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THE FDIC: DISCLOSURE

Address by

Robert E. Barnett, Chairman
Federal Deposit Insurance Corporation

before the

CPA Society and Robert Morris Associates, to (1)
(2) St. Louis, ~~Missouri~~ Mo.
(1) November 18, 1976, to (2)

During the past few years, senior staff and Board members of the FDIC have spent a great deal of time on problems related to accounting, financial reporting, and disclosure. Proposals and decisions affecting the form and substance of bank accounting and reporting have been generated in great quantity over the last couple of years from the Financial Accounting Standards Board, the AICPA, and the SEC, as well as from the FDIC itself and from the other banking agencies. I would like to review these developments, my attitude toward them, and the implications they have for banks and supervisors.

I

It was not many years ago that the bank supervisor's primary concern was that banks be able to raise capital when needed. The attitude with respect to buyers of securities was essentially that the investor, large depositor, borrower, creditor, and the general public really did not need much information because the supervisor had plenty of information and was using his best efforts to see that the bank did not fail. Even where Congress and the SEC took actions to improve disclosure in other industries, banking was left almost solely to the banking agencies.

Five years ago, disclosure to the public of the individual bank information we collected was not a major consideration at the FDIC or, for that matter, at any of the Federal bank regulatory agencies. The contents of the annual reports of income of individual banks were regarded as strictly confidential, except for a few hundred banks with 500 or more shareholders subject to the 1964 amendments to the Securities Exchange Act of 1934. Those banks had, since 1964, been complying with the registration, annual reports, proxy rules, and insider trading regulations and other requirements of Federal securities laws. But for the overwhelming majority of the banks, this was not so. While the front of the report of condition, the balance sheet information, was public, the detailed loan schedules on the back of the reports of condition were also confidential. An important item in each special survey questionnaire we sent to banks was the notice that returns would be treated as confidential and results would be released only as aggregates or averages. At that time, no outsider had managed to gain access to internal files or to photocopy reports of examination, listings of banks on the problem list, or critical memoranda by the regulators. And even if he had, newspapers would probably not have published such material.

But even five years ago, there were signs of growing interest in the details of the operations of individual banks. Some of the nation's large banks were publishing in their annual reports a considerable amount of information about their own operations beyond what regulatory rules required. Competition among banks and between banks and other types of financial institutions was increasing and with it was an increased interest in what individual competitors were doing. Moreover, whenever a bank submitted an application to merge with another bank, it was required to give an account of the competitive factors that were involved in the relevant market areas. With mergers the vogue at that time, there was a brisk demand for information about competing institutions which would enable bankers to measure market shares of the various banks operating in local and regional markets. At the FDIC, we were receiving large numbers of requests not only for the aggregated data we regularly compiled, but also data aggregated in special ways, for small areas, and for particular groups of banks. Academicians were besieging banks and the bank regulatory agencies with requests for individual bank data to enable them to carry on comparative analyses involving a whole host of other issues with broad public policy implications. And the accounting profession was hard at work on bank accounting problems, persistently but with a somewhat piecemeal approach. In short, there was evidence of growing interest in unpublished bank data.

The SEC gained more clout over the banking industry about this time, although almost by accident. While banks were exempt from much of the securities legislation of the 1930s, bank holding companies were not. Thus the expansion of the bank holding company movement of the 1960s and early 1970s led, incidentally, to more power for the SEC over bank subsidiaries of holding companies.

The long tradition of the banking agencies has been tied to confidentiality of unfavorable news. This has reflected the viewpoint of banks, their depositors, their borrowers, their creditors and the supervisors. Bankers have been willing to discuss their problems forthrightly with examiners, and examiners have been willing to relay their suspicions to the banker because each appreciates that the entire procedure is treated in confidence. The examiner wouldn't discuss his findings with a newspaper reporter, and the banker has felt no obligation to report the examiner's judgments to his stockholders. When a bank has been found to be in very weakened condition, the FDIC and the other agencies have attempted to explore possible solutions (or to seek potential purchasers). Obviously, the more publicity given to such a situation, the more difficult it is to solve the problem successfully.

I doubt if much thought was given to the need for data by security holders, creditors, large depositors or the general public. During this period, banks did not generally have securities outstanding other than stock and of that most was closely held and not actively traded. If any further thought was given to stockholders, I suspect the conclusion drawn was that what benefitted the bank and its depositors probably benefitted security holders as well.

