

NATIONAL PRESS CLUB LUNCHEON WITH ROBERT HE

SUBJECT: FINANCIAL MARKETS REGULATORY REFORM

MODERATOR: DONNA LEINWAND, PRESIDENT, NATIONAL PRESS CLUB

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**DONNA LEINWAND:** (Sounds gavel.) Good afternoon, welcome to the National Press Club for our speaker's luncheon. My name is Donna Leinwand, I'm a reporter with *USA Today* and I'm president of the National Press Club. We're the world's leading professional organization for journalists and we're committed to a future of journalism by providing innovative programming and journalism education and fostering a free press worldwide. For more information about the National Press Club, please visit us on our website at [www.press.org](http://www.press.org).

On behalf of our 3,500 members worldwide, I'd like to welcome our speaker and our guests in the audience today. I'd also like to welcome those of you who are watching us on C-SPAN. We're looking forward to today's speech and afterwards, I will ask as many questions from the audience as time permits. Please, hold your applause during the speech so that we have time for as many questions as possible. For our broadcast audience, I'd like to explain that if you hear applause, it may be from the guests and members of the general public, and not necessarily from the working press.

I'd now like to introduce our head table guests and ask them to stand briefly when their names are called. From your right, Keith Hill of BNA, treasurer of the National Press Club; Peter Semler, a *Deal* reporter; Ron Orol of Market Watch; Russell Golden of FASB, and a guest of our speaker; Terry Polley, Financial Accounting Foundation and a guest of our speaker.

Skipping over myself at the podium here, Angela Greiling Keane, a *Bloomberg News* reporter and chair of the club's speaker's committee. I'll skip over our speaker for

just a moment. Bob Carden, of Carden Communications, the speaker's committee member who arranged today's lunch. Thank you very much, Bob. Allen Weltzmann of FASB, and a guest of our speaker; and finally, Knight Kiplinger of *Kiplinger's*. (Applause)

The Financial Accounting Standards Board is one of those quasi government agencies that sets the business rules in this country; specifically FASB, as it's known, develops generally accepted accounting principles that businesses must adhere to when reporting their results. This is done so businesses can't, in theory, cook the books to make themselves and their stock prices look better than they really are.

Good enough. But if you picked up a newspaper in the last year, you've probably noticed that more than a few companies aren't doing very well. Fingers have pointed everywhere, at shortsighted CEOs, sleeping or negligent regulators, overspending consumers, and sleazy lenders. FASB has been spared much of that criticism. Companies did generally follow standard accounting rules. These days, FASB is a bit like the most popular girl at the dance. Companies, particularly banks, want some modification of accounting rules from FASB that might make their balance sheets look a little bit more appetizing.

Our guest today, Robert Herz, is head of FASB and has been so since 2002. He's one of many experts trying to figure out the best way to get out of this economic hole and make sure it doesn't happen again. Mr. Herz is a certified public accountant and was at PricewaterhouseCoopers and Coopers & Lybrand prior to accepting his current position. President Obama recently announced a broad set of new regulatory measures aimed at stabilizing the economy. We look forward to hearing our guest take on this and other economic issues facing the country. Please join me in welcoming Mr. Robert Herz to the National Press Club. (Applause)

**MR. HERZ:** Well, thank you, Donna. Thank you for that very generous introduction. It is a real pleasure to be here today, a real great honor. I've been on panels here at the National Press Club, I've been in the audience a number of times. I've watched many of the speakers on C-SPAN and I've always watched with great envy, not only because this is such a terrific venue to speak at, but also because you get awarded the coveted NPC coffee mug at the end.

**MS. LEINWAND:** We'll see, we'll see. (Laughter)

**MR. HERZ:** Now I've got an incentive, okay. Before I start my remarks, I do need to say that the views that I will express today are my own, and not official positions of the FASB. But what I can assure you is that any opinions I give today do reflect the opinions of our chairman. (Laughter)

By most measures, the past two years have been a very difficult and challenging period for virtually everyone. As we continue to examine the causes of the global financial crisis, many important lessons are emerging; lessons for all of us in the capital

markets, lessons that challenge some of our core beliefs and our core operating principles. History does not repeat itself, people repeat history. So hopefully, the lessons learned will help us build a stronger, solid financial system going forward.

I think there's a general consensus that the excess leverage at many levels and lax lending practices fueled the creation of complex and risky structured securities and derivatives that would then spread across opaque and unregulated markets around the world. When the risk became evident, the lack of basic supporting infrastructures in terms of timely and accurate information flows, clearing mechanisms and price discovery, compounded the problems, leading to freezing credit markets, plummeting equity markets and significant downward pressure on economic growth.

However, one very welcomed development arising from the financial crisis, I believe, is that a much broader constituency is calling for greater transparency as a necessary ingredient for recovery and rebuilding of investor and public confidence. Included in this has been the need to improve and strengthen certain accounting and reporting standards. While accounting did not cause the crisis and accounting will not end it, it did reveal a number of areas requiring our attention.

