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Remarks by [on disclosure of information and the health of banking industry]

Robert E. Barnett, Chairman
Federal Deposit Insurance Corporation

before the

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Bank & Financial Analysts Association,
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Friday of this week, I am scheduled to testify before the Senate Banking Committee on the health of the banking industry. I am pleased that the Committee is holding this type of review of the condition of the banking system, and I hope that this will be a regular part of the Congressional oversight of the banking industry and the banking supervisory agencies. Regular routine disclosure and discussion of information concerning the banking industry is in the public interest. It is the occasional disclosure of dramatic items taken out of context that does a disservice to the banking industries, banking agencies and the U. S. economy. Disruptive effects of leaks of confidential information can be properly minimized by routine and regular dissemination of information concerning the condition of banks and by regular oversight hearings by the appropriate Congressional Committees.

Some of the discussion of the last year or so has related to disclosures concerning our list of problem banks. In the past, we have treated information about the problem list as confidential on grounds that it grows out of the process of bank examination. While I certainly believe that the examination report of an individual bank is properly confidential, I believe there can be a greater disclosure of information concerning the aggregate results of our examination process, including regular public dissemination of information on the status of our problem list. I believe that if that had been done

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regularly, the occasional unauthorized disclosures of such information would prove much less shocking and newsworthy.

Making more information available concerning the problem list is in keeping with other developments in banking over the last several years in the direction of ever greater disclosure of financial information concerning the operation of individual banks. This movement in the direction of greater disclosure has come about as the result of action of the SEC, the FASB, the accounting industry, and the banking agencies. There have also been steps taken toward improved disclosure by banks on their own volition following careful study of the appropriate public and private interest involved. The recent publication of a new policy statement on disclosure by Bank of America is a case in point. At this point, it seems probable that the general movement in this direction has been desirable both from the point of view of the general public and from that of the banking industry.

In my remarks tonight, I would like to discuss the general health of the banking industry and then examine this trend toward greater public disclosure of information concerning the health of the banking industry and individual banks.

Let me first state my belief that the banking industry is in reasonably sound condition, certainly in much better condition than it was during the past year or two. The statistical trends in the

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industry over the past year seem to reflect movements toward stability, increased capital ratios, better liquidity, declining loan losses (although they remained high in 1976) and higher earnings. Nonstatistical items, such as management experience, also have improved. The industry is in an appropriate position to recover from the remaining ill effects of the problems of the early 1970s.

This is a significant achievement if the developments of the past number of years are listed: Over the last 15 years, banks have chosen to operate in a riskier manner; At the same time, the U.S. and world economies have become riskier places in which to do business; Over the last 5 years or so, there have been some very unfavorable economic developments which had serious effects because of the riskier structure of the economic system; The banking system, as a result of these unfortunate events, the greater risk in the economic environment and the greater risk inherent in their own financial structure and operations, underwent a severe shock; The banking system was hit hard by the confluence of these forces in the 1973-74 period, and this resulted in severe problems for a number of banks, including some large banks; Despite all of this, the banking industry and the financial system were basically sound and stable, and this enabled the industry to weather the storm. Let me go back and consider these points in order.

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Over the last 10-15 years the banking system has become a riskier one as banks, particularly the larger banks, have operated in a more aggressive manner. Since the early 1960s, many banks, and particularly the large banks, abandoned their traditional conservatism and began to strive for more rapid growth of assets, deposits and net income. Large banks began pressing at the legal boundaries of allowable activities for banks. Beginning in the mid-1960s, national banks were allowed to expand their activities into fields which, to many observers, involved more than the traditional degree of risk for commercial banks. Whether such activities are inherently riskier, or riskier only in their newness to bank managers is a problem I must leave to others to resolve. Suffice it to say that at least in the short run, they are riskier. These included such activities as direct-lease financing, underwriting of revenue bonds, expanded foreign operations and others. I am not suggesting that banks should not be in these activities. One could make the argument, I believe, that such increased riskiness is healthy, desirable for the nation's economy, and competitively responsible. Nevertheless, these activities are examples of the general trend toward increased aggressiveness and increased willingness to bear risk on the part of the banking system in general, and large banks in particular.

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The bank holding company movement is another such development. It allowed banks to get into areas somewhat different from their traditional activities; again, not necessarily inappropriate, but activities at least generally perceived to involve a greater degree of risk.

