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Testimony by

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INTRODUCTION

I am pleased to be here on behalf of the Federal Reserve Board to discuss regulatory accounting standards and capital requirements for depository institutions. Both of these standards play particularly important roles in the supervisory process. Accounting standards, by promoting consistent and accurate financial reports, enhance the ability of supervisors to monitor developments at depository institutions and to identify situations of deteriorating financial conditions that require immediate corrective actions. Capital standards are perhaps even more critical. A strong capital position enables an organization to withstand an unexpected set back and return to financial health, and when that does not prove possible, helps to limit potential losses to the government deposit insurance fund.

The importance of accounting and capital standards, of course, was recognized by the Congress when it enacted the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). FIRREA directed the depository institution supervisory agencies to develop uniform accounting standards for all federally insured depository institutions, and mandated that capital standards for thrifts be no less stringent than those for commercial banks. Furthermore, the Congress asked the agencies to submit reports discussing any differences among their accounting and capital standards by August 9, 1990. The Federal Reserve's report was submitted on that date.

Today, I do not want to repeat all of the details set forth in that report. Rather, I would like to address some important policy issues regarding the accounting and capital standards employed by the Federal Reserve and the other banking agencies. I particularly want to focus upon those issues raised in your letter of invitation, Mr. Chairman, including market value accounting and our view on how the banking agencies might proceed to assess interest rate risk for examination and capital adequacy purposes.

THE ROLE OF ACCOUNTING STANDARDS

The Federal Reserve has long viewed accounting standards as a necessary step to efficient market discipline and bank supervision. Accounting standards provide the foundation for credible financial statements and other financial reports. Accurate information reported in a timely manner provides a basis for the decisions of market participants. The effectiveness of market discipline, to a very considerable degree, rests on the quality and timeliness of reported financial information.

Financial statements and regulatory financial reports perform a critical role for depository institution supervisors. The supervisory agencies have in place monitoring systems which enable them to follow, on an off-site basis, financial developments at depository institutions. When reported financial information indicates that a deterioration in financial condition has occurred, these systems can signal the need for on-site examinations and any other appropriate actions. The better the quality of financial information, the greater the ability to monitor and supervise effectively.

Financial statements provide information needed to evaluate an enterprise's financial condition and performance. Generally accepted accounting principles (GAAP) must be followed in the preparation of financial statements filed with the Securities and Exchange Commission or that otherwise are audited by Certified Public Accountants (CPAs). The regulatory financial statements for federally insured commercial banks and savings banks are the Reports of Condition and Income, commonly referred to as Call Reports. The Call Reports, the form and content of which, by law, are developed by the Federal Financial Institutions Examination Council (FFIEC), are currently required to be filed in a manner generally consistent with GAAP. In those few instances, where the Call Report specifies reporting requirements which differ from GAAP, these requirements are intended to be more conservative than GAAP.

Call Reports include balance sheets, income statements, and supporting schedules providing information on types of loans, securities, and deposits, and the extent of off-balance sheet activities. Other supporting schedules also provide information on past due and nonaccrual loans and leases, loan losses and recoveries, and changes in the allowance for loan and lease losses. Certain information on the maturity or repricing frequency of securities, loans, and time certificates of deposits is also presented. Furthermore, the Call Report provides information necessary for the calculation of capital ratios.

FIRREA MANDATE FOR UNIFORM ACCOUNTING STANDARDS

As you know, Section 1215 of FIRREA provides that each federal bank and thrift regulatory agency "establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes." As I have explained, the banking agencies, under the auspices of the FFIEC, have in place uniform Call Reports for all commercial banks and savings banks supervised by the Federal Deposit Insurance Corporation (FDIC). The banking agencies base their capital adequacy and other regulatory and supervisory computations on the Call Report. Thus, for the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), and the FDIC, uniform "accounting standards" for capital and other regulatory purposes are in place.