And so over the past 18 months, we have responded vigorously with a number of new standards and enhanced disclosure requirements relating to securitization, special purpose entities, credit default swaps, derivatives, financial guarantee insurance, fair value measurements and credit exposures.

Unfortunately, there have been certain major companies, including some of them that subsequently failed and had to be rescued by the government, and some industry trade groups that have sought political intervention into accounting standard setting. While that is certainly their right, and while we welcome active dialogue with lawmakers, politicizing standard setting by special interests does risk undermining public confidence in the whole financial reporting system.

The investing public expects and deserves unbiased and transparent financial information that's not skewed to favor particular transactions, particular companies, or particular industries. We work hard to meet that expectation, trying to be very open, thorough, objective and timely in responding to reporting issues that arise in a very challenging environment.

Transparency is not just a buzzword or a cliché, it's a fundamental and absolutely essential attribute of sound financial markets. Relevant, trustworthy and timely information is the oxygen of financial markets. Depriving the markets of such information, or polluting the information, can have very adverse consequences.

And so, additional systemic actions are needed by others, I believe, particularly in the areas related to the complexity and risks inherent in complex financial products, and to the information systems around the markets for structured securities and derivatives.

Transparency to the American public around taxpayer funded investment with financial support of major U.S. companies is also essential.

Donna said, last week the administration issued their plan for financial and regulatory reform. The GOP has also released a proposal on regulatory reform. Various private sector groups have also issued lengthy studies with detailed recommendations on changes to our financial and regulatory system. Congress has become discussing these and other proposals for change. While I may not be in the best position to offer an overall blueprint for regulatory reform, or the particular structural elements of it, I do have some strong views on the subject, borne from observing and participating in the events of the past few years, and from a career dedicated to improving the functioning of capital markets through the enhanced quality of information provide to investors.

So, I'd like to provide my thoughts on some of the key objectives and principles that should guide the reforms, kind of an outcomes-based approach to it. What would be desirable outcomes from regulatory reform? I do so without any pretense that these are the only or the most critical matters that need to be addressed. But I hope that my thoughts will be useful in evaluating the many detailed proposals now emerging. And I will comment also on the relationship in these matters and our role and activities as the nation's accounting standards setter.

As we address and evaluate potential reforms, I think we need to strike the right balance between regulation that's respected and that effectively recognizes and manages risk and regulation that fosters sound economic growth and competitiveness and that lets those who fail, fail.

I believe that the primary objective of any redesign of our financial and regulatory systems should not only be to avoid a repeat of the financial crises of the past 20 years, but moreover to create a solid and durable platform for sound and stable economic growth through an effectively functioning financial system that deserves and that maintains public trust and confidence in our capitalist system and our way of life.

While that may sound rather grandiose and somewhat vague, isn't that what financial institutions, capital markets and financial regulation are all about? To promote and protect our economic wellbeing and those of future generations? Sustaining public support for our way of life, including the many wonderful freedoms we enjoy depends on people believing that our system offers the promise of a bright future. Investors seeking to build wealth, to fund the increasing cost of health care and college tuition and to provide retirement security cannot have their nest eggs broken and scrambled every six or seven years. Reform of our financial and regulatory systems is part of rebuilding and maintaining a healthy economy and a bright future. In the parlance of politics, it's all about the economy. Right. (Laughter)

Now, I think that's the easy part. Now let me talk about some key principles that I believe are important components of any redesign of our financial and regulatory systems. As I've already noted, transparency is certainly one of those key principles. But

there are other important related ones. First, we must clearly acknowledge the need to have proper infrastructure supporting the financial markets. Without infrastructures to facilitate the timely flow of relevant and reliable information that enables informed decisions, ready price discovery and effective clearing mechanisms, markets become dysfunctional. Effective regulation, oversight and enforcement are also key ingredients of sound markets, as is the appropriate exercise of due diligence by investors and proper risk management by financial institutions.

While all of this may seem rather obvious, it was precisely the absence of many of these basic features from rapidly growing segments of the credit and derivatives markets that were at the heart of the U.S. credit crisis that then broadened into a global financial and economic crisis. The problems and chain of value destruction are now well chronicled, and with the benefit of hindsight, we can now see problems and failures across most of the chains.

Unfortunately, balkanized regulatory systems, both in the U.S. and across international capital markets, coupled with a deregulatory philosophy by key policymakers may have made it difficult, if not impossible, to reign in the inherently unsound practices and overall exuberance driving these activities.

Once the risk became more evident and the music stopped, the sheer complexity of many structured credit products and derivatives, coupled with the lack of clearing mechanisms, price discovery and standardized information on these instruments, compounded the problems. The result was not only a freezing of the credit markets, but also a loss of public confidence in financial institutions in the capital markets and to a certain extent in our economy.

