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Remarks of J. L. Robertson

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NABAC

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Disclosure Accounting by Banks

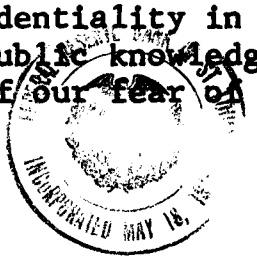
When I received the Convention program, I had a disturbing thought and checked to see whether my remarks on "Disclosure Accounting" were to be followed by a rebuttal speech entitled "Concealment Accounting". The absence of any such topic quieted any fears that I might have stumbled unknowingly into a debate between those two approaches.

So I assume we are in general agreement that the function of financial statements - even when issued by banks - is to reveal rather than to hide, and that our interest has to do with what should be disclosed, and how, and to whom. Some disclosure is required by law and regulation, but perhaps even more important is the extent to which disclosure is required by economic self-interest or by our regard for the public interest.

I suppose there has been a modicum of bank financial disclosure for hundreds of years. But until recent decades the disclosure was rarely more than what has been required by the National Bank Act and by various state laws. I refer, of course, to the periodic reports of condition - affectionately named "Call Reports" - that are demanded every few months by bank supervisors and are published in local newspapers, usually in the smallest possible type and dullest possible format!

Call Reports, as well as the "voluntary" statements of condition that some banks publish, are no more than balance sheets. Aside from their use by supervisory authorities, their principal purpose has always been to assist members of the public to decide whether to deposit funds with Bank X or Bank Y. In the current jargon, those reports are "depositor-oriented". That being their function, from the governmental viewpoint there rarely has been much opposition to what we euphemistically call "conservative presentation" - more bluntly, hidden assets and understated values. Who could possibly object if bank deposits were even better protected than depositors realized?

Conservative presentation was consistent with a strong tradition of confidentiality in banking, not only because people object to public knowledge of their financial affairs, but also because of our fear of the special dangers, such as



"runs", supposedly attendant upon rumors about the condition of banks. With some justification, banks - like the one with which my family was connected in Broken Bow, Nebraska, eighty-odd years ago - could see little to be gained, and very real possibilities of ill will and other harm, if any of their transactions or the results of their operations were revealed. Thus was built up the banking tradition of not disclosing anything beyond what the law required.

In our lifetime, however, the contra arguments on bank disclosure weakened while the pro arguments became compelling. Because of the development of central banking, which has been successful in moderating the extremes of economic cycles, and the establishment of a system of deposit insurance that enjoys complete public confidence, banks and their depositors are less fearful about the disclosure of financial information. But the principal development that has made bank financial disclosure an appropriate topic for our discussion today is the increase of public participation in the ownership and trading of bank securities.

Since the enactment of the federal securities laws in the New Deal days, it has not been seriously questioned that the investing public should have ready access to significant information on the stocks that they buy, sell, or keep tucked away in deposit boxes. Most of us agree on that, as a matter of principle - or when we are looking at the matter from the investor's viewpoint. But when it comes down to revamping our own banks' accounting procedures or publishing a detailed income statement, we are a little less enthusiastic!

For thirty years most of our country's banks - even the largest - were immune from the legal disclosure requirements of the federal securities laws. The stocks of banks are explicitly exempted from the Securities Act of 1933, which prescribes elaborate registration and prospectus requirements for larger securities issues of most corporations. And until this year the disclosure mandates of the Securities Exchange Act of 1934 did not apply to banks because their stocks are traded over the counter whereas the 1934 Act applied only to securities traded on exchanges.

Last year, however, Congress changed the law in the latter respect. Today every bank with 750 stockholders must

file with its federal bank supervisor a registration statement and periodic reports, principally financial statements, that are open to public inspection. Administration of the Securities Exchange Act in the banking field was transferred from the Securities and Exchange Commission to the federal bank supervisory agencies. The Federal Reserve System and the Federal Deposit Insurance Corporation adopted identical regulations, which I shall refer to as Regulation F. If you are downtown tomorrow and visit the Federal Reserve Bank, you may want to stop at its public reference room and see what some 175 banks have revealed about their financial affairs. These registration statements and quarterly and annual financial reports are open to public inspection in every Reserve Bank and in Washington.