Beginning at about the same time, larger banks began to advocate and practice the concept of liability management. This involved a change from the traditional balance sheet requirement of adequate liquidity of assets to a willingness to go into the money market and buy liquidity if needed, regardless of prevailing rates.

Most of the traditional financial measures of bank aggressiveness and riskiness show these trends. In 1960, for example, banks with deposits of between $5-10 million had an average loan-deposit ratio of 46 percent, whereas banks with deposits over $500 million had a loan-deposit ratio of 56 percent. Both size categories of banks showed significant increases in this ratio over the last 15 years, but the increase has been more dramatic for the large banks. Their loan-deposit ratio at the end of 1974 was 79 percent as compared with 63 percent for the smaller banks. This came about as a result of a very large increase in the volume of business loans (including commercial real estate loans) in the early 1970s. In addition to the loan-deposit ratio, the capital-asset ratio showed the same trends. The capital-to-asset ratio of both size categories

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of banks was nearly the same in 1965, and averaged for all banks, about 8 percent. Since that time the small banks have maintained their capital ratio at about 8 1/2 percent, while the large banks' ratio has declined to under 7 percent, causing the average of all banks to drop to about 7 percent. While one can argue the merits of these or other ratios as measures of risk, for whatever they are worth, they do exhibit a change in traditional ratios of risk measurement, with a much greater change on the part of the larger banks than the smaller ones.

One of the areas in which large banks have moved with great vigor in recent years has been the international area. Approximately 140 American banks have foreign branches, or one percent by number of American banks, compared with only 27 in 1968. These banks, while small in number, account for nearly half of total U. S. bank deposits, and the assets of their foreign operations amount to about 30 percent of their total assets. Part of this operation involved a much greater role for American banks in lending to foreign businesses and governments. Operation outside the country in which a corporation is originally established is not necessarily riskier than domestic operations. But for most American banks engaging in this activity during the 1960s and 1970s, it was at least a new venture, and new ventures are almost necessarily riskier than those in which one has built up a solid base of experience. Not surprisingly, a number of American

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banks have incurred losses in their foreign operations. Again, none of these losses have been sufficient by themselves to result in a bank failure, although the international operations of Franklin National Bank greatly added to its other problems.

Related to the move into new types of activities, and new geographical areas for banking activity, has been a change in orientation of American banks. Performance began to be a more important consideration, as did growth. Banks became more concerned about their immediate profit picture and the price of their stock. In several cases, banks took on activities, loans or commitments that seemed to have the promise of immediate profitability or favorable stock market reaction.

Part of this was associated, at least in the United States, with a new breed of banker -- younger and more aggressive. Not only did youth tend to make for more aggressiveness, but we began to see rising to positions of responsibility bankers who had not had direct personal banking experience during the depression of the 1930s. One can take that argument only so far, however, since some of the industry leaders during this period were individuals who were personally familiar with the depression.

It is generally acknowledged that the state of the world economy has become riskier in recent years. There are several forces at work here: The long-run world inflationary trend is one aspect of it.

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Another is the replacement of the system of relatively fixed exchange rates that has prevailed for most of the post-World War II period by a system of more-or-less freely fluctuating exchange rates. A world of fluctuating exchange rates is a riskier one in which to do business. In fact, the means by which business firms have minimized their exchange risks have been by a greater willingness of banks to take on the exchange risks. On the domestic scene, over the last 20 years corporations have restructured their balance sheets on a rather massive scale, substituting debt for equity and increasing their leverage. Not only did the financial structure of the firms that banks lend to become riskier, but at the same time corporate profits were weak, so that the corporations have found themselves more dependent on external financing for both their long-term and short-term financing needs.

Once both the banking system and the economy arrived in this riskier position, the world was beset by an extraordinary combination of crises. First the world energy crisis precipitated by the OPEC Cartel -- the embargo and the huge increase in the price of oil. This produced a massive shift in the balance of payments of the U.S. and other countries requiring the financing of resulting deficits and reinvestment of the OPEC surpluses. One result was the serious threat to the status of multi-billion dollar oil tanker loans. Another was to generate questions about the economic outlook of less developed

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countries who were, in fact, the hardest hit by the increase in oil prices.

