

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

ACCOUNTING AND CAPITAL STANDARDS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

SEPT.

10:00 A.M.

MONDAY, ~~SEPT~~ 10, 1990

Room 538, DIRKSEN SENATE OFFICE BUILDING

Good morning, Mr. Chairman and members of the Committee. We appreciate this opportunity to testify on the accounting and capital standards for federally insured depository institutions and the differences in these standards among the federal banking and thrift supervisory agencies. In accordance with Section 1215 of the Financial Institution's Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Federal Deposit Insurance Corporation has submitted a detailed report to the Committee on Banking, Housing, and Urban Affairs regarding these differences.

In your letter of invitation, we were asked to discuss:

- the adequacy of generally accepted accounting principles (GAAP), based on historical cost, in promoting the safety and soundness of financial institutions;
- the differences in accounting and capital standards among the various agencies and how we are working to resolve them; and
- our comments on simplification and reduction of differences in accounting and reporting standards.

GAAP as the Reporting Standard

The regulatory reporting standards followed by the three federal banking agencies -- the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC -- are substantially consistent with GAAP as

applied by commercial banks. Over the years, the three agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), have developed uniform Reports of Condition and Income -- also known as "Call Reports" -- for all commercial banks and FDIC-supervised savings banks. The uniform Call Report serves as the starting point for calculating banks' risk-based capital and leverage ratios, and is used extensively for other regulatory purposes. Thus, differences in accounting and reporting standards do not exist among commercial banks and FDIC-supervised savings banks.

The Office of Thrift Supervision requires each thrift institution to file a "Thrift Financial Report" (TFR), based on GAAP as it is applied by thrifts. However, the TFR differs greatly from the bank Call Report in both the information required and its form of presentation. While some of these differences arise from differences in GAAP between banks and thrifts, others arise from the banking agencies' adoption of regulatory reporting standards that affect reported levels of capital in ways which are more conservative than bank GAAP.

Fair presentation of the financial affairs of a depository institution is the goal of GAAP financial statements. The FDIC's primary interests are the safety and soundness of insured financial institutions and the protection of the insurance funds. The agencies support GAAP as the overall reporting

framework and expect banks to follow GAAP for regulatory reporting unless our standards require a different treatment. Departures from GAAP arise where the banking agencies believe a different approach better enables us to assess banking risks. A review of the so-called RAP-GAAP differences for banks clearly shows that RAP does not improve the reported financial condition of banks. In fact, RAP tends to produce lower bank earnings and capital, and higher total liabilities.

Reporting Differences

Several variances in regulatory reporting between banks and thrifts reflect the different approaches of the banking agencies. The most significant difference involves assets sold with recourse. The member agencies of the FFIEC are currently considering whether to eliminate differences between bank regulatory reporting and GAAP for sales of assets with recourse. The opportunity to do away with this difference results from the introduction of risk-based capital standards which explicitly require capital for off-balance sheet exposures. The agencies anticipate input in response to the June 1990 "Request for Public Comment on Recourse Arrangements." We hope to revise bank reporting standards to eliminate differences among regulators without sacrificing safety and soundness considerations. Accounting for excess servicing fees and a change in the regulatory reporting treatment for these receivables also may be considered.

The banking agencies' concern about the apparent breadth of acceptable practice in accounting for financial futures contracts, particularly as this relates to the deferral of losses, results in the current difference in accounting for these instruments between banks and thrifts. However, the FFIEC's Task Force on Reports is working to draft appropriate regulatory reporting safeguards to permit all institutions to account for futures contracts in accordance with GAAP. The reporting of in-substance defeasance of debt in accordance with GAAP is not permitted for bank regulatory reporting purposes because of uncertainty regarding the irrevocability of trusts established for defeasance purposes.

Another apparent difference between thrift and bank regulatory reporting concerns a general valuation allowance for loan losses on troubled real estate loans. Thrifts often use specific valuation allowances for individual loans and, for those loans with specific reserves, do not seem to provide for an additional general allowance. We expect the general allowance to include an amount that reflects the risk of error in the specific loss estimates, and believes that this method is encompassed by GAAP. The FDIC is having intensive dialogue with institutions about the adequacy of their loan loss allowances. The GAAP rule, even for thrifts, leaves considerable room for judgment and, needless to say, our judgment frequently calls for a larger reserve than management believes is necessary.