In short, we cannot again allow huge, unregulated and opaque financial markets. In modern times, the proper operation of capitalism depends on the appropriate regulation of institutions, of financial products that have market participants and on the existence of infrastructure that supports transparency and the smooth functioning of the markets. Far from constraining markets and capitalism, these are essential elements in its effective operation and a public trust in the system.

In my world, that of accounting and accounting standards, the absence of these elements makes our task very, very challenging. I don't believe in blaming others, but I'd like to just set the scene for a few of my observations. For some of the most difficult, the most difficult accounting and reporting issues emanating from the financial crisis stem at least in part from the lack of proper regulation to risk management, unsound lending and securitization practices, and the absence of proper market infrastructures around the dark markets restructure of credit products and derivatives.

Under such conditions, accounting valuation are significantly challenged. Where proper accounting and valuation require that companies and market participants be able to identify, understand and reasonably calibrate risks and returns emanating from financial assets and obligations, and be able to ascertain exchange prices. Thus, it is not

surprising that many of the issues that we've had to deal with over the past 18 months surround the determination of values in inactive and disclosed markets, the recognition of impairments of financial assets, accounting for securitizations and use of off-balance sheet structures by certain of the major financial institutions, and the overall quality and timeliness of disclosures of risk.

The financial crisis has also highlighted a number of relationships of public policy importance between accounting standards and financial reporting to investors, on the one hand. And, on the other hand, regulatory reporting by the banks and regulatory policy by bank regulators. Now, both are accounting standards and regulatory policy and capital determinations impact on financial institutions, and both are vital to the respective operation of the financial system and to our economy. But there seems to be some confusion, a bit in the media sometimes, excuse me, and elsewhere, about the relationship between the accounting standards we set and regulatory capital. We do not determine regulatory capital, the bank regulators do. However, under the laws enacted by Congress in the wake of the S&L crisis, the determination of regulatory capital by the bank regulators does start with the gap numbers. But the regulators then have some discretion to adjust those numbers and they also have a number of other tools to address capital adequacy, liquidity issues and concentration of risk at regulated institutions.

So, the regulators have a natural interest in the accounting standards we set. Likewise, investors have both an interest in our standards and on the impacts of regulatory requirements and regulatory actions on the institutions in which they have invested. In that regard, I would like to commend the Fed and the other U.S. bank regulators on the transparency they provided on the results of the recent stress test of the major bank holding companies.

Certainly, whether it's as depositors, as investors, as businesspeople or citizens of this great country, we all share a deep interest in the strength and stability of our financial system and the economy. But the public policy missions and focus of accounting standards setting and that's the focus of prudential regulation in helping achieve these goals, are somewhat different. Our focus, as accounting standards setters, is on the communication of relevant, transparent and unbiased financial information on corporate performance of financial condition to investors and the capital markets. That information is aimed at facilitating informed investment decisions, and it is essential to the effective allocation of capital across the economy.

The transparency provided by external financial reports also contributes to financial stability by reducing the level of uncertainty in the system. On the other hand, the equally critical and important focus of the bank regulators is on the safety and soundness of individual institutions, on protection of customer deposits and on overall financial stability of the system.

Now, given our different missions and our different focus, it's not surprising that we would sometimes have different perspectives on particular accounting and reporting

matters affecting financial institutions. For example, bank regulators and the institutions they regulate may be less enthusiastic about the use of fair value measurements because it concerns over potential pro-cyclical effects, volatility in reporting, and impacts on regulatory capital while we as standards setters and investors use such information as important in understanding and evaluating the financial condition, risks and performance of the institutions.

Despite the differences in mission and focus, my experience has been that by working together and sharing perspectives, we can often find common ground and develop common solutions that meet the needs of the regulators while preserving the integrity of reporting to investors. But in some cases, a single accounting or reporting treatment may not properly achieve the objectives of both the regulators and sound reporting to investors in the capital markets.

In such cases, transparency under different treatments is important. Moreover, it's not appropriate to subordinate or subvert external reporting requirements to the needs of the regulators, or vice versa. Both are essential public policy goals in insuring the proper operations of financial systems in the economy.

Therefore, preserving and clearly delineating the separate public policy mission of accounting standard setting and also the securities regulators in terms of investor protection and transparency, and that of financial institution regulators in terms of safety and soundness and financial stability, are in my view important in regulatory reform.

The goal should be to promote a close working bond, while insuring that transparency and sound reporting to investors in the capital markets are not subordinated to the objectives of prudential regulation. And on the other hand, as I said, that the regulators are not inappropriately handcuffed by requirements that they mechanically conform their treatment to gap. Accordingly, I would support a greater decoupling between the determination of bank regulatory capital and our standards.

My next principle is that any reforms of our financial and regulatory system must be perceived by the public as substantive, as balanced and as producing fair and equitable outcomes. On the one hand, they must not stifle innovation and appropriate risk taking; but on the other hand, I also believe that the reforms need to convince the American public that we have taken the steps necessary to move beyond the one-way capitalism, the heads I win, tails everybody else loses, practices and mindsets that have, quite rightly in my view, sparked widespread outrage.