On the other hand, the Office of Thrift Supervision (OTS) utilizes the Thrift Financial Report (TFR) which differs from the bank Call Report in scope, detail, and definition of terms. Furthermore, the TFR is based entirely on GAAP for thrifts which is somewhat different from GAAP for banks. Some of the reporting differences between banks and thrifts were appropriate given the different type of assets that thrifts typically held. However, FDIC-insured mutual savings banks file the same Call Report as commercial banks and the FDIC has been able to accommodate the differences between these two types of institutions while still preserving comparability and definitional consistency.

Table 1 in the appendix summarizes the primary areas of difference that exist between the reporting standards of the federal banking agencies and the OTS. Some of these differences, such as those involving loan loss reserves for real estate loans and the valuation of foreclosed real estate, arise from differences between GAAP for banks and GAAP for savings and loans. Other differences arise in those areas in which bank reporting standards are intended to be more conservative than GAAP, such as in the areas of asset sales with recourse, futures contracts, excess servicing, and in-substance defeasance of debt. These areas of difference are discussed in more detail in our report to the Congress.

The Federal Reserve Board and the other banking agencies have held preliminary discussions with the OTS to study ways in which a more uniform reporting scheme can be developed for all banking and thrift institutions. The Federal Reserve Board is prepared to work constructively to resolve differences between the Call Report and the Thrift Financial Report. Also, the Financial Accounting Standards Board (FASB) and the American Institute of CPAs have been asked by the FDIC to consider eliminating the differences in GAAP as applied to banks and thrifts. More uniform reporting by all institutions is a goal of the Federal Reserve Board.

MARKET VALUE ACCOUNTING

A major issue relating to accounting standards is the appropriateness of market value accounting. Under market value accounting, an institution's assets, liabilities, and off-balance sheet items would be reported in financial statements at their market values. Alternatively, market values could be disclosed in supplemental schedules without affecting the balance sheet and income statement.

The problems in our financial system over the last several years have focused attention on the differences that often exist between accounting and economic measures of the financial condition and performance of banking and thrift institutions. Market value accounting has been proposed by some as a way to narrow these differences between accounting and economic measures. It is argued that the use of market value accounting might lead to more effective regulation and supervision of financial institutions and to the closure of problem institutions long before they would become insolvent on the basis of financial statements prepared under GAAP.

While market value accounting has theoretical appeal, a number of concerns have been expressed regarding this accounting model that should be considered. One major potential problem is that market values do not exist for a large portion of a financial institution's assets and liabilities and standards have not been developed for the estimation of reliable market values for these items. In addition, the overall cost and reporting burden associated with market value accounting could be considerable, including the cost of verifying market value quotations and estimates during audits and supervisory examinations. Furthermore, market value accounting could result in more volatility in the reported financial condition and earnings of financial institutions.

Clearly, information about the economic value of financial institutions is beneficial for supervisory purposes. However, the Federal Reserve believes that the preceding issues should be thoroughly studied before dramatic moves toward market value accounting are made. In particular, the Federal Reserve is concerned that, without the development of standards for the estimation of market values, financial statements prepared on a market value accounting basis would not be reliable or verifiable by audits and examinations. The federal banking agencies are reviewing the use of market values in connection with the federal deposit insurance study mandated by the FIRREA. At the same time, the FASB is studying the need for greater use of market values in GAAP as part of a project to develop new comprehensive standards for all financial instruments. These studies should provide additional information regarding the appropriateness of market value accounting for purposes of bank regulation and financial reporting.

It is also important to emphasize that much can be done to reduce the differences between accounting and economic measures of financial condition and performance without adopting market value accounting. This is accomplished when declines in economic value that result from credit problems are accurately reflected in loan loss reserves and capital positions in a timely manner.

