NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION

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FOR RELEASE TO P.M. PAPERS
THURSDAY, JANUARY 28, 1965

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Expanding credit and service demands on banks will generate a need for new bank capital "on a much larger scale than we have known since the 20's," Chairman Joseph W. Barr of the Federal Deposit Insurance Corporation predicted today in a speech before the Banking Law Section of the New York State Bar Association at the Hotel Biltmore.

"Some of this projected capital need," Mr. Barr said, "will be met by retained earnings, some will probably be met by debentures, but certainly there will be an expanding need for equity capital and a need to attract not only more funds but more investors into the common stocks of commercial banking.

"Since the end of World War II, banks have been shifting out of governments into loans and, in addition, the loan demand has greatly expanded. While the increase in loans has been better than 10 percent a year, total assets have been increasing little more than $4\frac{1}{2}$ or 5 percent. There are obvious limitations to these kinds of changes in the banking structure.

"While the current need is becoming increasingly obvious, any realistic look at the future will indicate the necessity for quite substantial amounts of new banking capital. The broad objectives of

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the quest for the Great Society on which this nation is now embarked will certainly require an expansion of bank loans at the current or even an increased rate. And there will be a steadily mounting demand for the services that banks provide."

The new bank securities law requiring full financial disclosure by commercial banks whose securities are traded in over-the-counter markets--currently about 600 banks come under the law--presents an important challenge to bank supervisory agencies which heretofore have been geared to the protection of depositors who provide about 92 percent of their resources. The disclosure law gives FDIC, the Federal Reserve System and the Comptroller of the Currency jurisdiction in this area.

Discussing the problems encountered in writing the regulations to carry out the disclosure act, Barr declared that "perhaps the most controversial of all issues was that of whether certification of financial statements by independent public accountants be required.... Very strong opposition developed on grounds that this was unnecessary in view of examination and supervision to which banks were already subjected; that it would involve duplication of efforts of internal auditors and state and federal examiners, and that it would represent a substantial financial burden.

"As finally adopted, the Regulation permits a choice on the part of the bank whether to file statements certified by independent public accountants, or simply verified by a bank's own accounting

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officers. But this does not settle the issue for all time.... Independent certification remains a desirable long-range objective; it just does not seem to be practicable now. More essential for the present are the problems of making financial reporting by banks more comparable and improving internal audit procedures. Many of the specific requirements of the Regulation are aimed directly at these objectives.

"Certainly, it is imperative that any institution or industry that is as important to our people as banking have the fullest possible access to the life-blood of our competitive securities markets. The recent amendments to the securities acts will go a long way in achieving this objective.... The Securities Act of 1964, therefore, seems to be unusually well timed to meet the needs of public policy, the needs of investors, and the needs of the banking community."

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PUBLIC DISCLOSURE -- IS IT WORTH THE BURDEN ON BANKS?

Address of

JOSEPH W. BARR, CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION
Washington, D. C.

before the

Banking Law Section
NEW YORK STATE BAR ASSOCIATION

at

Luncheon Meeting

Thursday, January 28, 1965

Biltmore Hotel, New York City

Address of
Joseph W. Barr, Chairman, Federal Deposit Insurance Corporation
Before the Banking Law Section of the New York State Bar Association
Biltmore Hotel, New York City
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PUBLIC DISCLOSURE - IS IT WORTH THE BURDEN ON BANKS?

I would like to use the time that you have given me today to talk with you about one of the most important supervisory challenges currently claiming the attention of bank regulatory agencies. The challenge derives from amendments to the securities acts enacted last August which, for the first time, require full financial disclosure by larger corporations whose securities are traded in over-the-counter markets. For the first time, commercial banks -- in the beginning about six hundred of them -- must disclose historical, managerial, and financial information needed by potential investors in bank securities in order to make informed investment decisions.

This was not precipitate or hasty legislation on the part of the Congress. Some of you will recall that over two years ago, the SEC was directed to undertake a thorough and intensive study of the securities markets. In its deliberations over ensuing legislative enactments, of which the extending of disclosure requirements to over-the-counter markets was only one part, the Congress gave careful consideration to the uniqueness of the banking industry. One decision which I think was of crucial importance gave jurisdicition over banks in this area to bank regulatory agencies -- the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. I was then Assistant to the Secretary of the Treasury, preoccupied with the tax reduction bill, and therefore only generally concerned with the securities laws amendments. But I can nevertheless understand and appreciate the desires of the Congress in leaving the new disclosure supervision to the regulatory agencies.