Several reporting differences between banks and thrifts result from differences in GAAP itself. The FDIC has long supported eliminating the variations between GAAP for banks and thrifts. Last November, we wrote to the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) to urge the elimination of existing differences in bank GAAP and thrift GAAP. The FDIC requested their assistance because of the increasing similarity of the banking and thrift industries and to satisfy the Congressional mandate to adopt uniform regulatory accounting standards for all depository institutions.

In response to our request, the FASB notified the FDIC that it is considering a limited scope project on whether and how a financial institution should discount estimated cash flows from collateral in determining loan losses. Thrifts use a net realizable value approach which discounts cash flows basically at the institution's cost of funds. For banks, a fair value approach which incorporates an investor's desired rate of return as the discount rate is normally followed. If the FASB resolves this issue, it will eliminate one of the major differences between bank and thrift GAAP which affects all loans with real estate collateral and possibly the valuation of all foreclosed real estate. The FDIC continues to urge the banking and thrift committees of the accounting profession to merge and unite their audit guidelines. The duplication of effort between these two functions remains a serious hindrance to consistent accounting practice.

In addition, the FASB has indicated that it will be addressing the issue of disclosure of market value information as the next step in its ongoing financial instruments project. The FDIC has not supported using market value accounting in place of historical cost accounting as the basis for preparing depository institutions' financial statements. Our concern is based primarily on the great difficulty in obtaining reliable market value estimates for many bank or thrift assets and the cost of doing so. Market values would also have to be determined for the liability side of the balance sheet. A valuation of an institution's intangibles must be considered as well. Nevertheless, additional disclosure of market values where available would certainly assist both regulators and the public.

The AICPA's Accounting Standards Executive Committee has been addressing two other issues that have caused differences in accounting practice between banks and thrifts. The Committee's proposal requires the use of market or fair values in certain circumstances and will provide a more realistic and conservative picture of an institution's financial position. First, the exposure draft of an AICPA proposed statement on "Reporting by Financial Institutions of Debt Securities Held as Assets" would more clearly indicate when assets should be reported at the lower of cost or market value rather than at historical cost. The proposal provides guidance on evaluating whether an institution plans to sell securities in the foreseeable future.

Second, a proposed draft of an AICPA statement on "Accounting for Foreclosed Assets" would require a lower of cost or fair value accounting treatment for foreclosed assets such as other real estate held by both banks and thrifts. With the addition of certain safeguards and assurances, we urge early adoption of these two proposals.

Capital Differences

With regard to capital requirements for banks and thrifts, a number of changes have taken place in recent years and further revisions are expected by the FDIC before year-end.

In response to Section 908 of the International Lending Supervision Act of 1983 and other factors, the three federal banking agencies adopted uniform capital rules for all banks in 1985. That standard is 5.5 percent primary capital to book assets and six percent total capital.

In the first quarter of 1989, the FDIC and the other banking agencies issued risk-based capital guidelines. Under the guidelines, banks are to meet an interim minimum ratio of capital to risk-weighted assets of 7.25 percent by year-end 1990 and a final minimum ratio of eight percent by year-end 1992. At least one-half of this total capital requirement is to be comprised of Tier 1 capital elements. For most banks, Tier 1 capital is equal to their common equity capital, less intangible assets such as goodwill.

In accordance with FIRREA, the OTS adopted a risk-based capital framework for savings associations that became effective on December 7, 1989. Upon adoption of the new framework, thrifts were required to meet a 6.4 percent risk-based capital minimum. This risk-based standard is scheduled to increase to 7.2 percent by year-end 1990 and eight percent by year-end 1992. OTS also adopted a three percent core capital leverage test. Currently, there is no direct bank corollary to OTS' core capital leverage test. However, it appears to be lower than the OCC's current 5.5 percent primary leverage capital requirement for national banks even when adjusted for the loan loss reserve.

The banking agencies' existing uniform leverage requirements are based on a definition of primary capital plus secondary capital and the agencies are in various stages of revising these standards so that the capital definitions would more closely track those used in the risk-based capital framework.