These developments, along with such developments as wide swings in commodity prices, not only helped produce inflation at a record rate, but led to a recession deeper than any downturn since the 1930s. The inflation and recession combined with what appears to be a peaking of another of the periodic cycles of real estate speculation in the U.S. to produce massive deterioration of the real estate market, generating huge loan losses. A separate crisis in municipal credit was triggered by New York City's near default. In the midst of all this, we had the failure of what had been the twentieth largest bank in the United States and many news stories about the regulatory agencies' list of problem banks.

One observer of the banking scene put it this way:

> "some time after 1965, the halcyon age apparently ended. Rising inflation was the harbinger, but certainly not the sole cause or symptom, of heightened economic instability. This was a period of collapse of the Bretton-Woods Agreement and disappearing anchovies, of social unrest in America and widespread drought abroad. An American president was shamed into resignation and traditional allies grew restive as former adversaries were embraced under the guise of detente. In addition, petroleum producers established a potentially disastrous precedent for other primary materials producers in effectively cartelizing the industry. In short, the period after 1965, and particularly after 1970, was one in which numerous seemingly unrelated shocks buffeted the economic system. Quite expectedly, the system lurched to and fro, while stabilization policy-makers sought to administer offsetting shocks."*

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* Stuart Greenbaum, Professor of Finance, Northwestern University, "Economic Instability and Commercial Banking." Compendium of Major Issues in Bank Regulation, Senate Banking Committee, May 1975.

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As a result of all of this, we saw 16 bank failures in 1976, the largest number in nearly 25 years, following closely the 13 the previous year. The number of banks on our problem list, which includes national banks and state member banks, as well as non-member banks, increased from 156 on December 31, 1973, to 349 on January 1, 1976. We usually expect the number of our problem banks to level off and decline after some time lag during the recovery period for the economy. The time lag was much greater in the case of the 1973-74 recession, and during 1976 the number of banks on the problem list actually increased, rising to 373 by early summer of 1976 and fluctuating around that number since that time. As of January 1, 1977, we had 379 banks on the problem list, and as of March 8, 1977, we had 384. It is significant, however, that the number of banks in our serious problem categories has declined substantially from a high of 128 in the spring of 1976 to 115 at the present time, and that the number of banks that were not on our problem list was always about 14,500 throughout this period. Similarly, although 16 insured banks failed, well over 99 percent of all depositors had immediate access to their entire deposit amount because of successful purchase and assumption transactions.

With all that bad news as background, we can look at more recent developments with some optimism. Nineteen seventy-six was a good year for the banking system in terms of earnings and

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improvement in financial conditions. Bank liquidity positions improved dramatically with substantial increases in holdings of government securities. While banks might have preferred that loan demand were stronger, we must recognize that that lack of demand has led to an improvement of the liquidity position of the banking system. The liquidity position was also improved by the continued displacement of volatile money market sources of funds with stable savings type deposits. The reduction in interest costs allowed an increase in earnings despite the relatively slack loan demand. The capital position of the banking industry also improved during 1976, as the growth rate of capital, through retention of earnings, was higher than the modest growth rate of total assets and deposits.

Bankers necessarily have learned something from their experiences of the last few years. Activities that were new to many of them in the 1960s are more familiar now that they have lived with them through bad times as well as good. Bankers' attitudes toward risk and appropriate loan policy have benefitted from this experience. The real estate developer with a great idea will sit down with a loan officer more experienced and more skeptical than a few years ago.

Bank loan problems still exist. Since the major element of problem loans for banks over the last few years has been real estate loans, these are loans that take a long time to work out, and

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hence the volume of underperforming loans and classified loans is still high. But net loan losses in 1976, while high, were less than the record levels of 1975.

All in all, it does seem fair to say that the banking system has turned the corner and its condition is improving. A key factor in its continuing recovery will be cost of carrying problem assets until their disposition and whether the opportunity cost of missed investments will exceed or fall short of ultimate recovery volumes. Thus, although some banks are not yet clear of the serious financial problems that surfaced during the 1973-74 recession, the industry as a whole continues to experience steady improvement in both balance sheet liquidity and capital strength in early 1977. We might note that no bank has closed because of financial difficulties so far in 1977. By this date last year, we had seen four bank failures.