The situation has changed. In all publicly held corporations, the obligations on management and insiders for full disclosure of the financial condition of their company have become more clear cut. Banks and bank holding companies have more securities outstanding and they are traded on a regular basis. As a result of a series of Congressional actions, it has become clear that the banking agencies cannot rely on the confidentiality that has been a basis of traditional regulation.

II

The move toward broader disclosure has taken several different directions. There has been a clear requirement for more disclosure of relevant information concerning the finances of the bank. Until about five years ago, for example, many banks did not distribute, even to stockholders, an annual income statement. The banking agencies had always collected such a statement, but until 1972, treated it as confidential.

The FDIC led the way in 1972 in making public the reports of income and condition for individual banks. Our thinking at the time was that publishing this information provided equal access to information then known only to "insiders," greater competition in good banking markets, incentive for banks to perform well, better access to capital markets for banks making such disclosure, availability of more complete data for researchers and legislative committees, development of more uniform accounting rules, and consistency with the spirit of the Freedom of Information Act. It is a sign of change in only four years to recall that at the time the decision to make this information public was a controversial one -- one on which we received many comments including some compliments and some complaints. Despite the complaints, we think this has proven to be a constructive development. We have supplied copies of thousands of documents to bankers, academicians, and other analysts. We are continuing to push for meaningful disclosure in this area, and are attempting to increase both the quality and the timeliness of the reports sent in by the banks.

In the last few years, the need for additional information by the public has grown. Economic developments -- unusually severe inflation, fluctuating foreign exchange rates, the most serious recession in forty years -- and banking developments such as rapid expansion of overseas operations of multinational corporations and greater reliance on borrowed funds, all have combined to produce a growing interest by diverse groups in the financial results of bank operations. In the past two to three years, losses have been sustained by shareholders in many commercial banks and holding companies as the market has turned down on bank stocks. Partly as a result, public accountants, bank stock analysts, and the SEC, among others, have stepped up their efforts to dig deeper into bank financial operations. Bankers are being pressed not only to describe what they are doing, but to predict where they think they are going.

My personal position is that the disclosure of information which reveals the earnings characteristics of the asset base, its stability and profitability, will subject those banks in bank holding companies whose stock and debt is traded on exchanges or over-the-counter to market forces which in turn will be a powerful force in compelling the banks to correct weak asset conditions. At the same time, banks in good condition should be rewarded by the market with easier and cheaper access to the capital markets, solid growth, and good profitable opportunities. Too often supervisory pressure on bank managements whose policies are dilatory or involve excessive risk-taking are ineffective. Supervisors seldom criticize bank management in public on the assumption that publicity might have adverse effects on the stability, or even solvency, of the bank. Investors informed by adequate disclosure, however, can affect the price of that bank's securities in a manner which will promptly compel management attention. This is not to say that disclosure should or could displace regulatory surveillance; both are tools to strengthen the banking system and they can be complementary.

At the other extreme, there have been unauthorized disclosures of information about banks and bank holding companies that we consider best left confidential. Bank examination reports and names of banks on agency problem lists, for example, probably will help sell newspapers, but it is doubtful that their publication contributes to confidence in the banking system. Even if the stories in which such information is revealed would emphasize or even explain the nature of problem lists or examination reports, which they seldom do accurately or thoroughly, most regulators will argue that such stories do much more harm than good.

Each of the banking agencies has its own list of "problem banks" or problem holding companies. These are classified in accord with the differing criteria of the different agencies in accord with their differing responsibilities. We find these classifications useful even though they are reached through subjective judgments. As Chairman of the FDIC, I want to know all the banks that our examiners, in their best opinion, think pose a risk to the Corporation. I want to know which banks they are, even if the examiner cannot provide conclusive proof that the bank is in poor shape (by that time it may be too late to do anything about it). This means that the list, in addition to being subjective, will include some banks which will easily recover from their difficulties. It will most certainly reflect the condition of the banks as the review process began, sometimes many months before, and not necessarily the condition of the bank at the time it appears on the problem list. In part because of these reasons, we do not generally formally notify even the management or directors of a problem bank that the bank is on our problem list. Obviously, then, we do not want the problem list publicized.

