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PUBLIC DISCLOSURE REQUIREMENTS FOR BANK SECURITIES

Remarks of

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The latitude your chairman has afforded me in the particular topic I have chosen to discuss today may well defraud your expectations for this session. However, his indulgence affords me an opportunity to discuss issues I have been close to for the past several months and which seem to me to be material to a discussion of banking and the securities business. I have reference to the proposed disclosure requirements to be imposed on banking organizations by the Federal bank regulatory authorities and the SEC and their effect on the issuance of debt and equity securities by banks and bank holding companies.

On October 1, the Federal regulatory agencies--the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation--issued for public comment several proposed changes in the periodic balance sheet and income statements for commercial banks generally and several new supplemental reporting requirements for large banks.

The more important changes are:

1. A step-up in the frequency of income reporting to a quarterly basis for large banks and semi-annual for smaller banks.
2. Separate income and balance sheet statements for operations of foreign offices (including Edge Act corporations) in the aggregate; these are integrable with statements of domestic operations.
3. Schedules for reporting foreign operations according to the location of the depositing or borrowing customer, which include three categories of foreign assets (total, balances with and loans to banks, and other loans and securities) and three categories of foreign liabilities (total, liabilities to

banks, and other deposits). Seven areas of the world (Europe, Canada, Latin America and Caribbean, Asia, Africa, Oceania, and U.S.) and international organizations are shown. The balance sheet items so distributed include those on the books of both foreign and domestic offices (shown separately).

4. To shed light on intermediation exposure, there is a maturity schedule (under 3 months, 3-6 months, and over 12 months) for all large denomination time deposits issued by domestic offices. The proposal also includes a schedule indicating scheduled maturities covering four classes of domestic loans (construction and land development loans secured primarily by real estate; other loans secured primarily by real estate, excluding loans secured by 1-4 family residential properties; commercial and industrial loans; and other loans except loans to individuals and loans secured by 1-4 family residential properties). The maturity of loans and deposits in total and for three classes of due from banks (banks in the U.S., foreign branches of U.S. banks, and foreign banks) are covered in a schedule applicable to foreign offices.
5. The aggregate of loans with maturities in excess of one year and carrying a fixed interest rate is called for as is the total of such loans having some type of floating rate.
6. A schedule on loan commitments at domestic offices by type of loan and borrower would replace a special reporting series now in use, and new information would be requested on total unused commitments outstanding at foreign offices.
7. Loan charge-offs and recoveries for five categories of domestic loans (commercial and industrial loans, loans to individuals, loans secured primarily by 1-4 family residential properties, other loans secured primarily by real estate, and all other loans) and for foreign loans in the aggregate would be reported quarterly.
8. Finally, an additional schedule would show the effect on earnings in each reporting period ensuing from nonpayment of interest or renegotiation of lower interest payments as a result of borrowers' financial difficulties.

On the same date the banking agencies published their proposals for comment, the SEC published similar proposals as applicable to annual

bank holding company reports and to prospectuses for issuance of securities.

In general, though it may not be immediately apparent, the two publications have much more in common than in difference. Both address the problem of providing a common data background for major banks. The condition and income reports prescribed by the banking agencies for all banks establish the data base for the various ratios and relationships called for by the SEC. The supplemental material for large banks deals with (1) the maturity structure of assets and liabilities, domestic and foreign; (2) interest rate flexibility; (3) foreign operations; (4) loan losses and non-current loans.

The major difference in the two publications, in my opinion, is that the banking agencies' proposals are more definitive and in some respects more comprehensive. For example, they provide maturities for four categories of domestic loans instead of one; maturities on balances due from banks at foreign offices, by type, and foreign deposit liabilities, which SEC omits; full foreign office balance sheet and income statement instead of selected foreign balance sheet and revenue or net income reporting; and an asset and liability breakdown by geographic area instead of only total assets. The banking agencies do not specifically invite comment on certain alternatives set forth in the SEC proposals. The two principal instances in which the SEC offers alternatives are in the treatment of foreign operations and non-performing loans.

As to foreign operations, the banking agencies seem to me to have proposed a basis and scope of reporting that will provide all needed information on a compliance-cost-effective basis. As to non-performing loans, the additional disclosure proposed by the SEC compared to that recommended by the banking agencies would be, in my opinion, counterproductive to steps needed to strengthen the capital position of large banks generally. The record of external capital added in 1975 supports that view. The SEC in its publication does not reject the banking agencies' posture but calls for comments on alternatives that would be more costly to comply with. Further, they involve the use of projections, implicit and explicit, which I believe could create more confusion and uncertainty than is warranted.

Many of the disclosure details and technicalities I have been trying to present in capsule form must seem inappropriate for a Sunday afternoon forum. But, there is, in my opinion, no other way in which the regulatory issues of disclosure can be presented. This approach also gives a substantive background for comment on broader disclosure issues which are not technical and raise questions affecting the essential nature of our banking system.