In the process of adopting risk-based guidelines and revising the capital definitions for the leverage standard, we hope that the agencies will avoid any meaningful reduction in minimum capital requirements. At the same time, we are trying to coordinate our minimum capital standards with those that have been established or proposed by the other federal banking and thrift regulators. In this regard, the FRB and the OTS have adopted, and the OCC has proposed to adopt, new minimum leverage standards. The FDIC staff is in the process of devising a

proposed revision to our existing 5.5 percent primary and six percent total capital leverage standards. The FRB and OTS rules and the OCC proposal require institutions they supervise to maintain Tier 1 core capital equal to at least three percent of total assets. While these agencies' core capital leverage standards appear on their face to be the same, the critical issue still unresolved is how these standards should be applied to individual institutions. The FRB rule applies the three percent leverage ratio only to banks in the very best condition, while all other banks will need to maintain a minimum of at least four to five percent.

We agree with the establishment of a revised leverage standard that excludes the allowance for loan losses from the definition of capital. We also note that most banks' loan loss reserves do not exceed more than one to two percent of their assets. As a result, most banks meet the existing six percent total capital leverage standard by having a minimum of at least four to five percent in common equity capital plus their loan loss reserves. Therefore, if loan loss reserves were excluded from a revised definition of capital, we believe a minimum leverage standard of at least four to five percent would be appropriate for the great majority of banks. It would also accomplish our objective of avoiding a reduction in capital standards.

To the extent that a lower absolute minimum such as three percent is allowed for any bank, we agree with the Federal Reserve's position that a lower leverage standard should be acceptable for only the most highly-rated banks (those rated "one" on the interagency scale) and only if these institutions are not anticipating or experiencing significant growth or expansion of activities. We feel strongly that a four-to-five percentage leverage ratio is the minimum acceptable level for institutions that are not among the most highly rated.

Moreover, because the existing risk-based capital standards focus primarily on credit risk and largely ignore interest rate risk and operational risks, a prudent minimum leverage requirement must be maintained as a check against institutions with limited credit risk but with a significant exposure to other risks that are not credit related. On the other hand, the OCC's proposed revision of its leverage standards merely specifies that each national bank must meet a minimum core capital leverage ratio of three percent. No guidance is provided on which institutions are entitled to get by with three percent and how much more capital the others need to maintain. While we believe it is imperative for the agencies not only to have the same minimum capital standards on paper, it is even more important to apply these minimum standards in the same way in practice. The OCC and the FDIC have not yet been able to come to an agreement on this point.

It should also be noted that FIRREA requires that OTS adopt capital rules equivalent to those in effect for national banks.

OTS already has in place a three percent minimum core capital leverage standard which should in theory result in institutions that are not in the best condition being required to maintain higher levels of capital. However, it is not clear to us that OTS has a firm policy of establishing higher minimums for individual institutions that are in a less than fully satisfactory condition.

We hope to issue our revised leverage proposal in the near future and finalize action on a new standard by year-end 1990 -- the date when the first minimum risk-based capital ratio for banks must be met.

Differences in Bank and Thrift Capital Standards

As discussed in our report to the Committee, there are a number of differences between the way the banking agencies measure capital for banks and the manner in which OTS measures capital for savings associations. Most notable among these differences are the treatment of goodwill, subsidiaries, and transactions with recourse arrangements.

Banks currently must deduct goodwill in calculating regulatory capital. However, up to one-half of a thrift's three percent core capital requirement currently can be represented by "qualifying supervisory goodwill." Over a

five-year phase-out period, savings associations gradually will be eliminating the qualifying supervisory goodwill that can be included in their regulatory capital calculations.

As discussed earlier, efforts are underway to reduce differences among the banking and thrift agencies with respect to the capital treatment for transactions involving off-balance sheet recourse arrangements. Responses to the June 1990 "Request for Comments on Recourse Arrangements" will be carefully evaluated. These comments will help the agencies reach a uniform and prudent supervisory approach for determining how capital standards should apply to the various types of recourse arrangements.