So while the taxpayer-funded bailouts of major institutions and other major companies were necessary to avert deeper harm for the economy and to our society, the too big to fail phenomena is clearly fraught with danger and is perceived by many as just downright unfair. Accordingly, reforms of our system must have an eye to avoiding or at least reducing the incidents of this in the future.

And I think there's been similar issues associated with excess executive compensation. Perverse incentives seem to motivate the leaders of certain major financial institutions to adopt what we now see were high risk strategies in an apparent quest for big corporate, and perhaps big personal, payday. There are many excellent CEOs of U.S. corporations, and I think few would object to Bill Gates or Warren Buffet with being worth billions because they've added tremendous value to their shareholders, their employees, and to our society.

But I think it really rubs many people the wrong way when the CEO of a large company gets paid \$150 million during the three or four years he or she was in charge and then after running the company into the ground is given another 50 million to leave. In the past when I've voiced this point of view, some called me crazy, some called me anti-capitalist. To the contrary. My concern has been that these kinds of practices were eating away at the fabric of our capitalist society. I'm therefore heartened that there now seems to be more widespread recognition of this problem.

But don't get me wrong. I am not in favor of the government setting and enforcing specific pay levels or pay limits in the private sector. But the investing public does need to see that the private sector is effectively addressing this issue, either through continued improvements in transparency and improvements in corporate governance, or by other means. Success should be rewarded, failure should not.

My final set of principles relates to our ability to operate successfully on the global stage. The crisis has been global in scale, as clearly demonstrated the many linkages between the financial markets and economies around the world. It has also revealed the problems that can result from regulatory gaps and differences in regulation across international financial markets. Resolving these problems and preventing them from happening again requires active coordination of financial market regulation across the major capital markets of the world.

So while the prospect of having the single global capital markets regulator or single set of regulatory rules across the international capital markets is not realistic in the foreseeable future, in my view, much can be achieved through continued focus by groups such as the G20, the International Organization of Securities Commission, the Basel Committee and the Financial Stability Board to develop solutions to regulatory problems in global financial markets.

In that regard, the U.S. continues, at least for the foreseeable future, to be the single largest national economy in the world, and we have the largest capital market in the world. Therefore, our actions, our financial and regulatory missteps and our economic wellbeing has significant impacts on the rest of the world. While the credit crisis may have originated in the U.S., the shockwaves reverberated around the globe. So it's not surprising that while some have accused China of exporting toxic toys, we've been accused by some of our foreign partners of exporting toxic securities.



Unfortunately, there's some truth to this accusation. And now, after having seen the S&L crisis, the dot com bubble, and the U.S.-induced global financial crisis, some of our foreign colleagues are understandably questioning our ability to run sound capital markets and a reliable financial and regulatory system. We need to take these concerns very seriously. The United States capital markets and our financial system has been, and must continue to be, one of our crown jewels. We can't risk a sustained loss of confidence in them, either at home or abroad.

The good news, I think, is that as a country, we're generally quick to recognize and address these types of problems. And I think the strong actions by the administration, the Fed and by Congress to shore up our financial system and to revive economic growth have signaled to the rest of the world our commitment to act forcefully in the face of crisis.

Now, while our actions and our economic wellbeing significantly impact the global economy and the international financial system, we are no longer the sole dominant or controlling party. So we have the dual challenge and the responsibility in the global context of both insuring the health and vitality of our capital markets and economy, not only for our benefit, but also for the sake of the rest of the world, while also being an active and constructive participant in developing and supporting global financial and regulatory solutions and mechanisms. We need to be both credible and persuasive, seeking to inject the good aspects of our DNA into the global efforts where appropriate, while also being careful to avoid trying to dictate to others, or in part, outdated parts of our system.

Thus we must, in effect, ride two horses; taking care of business at home while also working with colleagues around the world as leaders and as good citizens of the world in advancing global agendas.

That's precisely what we at the FASB have been doing in terms of the world of accounting standards setting. Recognizing the potential benefits that could result from having a single set of high quality accounting standards across the global capital markets, we have devoted substantial time and effort in recent years to working with the International Accounting Standards Board on jointly improving and converging our respective standards.

At the same time, we also strive to take care of business here at home by responding on a very timely basis to reporting issues in our system. Riding these two horses is not always easy, and it sometimes requires timely actions in terms of improving U.S. gap in an area while also working in the longer-term on global solutions.

So those are my views in terms of the major objectives and principles on reform of our financial and regulatory systems. To recap, I believe that significant reforms are needed. They should have as their primary objective building a solid and sustainable platform for sound and stable economic growth through properly functioning financial markets, again, that maintain the public confidence in our system and our way of life.

Also, the reforms should be guided by key principles related to transparency, to insuring proper infrastructure, supporting markets to promoting outcomes that are widely perceived as balanced, fair and equitable and to operating properly in a global context.