It is perhaps unfortunate that the initial disclosure of the numbers of banks on our problem list came at a time when the numbers were larger than they had been previously. Nevertheless, the periodic dissemination of such information is useful and appropriate public information. Confidential information concerning the condition of an individual bank that arises from the examination process should remain confidential. But aggregate information that relates to the health of the banking system as a whole is appropriately a part of the public record. It remains our intention to make such

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periodic disclosure of aggregate information from our problem list in regular forums such as periodic Congressional hearings on the condition of the banking industry.

When I say that we are not going to make available information about individual banks from the examination process, this does not mean that depositors and investors are lacking appropriate information concerning the operations of the bank. There is now a great deal of information in the public domain. This has been a recent change and it seems to me appropriate to review how this point was reached.

Until fairly recently, the amount and quality of financial reporting by banks was far below that available for other business firms. All banks filed annual reports of income with the supervisory agencies, but these were treated as confidential by the agencies, except for the few hundred banks with 500 or more stockholders that were subject to the 1964 amendments to the Securities Exchange Act of 1934. Most investors and depositors were basing decisions about banks on the only financial data available -- for most banks this was a quarterly balance sheet.

Even where income reports were available, the accounting standards followed by most banks had substantial shortcomings. For example, loan losses were not treated as an ordinary operating expense, and most banks' income was reported on a cash rather than an accrual basis.

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Changes in this situation have been occuring over time. The accounting requirements of the banking agencies were significantly changed in 1969 to require calculation of a provision for loan losses as an operating expense and to require accrual accounting for banks of over $25 million in size. All banks were required to report income taxes on an accrual basis.

A major step forward was made in 1972 when the FDIC, followed by the other banking agencies, decided to make public the required bank income reports. The FDIC view at the time was that publishing this information provided (1) equal access to information then known only to "insiders," (2) greater competition in good banking markets, (3) incentives for banks to perform well, (4) better access to capital markets for banks making such disclosure, (5) availability of more complete data for researchers and legislative committees, (6) development of more uniform accounting rules, and (7) consistency with the spirit of the Freedom of Information Act. At the time, the decision to make this information public was a controversial one: most bankers and many supervisors believed that depositors were the only group to be considered and they were better served by limiting financial disclosure and allowing the supervisors to operate in relative secrecy.

Further changes were made over time as the banking agencies tended to move the accounting basis of the reports of condition and

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of income required of all banks more closely both to an accord with generally accepted accounting principles and with the reporting of those banks which had been subject to the 1964 amendments. Several additional changes were made in 1976 which (1) required the loan loss reserve to be split into its three component parts -- a valuation reserve, a contingency reserve, and a deferred tax liability; (2) required removal of unearned discount from the loan account; and (3) required the presentation of subordinated notes as liabilities rather than capital.

During the last several years, the SEC has gained additional responsibility for bank accounting and disclosure, 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, quite incidentally, led to more power for the SEC over bank subsidiaries of holding companies. The SEC, whose statutory mission is disclosure, has been aggressive in putting its theories to work with banks.

While the concept of full disclosure for nonbanking business firms has been well established for many years, disclosure in banking has lagged behind. Disclosure of unfavorable news for a nonbanking business is unlikely to lead to an immediate adverse impact -- that is, disclosure of an operating loss by, say, General Motors is not likely to lead car buyers to shift their preferences from Chevrolets

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to Fords. Disclosure of unfavorable news concerning a bank might, it was feared, trigger a run. The bulk of a commercial bank's liabilities, unlike those of manufacturing firms, are, in practice, payable on demand.

Even apart from concern about runs, the banking supervisory agencies have traditionally been concerned about the ability of banks to raise capital. At some point, disclosure of unfavorable results, it was argued, can make the sale of debt or equity more difficult and thereby make it more difficult for a bank to remain viable.

Whatever the merits of the argument that the investor's need for adequate information should be compromised by concern with maintaining the stability of the banking system, the issue has by now been resolved most decidedly on the side of full disclosure. But acceptance of that conclusion does not immediately resolve all current issues concerning bank accounting and disclosure. Several of these issues still pose knotty problems even for those who agree that banks, like other publicly held firms, must make full disclosure of material facts to investors and potential investors.