As most of you are aware, an important element of the SEC's approach to financial statements has been its insistence upon certification by outside accountants. Initially we considered following the same course in connection with banks. This was a tempting alternative, because the responsibility for defining acceptable bank accounting principles and reporting standards would have been partially shifted from the agencies to the CPA's.

In the end, however, we concluded that greater comparability of informative financial statements could be achieved through the promulgation and enforcement of certain uniform standards of bank accounting and financial reporting, and that outside accountants' certification, with its attendant increase in costs, is not essential in the case of banks, which already maintain a fairly elaborate verification system independent of day-to-day management control. Consequently, Regulation F permits financial statements to be "verified" by a bank's principal accounting officer and its auditor.

The decision to prescribe and enforce uniform minimum standards of bank accounting and financial reporting constitutes the chief innovation of Regulation F. Besides adopting the general principle of accrual accounting, a number of uniform accounting practices were established, including such matters as the valuation and amortization of fixed assets,

and the separation of contingency reserves and valuation reserves. Certain financial reporting practices were also prescribed, such as the use of a type of "all-inclusive" income statement and the consolidation of financial information with respect to the bank and its bank premises and foreign banking subsidiaries. Until Regulation F was adopted, these had been points of divergence beyond the memory of living man.

Some of them are still controversial. For example, some of you may be aware of the continuing controversy as to whether (and how) loan loss or security profit-and-loss should be reflected in the portion of the income statement that relates to net operating earnings. I do not intend here to discuss the relative merits and difficulties involved in those suggestions. It is appropriate, however, to assure you that a Regulation F requirement can be changed whenever there is a consensus that a different practice would better serve the public needs.

Regulation F and the consequent public disclosure of banks' financial affairs are not the product solely of government and the banks immediately concerned. They represent the current results of a continuing industry-agency "joint venture". The entire regulation was developed by us only after we had received the benefit of months of effort by committees and other groups that represented the American Bankers Association, NABAC, the American Institute of Certified Public Accountants, the Financial Analysts Federation, and clearing house associations, to mention a few. The effectiveness of their work is evidenced by the ease with which Regulation F has gone into effect and the surprisingly few "bugs" that have turned up in its year of operation. Various proposals for amendments that promise further improvements are under active consideration, and we hope soon to be in a position to consult again with industry groups.

We cannot afford to be complacent. We have made progress toward the goal of bank financial statements that are adequate to inform and "protect" investors. But there remains much to be done, both in sharpening the tenets of "disclosure accounting" and in broadening its applicability.

From the investor's viewpoint, adequate financial information about bank securities serves at least two functions. It enables him to evaluate the particular institution and the particular security from the standpoint of soundness, earnings, and prospects. But perhaps equally important to an investor is the opportunity to compare effectively the stock of one bank with that of another. One of the reasons why the FDIC and the Federal Reserve System adopted identical regulations was our conviction that comparability of informative financial statements is a paramount objective and benefit of disclosure accounting.

When we look at the raw statistics, it is apparent that the road ahead is still a long one. Of the 14,000 commercial banks in the United States, less than 200 are reporting their financial conditions and the results of their operations in the uniform and comparable manner that has been prescribed for state banks that are subject to those disclosure requirements.

Those reporting state banks do include practically every state bank with at least 750 stockholders, and consequently those whose stock is most actively traded. However, the investor who is interested in stocks of even the great metropolitan banks cannot, under present arrangements, readily compare the securities of state banks and those of competing national banks. This is perhaps the most unfortunate result of the transfer of the administration of the Securities Exchange Act with respect to bank stocks from the SEC, and its distribution among the three federal bank supervisory agencies.