Again, let me emphasize that while I view the thoughts I've offered today as very important themes and desirable outcomes that should be borne in mind in regulatory reform, I'm certainly not asserting that these are the only critical matters that need to be addressed. Clearly, there's lots of opportunity for positive change.

I am an eternal optimist and believe that we are up to the challenge. Now at this point, I'm beginning to remind myself a little bit of the little boy who's got two medals pinned to his chest, a little silver one and a big gold one. And if you ask him, "What'd you get the little silver one for?" he says, "For singing." You say, "What about the big gold one?" And he says, "For stopping." (Laughter) And so I'm going to stop and thank you for listening to my thoughts today. Thank you. (Applause)

**MS. LEINWAND:** Okay, and now for our final round, we'll see if he wins the NPC mug. Okay, you mentioned that much of the financial collapse was caused by a lack of oversight and/or stringent accounting procedures. Are stronger controls in both areas really going to make a difference? Why or why not?

**MR. HERZ:** You know, I think there are many causes of what happened, and not all of it clearly could have been foreseen. I have pointed, in particular in my speech, to the lax lending practices and various people will determine as to why that occurred. And I've also pointed to essentially the packaging those loans into complex securities and building derivatives on top of that and then spreading those around the world in very opaque and unregulated markets.

And again, my points are that the system does not work well if people don't understand the risks and complexities and in order to do that, you need proper infrastructures, proper transparency, proper information, systems for markets to operate properly. You can't operate good markets, sound markets, without those elements. That's one of my real key points.

**MS. LEINWAND:** Should Glass-Steagall be reinstated? Why or why not?

**MR. HERZ:** I have an honorary law degree, but I would not even start with that. I think, again, the point I would come back to in my speech would be that people have to believe that the system works properly and that there aren't all sorts of conflicts of interest and perverse incentives built into it. Some people believe that by removing Glass-Steagall and the walls between investment banking and banking, that created some of those conflicts of interest and created also the too big to fail phenomena. But, again, I would try to judge those kind of questions in terms of my desired outcomes. Does it lead to those outcomes to a system that produces fair and equitable results that isn't perceived-

- That's perceived by people as something that's functioning and is trustworthy, that is a system that people say, "Gee, you know, this makes sense. I trust it."

**MS. LEINWAND:** Who or what specifically shoulders the most blame for last year's market collapse?

**MR. HERZ:** The wall of shame is large. And I'll probably leave it there. As I said, across the whole chain there have been issues and failures. And I think at the heart of it was that we got into some practices, as it turned out, some basic assumptions about how the world would self-regulate and the like. Some assumptions there that just didn't pan out. And I think that took many people by surprise.

**MS. LEINWAND:** If you consider the March congressional hearing to be a politicization of accounting, do you also consider the Obama Administration regulatory reform plan accounting proposals in the same light? If not, why not?

**MR. HERZ:** That was kind of a two-part question. You know, the March hearings, I've testified maybe 20 times on the Hill and lawmakers and other policymakers here in Washington have a natural interest, and I think a responsibility to understand what we're doing. So, I kind of view that as part of the role.

What I don't particularly welcome is when people try to exert political pressure on us to get us to change particular accounting rules or to block them, or the like. But I clearly understand that accountability to-- We have accountability to our trustees, to the SEC and ultimately to Congress that that's an important way the system works.

Now, the Obama proposals, I don't view those as politicizations of accounting. There's some recommendations in there towards the tail end that were actually included in the recent G20 declaration, their recommendations. I think they're consistent with a lot of the things we're doing directionally. So, you know, I don't consider that really politicization of accounting.

**MS. LEINWAND:** I didn't say this would be easy. You didn't name names when you accused major companies and trade groups of politicizing accounting standards. Something, getting in the interest of-- Okay, let's see. So in the interest of disclosure and transparency, please name names. (Laughter)

**MR. HERZ:** Okay, I won't name all the names but I'll give you a few examples, maybe. And again, our system works because people advocate their causes. We have a very important cause of public policy mission, and that's good reporting to investors in the capital markets. So I understand. I don't welcome it, but I understand that people will, in what they view to be their interest, will try to get the answer they want. And if they don't get the answer they want from us or from the SEC, they may take their-- They do take their views off into Congress. And our role is to explain to Congress why we're doing things, what we're doing and why it makes sense.

Now, with that introduction, I'll give you one good example, a three-letter insurance company that begins with A and ends with G. About a little over a year ago, probably it was April of-- All these things blend when you're having a good time-- 2008, the then-CEO of AIG, Marty Sullivan, I think it was well known that he spent a fair amount of time here in Washington and on Capitol Hill trying to convince lawmakers there that there were no problems with the credit default swaps that they had entered into, that it was all this bogus fair value accounting. And, of course, we're now as taxpayers some \$150 billion-plus into AIG. There were real problems there. And in fact, the accounting was really the first sign to alert people that there were problems there.