Likewise, we consider the examination report part of a confidential process. Bankers are willing to discuss frankly the weaknesses in their loans because they are confident that anything told to an examiner will be treated in confidence. Bank examination represents an independent assessment of a bank's condition by a trained professional. The necessary information gathering and loan discussion are facilitated because the banker views it as a cooperative affair rather than an adversary process. Time and money can be saved if this cooperation continues, and our career examiner employees are convinced that the data gathered through this process and the criticism extended by our examiners are both honest and thorough. If the confidentiality is lost or the process becomes adversary, there quite possibly would be a deterioration in the quality of examinations.

III

I feel that what has been discussed so far is rather clear cut. There is need for disclosure of financial information about banks and there is some information which should not be made public. There are difficult areas that fall somewhere between these poles, however. In recent months, we have seen various groups, including the FASB, the AICPA, and the SEC propose accounting and disclosure treatments that may lie beyond what is essential but perhaps is not a violation of necessary confidentiality. Some of the accounting changes that have been made, which we have supported, were intended to correct obvious deficiencies of traditional bank accounting. Until recently, for example, bank accounting for loan loss reserves did not distinguish realistic provisions for losses from allowances set up on a formula basis to accord with tax provisions. Now it does. That, plus treatment of deduction of unearned discount on loans, inclusion of capital notes as liabilities, and others, are examples of improvements in bank accounting made in recent years with the concurrence and support of the banking agencies, the accounting profession, and the SEC. Reporting has been improved this year by the requirement for semi-annual income reports from all banks and quarterly reports from the large banks. Some of these changes have been traumatic to some bank managements, but these changes have not involved difficult issues of principal or caused interagency controversies. There are controversial issues that remain, however.

Let me look first at the recent FASB proposal that theoretical market losses on corporate stock held by a bank must be reflected on its balance sheets. This has limited applicability to commercial banks, since banks in only a few states can hold corporate stock. Mutual savings banks, however, hold large amounts of common and preferred stocks. These investments are made as a permanent commitment of funds, and the banks generally have the liquidity and the staying power to hold these securities indefinitely. We, therefore, opposed running these losses (and subsequent gains) through the income statement and capital accounts, although we favored disclosure of the amounts involved.

I would like to spell out some of our reasons for opposing this accounting change because it is relevant to other accounting issues that have arisen. I am not an accountant and I will not argue the fine points of accounting theory. I do believe that accounting should be a guide for management and investors which presents financial statements that serve as the foundation from which sound managerial and investment decisions can be developed. In order to be a useful guide, accounting rules followed logically should lead to correct managerial and investment decisions. Yet the opposite may occur here. If mutual savings banks must write down to market price theoretical losses in preferred stocks, or if they must show losses and gains on theoretical transactions that they have never contemplated entering into, they might be discouraged from making such investments. But, according to most state laws, preferred stocks are an appropriate investment for savings banks (and, in some cases, for commercial banks). I do not like to see an investment deemed appropriate by legislative action refused simply because of an accounting rule. (One might argue that investment in preferred stock is not a good bank investment, regardless of what state legislatures have decided. But I feel that those who wish to argue this point should do so directly in the legislature.)

At the same time, I recognize that our present accounting rules do not necessarily lead to correct decisions with respect to securities transactions. Some bankers are reluctant to sell securities at a loss, if they must recognize it as such, even when tax laws and reinvestment opportunities make that the right economic decision. Our present accounting requires such recognition of a loss if they sell.

Of more concern than the FASB decision on equity securities is the possibility that the FASB may seek to expand this decision to debt securities as well. That has not yet become a proposal of FASB, and perhaps it will not. If it does, I suspect that the FDIC will want to testify along the lines that I have outlined.

While we were not able to convince the FASB of the error in their position that theoretical losses on corporate stock should be taken, we like to think that our comment to the FASB on that proposal had some influence on the final decision to require writedowns directly against capital accounts thereby avoiding impact on the net income line.

Of more significance than the accounting for losses on securities is the consideration by the FASB of a proposal for writedown of loans that have been restructured. Several days of public hearings were held on this matter and many banks and bank trade associations registered their disapproval. The FDIC submitted a comment on the proposal in accord with principles I have referred to. I believe that investors are entitled to meaningful information about the quality of a bank's loan portfolio. Where loans have been restructured -- that is where the maturity has been extended or the interest rate reduced -- full and complete disclosure of material information regarding the restructured debt should be included in supplementary schedules and footnotes. The disclosure should include a comparison of the principal values, the interest rates, the maturity dates, and a computation of any material effect on future earnings. On the other hand, it would clearly get into the realm of confidential matters for the bank to disclose the details of particular loans subject to new terms.

