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An Address By

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Washington, D. C.

Before The

Chesapeake Chapter

Robert Morris Associates

at the

"Senior Management Night" Dinner

Shoreham Hotel

Washington, D. C.

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6:00 P. M.

ADDRESS

A major problem facing the banking industry today, and one which deeply concerns the Federal Deposit Insurance Corporation, derives from recent legislation requiring full disclosure by corporations having stock traded in the over-the-counter market. Because both the regulatory agency and the industry it regulates should be concerned with creating rules to implement this new legislation, and because this task may be with us for some time, I thought it would be appropriate for us to discuss this topic tonight, not with the expectation of arriving at instant solutions, but in the hope that we can stimulate and organize each other's thinking. I take the view that our thinking should not be crystallized until we have investigated every area of approach, including not only those open to the regulatory bodies but also those open to the industry.

To begin with, we should recognize that the new law requires us to adopt a new approach. Banks and bank regulatory agencies have always been depositor oriented. The overwhelming thrust of bank legislation and bank regulatory regulation in the past has been to protect the depositor. There are excellent reasons for this posture: unlike other industries, banking operates primarily with "capital" which is not risked in the normal sense of the word, but which is placed in the form of deposit funds entrusted to the bank in a fiduciary capacity.

Too few people outside the industry realize that the righthand side of the bank balance sheet shows on the average 92 percent made up of deposits, and only some 8 percent of risk capital.

This unique banking "capital" structure means, in my view, that bank supervision must still focus primarily on the depositor's safety. Moreover, I feel we should still stress service to the community as the industry's second area of concern, given the position it occupies as the guardian of the nation's credit and deposit-based currency supply.

At the same time, Congress has now instructed that we apply certain stockholder-oriented practices to banking, practices which are commonplace in most other segments of the business community.

Our task is not an easy one. We must seek means to implement the will of the Congress by creating extra safeguards for stockholders, while continuing to safeguard our primary responsibility -- the depositor. The latter responsibility has caused the banking industry to become the single most regulated industry in the nation. We must, therefore, seek ways to implement our new responsibility without making an already heavy regulatory burden intolerable.

Perhaps, before discussing steps which could be taken, a brief review of the legislation and its history would be helpful. On August 20 the Securities Acts Amendments of 1964 became law. For the first time commercial banks -- initially about 600 of them -- were subjected to a Federal regulatory pattern which had heretofore applied only to companies with securities listed on a national securities exchange.

The regulatory pattern in question, administered by the Securities and Exchange Commission, required public disclosure of all historical, managerial and financial data needed by a stockholder to make an informed investment decision about a particular company.

This legislation has been on the books for 30 years, giving substantial protection to investors in companies actually listed and traded on national securities exchanges. Two years ago the Congress directed the SEC to make an intensive study of the securities markets, including the over-the-counter markets. Following some vigorous proposals reached in the SEC staff studies, the Congress debated at length the pros and cons of new legislation, which resulted in the present law.

Among the decisions reached by Congress after that lengthy legislative debate were two which concern us, the decision to extend the disclosure requirements to the over-the-counter markets, and the decision to include banks in the new legislation, despite the heavy regulatory burden already borne by them and despite their orientation toward depositor protection.

The Congress felt that there is a growing need to protect stockholders who invest in the fast growing over-the-counter securities markets. In extending disclosure procedures, and in giving the SEC jurisdiction in this area, Congress carefully considered the unique banking structure. The final decision, which we must now implement, was to bring the banking industry under the general terms of the disclosure legislation, but to place supervisory authority, not in the SEC, but in the existing bank regulatory agencies, the Comptroller of the Currency, the Federal Reserve Board, and Federal Deposit Insurance Corporation.

Thus, in effect, the Congress told us to continue our traditional role as the protector of the nation's bank depositors, while blending in added protection for the stockholders and investors.

Our first step in carrying out this assigned mission was to publish in the Federal Register, last September, proposed regulations and rules, to be followed by banks in meeting the requirements of the law.

Before turning to a consideration of the problems posed by the rules, for which formal answers must be found in the near future, it might be helpful if I outlined the staff thinking which led to that publication. Staff members had been considering such rules and regulations for over a year, ever since the Act passed the Senate. During this period, the staff had been working closely with the staff of the Federal Reserve Board. Two schools of thought developed during the time that the legislation was making its careful way through Congress and onto the desk of President Johnson.