There are trade groups that represent financial institutions, a number of them that, again, it's kind of in your introduction. They have views that the accounting ought to be one way or the other, particularly in dislocated markets. That was part of the hearing in March, and again I'm not going to tell them to stop that. But the risk is that the perception can be if too much of that goes on, that it does make people think that, you know, the politics are to bend the accounting rules. And that is dangerous because, in fact, we kind of create the rule or bending the rule is not appropriate.

**MS. LEINWAND:** With the new era of TARP and government ownership of U.S. companies, do you have any concerns about financial transparency?

**MR. HERZ:** You should ask Elizabeth Warren that. It is very important. I mean, we talk about transparency to the owners of the business, the investors, the people who invest capital in it. Well, all of us are now investors in those businesses. And so I think transparency is very important, what's being done with our money, where it went, how the institutions are using it and the like.

Just a side note, about three weeks ago I went to China. We have an active dialogue with the folks who set accounting and auditing regulation at the Ministry of Finance in China. And they've had an exchange with us learning how we do things, a person once a year for a year. And this time I went over and kind of a sign of the times, I said to the Chief Accountant of China, "You know, give me all of your rules, disclosure rules and accounting relating to state-controlled enterprises. There may be something we could learn now." (Laughter)

**MS. LEINWAND:** In your speech, you stressed transparency. Give your thoughts on the Obama Administration's plans for disclosures and new reforms that will increase transparency in mutual funds and OTC derivatives markets?

**MR. HERZ:** Well, again, I'm not going to get into structural solutions here. Whether there ought to be a consumer protection agency or not, but I do think that consumer protection, investor protection, are very important. Now, the proposals around OTC derivatives and securitizations, I think they are directionally a good move. I mean, they are consistent with my call that we need some real information systems, some real infrastructures around those systems.

We've built, in this country, systems par excellence for corporate reporting that underlie corporate equities and corporate bonds. We need kind of the same approach, in my view, underlying those other markets.

**MS. LEINWAND:** All right, I'm going to press you a little bit on this Consumer Financial Protection Agency. Why or why wouldn't it be a good idea to have one?

**MR. HERZ:** Again, I'm not going to say whether having a single agency versus it being spread into different places makes sense. But I do believe that there is a real need for some review of financial products before they're issued, whether they are suitable, and the like, and making sure there's proper disclosure. I mean, we've had lots of instances we've seen of predatory lending, we've had lots of instances of complex products that it's not clear what their purpose exactly was. And it is clear that a number of people did not understand them. And those were at the heart of the problem.

**MS. LEINWAND:** How close is the FASB in getting common mark to market rules with IASB?

**MR. HERZ:** Well, let me re-couch that. Well, we have very common standards and guidance relating to how to apply fair value, very common, that aspect. That may be one question. Your question may be also, we are working jointly with the ISB to try to revamp, overhaul, improve, simplify our respective standards for accounting for financial instruments more broadly. That's a project where we're working a time frame to try to get an exposure draft out in the next few months.

**MS. LEINWAND:** How can assets be correctly mark to market if there is no market, no transactions, no fair market pricing, a situation of total market paralysis?

**MR. HERZ:** Yeah, well that is at the core of some of the more thorny issues that have arisen over the past year. Now, there are transactions going on for most things. But, they may be very inactive and it's not clear always who the parties are and what their motivations are, and whether they're distressed sellers, and the like.

The standard that we put out a few years ago, the famous statement 157, which by the way did not introduce fair value, did not increase the use of fair value. Fair value's been around for time in memoriam. And the idea of marking assets down when there's bad times has been around probably for centuries.

But, the problems are that we've now got, what was unexpected, was that we had all these structured securities and complex derivatives and everything was fine until people started to understand what was backing them up; i.e., mortgages, other things related to the economy, to housing and when that all became evident and the housing market turned, the music stopped. Much less volume, the prices went way down. People were less willing sellers and the like.

Now, that is what we call a level three valuation, just to get technical here. Meaning that there are not a lot of observable transactions happening. And our standard covers level three. Level three traditionally was meant for, in some cases, very exotic derivatives, but more usually things that for which there are not liquid markets, like intangibles. And there are well-worn techniques for that, but the issue then has been kind of making those portable in a much broader scenario of trillions of dollars of securities that all of a sudden unexpectedly became illiquid.

**MS. LEINWAND:** If the rewarding of stock options as compensation for CEOs generates risky behavior, how should CEOs be compensated?

**MR. HERZ:** Not my area of expertise. I do have-- Stock options is obviously an issue we have dealt with and a few years ago we did require expensing of stock options. That was also an opportunity where I got to testify a number of times before lawmakers. And you know, my own view is it kind of depends on the business and the business model. I think a certain amount of tie-in to equity and performance-based awards and I did write a book with some others about ten years ago called-- That got into non-financial key performance metrics, what's driving the value of businesses from a longer-term point of view? And I think tying the compensation to a number of those metrics and not just short-term financial performance is very important.

