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DISCLOSURE FOR BANKS
AND BANK HOLDING COMPANIES

Remarks of

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at a joint meeting of

The New England Chapter, Robert Morris Associates
and
The Massachusetts Society of Certified Public Accountants

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DISCLOSURE FOR BANKS AND BANK HOLDING COMPANIES

The recent and continuing debate in professional, government and public circles on appropriate disclosure by banks and bank holding companies has yielded little net public benefit to date. Coming at a point in the nation's economic recovery where it is now important to encourage a revival in investment, it has aroused naive concern and may induce conservative lending practices on the part of bank managements which could hold back the availability of business and real estate credit. The impact of the new disclosure proposals also may be to impose significantly different methods of financing for State and local governments and possibly some types of business enterprises as well.

The other side of the coin is that an outcome of the debate may be a more timely and more pertinent disclosure system. A meaningful improvement in financial reporting by banks and bank holding companies would, in turn, enable participants in markets for bank debt and equities more accurately to differentiate among institutions as to soundness, earning prospects and management capability. And from my point of view, the market reaction to bank performance and condition is a far more effective cathartic for management than jawboning by bank regulators.

So far as I have been able to observe, the parties involved in this controversy are not at odds as to the usefulness of disclosure and the constructive role markets might play in channeling resources

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to better managed and more profitable institutions. Markets have made glaring errors in past evaluation of bank securities, not so much, I believe, through the lack of relevant and refined accounting data as through misreading economic trends, failing to perceive the significance of management changes or the reasons for diversity in earnings trends--in short, for giving insufficient attention to the data that were available. Nonetheless, the case for more timely and meaningful data is a strong one.

In this context of comments I should add reference to the fact that it is only with in the past decade or less that many of our banks have provided anything more than the most rudimentary facts about their assets, liabilities, earnings and operations. While little may have escaped bank examiners' attention and reports by many banks to their stockholders are exemplary as to disclosure, the quarterly balance sheets mandated by law and intended to inform the public of the condition of individual banks have remained outmoded as to disclosure needs and of limited usefulness to either investors or depositors. Although disclosure inadequacies are mainly those of omission, there are some of commission too.

For example, as with nonfinancial institutions, window dressing around statement dates is an "accepted" practice even for banks. Often, the practice is not so much to put a better light on financial relationships that the public might interpret as adverse as it is to tout a ranking in a particular banking market. How much

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being number one or number two in some local, regional, national, or international market means to investors I could not say--the cost of arranging that status is sometimes high. Perhaps the practice should be considered under the heading of advertising license; in any event, its contribution to meaningful disclosure is negative.

A proper disclosure policy should afford market participants financial data in a convenient form for evaluating and comparing the debt or equity securities of various issuers from the standpoint of safety, yield, and marketability and for bringing to light points of unusual significance for a participating bank. Similar benefits would be realized by depositors or other creditors whose claims are uninsured because of size or character. These claimants include banks, governments, nonfinancial corporations, trust funds and institutional investors. Many of these interests have views on disclosure peculiar to their actual or prospective ownership or creditor status. My own approach as a bank regulator, not unnaturally, is colored by a background and experience of looking for information bearing on the viability of a banking institution. However, variation in points of view need not, in my opinion, result in a significant expansion in over-all disclosure requirements. There could hardly be significant differences in various users' attitudes toward the need for an evaluation of management quality and performance, earning performance and potential, asset quality relative to yield, intermediation and foreign exchange exposure, or leveraging. Even if every fact reasonably pertinent to these factors were available there would still be no necessary unanimity in judgment. Nor is that a goal sought by disclosure requirements.

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Based on my experience there is much more to be gained from increasing the frequency of disclosure and making greater use of the income and expense statement, including off-statement supplements, than there is from restructuring the balance sheet in one way or another. And I have in mind proposals to use actual market values or constructed values based on the current level of interest rates.

The erratic behavior of interest rates over the life of a medium- or even short-term security and the consequent fluctuations in capital values that would be incorporated into a revaluation is far more likely to mislead than inform investors as to the bank's condition. In banking, the disadvantage or advantage of an interest rate change will often have been preallocated to depositors or borrowers through the loan or deposit contract. In any event, such changes should, because of the nature of banking, impinge primarily on the bank's customers and not on the bank.