If an investor in this city wants to make an informed selection of a bank stock for his portfolio, the necessary information on the state banks is conveniently available to him right here at one place - the Federal Reserve Bank. Unfortunately this is not true of the local national banks, which include several of the largest. The result is that the disclosure principles of Regulation F are achieving only a fraction of their potential benefits.

There are bankers who contend that such differences of policy and interpretation among federal bank supervisors

are advantageous. All who have heard me advocate unification of the federal bank supervisory agencies in a Federal Banking Commission know that I believe differently. Parenthetically, it is ironical that the present rapid erosion of the dual banking system, which is visible to all who care to see, may hasten the very thing some bankers profess to fear - a single supervisory agency.

I can understand the feelings of those who want to retain the ability of their banks to switch from one system to another in order to obtain the most lenient supervision. I can even understand the opposition of a bank supervisor whose job might be placed in jeopardy by unification. But I find it simply impossible to understand how anyone could sincerely oppose uniform and coordinated policies in the field of financial disclosure. The very purpose of disclosure under the Securities Exchange Act is to enable the investing public to compare and evaluate intelligently the securities of different banks, and this purpose is defeated unless investors (and their advisors) have convenient access to information that presents the significant facts in similar ways.

Of course, if a unified federal supervisory agency - a Federal Banking Commission - were established, this problem would be solved, and I could stop being concerned about such matters and devote my full attention to the formulation of monetary policy. Investors would then have access to comparable and informative financial statements and would be in a position to make a better informed choice than is now possible between the stocks of national and state-chartered institutions. This fact, and its meaning to banks and to the investing public, should be brought out sharply by a careful analysis of the existing law and administrative practices under which federal banking agencies exercise their supervisory functions. You may have noticed that such a study is called for by a provision of a bill recently introduced in the United States Senate by a very formidable group - Senators McClellan, Jackson, Ervin, Ribicoff, Harris, Mundt, and Lausche.

However, even if national banks and state banks are operating under a uniform disclosure system by 1967, when

Regulation F will become applicable to banks with as few as 500 stockholders, over 90 per cent of the nation's banks will still be exempt from its financial disclosure requirements.

Therefore, we must hope that the essential "rightness" of informative disclosure, presented fairly, as well as the benefits to be derived therefrom by a bank, its depositors, and its stockholders - including, perhaps, a better market for the bank's stock - will gradually persuade financial institutions not subject to Regulation F to embrace the course that it prescribes.

This is not a vain hope. The Gordian knot has been cut with respect to major controversial matters. The promulgation of Regulation F has stimulated thoughtful and articulate expressions of views by commentators and professional organizations. Some of those have already urged all banks to adhere to the financial disclosure requirements of Regulation F. It has even been suggested that those requirements represent the minimum disclosure policy a bank should follow.

NABAC in particular has assumed an appropriately evangelistic role by initiating and recommending uniform bank accounting practices through bulletins issued by your Accounting Commission. And, as I noted earlier, the Federal Reserve and the FDIC will continue to seek improvements in the regulation itself through consultations with the industry's leaders in this field. Consequently, it may be anticipated that greater uniformity and adherence to standard principles will develop, both as a matter of internal accounting procedure and in the information that banks reveal publicly.

From here on, regular publication of financial information, based on widely accepted accounting principles, will likely become standard practice not only among state banks with many owners, but also among banks with only a few hundred stockholders, and among national banks both large and small - as a result of competitive pressures and the demands of the investing public, if not by regulatory requirement.

Now you may contend, and with considerable justification, that while the investing public demands comparable financial statements that present fairly the condition and results of operation of banks, it does not demand a proliferation of apparently inconsistent financial statements about the same bank for the same period. In so far as the market is concerned, more than one statement is a disservice, because investors and others inevitably are confused by divergent presentations.

Presently some banks that are subject to Regulation F publish three different balance sheets as of approximately December 31 each year. First, there is the Call Report, which the law specifically requires to be published. Second, there is the bank's balance sheet for advertisement and general publication purposes, which usually appears in print within a few days after publication of Call Reports. Third, there is the Regulation F balance sheet, which usually is not available to the public until several weeks later.