**MS. LEINWAND:** Are there any accounting standards that cannot be circumvented by determined corporate crooks? Don't tougher rules simply impose a reporting burden on honest businesses?

**MR. HERZ:** You know, good reporting requires not only good standards, but it does require faithful implementation of the standards, it requires good auditing, it requires good review and enforcement by the regulatory agencies. I think things are getting better in terms of those other elements, I hope the accounting standards are also getting better. But there is no absolute, there is no absolute guarantee that corporate frauds will not continue to exist. I think we're getting better at it, but at the detection mechanisms and enforcement mechanisms. But there is no-- We have not seen the last fraud, I am 100 percent confident of that.

**MS. LEINWAND:** What is your reaction to the recent charges by ITAC that FASB has lost its independence?

**MR. HERZ:** Okay, I probably ought to-- I'm not sure everybody knows who ITAC is.

**MS. LEINWAND:** I don't. (Laughter)

**MR. HERZ:** Yeah, it's not the International Trade Agreement Consortium, or something, it's one of our advisory groups called the Investor Technical Accounting Committee. We have many advisory groups that are standing groups. We have project groups, we've got an Emerging Issues Task Force. And those bring together

knowledgeable parties from key constituencies. Investors are represented on just about all of those groups.

ITAC wrote a letter recently to the chairman of our parent organization, the Financial Accounting Foundation, expressing some concerns over the actions we took in April and the process therein. I think we believe pretty strongly that we responded to genuine issues in the system in a very highly responsible manner. I think that it's important to distinguish between a correlation of events and causation of those particular events. The particular issues and question of guidance we delivered, without going into a long story, the SEC did a very good study mandated by Congress that they delivered at the end of the year on mark to market and fair value accounting that supported its use, but also had a number of recommendations for improvements in practice and guidance.

And after discussing those with a number of parties, including our valuation group and other advisory groups, we put those items on our agenda to look at. The staff started work, there was a hearing in March and my response to questions there, I laid out our proposed timetable, which was to have that guidance issued in time for the second quarter reporting of this year. And let's just say that a number of the folks on the committee there kind of strongly urged either us or the SEC to try to expedite the guidance.

And we'd already done some of the work and I went back and consulted with my fellow board members and senior staff as to whether and how we could best expedite that guidance. We went through an accelerated process, but within our existing timeframes, it was intensive, it was extensive. We got over 700 comment letters, we had many, many meetings with constituents, we had many, many lengthy discussions with investors and financial institutions. And really, it was a rich process and all that impacted the final guidance that we issued, which actually really due to the investors we talked to included significantly, significantly expanded disclosures on a quarterly basis that enabled investors to better judge the quality of some of these problem assets.

**MS. LEINWAND:** Congress has a lot on its plate. Do you think requiring regulation of the unregulated over-the-counter markets will get done?

**MR. HERZ:** My track record on guessing how Congress will behave is not great, but I think this one will get done. Now, will it get done in all aspects and will the cut that they've been talking about between standardized contracts and customized ones, that remains to be seen. But I made the point in my speech about the need for infrastructure, information systems, transparency around these kinds of markets and I think there's a lot of other people that believe that that needs to be done.

**MS. LEINWAND:** How do you counteract the too big to fail syndrome when you have vested interests on Capitol Hill and in the private sector?

**MR. HERZ:** Other people are better equipped to tell me that. Now, I think what's in the President's plan, I'm not sure it addresses the too big to fail to begin with,

but it does at least kind of say that if we do have a very big institution that's integral to the system, we can't be kind of held hostage. There have got to be mechanisms to kind of get us out without either the taxpayer footing the bill or causing havoc to the financial system. Getting from the place we are now with very large financial institutions to a place where we had a group of smaller financial institutions breaking up the GSEs, for example, I think that requires a lot more study and it's not my area of expertise.

**MS. LEINWAND:** One area of accounting under scrutiny is the use of balance sheet finance of off-balance sheet financing including securitizations. If we put all of that back on the balance sheet, won't the financial statements be meaningless?

**MR. HERZ:** No. (Laughter) The ones that belong on the balance sheet should be on the balance sheet. The ones that don't belong on the balance sheet won't be on there, but there'll also be very enhanced disclosure. Just for folks, we issued last week, I guess it was-- Was it last week, two weeks ago? Time flies-- Two new standards around securitizations and special purpose entities that come into force beginning of next year. We worked closely with the bank regulators on that. In fact, those rules were new rules that were reflected in stress test.

**MS. LEINWAND:** Reliable financial statements are critical for investors to make good decisions, but so are credit ratings for purchasers of debt. What reforms make sense to restore credibility of credit ratings?

**MR. HERZ:** Again, this is just as an observer of the scene. You know, I think that the processes by which they go through, I know that the various credit rating agencies have taken a good look at what they've been doing and have already made a number of amendments both to their processes and to deal with potential conflicts of interest. There are some who would say that the way they are paid by the issuers is not great, that it creates a conflict of interest. That's a thorny issue and a difficult one. It's the same issue that has arisen over time with the auditing profession. You know, mechanisms get built to deal with that because the alternative business model is maybe not a viable one.