Chairman Greenspan addressed the need to accurately measure capital positions in his testimony before this Committee on July 12, 1990, when he discussed his proposal for prompt corrective action. In this regard, a key part of this proposal is the conduct of on-site examinations — focusing on the quality of asset portfolios and off-balance sheet commitments — at least annually, where it is not already in practice. This rigorous review helps ensure that the loan loss reserves are consistent with the quality of the portfolio. When they are not, the examiner requires that additional reserves be created with an associated reduction in the earnings and equity capital of the bank. This process leads to a timely review of the adequacy of loan loss reserves and an accurate measurement of capital positions. When the resultant capital position of the bank is not adequate and credible capital raising commitments are not met, the regulatory agency should promptly require such responses as lowered dividends, slower asset growth, divestiture of affiliates, and other corrective measures while an institution's capital position is still positive. Such a policy not only deters banks from riskier lending practices, it also minimizes the ultimate resolution costs.

While the adjustment of recorded asset values for inherent credit losses could be accomplished through market or economic value accounting, it can also be accomplished under existing GAAP. Timely, thorough on-site examinations focusing on asset quality, together with rigorous application of GAAP, result in loan loss reserves that accurately reflect the estimated credit losses inherent in loan portfolios and in accurate reported capital positions. This process narrows differences between accounting and economic measures of depository institutions' financial condition and performance, while avoiding many of the potential problems associated with market value accounting. While not provided for in current GAAP, if further guidance were provided to determine an appropriate method for deriving the present value of asset and liability cash flows, even more accurate measures of market or economic value could be estimated.

THE IMPORTANCE OF CAPITAL STANDARDS

For a number of years, the Federal Reserve and the other banking agencies have been working to strengthen bank capital positions. The Federal Reserve has long viewed adequate capital as essential to protecting the soundness of individual banks and our banking system as a whole. While some have set forth arguments about the competitive disadvantages of stronger capital requirements, we must not ignore the long-term benefits of strong capital positions. Well-capitalized banks are the ones best positioned to be successful in the establishment of long-term relationships, to be the most attractive counterparties for a large number of financial transactions and guarantees, and to expand their business activities to meet new opportunities and changing circumstances. Indeed, many successful U.S. and foreign institutions would today meet substantially increased risk-based capital standards. In addition, although there has been uncertainty lately in the current market, the evidence of recent years suggests that U.S. banks have raised sizeable amounts of equity. The dollar volume of new stock issues by banking organizations has grown at a greater rate since the late 1970s than the total dollar volume of new issues of all domestic corporate firms.

I would like to elaborate on some of the important benefits that would result from stronger capital requirements. First, a stronger capital position would strengthen the incentives of bank owners and managers to evaluate more prudently the risks and benefits of portfolio choices because a substantial amount of their money would be at risk. In effect, the moral hazard risk of deposit insurance would be reduced. Second, stronger capital levels would create a larger buffer between the mistakes of bank owners and managers and the need to draw on the deposit insurance fund. For too many institutions, that buffer has been too low in recent years. The key to creating incentives to behave as the market would dictate, and at the same time creating these buffers or shock absorbers, is to require that those who would profit from an institution's success have the appropriate amount of their own capital at risk. Third, requiring stronger capital positions would impose on bank managers an additional market test, in that they must convince investors that the expected returns justify the commitment of risk capital. Those banks unable to do so would not be able to receive the additional funds necessary for expansion. Fourth, strongly capitalized financial institutions are in a better position to take advantage of opportunities that may arise. Furthermore, it would not be necessary to apply as rigorous supervisory attention to such institutions. Thus, it is important that regulators make sure that financial institutions are operating not from a minimal capital base, but from a strong capital base.

The three federal bank regulatory agencies have a long established history of co-operation in setting minimum capital standards. Throughout most of the 1980s, the banking agencies required banks to meet minimum ratios of capital-to-total assets or leverage ratios. In 1989, the federal banking agencies also adopted a risk-based capital standard. Furthermore, the Federal Reserve System has adopted new leverage guidelines that will supplement the risk-based capital framework. However, the primary supervisory emphasis has shifted to the risk-based capital requirement. Prudent banking organizations would continue to operate with a cushion above the minimum leverage and risk-based capital ratios.