On the one hand, some of our staff people felt that it would be most appropriate to study the problem thoroughly, over a period of time, and present informal regulations to a selected number of banks, trade associations, and professional groups for their comment. From these could be evolved a set of regulations, which, after conferences with the other regulatory agencies and the SEC, would be published in the Federal Register. That approach, it was believed, would eliminate publicized friction, and would result in strong industry support for the formally published proposals.

On the other hand, there was sentiment for more immediate action. Many felt a sense of urgency which suggested a quicker method of presenting the regulations publicly. In this approach existing SEC regulations would be modified somewhat and published as soon as possible. Those supporting this view urged that the 30 years of experience in the field by the SEC should not be discarded, and that our regulations at least should use that experience as a starting point. Finally, this school of thought believed that public reaction to such an approach would be helpful in revising final regulations to meet the needs of the industry.

As you know, we finally adopted the latter view, and published, almost simultaneously with the Federal Reserve, rules and regulations closely patterned on existing SEC rules and regulations. It should be emphasized that these are merely proposed rules and regulations; the final product may not necessarily be similar to those published for comment. It was not intended that early publication of the rules would curtail our effort to develop final rules and regulations which will fit the needs of the banking industry. Indeed, in every decision we take, as I hope in every comment the industry makes or will make, consideration must be given not only to the job to be done for stockholders but of the necessity for discharging our primary responsibility for depositor safety.

There has been, as you all know, considerable response to the published rules and regulations, and much has been unfavorable. The chief objections have been that the regulations discriminate against state banks, that they cause a duplication of effort and that the cost of certification will be burdensome.

The latter point is one which concerns us all, and I will look at it more closely in a few moments. On the first point, that state banks will be harmed competitively, I believe that the FDIC must take the position that we seek not to discriminate for or against any system of banking, but that we must carry out our obligations as imposed on us by the Congress.

We cannot and will not engage in a "competition in laxity." We want to develop regulations which will at the same time implement the will of Congress, protect the investor and stockholder, and do the job with the least possible cost to, and burden upon, those banks covered by the law.

I might add, parenthetically, that we are hopeful that this approach to disclosure will accomplish two things. If wisely done, the improvements wrought in those banks covered by our regulations should prove so beneficial to banking and so welcome to the public, as to eventually spark all banks into accepting them. At the same time, proper rules of disclosure should make bank stocks more attractive to the public, and bank capital easier to raise, a development quite welcome to FDIC, and, I hope, to the banking industry as a whole.

What specifically does this new law do? The Securities Acts Amendments of 1964 are designed to make available to stockholders and prospective stockholders, in banks of a certain size and with a certain number of stockholders, information which will aid in making informed investment possible. Four principal requirements are imposed under the law:

1. Banks which are covered under the Act must file with the appropriate federal agency an initial registration statement, with periodic amendments as

needed, containing information of a managerial, legal, historical, and financial nature.

2. These same banks must file periodic reports, primarily containing financial information, on an annual and semi-annual basis.

3. They must file and use proxy statements prior to any regular or special meeting of stockholders.

4. They must file monthly reports by directors, officers, and large stockholders revealing their holdings, purchases, and sales of stock -- so-called "insider reports."

In the time remaining this evening, I would like to look at the two problems which are proving most troublesome both to those of us in the supervisory agencies and to the industry. These are the need for more uniform auditing and accounting practices, and the need for certification of reports, specifically for outside certification. Actually to a large extent these two problems overlap, and as regulations are developed, and the industry begins to meet the responsibilities imposed by the Act, these are the areas which will cause the most concern to everyone.

I should remind you once again that up to this time our principal goal as supervisors, and yours as an industry, has been toward the protection of the depositor. The fiduciary responsibilities thus imposed have caused the industry to be more concerned with safety than with disclosure. Whereas industries regulated by SEC, and oriented toward the stockholder, have accepted uniform accounting as a matter of course, this concept is a relatively new one for bankers. When we suggest now that banking should begin to move toward more uniform accounting procedures, we are not seeking to discredit present practices or the reasons for their development, but only to suggest that the time has come for a further evolution in the industry. Development of more uniform accounting procedures will in no way interfere with the protection of depositors, and it well may help. Uniform accounting does seem mandatory to fulfill the intent of the new law -- stockholder protection.