There was general awareness of the fact that the existing bank regulatory agencies have always been depositor oriented and have been largely responsible for putting the banking industry in a position where its reporting system was geared to the protection of depositors, with only rather cursory attention to the needs of [illegible] investors. It has seemed to me that the Congress exercised a sort of rough and ready justice by assigning to the bank regulatory agencies the responsibility for straightening out a situation which they helped to create.

There were very good reasons for this cautious regulatory attitude. Unlike other industries, banks do not function on "risk capital" in the normal sense. About 92 percent of their resources derive from deposits entrusted to their custody in a fiduciary relationship. These relative magnitudes alone explain the traditional concern of regulatory agencies for depositor protection.

But there are historical reasons as well. In banking, the failures of the 20's and 30's still lurk in the memory of most of us and tend to support a continued concern over the safety of deposits. In addition, the period of the 30's, 40's, and 50's produced no significant demands for large increases in bank capital, and the attraction and protection of new investors was not a matter of overriding importance.

The picture now is quite different. Since the end of World War II, banks have been shifting out of governments into loans, and, in addition, the loan demand has greatly expanded. While the increase in loans has been better than 10 percent a year, total assets have been increasing little more than $4\frac{1}{2}$ percent or 5 percent. There are obvious limitations to these kinds of changes in the banking structure, and we may well be approaching these limitations. One indication, of course, is the recent interest in notes and debentures on the part of bank managements. This has created some headaches for the regulatory agencies but nevertheless represents the obvious need of banks for capital and is an unavoidable consequence of bank expansion. It would thus appear that the Securities Act of 1964 was well timed. Just as the banking community was arriving at a position where it felt a real need to attract new investors and additional capital, the 1964 Securities Act came along to require the disclosure of information which can support new investment.

While the current need is becoming increasingly obvious, I am convinced that any realistic look at the future will indicate the necessity for quite substantial amounts of new banking capital. The broad objectives of the quest for the Great Society on which this nation is now embarked will certainly require an expansion of bank loans at the current or even at an increased rate. And the steadily mounting demand for the services that banks can provide can very well accelerate. Banks have traditionally thought of themselves as suppliers of credit, but it is becoming increasingly apparent that banks are potentially the greatest service mechanism in our economy. When one considers the central position of banking in the flow of payments and data in conjunction with the application of advanced computer and communication techniques, it seems that the service potential is almost limitless. Thus, I would be willing to go out on a limb and predict that the twin thrust of expanding credit and service demands will generate a need for new bank capital on a much larger scale than we have known since the 20's.

Some of this projected capital need will be met by retained earnings, some will probably be met by debentures, but certainly there will be an expanding need for equity capital and a need to attract not only more funds but more investors into the common stocks of commercial banking. I would repeat, therefore, that the Securities Act of 1964 seems to be unusually well timed to meet the needs of public policy, the needs of investors, and the needs of the banking community.

I would like now to turn to some of these problems of writing the Regulation and give you some feeling of our approach to them. First of all, what was the intent of the Congress? I would put it something like this -- "you must continue your concern for depositors, but your financial reporting practices, which have been geared to the protection of depositors, must from now on take into account the needs of stockholders and investors as well. The two purposes must be blended." This is the task we have been grappling with for many weeks, and that we expect will require continuing attention for some time to come.

I do not need, before this knowledgeable audience, to detail the provisions of the Act or of the Regulation. As you know, initial rules were proposed for comment last September, and the final Regulation appeared at the end of December. Banks covered under the Act -- those with $1 million of assets and 750 stockholders -- about six hundred in all as I have indicated -- must file an initial registration statement and periodic amendments. They must file annual and quarterly financial reports. Rules are prescribed for the solicitation of proxies prior to stockholder meetings. So-called "insiders" -- directors, principal officers, and large stockholders -- must report their holdings, purchases, and sales of stock.

Between the time that the initial draft inviting comment was issued and the final Regulation, we had a very healthy response from many banks and individuals, as well as from representatives of banking groups, security analysts, accountants, and others. In addition, all-day conferences, which some of you may well have attended, were held with committees of the American Bankers Association, the New York Clearing House Association (let me say for any of you who might have worked with the Clearing House group that they did an enormous amount of very useful work), the Financial Analysts Federation, the American Institute of Certified Public Accountants, and others.