Several factors account for the differences in the capital treatment of subsidiaries by banking and thrift regulators. For example, due to FIRREA, a savings association subsidiary that engages in any activities impermissible for national banks is required to be "separately capitalized" by the parent thrift, rather than consolidated, for OTS regulatory capital purposes. On the other hand, the FDIC generally requires state nonmember banks to "separately capitalize" only securities subsidiaries that are established pursuant to section 337.4 of the FDIC's regulations. Other bank subsidiaries are generally consolidated when calculating a bank's regulatory capital.

The OTS also requires most "less than majority-owned" subsidiaries to be subject to consolidation on a pro-rata basis. On the other hand, the FDIC normally treats an institution's investments in such entities in the same way as any other asset. We would require pro-rata consolidation only if the specific circumstances deemed such an approach to be appropriate on a case-by-case basis.

The issue of whether majority-owned subsidiaries of banks should be consolidated or separately capitalized continues to be discussed, particularly as it relates to the future structure of the banking industry and the deposit insurance system. Today, some state-chartered banking institutions are authorized to engage in nontraditional banking activities, in accordance with certain laws that already have been enacted by the state legislatures. Examples of these activities include insurance underwriting -- as recently authorized by Delaware -- and real estate development. As the structure of the banking industry evolves and changes over time, it is possible that other nontraditional activities will be authorized in the future.

Riskier and nontraditional activities should be financed through owners' equity or other outside sources of funds, rather than through the use of insured deposits. If the activities permitted for banks and thrifts continue to expand to include securities underwriting, real estate development, insurance

underwriting, and other nonbanking activities, adequate capital cushions will be needed. These activities should be conducted through separately capitalized bona-fide subsidiaries with appropriate safeguards. Otherwise, much higher capital requirements should be established at the parent bank or thrift level.

Capital Requirements for Interest Rate Risk

The federal banking agencies have not proposed a specific interest rate risk component for their risk-based capital requirements. However, on a case-by-case basis, higher capital has long been required for institutions with excessive levels of interest rate risk. Those with only moderate interest rate risk exposures and with no other supervisory problems can conceivably operate closer to the eight percent minimum risk-based capital requirement than those with excessive interest rate risks. However, we do not view the absence of interest rate risk as a "credit" that can be applied to reduce risk-based capital below the eight percent minimum level. Instead, we view the presence of significant interest rate risk as a very strong indication that a capital ratio over and above the eight percent risk-based minimum is warranted.

The FDIC and the other U.S. banking agencies will continue to work with each other and with regulators from other countries and the Basle Committee on Banking Supervision to develop

explicit capital requirements for interest rate risk. The committee has been investigating to see what type of information should be gathered from banks in order to do an adequate assessment of interest rate risk and has devised a measurement tool which regulators here and abroad will be testing. Whatever measurement system is adopted, it should be sufficient to allow regulators to supervise institutions without imposing regulators as the institution's de facto managers. In the interim, close supervision and higher capital will continue to be required for those institutions with undue levels of interest rate risk.

Reliability of Financial Information

Since the reliability of financial information is vital to our supervisory efforts, we are implementing several accounting and capital initiatives. We expect these initiatives to promote more reliable bank and thrift financial information and to enhance our supervisory efforts to maintain a safe and sound financial system. These measures include:

- o Increased reliance on a more narrow definition of capital; that is, a definition of Tier 1 or core capital that generally includes only common equity capital, net of intangibles.

- o Continued emphasis on ensuring that banks and thrifts promptly recognize charge-offs and nonperforming loans and

that they regularly replenish their general loan loss reserves to levels necessary to adequately reflect the inherent risks in their portfolios. However, while we routinely urge banks to maintain adequate reserves for loan losses, changes enacted to the tax code in 1986 tend to be a disincentive for banks to maintain reserves at the level we believe to be adequate. Large banking organizations are no longer permitted to use the reserve method for taking bad debt deductions for federal income tax purposes even though reserves are required under GAAP for financial reporting purposes. In our view, this tax policy is detrimental to the banking system.

- o Continuing efforts to facilitate early intervention in problem bank and thrift situations, particularly in those instances where some general loan loss reserves might still remain but where equity capital has been exhausted or substantially eroded.

- o A commitment that the exercise of new nontraditional activities, if exercised at all, shall be separately capitalized and insulated from the capital supporting deposits.

These measures should help provide prompt recognition and timely resolution of problem institutions that are no longer viable, economic entities.