The real issue goes to the appropriate accounting for these restructured loans. We cannot agree that the loans in question should be revalued to some approximation of market value. Loan restructuring is not an unusual experience in a bank loan. If a borrower is having difficulty meeting the original terms of a loan, extending the maturity or lowering the rate may be the best way of assuring that the principal will ultimately be paid in full. A writedown to "market value" has several shortcomings. It implies that a loss of principal has occurred or will occur and, hence, is likely to be misleading. Moreover, its impact on management might well be perverse. The requirement for writedown may cause bank managements to be more reluctant to agree to the restructuring that may, as I have noted already, actually improve chances of full recovery. Even worse, if temporary difficulties with loans are going to be subject to such accounting treatment, perhaps the bank will decide not to make the normal risk loans that can lead to such difficulties, or will elect to take adverse action against the borrower rather than to effect workout arrangements. If banks change their lending policy away from one of assuming normal risks and toward one of making only riskless investments, small business, farmers, and the whole economy will be the losers. I appreciate that this exaggerates the possible result, but it does, I believe, illustrate the point.

Again, as a non-accountant, I view any accounting treatment that leads to poorer management decisions as poor accounting. We thus opposed the FASB proposal and noticed the large number of comments from various sectors of the financial community in agreement with our position. Let me stress that we are not opposing the investors' and depositors' right to know what is relevant to him. We favor disclosure of the aggregate amount of loans that have resulted in renegotiated terms. Disclosure is important to investors and depositors. Reflection on financial statements as a writedown, however, is a separate question -- one which goes to the ultimate theory and purpose of accounting statements.

I have stressed that we favor appropriate disclosure for investors in bank securities and for bank depositors. Securities laws provide that firms publicly offering securities, including bank holding companies, must make certain disclosures to investors and potential investors. This reporting requirement does not directly apply to banks, though all issuers of securities are subject to the fraud provisions of the law.

IV

The Comptroller of the Currency has recently issued proposed regulations for an offering circular describing information that must be furnished by all national banks before they may issue new debt or equity securities. Two years ago, the FDIC issued a proposed offering circular regulation covering the offering of securities by nonmember banks. We received many comments on that proposed regulation and, while our staff has worked on revisions of the proposal, we have never issued it in final form. The reasons are relatively simple. Adopting SEC type regulations for smaller institutions involves a substantial burden on small banks seeking to issue securities. This burden, plus less-than-bullish information which might be revealed by some banks, might make it more difficult for some banks to raise capital. These are difficult hurdles for our agency to overcome. On the other hand, it is clearly appropriate that potential investors have the information at hand to determine whether the securities they are planning to buy are worth the price. We certainly recognize that banks are susceptible to lawsuits based on common law fraud and violations of Section 10(b)(5) in the sale of their securities.

We have been reviewing the Comptroller's proposal and find it similar to ours in most basic respects, although the Comptroller's proposal would exempt only issues of under $100 thousand, while ours would exempt issues under $500 thousand. While our Board of Directors has not reached a conclusion on the staff revision, the proposed regulation remains on our pending agenda. The extent to which we treat large and small banks differently is an important part not only of this issue, but of a great many other supervisory issues.

This discussion of SEC type regulation of offering circulars brings us to what is the most recent issue we have had concerning disclosure, and that is negotiations concerning the SEC's Guides 3 and 61 that apply to new issues of securities and to annual reports of bank holding companies or banks subject to SEC regulation. The banking agencies have been discussing these matters with the SEC for about two years. At that time, the SEC was concerned that bank holding companies were not making sufficient disclosure concerning the quality of their subsidiary banks' loan portfolio. The initial SEC proposal was that banks be required to disclose the amount of loans classified substandard, doubtful, and loss by bank examiners. We objected to that for the reasons I mentioned earlier. We would view it as compromising the confidential nature of the bank examination process. For over a year since that time, we have been discussing, both at the staff level and among the heads of agencies, what the best substitute for classified loans would be in attempting to get some measure of the quality of loan portfolio.