Some banks cannot meet the requirements of the new law without changing their accounting practices. Investment analysts have long pointed this out and have been critical of the lack of uniformity in bank accounting which makes comparison of alternative investments difficult and sometimes highly unrealistic. The accounting profession in general has for many years cited the failure of banks to adhere to generally accepted accounting principles. Frankly, while some banks do follow acceptable accounting practices, the diversity in approach by even the largest banks is such that comparisons of data between banks can be misleading rather than informative, and make informed investor decisions impossible, except to the most sophisticated.

All the variations in the field of accounting make the task of the investor a difficult one. I do not pretend to have the solutions. But I do think you can do a great service if you will help develop a more uniform accounting base for banking.

Adjustments in accounting might create some problems for supervisors and might vex those banks which have selected methods of accounting to conceal embarrassing information. In the long run, however, the bank, the depositor, and the industry, as well as the stockholder, will be better served by honest facts honestly presented.

The question of certification is more complex -- at least in the short run. Not all regulated industries use certification by outside certified public accountants, but the evolutionary trend has for several years been toward such a practice. Pressures by leaders in the various industries, by regulatory bodies, and even by bankers themselves, have accelerated this development.

There has been so much discussion of certification in recent months that it is easy to slip into thinking that certification, per se, is our ultimate goal. This is not the case. Our goal is to implement the Act effectively and to make as certain as possible that investors are provided with the information that they need to make rational buy, sell and hold decisions.

Bankers know the value of independent certified audits. So do many investors who buy bank stocks. The accounting profession and the financial analysts feel that current bank financial reporting is not sufficient for disclosure purposes, and the basic position of the SEC for many years has been toward uniform accounting, coupled with independent certification.

The question of cost has been raised by bankers. It is, of course, true that outside audits are expensive. On the other hand the banks which will be affected by this new Act generally speaking are the nation's larger banks better able to bear that cost.

Equally as important as the dollar outlay, I think, is the time and energy used up by any outside examination or audit. The cost in time of management and of highly trained personnel from outside examinations is already high in banking, which is as we all know the most tightly regulated industry in the nation.

As it now stands any state chartered bank is subject to examination by state authorities, plus one of the federal agencies, at least once yearly, with all the interruptions to staff and disruption of records that that entails. Additionally many banks are subject to Internal Revenue Service audits, and to state and local audits of one form or another. To add to these burdens another intensive audit (and such an outside certification as this one would require a complete audit) might prove to be more load than some banks could be expected to carry.

Some banks will argue that they have extensive internal audit programs now, and so they do. But this is also true in many other industries, and these industries have found that independent outside audits were still necessary. Banks themselves, as lending institutions, often require outside audits even when a sound internal auditing program is in operation. A good internal audit can help, but in a different way; the good CPA will give weight to a sound internal audit system, and often it will simplify the external audit, speed it up, and cut down its cost.

This is a knotty problem. If uniform accounting procedures were followed by banks, some people suggest, then perhaps the Federal agencies themselves could act as certifying agencies. But while this is theoretically possible it would entail great strain on the manpower available to supervisory agencies, and appreciably increase their operating expenses -- which in the final analysis are paid by the banking industry itself.

The Congress has excluded the banking industry from regulation by the SEC, but the Congress has not excused the industry from adopting some procedure which will increase stockholder protection.

It seems to me that the banking industry, and the supervisory agencies, should accept the concept of certification, and move toward it by developing uniformity in their accounting and reporting. I don't believe that certification can be imposed on banks immediately. I advocate an orderly program to upgrade and unify bank accounting practices and to build a balanced approach to the needs of depositors and shareholders alike.

Within the time-honored framework of an industry which exercises a fiduciary responsibility toward depositors and communities, cannot the industry itself help develop standards and methods which will be responsive to the mandate of the Congress and the realities of banking itself?

We in the Federal Deposit Insurance Corporation pledge that we will work with bankers, accountants, and financial analysts to seek positive, intellectually sound methods for reaching this goal. Working in this way, we can make sure that the 1964 Act will not be a harrassment to the banking industry, but will rather help that industry better to serve its customers, its stockholders, and the nation as a whole.

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