While a choice need not be made among high priority disclosure needs, compliance costs and privacy considerations become factors as additional facts become redundant or only marginally relevant.

The case for greater frequency in reporting--and in the present context this means quarterly instead of annually--rests mainly on the fact that a bank's earnings-asset-liability condition can change significantly in a short period of time as a result of internal decisions or external forces. Whenever financial changes occur

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swiftly or unexpectedly, as they sometimes do, yearly reports make stale reading and staler analyses. Prompt recognition of change--or no change--in a bank's condition serves two purposes. It informs the public and in light of that disclosure bank managements inclined to be dilatory are motivated to timely consideration and action. An incidental benefit is that frequent reports can also serve multiple statement needs such as those that arise in connection with proposals requiring approval of some government agency.

To get down to the core of the controversy over disclosure one must grapple with the issue of what facts are relevant. Materiality, a word of art in some quarters, can be made to encompass so broad a flow of minutia, conjecture, projection and prejudice as to make a travesty of the concept of financial analysis. On the other hand, materiality can be interpreted so restrictively as to actually conceal strengths or weaknesses that lie just beneath the superficial appearance a given institution may present to the public.

Reaching a reasoned middle ground on the substance of disclosure is made difficult because of long-established bank reporting practices which are clearly inadequate by present-day standards. This inheritance has given rise to the judgment that investors, in particular, have suffered from inadequate disclosure requirements and a failure on the part of bank regulatory authorities to give sufficient consideration to investor interests as well as those of bank creditors other than depositors.

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The current attempt to reach for confidential data and views of bank regulators who are presumed to qualify as investment advisors, or at least be a reliable source of information appropriate to that use, could, in my opinion, be counter-productive for a number of reasons. The main one is the conditioning and potentially debilitating impact of such a role on the examiner and the examination process. In addition, the scope of information available to examiners is not needed by investors and could be damaging to the traditional practices under which individuals, businesses and governments have long conducted their financial transactions. Banks endeavor to safeguard and respect the privacy of their customers within the limits of the law while recognizing as they must that, for the public protection, there are, in the United States, no customer relationships beyond the scrutiny of regulatory authority.

The disclosure advocated in some quarters would include categories of depositors, borrowers or others with whom the bank does business based on race, color, creed, country of origin or residence, nature of business or occupation and perhaps sex. The specific nouns often used for these categories can be recognized for their invidious characterization. Buzz words in banking today, such as "problem bank, "New York," "OPEC," "REIT," are associated with liquidity exposure, management deficiencies, or potential loss. Because of the crudeness of their applicability they can do damage to banks and their customers and have serious consequences for the financial structure of our economy. These

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particular words may have short lives but they will, no doubt, be followed by others equally damaging. There is little point in trying to suppress an idiomatic shorthand for bad, bad, bad, but there are no grounds and, in my opinion, great potential dangers associated with incorporating prejudice into analyses of quality of assets or management performance. After all there are good loans in the most distressed sectors of our economy and bad loans in those that are booming.

To remove prejudice from judgments about the quality of assets, liabilities, and earnings, objective categories must be used to measure loan or management performance. This can be done only if there is reasonable assurance that books of account reflect what has happened, that self-dealing does not exist, and that financial entities have accounting safeguards in place to maintain the integrity of the financial record. We should assume too that bankers are not fools throwing away their depositors' money nor are they possessed of the prescience to anticipate the events in the economy that may, for a time, change the quality of their assets or their earnings. Try to recall what your investment antenna told you a year ago, or even two months ago, and check it against today's market. If you're honest, you'll be humble; if by some chance you've been right on the button, take a bow while you can.

A nonbanker looking at the hazards banking appears to face may well wonder how it can be that bankers and banks have survived in a world buffeted by war, inflation, depression, floating exchange

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rates, gyrations in interest rates, regulatory constraints and competition from a broad range of institutions and financial alternatives. The explanation is that a bank is suspended in or supported by its environment. That environment consists of the bank's customers--depositors and other suppliers of funds on the one hand and loan customers or issuers of securities on the other. These suppliers and users of funds absorb the bulk of gain or loss from economic uncertainty and they ordinarily bear the initial shocks. The bank itself is like a cork floating serenely on the sea riding with the tides, the swells, the calms and storms. Of course, the cork will sink if its power of levitation is stretched by dead weight.