I want particularly to assure you that the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation worked very closely and very amicably on this difficult task all the way through. This does not imply that there was always full agreement. On many issues, there was heated debate between the two staffs. Many of these are very hard questions, as you know, and sharp disagreements flared and had to be resolved -- as often among members of the staff of the Federal Reserve or among our staff as between the two.

Perhaps the most controversial of all the issues was that of whether certification of financial statements by independent public accountants be required. You may recall this was a requirement in the initial rules issued last autumn. The main argument for certification is that it provides investors with an independent opinion, based on a competent audit, as to the fairness of the presentations contained in financial statements. Very strong opposition developed on grounds that this was unnecessary in view of examination and supervision to which banks were already subjected, that it would involve duplication of efforts of internal auditors and state and federal examiners, and that it would represent a substantial financial burden. All of these views were carefully analyzed and sympathetically considered. As finally adopted, the Regulation permits a choice on the part of the bank whether to file statements certified by independent public accountants, or simply verified by principal accounting officers. Please understand that this does not settle the issue for all time. Most of the interested groups agree, as do I, that certification remains a desirable long-range objective; it just does not seem to be practicable now.

Closely associated, and much more essential for the present, are the problems of making financial reporting by banks more comparable and improving internal audit procedures. Many of the specific requirements of the Regulation are aimed directly at these objectives, and all of us will continue to push in the direction of these generally desirable goals.

Also modified from earlier proposals are provisions governing the extent to which banks, in soliciting proxies, must disclose transactions between a bank and enterprises in which its directors and officers might be financially interested. Because of differences in the nature of banking from other industry, the new Regulation exempts from disclosure requirements any loan transactions where there are only very simple and largely irrelevant interlocking relationships. In addition, the Regulation does not follow SEC requirements in that stockholder proposals need not be included with the management's proxy solicitation and at the bank's expense. Our Corporation, and I am sure the Federal Reserve also, believes in democracy in corporate management, but this whole area in its application to banking deserves and will receive much more careful study by us all.

Along with the new Regulation, a number of controversial instructions governing the preparation of financial statements were issued. Among these are the requirement, after a one-year grace period, of accrual accounting; the requirement of income statements retroactively for three years; the showing of market value of securities that are not of investment grade; the reconstitution of fixed assets acquired over the last five years to reflect depreciated cost; the segregation from investments of gains and losses from bond-trading activities; and the provision for more meaningful valuation allowances.

Let me repeat what I said when the Regulation was released. It involves experimentation in some areas. It will be continuously reviewed and modified as experience dictates in order that the purposes of Congress may be most effectively realized. I am aware also that the Regulation might work hardships on certain banks -- such, for example, as the 120-day filing requirement. In such cases, you may be sure our Board, and I am sure the same is true of the Federal Reserve, will give sympathetic consideration to applications, with proper supporting evidence, for reasonable relief that is within our authority to grant.

These, then, are just some of the problems and some of the approaches that we have tried in grappling with them. This is an important piece of legislation. About the only way to obtain needed equity capital in our free enterprise society is through the broad-based securities markets. Full disclosure of financial information by banks will place them firmly in this market and will give the public the information it needs to support this market. With the heavy demands for additional bank capital in the next decade a virtual certainty, the advantages of access to a vigorous securities market must certainly outweigh the added reporting burdens.

The banking system in our society is the central structure and the very underpinning of the economy itself. Bank deposits are the primary medium of payment, and bank reserves represent claims on over one-fifth of all the accumulated wealth in the United States. The banking system provides some 20 percent of the direct credit used by business enterprises, not to mention indirect trade credit. It finances 27 percent of the mortgages, 36 percent of state and local debt, 40 percent of consumer credit, and 40 percent of the credit used by farmers. Our banking system not only constitutes the framework of our financial structure, but satisfies the credit needs and provides services to all segments of the population. I have long thought it more accurate to refer to banks as "people" or "personal" banks than as "commercial" or "industrial" banks. Certainly, it is imperative that any institution or industry that is as important to our people as banking have the fullest possible access to the life-blood of our competitive securities markets. I hope you will agree that the recent amendments to the securities acts will go a long way in achieving this objective.

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