Over the past several months, the issue of material disclosure of banking organizations' condition and earnings has been focussed on the attitudes of the SEC and the banking agencies in meeting their statutory responsibilities. But other groups also have an interest in the issue. The accounting and legal professions have views on the

breadth in tolerances of law and judgment on disclosure. Obviously, the financial institutions themselves are deeply concerned lest their profits and viability should be eroded. But the greatest concern, in my opinion, should be for broad public confidence in our money or banking system. The risk of undermining that confidence should not be taken by requiring official disclosures which serve lesser purposes and are based on conjecture and projections with unknown probabilities.

Banks today are not safe deposit boxes. They are expected to serve both the money and credit needs of their communities--consumers; business, large and small; and government, Federal, State and local. Broad participation in the economic life of a community or the nation is not without risk and uncertainty. Risks are implicit in such public responsibilities of banks as aid in financing the public and private maintenance and rehabilitation of our central cities for example. The response of the banking system as a whole to a broad participation in the life of the community is evident today from the asset portfolios that show the bulk of banks' invested assets to be about evenly divided among consumers, nonfinancial businesses and governments.

We could, of course, have banks whose community role was restricted to accepting deposits, providing a money transfer service, and investing in government securities. In the mid-1930's a Chicago commercial banker offered such a service and advertised his bank as 100 per cent liquid. For this he was known as "100-per-cent" Nichols. There are no present-day banks, so far as I am aware, that could come

close to matching Nichols' claim of 100 per cent liquidity. Those that lean in that direction are generally regarded as providing inadequate credit services to their communities.

In the past, there have been proposals to separate money services from credit services in our financial structure. Professor Simons of the University of Chicago urged this structural reform in the mid-1930's as he viewed the economic disaster of the early thirties and the perils of intermediation. As is often the case, it is harder to bring structural reforms into being than to live with the perils the economy has experienced and become inured to. Today, money and credit are inextricably interwoven in our financial system and are becoming even more so as thrift institutions are acquiring money powers.

Through trial and error banks have, since the collapse of the banking system in the thirties, gradually established operating techniques to absorb unexpected deposit withdrawals even though the assets supporting such claims have relatively long maturities. The process of intermediation or transformation, i.e., converting short-term liabilities into long-term assets, is operationally valid today for the banking system and for individual banks. But intermediation must not be carried too far. Nor should it be exposed to unanticipated demands generated by rumor or misconception. Certain safeguards are essential. There must be a powerful liquidity back-up for the banking system and individual banks. The Federal Reserve has the responsibility to back up the banking system's liquidity and that of member banks. Member banks back up

nonmembers. Still, intermediation can be hazardous for banks without strong reputations and knowledgeable managements. Usually intermediation entails ready access to domestic money markets and, in many cases, foreign money markets. Deposit insurance has been a major back-up to confidence in smaller banks where the bulk of the liabilities are covered by insurance. However, today, our larger banks are far from fully covered by deposit insurance and their exposure to a drain of uninsured deposit and money market funds over the short run can be substantial.

Some believe useful disclosure could be achieved by a periodic recalculation of a bank's assets based on actual market values or estimates of such values derived from the current rate of interest. Interest rates often change rapidly and if those changes are translated into capital values the result may be to create mischief without assisting investors in bank securities. Moreover, transitory changes of this type over the life of a given bank asset are of no moment unless the assets are sold or except as opportunities are created for realizing gains or losses. The relevant fact is the effect of changing interest rates on the earnings record and the constraint on shifts in the institution's investment policy.

A bank may have had poor earnings and the prospects for improvement may be poor. It may also have a substantial deficiency in market relative to the book value of its investments and loans. But its assets may still be of the highest quality. The earnings information is relevant; the imputation of current market value is not. Identifying

market values, actual or constructed, with the quality of the asset can lead to serious errors in judgment wherever the determination arises from a change in interest rate levels. It is true, of course, that quality considerations also affect asset values but this determination rests on a case-by-case basis.

Our banking system remains vulnerable to the disintermediation that Simons pointed out forty years ago. It is a weakness we must not overlook but one we have managed and can manage to live with. In light of this feature of the banking system, the kinds of facts about banking organizations which appropriately could be made available to serve the interests of investors may seem to some to be inadequate. As I have indicated, this issue can only be resolved on a point-by-point basis. The clearest line of demarcation I perceive has to do with projections of asset values.

By the very nature of their public role, banks have always been sheltered from rumors and speculation about their asset condition which may be or prove to be irrelevant and ephemeral. But I see no need to resist disclosure of recorded facts as they become known or can be anticipated with reasonable certainty. Projection and forecasting of losses due to interest rate developments, however, is another matter.

All of us use projections of economic and financial developments--bankers, businessmen, policy makers, and investors. We do so with varying degrees of confidence in such projections based upon our experience with them and our familiarity with the basis on which the



projections have been made, including hidden or implicit projections. I believe a strong case can be made in disclosure policy for distinguishing between the report of fact and the use of explicit or implicit projection. We are all aware, of course, that well established accounting conventions are replete with implicit projections that are essentially unavoidable. These are unavoidable in a sense. However, their existence does not justify shifting the onus of other projections from the investor or his advisor to the disclosure responsibilities of banking organizations' managements. And this, in my opinion, is the major issue that remains to be resolved.