Without trying to press the analogy too far, think of a bank as an institution that survives because it avoids dead weight and maintains a safe spread between what it pays for money and what it gets for it. Indeed, the very essence of good banking is the maintenance of a viable spread between the cost of funds and the return on them. No other fact for disclosure is of greater importance.

Before concluding my remarks on the complex and, in some quarters, emotional issue of what is appropriate in disclosure for banks and bank holding companies, I would like to set forth a few specific do's and don't's to illustrate the way I perceive the materiality issue.

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Do's:

1. Require frequent reporting - quarterly statements of condition, income and expense are needed for all depository organizations and particularly the larger institutions.
2. Insure the integrity of accounts - by giving more attention to internal control systems and to policing their operations.
3. Establish more definitive accounting standards to govern the timing of income or expense accrual. Front-end loading or any other skewed distribution of these flows or accounting procedures which convert their impact into asset or liability items should be revealed or avoided.
4. Require some method of indexing excessive exposure due to area or industry concentration. Banking law in the United States has the effect of encouraging concentration of banking institutions' investments geographically. Often as a derivative consequence, a like concentration in deposits and loans occurs in a particular industry such as agriculture. Most banks are sensitive to this type of risk exposure but as they are also obliged to meet their local communities' service needs, concentration of risk may be inevitable. Until the banking structure is modified to provide for greater diversification in loans and deposits, this risk of concentration should be made clear.

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5. The maturity profile of bank assets should be matched against the maturity profile of bank liabilities and should be reported in a manner and frequency which reveals the gross exposure to disintermediation. The net exposure requires taking into account offsetting liquidity resources as interbank balances, marketable securities, and access to market, bank and Federal Reserve credit.
6. The flexibility inherent in loan terms and interest rates should be summarized in a manner which shows the exposure of the institution to interest rate changes. However, such a requirement should not be interpreted to in any way inhibit banks from incorporating such flexibility into their loan contracts or if they have not done so, to modifying loan terms in a manner mutually agreeable to the bank and the borrower. The modification of terms may affect the flow of income directly but unless the loan is charged off in whole or in part, the modification of terms should not affect the book value of the loan or security involved.

The don't list is shorter because the do list by implication covers several don't's. Of course, neither list is complete.

Don't's:

1. Don't require banks to forecast or project their earnings or losses nor such environmental factors as trends in interest rates nor economic activity in the areas they serve. If

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they choose to do so let it be done at their own responsibility. Any projections would have a tendency to be self-serving, stimulate puffery and institutional vanity, of which there is already too much, and, if required by governmental authority, would gain a level of creditability which can be misleading.

2. Don't require the report of classified loans other than for the write-offs that have been taken in whole or in part. It has yet to be demonstrated that "specially mentioned" or "substandard" loan classifications provide significant clues to future loan losses. These categories have been used by examiners to direct attention to technical shortcomings that should be remedied but have a lesser bearing on loan quality. They often are more of a reflection on management than on borrowers.

While banks follow different policies with respect to the charge-off of loans, some move early to keep their loan portfolio in a prime condition and others await confirming evidence. In either event the examiners' findings are required to be taken into account by management.

On the "do" side, the use of a half-dozen or so loan categories for regular reporting of gross losses and recoveries would likely become over time a source of useful analytical data.

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3. Don't require banks to reveal the aggregate of non-performing loans--loans on which interest payments are delinquent. While it is appropriate to show the effect on income of a shortfall in expected receipts, reporting the aggregate of the total principal amount involved has the effect of exaggerating the severity of the situation, discourages negotiated workouts involving deferral of payments and may cause banks to enforce unduly harsh effects on their customers.

4. Don't bog down the whole process of disclosure in a myriad of details the effect of which will be to confuse and hide what is really going on.

Let me conclude by reminding you that disclosure requirements deserve serious consideration on all sides. The issue of what to disclose is not a simple one because a manageable number of facts or relationships pertaining to a bank or bank holding company must be selected from the thousands of bits of information generated by the detailed record-keeping systems used by such organizations. That selection process must serve the needs of shareholders, depositors and other creditors. It must also be recognized that disclosure can affect the vital role of banking in our economy in financing consumers, business and government.

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These objectives need not be in conflict but that result may easily come about if disclosure standards cause banks to alter their community role and be turned into, as at times in the past, risk-averting investors that put their funds predominantly into Treasury securities and other Federally guaranteed paper.

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