Risk-Based Capital

The risk-based capital framework adopted by all three of the federal bank supervisory agencies, in 1989, is based upon the international Capital Accord developed by the Basle Committee on Banking Supervision and endorsed by the central bank governors of the G-10 countries. Under this framework, total capital is comprised of Tier 1 (or equity capital) and Tier 2 (or supplemental) capital instruments. The risk-based capital standards establish for all commercial banking organizations a minimum ratio of total capital-to-risk-weighted assets of 7.25 percent for year-end 1990. This minimum standard increases to 8.0 percent as of year-end 1992. In addition to identical ratios, the risk-based framework includes a common definition of regulatory capital as well as a uniform system of risk weights and categories.

The principal objectives of risk-based capital are to make regulatory capital requirements more sensitive to differences in risk profiles of banks, to factor off-balance sheet exposures more explicitly into the assessment of capital adequacy and minimize disincentives to holding liquid, low risk assets.

Leverage Ratio

The banking agencies are also engaged in implementing new minimum leverage ratios that will be based upon a definition of capital consistent with the Tier 1 capital definition that is used in the risk-based capital guidelines. The Federal Reserve has issued a new supplementary leverage standard which will require a minimum capital-to-assets ratio of 3.0 percent for the safest institutions. These minimum risk-based and leverage ratio requirements will enable us to remove the current capital-to-assets standards at year-end 1990. Similar leverage guidelines are being developed by the OCC and the FDIC, as explained in detail in the Federal Reserve's report to the Congress on capital and accounting standards used by the regulatory agencies.

The objective of the new leverage ratio is to ensure that banking organizations which hold substantial amounts of low credit risk assets must still maintain a minimum amount of capital. A financial institution operating at or near the established minimum level must have well-diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings, and, in general, be considered a strong banking organization. Institutions without these characteristics, including institutions with supervisory, financial or operational weaknesses, are expected to operate well above the minimum standard. Also, institutions experiencing or anticipating significant growth are expected to maintain above average capital ratios.

It should be stressed that the banking agencies have generally viewed their capital ratios as minimums. Furthermore, most banking organizations would wish to operate well above these levels. Over the years, the Federal Reserve has encouraged banks to continue to strengthen their capital positions. We have done this primarily through the bank examination process, and by requiring strong capital positions of those institutions undertaking expansion.

DIFFERENCES IN CAPITAL STANDARDS

As you are aware, we have submitted a report to this Committee detailing the capital and accounting standards used by the federal banking and thrift agencies. The differences in the capital standards of the banking agencies and the OTS are discussed in detail in our report. A summary of the primary areas of difference are presented in Table 2 of the appendix. The staffs of the banking agencies and the OTS meet regularly to identify and address differences in their capital standards and work toward consistency.

ASSESSMENT OF CAPITAL ADEQUACY

While current capital standards generally provide a cushion against losses from operations or a weak loan portfolio, they do not address all risks of an institution. For example, the bank risk-based capital guidelines, at present, do not yet address non-credit factors, such as interest rate risk and foreign exchange positions.

Interest rate risk is defined as the sensitivity of an institution's earnings and capital to changes in interest rates. This sensitivity may result from differences in the maturity or repricing of an institution's assets, liabilities, and off-balance sheet instruments. This type of mismatch occurs, for example, when an institution funds a long-term, fixed-rate loan with a short-term or variable rate deposit. When significant interest rate exposure exists, a relatively small adverse change in interest rates may result in a substantial reduction in an institution's earnings and capital.

Interest rate risk has been evaluated in connection with the overall determination of an organization's capital adequacy and financial condition during on-site examinations. Since a conclusive assessment of capital adequacy can be made only after consideration of all the quantitative factors that determine the need for capital, we think it is clear that the time has now come to place greater emphasis on the quantitative measurement of interest rate risk and to more explicitly factor interest rate risk into the assessment of capital adequacy.

To this end, the Federal Reserve is working with the other U.S. banking agencies and regulatory authorities on the Basle Supervisors' Committee to develop methods to measure and address interest rate and other non-credit risks. These methods are necessary to enhance the basic risk-based capital framework.