**MS. LEINWAND:** Should all OTC derivatives, standardized and customized, go through clearing houses?

**MR. HERZ:** Yes.

**MS. LEINWAND:** Okay. Is accounting manipulation an inescapable outcome of dynamic provisioning?

**MR. HERZ:** Wow. Accounting inescapable dynamic provisioning? Dynamic provisioning seems to be a term that people are using for, like, in this question, cookie jar reserves or try to smooth numbers and the like. You know, I'm probably a Pollyanna and a windmill tilter, but I really think that we continue to need to strive to get beyond kind of the earnings management game and the focus on quarterly earnings and quarterly



estimates, and like that. I mean, to me reporting ought to be just kind of something you do as a matter of course and you do it faithfully and honestly without trying to game the system and kind of paint pictures that are more rosy than they really are. You know, I'd like to be 6'4" and have a full head of hair, but it doesn't happen. (Laughter)

**MS. LEINWAND:** Did we hear you right? Did you say you would support a greater decoupling of gap standards for accounting and regulatory standards for capital requirements? If so, please elaborate?

**MR. HERZ:** Yeah, I would. You know, and I think if you think about it also, how you report on a particular transition event, economic phenomena to a certain degree depends on the purpose and the audience you're trying to gear it at. So, tax reporting is not the same as accounting. Lot of cases, there's overlap. But when you have a different objective in mind, it naturally leads to some differences.

Now as I said in my speech, often you look at a particular transition, event and you can come to a common answer. You can say, "This is how it ought to be reflected." But in some cases, the idea of providing enough capital over time versus reporting to a company on its performance and that point in time financial condition can be different points of view.

So as I said, I think the important thing is, because we've both got a common interest in this, is as we do now, to continue to work together. But, I believe that the bank regulators should have a little more flexibility to-- Not unbounded flexibility, but some more flexibility to be able to take the gap numbers and make adjustments.

**MS. LEINWAND:** With the Obama Administration's recommendations that we move toward a global set of financial statements, when do you think full adoption of convergence will occur? Do you think the U.S. will follow the SEC's roadmap?

**MR. HERZ:** The SEC put out a proposal last November, the comment period ended end of April and they've gotten 200-plus comments. The ball's really now in their court to decide what to do to go forward. What I can tell you is that we continue to work closely with the International Accounting Standards Board, and with other international standard setters, I told you about China, for example, to try to get to this goal of a common set of high quality standards that would support common reporting across the capital markets. So we're just going to pursue that, but the determination of timing and that and how could use IFRS or who couldn't, those kinds of things, that rests with the SEC.

**MS. LEINWAND:** We are just about out of time, but before I ask the last question, let me make a few announcements. First of all, let me remind our members of future speakers. On July 1<sup>st</sup>, Wayne Cluff, Secretary of the Smithsonian Institution, will discuss bites, stars, helixes and history. On July 8<sup>th</sup>, Admiral Mike Mullen, Chairman of the Joint Chiefs of Staff, will discuss recent developments in U.S. national security and

priorities going forward. And on July 10<sup>th</sup>, Morris Dees, Founder and Chief Trial Council for the Southern Poverty Law Center will be here.

Second, I would like to give our guest the traditional NPC mug.

**MR. HERZ:** I earned it, huh? (Laughter)

**MS. LEINWAND:** You earned it, here you go.

**MR. HERZ:** Thank you. (Applause)

**MS. LEINWAND:** You're welcome. Wait, wait, you got one more here. Not off that easy. Some saw the perils of credit default swaps and other exotic instruments before the financial collapse. What do you foresee as the next problem in your world?

**MR. HERZ:** I think the next issue that I see is dealing with loans and loan accounting. That's going to be part of our financial instruments project. Right now, loans are accounted for on a cost basis and what's called an incurred loss model. And I think it's been kind of clear that that is-- Kind of the provisions there have lagged downward, a downward spiral. And I think trying to think about a better model there, and that might also have a byproduct, I think, of reinforcing sounder lending practices as well. So that's one.

In a few years, I agree with other people who say we need to think about inflation, and inflation has some accounting consequences as well.

**MS. LEINWAND:** Okay. Thank you all very much for coming today. I'd also like to thank National Press Club staff members Melinda Cooke, Pat Nelson, JoAnn Booz and Howard Rothman for organizing today's lunch. Also, thanks to the NPC Library for its research. The video archive of today's luncheon is provided by the National Press Club's Broadcast Operations Center. Our events are available for free download on iTunes, as well as on our website. Nonmembers may purchase transcripts, audio and video tapes by calling 202-662-7598, or emailing us at [archives@press.org](mailto:archives@press.org). For more information about the National Press Club, please go to our website at [www.press.org](http://www.press.org). Thank you.

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