges. In the present, unfortunate economic environment, OTTI accounting has resulted in the recognition of losses that far exceed the expected credit losses on certain debt securities.

I'll use an example to illustrate. Let's say we have mortgage-backed securities with a cost of $100. Assume the credit quality of the underlying mortgages deteriorates, and therefore the fair value of the securities now is below cost. Let's assume this decline will be deemed OTTI.

Based on extensive analyses and cash flow projections, in this example we estimate credit losses over the life of these securities to be $10. This might suggest a value of approximately

$90. However, the fair value of these securities, based on market participant assumptions, is estimated at $60. Even though we do <u>not</u> plan to sell these securities, we must charge to earnings, and reduce regulatory capital, by the entire $40 difference between the cost and estimated fair value– <u>not</u> just the $10 of estimated credit loss.

In a more certain economic environment, with an active, liquid market, perhaps the fair value of the securities in this example would be closer to $90, and therefore the impairment would approximate $10 – the estimated credit losses. Unfortunately, in the present, uncertain economic environment with its illiquid market, the impairment includes a non-credit component of approximately $30, which includes a liquidity discount.

When the economic environment improves and the market recovers, we would expect the fair value to approximate $90, as it aligns more closely with the estimated credit losses. So, does it make sense to include the $30 in the OTTI charge to earnings and thus in regulatory capital? In this example, the $30 is clearly a temporary component of the impairment.

The answer is: No, it does not make sense to automatically reflect the entire $40 impairment as a charge to earnings and regulatory capital. Instead, why not account separately for the $30 non-credit component– which is temporary - in a manner that does not reduce earnings and regulatory capital by this amount? Only the estimated credit losses of $10 – the permanent component – should immediately reduce earnings and regulatory capital.

Congress, banks and others understand that the current accounting rules have required banks to take steep write-downs since the secondary market for mortgage-backed assets dried up last year. They understand that application of mark-to-market accounting has gutted some banks' balance sheets even though the assets could eventually recover their value. Therefore, we support FASB's proposal so that:

- The component for changes in fair value for probable credit losses – the permanent component – will be reflected in earnings (and therefore in regulatory capital), and
- The component for all non credit loss changes in fair value – the temporary component – will not be reflected in earnings or regulatory capital.

I encourage all of you to respond to FASB's request for comments, letting them know how important these changes are to you. Again, the deadline for submitting comments is April 1, 2009.

Executive Compensation

Now - a few words about executive compensation. In the midst of a global crisis in banking, a recent WSJ/NBC News poll found that among consumers polled, the greatest cause for anger (named by 35 percent of respondents), was bank executives taking large bonuses while receiving taxpayer funds. Congress and the Administration are exploring legal means to stop previous payout of taxpayer dollars used to bail out key financial firms as bonuses to their executives. I too understand public indignation about private jets and multi-million dollar bonuses for CEOs who led their companies into deep trouble or even insolvency. In response to public opinion, Congress enacted executive compensation and corporate governance limits for TARP recipients.

Community banks are not the primary participants in TARP and they certainly are not those who engaged in practices that stimulated public fury. They should not be thrown into the same bucket with the large financial institutions that caused the current economic crisis and undermined public confidence in programs to restore the credit markets and shore up the banking system. Policymakers should be careful not to impose unnecessary compensation limits on community bank executives or the Capital Purchase Program may lose valuable participants in the program.

Regulatory Restructuring

I'll conclude with just a few remarks about current Congressional hearings on Regulatory Restructuring and what OTS believes should be the basic principles of any changes in this area. OTS and the other Federal Banking Agencies testified before the Senate two days ago on Regulatory Reform and there will be two more hearing on this subject in the House before the end of March. Our testimony from last Thursday is available on OTS's web site, but I'll just give you a few highlights:

First, OTS absolutely supports the continuation of a dual banking system, charter choice and allowing banks to choose the organizational and ownership form that best suits their needs. These are non-negotiable as far as we're concerned.

We proposed another change in regulator responsibilities for the first time at last Thursday's hearing. We would like to see two federal bank regulators, one for banks predominately focused on consumer-and-community banking products, including lending, and the other for banks focused on commercial products and services. The business models of a consumer-and-community bank and a commercial bank are fundamentally different enough to warrant these two distinct federal banking charters.
Also, we proposed that every individual or business offering financial products should be subject to the same set of laws and regulations. For instance, there is no justification for mortgage brokers not to be bound by the same laws and rules as banks.

Closing

It's been a pleasure to share the morning with you. I salute you for being the rock of your communities and continuing to keep credit flowing in your communities, while larger competitors have failed to do so.