In considering how best to factor interest rate risk into capital adequacy calculations, we are guided by the following principles:

1. The system should provide incentives to reduce risk or a means to ensure that those risks which are assumed are backed by sufficient capital to fully protect the deposit insurance system and investors.
2. The system should assess the impact on the firm of interest rate volatility and hedging activities, including proper risk weighting of hedging instruments.
3. The system should be straightforward so that it can be widely understood and utilized by bank directors and management.
4. The system or the data required to implement it should not place excessive burdens or costs upon the institution.
5. The system should strengthen U.S. banking organizations so as to enhance their international competitiveness.

Although domestic and international work has been underway for some time, we have not yet achieved a consensus on how to measure interest rate risk or assess an appropriate capital requirement. However, it is necessary to find a measure that produces an acceptable interest rate risk measurement tool.

While the Board has not officially approved a particular approach to interest rate risk measurement, there are a number of possible approaches that the Board is likely to consider. One alternative might be to require all institutions, regardless of size, to provide detailed information on the maturity and repricing of their assets, liabilities, and off-balance sheet exposures. This information would then be used to calculate an institution's interest rate exposure and the corresponding capital requirement. One drawback, however, is that this approach could impose substantial reporting burdens on institutions with minimal interest rate risk.

Another alternative that the supervisory agencies might explore in order to deal with interest rate risk involves a two phased approach. Under this approach, institutions would be screened by the use of a rather rough measure of interest rate risk, derived from minimally enhanced data that is for the most part, already available in the Call Report. For institutions that undertake interest rate risks outside of established parameters, more detailed reporting would be required and could be the basis for a more precise calculation of an additional capital requirement.

We would certainly work to ensure that any approach that is finally adopted would be compatible with the interest rate risk measurement mechanism that might be developed internationally under the auspices of the Basle Supervisors' Committee. The approach that is finally adopted should be designed to afford regulators considerable comfort that institutions with undue interest rate risk have been appropriately identified, that a reasonable amount of additional capital for that added risk is being held, and that additional supervisory action could be taken as warranted. In addition, institutions that undertake interest rate risk outside of the established parameters would be expected to have the management expertise, together with strong reporting and control systems that would enable them to undertake such risks on a knowledgeable basis. Moreover, the interest rate data that banks provide would be verified regularly through the examination process.

One area that must also be addressed involves the accounting treatment for off-balance sheet instruments. In order to better factor these instruments into the assessment of interest rate risk, more work will have to be done by the FASB to improve the accounting standards for these diverse instruments and provide more specific criteria for hedge accounting.

CONCLUSION

In summary, the Federal Reserve believes that both accounting and capital standards play an important role in the supervisory process. In addition to providing important information to market participants, accurate and timely financial reports enhance the supervisor's ability to monitor an institution's financial condition and take prompt corrective action.

Stronger capital positions and prompt corrective action by supervisors will help reduce excessive risk-taking by insured institutions. The requirement for depository institutions to maintain strong capital positions sufficient to cover on- and off-balance sheet risks will promote the safety and stability of our banking system and protect the interest of the U.S. taxpayers. The Federal Reserve will continue to work with the other supervisory agencies to develop uniform capital and accounting standards that achieve these important objectives.

Table 1

Summary of Differences in Reporting Standards

Resulting from differences in GAAP for banks and thrifts

- **Specific valuation allowances for, and charge-offs of, troubled real estate loans not in fore-closure** – The banking agencies require reduction of the value of a troubled real estate loan to the fair value of the underlying collateral, generally determined by a current appraisal. The OTS requires a reduction of the value of the troubled real estate loan to the estimated net realizable value (NRV) of the collateral, which may exceed its fair value.

- **General valuation allowances for troubled real estate loans** — The banking agencies require that the general valuation allowance be sufficient to cover estimated losses on all loans, including the remaining balances of troubled real estate loans that have been reduced to the value of the underlying collateral. Once troubled real estate loans have been reduced to the NRV of the collateral, the OTS does not require that general valuation allowances cover the additional risk of loss in these loans.