Recommendations on Accounting and Reporting Standards

The FDIC, through its participation in the FFIEC Task Force on Reports, is continuing to study ways to eliminate differences between the Call Report standards and GAAP that are consistent with the agencies' supervisory responsibilities. However, since most of the significant differences as they relate to bank regulatory reporting have been resolved or their possible resolution is under study, the primary way to reduce the remaining differences and simplify accounting standards for banks and thrifts is to adopt a more uniform regulatory reporting scheme for all depository institutions.

Although the preparation of both the bank Call Report and the Thrift Financial Report is predicated on GAAP, the required information and the form of presentation in the reports are significantly different. The Thrift Financial Report, for example, requires a great deal more detailed information on assets and their scheduled maturities compared with the bank Call Report. On the other hand, the bank Call Report has certain information needed for deposit insurance assessment purposes that is not included in the Thrift Financial Report. The FDIC staff has begun to identify, starting with deposits, the basic information needed in comparable form from all depository institutions for safety and soundness, insurance assessment, statistical, and economic purposes.

Once the necessary information has been identified, we will be prepared to resolve the differences between the Call Report and the Thrift Financial Report. We are committed to taking the best features of both regulatory reports to create a uniform regulatory reporting framework that can be applied to all 13,000 commercial banks and FDIC-supervised thrift institutions, as well as the 2,500 OTS-supervised thrift institutions. We are also prepared to work closely with the accounting profession on matters of mutual concern.

Improving Auditing of Federally-Insured Depository Institutions

The commentary on Section 1215 of FIRREA in the Conference Committee Report also asked for our thoughts on improving auditing of federally-insured depository institutions. OTS requires audits of financial statements at all thrifts. The banking agencies, however, do not require such external audits because of concerns over: 1) the costs to small institutions versus the benefits; and 2) the paucity of experienced bank auditors in rural areas. Nevertheless, the FDIC has a longstanding policy of strongly encouraging institutions to have an annual audit by an independent external auditor. The FDIC will continue to encourage audits of banks and to monitor the results of these efforts.

In this regard, the FDIC adopted formal policy statements in late 1988 and earlier this year in an effort to improve the audit coverage of supervised banks. An annual item in the Call Report requires each bank to indicate the scope of its external audit program. This enables the banking agencies to monitor the extent and types of external auditing work conducted at banks. Approximately two-thirds of all banks report that opinion audits were performed either of their own financial statements or of their parent bank holding company during each of the past three years. For the calendar year 1989, only 13 of 420 institutions with over \$1 billion in assets and 92 of 2,172 institutions with over \$150 million in assets (the size threshold at which the Federal Reserve Board requires bank holding companies to be audited) reported having less than full scope external audit coverage.

Effective communications between auditors and examiners are essential to the success of both the audits and the supervision of banks and thrifts. We encourage the exchange of information with an institution's auditors because communication can help to clarify or resolve issues and concerns as they arise and can provide a better understanding of corrective actions that may be appropriate for an institution to take. For several years, FDIC policy has permitted banks to allow auditors to review our examination reports and to attend our examiners' exit interviews with management and meetings with bank directors when invited by the bank. Section 931 of FIRREA now mandates that institutions

furnish their most recent report of examination to their auditors and we have so advised the banks we supervise. The American Institute of Certified Public Accountants (AICPA) has also been addressing the issue of communication and has drafted a proposed Statement of Position (SOP) on "Inquiries of Representatives of Financial Institution Regulatory Agencies." The SOP would indicate that examination report reviews, discussions with examiners, and attendance at exit interviews are vital elements of sound auditing practice.

In the past year, the FDIC entered into an agreement with the Florida Board of Accountancy that, if our examiners or liquidators encounter what appears to be substandard auditing work by an accountant in an institution in that state, we will refer the accountant to the state board for possible disciplinary action. In an effort to improve the reliability of audits, the FDIC and the other member agencies of the FFIEC have had discussions with the AICPA and the National Association of State Boards of Accountancy regarding the agencies' participation in such disciplinary referral programs nationwide. We hope to have some referral procedures in place during 1991.

Thank you for your attention. I will be happy to answer any questions on my testimony or the FDIC's report.