We have had mixed success on the basic issues discussed. The SEC, for example, recognized the difficulty in getting comparable figures on loan commitments and so dropped that requirement. On the other hand, the SEC is now requiring that all bank holding companies offering securities disclose the amount of loans past due, and the amount of loans on which the terms have been renegotiated. Incidentally, the SEC calls these "nonperforming" loans. A more accurate description, in my judgment, is "underperforming." While different people may differ as to whether loans past due should include loans 30 days past due or 60 or 90, at least these are reasonable objective categories and we support the effort to show the potential income impact of underperforming loans. Our disagreement has focused on the SEC's desire for another category of underperforming loans -- loans that raise in management's mind "serious doubts" that the borrower will be able to meet the original terms of the loan. We think this is too subjective and, in any case, that the principal amount of such loans is rather meaningless.

Our discussions over the months with SEC have produced some agreements and some moderation of original SEC positions. I feel that this is a tribute to the ability of the individuals at the different agencies to reach positions acceptable to each other, even though the statutory philosophy (i.e., disclosure v. confidentiality) often was dramatically opposed.

I believe I can summarize my views on this whole matter rather simply. I favor broad and full disclosure. I believe that depositors and investors in bank securities should have full information on which to base their investment or deposit decisions. I do not want to see details of individual transactions made public, nor do I want to see the confidentiality of the supervisory examination function seriously compromised. I believe that the accounting procedures followed by banks should be in accord with accounting principles and procedures accepted by the accounting profession and applied to other industries, making only those changes and exceptions for banks that are warranted by the nature of the banking business. If a proposed accounting principle leads to worse economic or business decisions, serious consideration should be given to the wisdom of adopting such a principle, even if it seems to make sense from an accounting standpoint. If an accounting change, by itself, leads banks to make poorer investment decisions, or leads them to refuse to consider a debt restructuring that may benefit both the bank and the borrower, or leads the bank to reject a swap proposal from a REIT that would benefit all parties, then I would send the accountants back to the drawing board. Likewise, of course, if a banker chooses to make poor business decisions (such as holding or selling securities) just because of the way he has to reflect such actions on his books in the short run, I would like to send him down to the minor leagues.

In any case, and regardless of differences of opinion on accounting principles, we are going to see a trend toward wider disclosure that I think is healthy and desirable. We do intend to defend to the greatest extent possible the preservation of confidentiality in those areas that should be confidential and we will seek to avoid disclosures that we think would be misleading or harmful.

V

Thus far today I have been talking about accounting and financial disclosure. But there is another type of disclosure opportunity available to the banking industry today that may not be available much longer. That is the opportunity to disclose voluntarily and in their own way the extent to which banks are meeting what many view as the "social responsibilities" of banks. Most businesses are not subject to pressure along these lines, and bankers may object to being singled out for special treatment, rather than welcoming the pressure as an opportunity. But bankers have often argued that banking is different, in that it has greater implications for public welfare, and thereby themselves have supported the arguments that it may be appropriate to subject banks to higher social standards.

One area in which banks have lost the opportunity to tout their own accomplishments is the area of disclosure of investments in mortgages. The Home Mortgage Disclosure Act now requires most banks to disclose, by zip codes or census tracts, the location of their home mortgage lending activity. By waiting until Congress acted, banks may have lost the opportunity to lead disclosure in this area. This legislation grew out of concern with redlining and disinvestment in our cities. While I have grave doubts that this disclosure will shed much light on the problem of urban disinvestment, this is an example of interest by the public in the way the deposits of the public are being administered and invested by the banks, and I believe an example in which banks generally had a good story to tell, but which lost the opportunity to tell it voluntarily.

As I have already indicated, some types of financial disclosure by banks can represent violations of privacy or may be unwise for other reasons. The same may be true of disclosures of "social responsibilities" information. There are some in our society who favor government dictated mandatory credit allocation to see that what they regard as high priority credit needs are met. I personally hope that we can avoid any more government interference than we already have with the bank lending function, but this may not be possible, or some would argue, even desirable. I think we must recognize that there is a broad social interest in the lending decisions of the banking industry. Somehow, bankers must find some way of disclosing meaningful information to the public about the nature and character of their investment decisions. Most banks probably do a creditable job of meeting high priority credit needs. But that fact has not always been demonstrated very thoroughly or convincingly. If bankers want to avoid greater pressure on the direction of government directed mandatory credit allocation, they are going to have to understand the public perception of desirable lending and get their message across as to the type of lending activity they are conducting. This is a different type of disclosure than balance sheets and the forms of financial reports, but it is a real need.

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