- **Valuation of foreclosed real estate** – The banking agencies require that foreclosed real estate be valued at the lower of book value or fair value on and after the date of foreclosure. After foreclosure, the OTS requires a valuation allowance for foreclosed real estate based on the NRV of the property and addresses the additional risk of loss through its risk-based capital standards.

Resulting from standards of the banking agencies that are intended to be more conservative than GAAP

- **Sales of assets with recourse** -- With the exception of sales of pools of residential mortgages, the banking agencies generally require that assets sold with recourse be treated as financings (i.e., remain on the balance sheet). The OTS permits assets sold with recourse to be removed from the balance sheet in accordance with GAAP.

- **Futures contracts, forwards, and standby contracts** — The banking agencies generally require futures and forward contracts to be marked to market and standby contracts to be reported at the lower of cost or market. The OTS practice is to follow GAAP, which may result in loss deferral when futures and other contracts are used for hedging purposes.

- **Excess servicing fees** – With the exception of sales of pools of residential mortgages, the banking agencies do not permit excess servicing fees resulting from sales of assets to be recognized as upfront income. The OTS permits upfront recognition of excess servicing fees, as permitted by GAAP.

- **In-substance defeasance of debt** – The banking agencies do not permit banks to remove debt from their balance sheets by irrevocably dedicating risk-free assets to a trust for the debt's repayment. The OTS permits this in accordance with GAAP.

Table 2

Summary of Differences in Capital Standards

- **Leverage ratios** — The FRB and OCC have recently revised their standards to a minimum 3% Tier 1 capital-to-assets ratio (FRB requires an additional capital cushion depending on a bank's financial condition). The FDIC is in the process of coming up with a ratio similar to the FRB. As required by FIRREA, the OTS uses a 3% core capital (Tier 1) ratio and a 1.5% tangible capital ratio standard.

- **Goodwill** — All goodwill is deducted for purposes of calculating bank capital. The OTS does not require deduction of "qualifying supervisory goodwill" through year-end 1994.

- **Other intangibles** — The FRB and OCC generally require that intangibles exceeding 25% of Tier 1 capital be deducted when calculating capital ratios. The FDIC has proposed a similar rule. The OTS, on the other hand, applies this limit to intangibles other than purchased mortgage servicing rights.

- **Subordinated debt** — All bank regulatory agencies limit subordinated debt to 50% of Tier 2 capital. The OTS has no limitation in Tier 2.

- **Subsidiaries & associated companies** — For the OTS, subsidiaries engaged in permissible activities are consolidated if majority-owned or pro-rata consolidated if owned between 5 and 50%. Investments in subsidiaries engaged in impermissible activities are deducted.

  The banking agencies have the flexibility to require consolidation, pro-rata consolidation or deduction of subsidiaries and associated companies but generally require consolidation of subsidiaries that are majority-owned.

- **Mortgage-backed securities** — The OTS assigns privately-issued "high-quality" MBS (i.e., those with AA or higher investment ratings) to 20% risk-weight category. The banking agencies only assign to the 20% risk-weight privately-issued MBS that are collateralized by government agency or government-sponsored agency MBS.

- **Assets sold with recourse** — In general, the banking agencies and the OTS require a full capital charge against assets sold with recourse. However, in the case of limited recourse, the OTS limits the capital charge to the lesser of the amount of recourse or the actual amount of capital that would otherwise be required against that asset. The bank and thrift supervisory agencies are reviewing all issues relating to recourse arrangements through the FFIEC.

- **Phase-in requirements** — The banking agencies, consistent with the Basle Accord, have a two-year phase-in, ending in 1992. The OTS has different phase-in rules, also ending in 1992, although the capital effects are very similar.

- **Mutual funds** — The banking agencies assign investments in mutual fund shares to the highest risk-weight of the assets that fund is permitted to hold. The OTS assigns risk-weights based on the assets actually held by the fund.