In my view, while disclosure of relevant information is important to investors, the form of that disclosure is frequently just as important. Full disclosure in an inappropriate way can lead to unnecessary harm to the affected bank while giving the public and the investor no additional useful information about the bank. Consider,

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for example, the recent FASB ruling that market losses on corporate stock held by a bank must be reflected in writedowns on the balance sheet. This has limited applicability to commercial banks, since banks in only a few states can hold corporate stocks. Mutual savings banks, however, hold large amounts of common and preferred stock. 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. While disclosure of the amount of market depreciation involved is appropriate, I do not see the advantage of reflecting this on the balance sheet, much less on the income statement (as the FASB had originally proposed). In fact, requiring balance sheet writedowns could have a perverse and unfortunate impact on management decisions.

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. If mutual savings banks must write down to market price unrealized losses in preferred stocks, for example, 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).

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Of course, our present accounting rules do not necessarily lead to correct decisions with respect to securities transactions either. 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.

With respect to the more controversial issue of treatment of restructured loans, disclosure of the volume of such loans and their impact on earnings are clearly relevant to the investor. But it does not seem necessary to reflect that amount on the balance sheet. It appears that given the information, the market will process it efficiently, and investors will not be misled, regardless of accounting procedures followed. Requiring immediate recognition of such arrangements on the financial statements may discourage some bank managers from taking the action which is best from a long-run point of view.

One of the most significant recent developments in bank reporting is the SEC promulgation of Guides 3 and 61, which set forth new standards for bank holding company reporting. The key issue in the new SEC requirements is disclosure of meaningful information concerning the quality of the loan portfolio. This has been a matter of discussion involving the SEC, the banks and the banking agencies for about two years. In view of the increase in

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bank loan losses, the SEC had a legitimate concern that bank holding companies make sufficient disclosure of the quality of their subsidiary banks' loan portfolios. Initially, the SEC proposed that the bank disclose the amount of loans classified adversely by the bank examiners. This was not acceptable to the banking agencies who were afraid that publication of these data would not only mislead the investor but would compromise the integrity and the confidentiality of the bank examination process.

It is fairly easy to gain agreement among all parties on some disclosure of two types of "underperforming" loans; viz., loans past due, and loans on which the terms have been renegotiated. These are at least objectively measurable, though it is not clear how tightly linked these loans are to future loan losses. Some bankers and supervisors objected to disclosure of the principal amount of such loans, preferring that only the effect on income of the lost interest be disclosed. This attitude probably represents an exaggerated fear of adverse public reaction to the publication of large dollar figures, and underestimates the market's ability to process information. There is more ground for criticism of the SEC decision to require disclosure of the amount of loans that raise "serious doubts" that the borrower will be able to meet the original terms of the loan. This is an extraordinarily subjective test and, in my judgment, produces data for banks that defy meaningful comparison with similar data from other banks.

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In summary, then, we have seen major changes in bank disclosure since the days when it was argued that secrecy was best and that full disclosure would adversely affect confidence in the banking system. Depositors and investors in bank securities should have full information on which to base their investment or deposit decisions, without compromising the supervisory examination function. In my judgment, the changes that have been made in recent years are consistent with these goals.

There are some additional issues related to disclosure and accounting that are currently under consideration at the FDIC. We published for comment some time ago a proposed regulation on offering circulars by nonmember commercial banks. We received a heavy volume of comments on that proposal and it now has been revised by the FDIC staff. It will be considered by the Corporation's Board of Directors in the very near future. We are also considering whether some additional regulations relating to disclosure by mutual savings banks are necessary. With the exception of a few institutions that have subordinated notes outstanding, most mutual savings banks do not have security holders in the traditional sense. We want depositors in those institutions, however, to have appropriate information on which to base their decisions. It will be important, certainly, to make sure that any requirements that may be considered take into account the unique character of mutual savings banks.

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I have mentioned SEC Guides 3 and 61 which apply to bank holding companies. We have been considering whether to apply the disclosure standards of Guides 3 and 61 to nonmember banks that are subject to disclosure regulations. A strong case can probably be made for the application of part of those standards to nonholding company banks. Obviously, we would not apply those parts of Guides 3 and 61 which we think are inappropriate, nor would we be inclined to apply them retrospectively.

Since I have been Chairman of the FDIC, issues related to disclosure have been important to us and the banking industry. Nearly all of the issues have been resolved on the side of more disclosure and better accounting. I think that is as it should be. But we have now arrived at the point of literally full disclosure for banks whose securities are widely held with the important exception of the examination report itself. We must be cautious from here on that the presumed benefits of greater disclosure are weighed against any possible impact on the bank supervisory process.

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