General acceptance of the disclosure accounting principles prescribed by Regulation F would result in the harmonizing of bank balance sheets for all purposes. But we cannot reach that goal until supervisory instructions that govern the form of Call Reports are changed to coincide with those for statements under Regulation F.

To make the Call Report instructions the same as the requirements for Regulation F financial statements, however, presents numerous difficulties. For example, the statutory Reports of Condition are not always called for as of end-of-quarter or end-of-year dates, and the information necessary to prepare financial statements in accordance with the Regulation F requirements may not be available by the time Call Reports must be submitted or published. Furthermore, to make all state-chartered banks comply with the financial reporting requirements of Regulation F might not be feasible for another reason, at least at the present time. Several of the practices prescribed are rather sophisticated, and many smaller banks have not yet adopted the elementary principle of accrual accounting.

It would be impractical in the present circumstances even for the Federal Reserve to insist that those member

state banks that are subject to Regulation F file Call Reports in accordance with the requirements of that regulation. Not only is there the question whether a Call Report could be adequately prepared by such banks, under Regulation F rules, in the time allotted, but also and perhaps even more important we must not forget the fact that those reports are used for nationwide statistical purposes. Because of that basic statistical function, a close compatibility of reports submitted to the Federal Reserve with those submitted by other banks to other federal bank supervisory agencies is essential. Unilateral changes in such instructions should be avoided.

Lack of uniformity in the past has made it necessary on occasion for the Federal Reserve to ask national banks to submit special supplementary reports. This is an unfortunate necessity and is particularly inconvenient for the banks. We hope that we have now negotiated a compromise form of report that will hereafter serve more adequately the purposes of the respective agencies, while not doing extreme violence to their various understandings (or misunderstandings) of what the law is - for example, whether Federal funds transactions are or are not loans and borrowings. But it is a nervous compromise; one that is not likely to be wholly satisfactory to anyone. And no one can tell how long it will last.

I can already foresee differences arising again as a result of a recent pronouncement by one agency that short-term promissory notes issued by national banks are not subject to the statutory borrowing limitation of section 5202 of the United States Revised Statutes. Obviously such notes must be shown some place on the liabilities side of a Call Report. If they are not subject to the limitation of the law, they must come within one of its exceptions. The only one they could reasonably fall into is the exception for "Moneys deposited with" the bank. It is hard for me to believe that that agency intended that promissory notes be reflected on Call Reports as "deposits", even though - from my point of view - that is the way they should eventually come to be classified. However, it will be time enough to cross that bridge when we come to it.

In the meantime, we must continue to strive to attain and retain not only uniformity in the Call Report area, but also quality and comparability in the information presented. Here again, my own view is that the only certain and lasting solution is the unification of the federal bank supervisory agencies, either by legislation or by a Presidential Reorganization Plan. A single agency obviously would have uniform statistical report forms and instructions. Such an agency could move much more readily and swiftly toward making the statistical forms needed for economic and financial analysis more fully compatible with the requirements for the financial statements needed by the investment community.

Despite the difficulties that remain, we must all agree that bank financial statements have begun to progress. They have moved in recent times from a "concealment" basis toward one of "disclosure accounting". Disclosure has become both a legal and a practical necessity for more and more commercial banks. It seems inevitable that financial statements based upon the disclosure principles of Regulation F will have an increasing place hereafter in the marketing of securities of banks, both large and small.

Up to now we have built only one section of a firm foundation for what will become a much larger structure. How rapidly that structure will be built and the extent of its usefulness will depend considerably on the willingness of persons and groups interested in bank accounting and financial statements to develop and urge sound practices for adoption by banks and by the federal bank supervisory agencies. It lies within the power of banks themselves to direct this current of change into channels that will benefit not only investors in bank securities and individual banks in their competitive situations, but also the nation's dynamic economy.