DISCLOSURE: ARE BANKS REALLY DIFFERENT?

Remarks by

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The title I selected -- "Disclosure: Are Banks Really Different?" -- may imply that I plan to stress the differences between banks and other financial, commercial and industrial organizations. And because of these differences, argue that banks should be sheltered from disclosing meaningful information about their operations. That is not my intention.

Obviously, in a number of ways banks are different from other corporations. You are well aware of their special role in money creation, as commercial lending institutions, and as depositories for the public's balances. Even more important, they depend on public confidence in a way other organizations do not. But these differences do not, in my view, justify sheltering the industry from meaningful disclosure.

In advocating more disclosure, I am not out of step with other Federal Reserve officials or bank supervisors. At the Hearings conducted last July by Senator Proxmire's Committee on Banking, Housing and Urban Affairs on bank disclosure issues, not one of the many witnesses was opposed to meaningful disclosure. The controversy centered on what was really meaningful, and what might, on the contrary, be misleading and thus create more problems than disclosure was intended to solve.

Let me mention a couple of reasons why I favor more disclosure. As a matter of principle, in our private enterprise system, market forces are assumed to be efficient allocators of scarce financial resources. To enable markets to play this role, meaningful information must be readily available to investors to permit them to make informed assessments of the inherent risks and potential profitability of various alternatives for their investment funds.

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Thus, disclosure of meaningful information by all users of funds is necessary to enable the public to make good decisions about where and how their funds can best be put to work.

A second reason that implies a greater premium on disclosure today than in the past is the trend toward increased risk-taking by professional managements. Managers, be they bankers, industrialists, retailers, or whatever, work with and administer the funds of other people -- stockholders, bondholders, depositors and other creditors. Since World War II, managers have in general become more dependent on debt than equity funds. This greater leverage entails more risk than in the past. And as a result, I believe they have an obligation to disclose more material facts about their operations and prospects.

Obviously, "meaningful disclosure" is a slippery term. To me, it means the timely release of enough information, including financial information, about the past and present operations of a business venture to enable reasonably knowledgeable and interested parties to make intelligent decisions. In the case of banking, the list of interested parties is quite diverse. It includes existing and potential equity and debt holders, investors, depositors and potential depositors, borrowers and potential borrowers, other creditors, investment analysts, economists and bank supervisors.

Actually, the current controversy concerning disclosure by banks is more heated than is warranted by the changes proposed. The extra heat derives not from disclosure as such, but from the awkward timing of the issue. Investors and creditors alike are concerned about the asset quality of banks as a result of the well publicized difficulties of some with real estate loans, more recently compounded by questions concerning the holding and valuations on New York securities.

And these questions concerning asset quality come along on top of earlier concerns about liquidity and capital adequacy. Thus, with or without more disclosure, I think the banking industry -- or at least parts of it -- has created doubts in the minds of investors and the general public that are not going to go away until the basic problems are resolved.

If today banks are little different from other corporations when it comes to disclosure, this represents quite a change from a few decades ago. It has been more than 40 years since Congress hurriedly put together the Securities Act of 1933, followed by the Securities Exchange Act of 1934. The basic reason for the 1933 Act was to inform the investor of facts concerning securities, and provide protection against fraud and misrepresentation. The purposes of the Act were to provide full, fair and accurate disclosure of the character of securities offered for sale in interstate commerce and to prevent unethical, dishonest, fraudulent and unsafe practices in the sale of such securities. The 1934 Act created the Securities and Exchange Commission. That legislation, in effect, put the force of Federal law behind financial reporting requirements for companies whose securities were traded on national stock exchanges, and provided for registration and disclosure in connection with new security issues offered by those companies.

As you know, banks were exempted from all but the fraud provisions of that legislation. It was also the practice, prior to 1960, for banks to avoid listing their securities on national security exchanges. Thus, through exemption from security registration requirements of the Securities Acts and avoiding the disclosure requirements of national security exchanges, most banks had almost complete freedom to choose the type and timing of information to be disclosed about themselves. The major exception was that all banks had to publish periodically their report of condition. Quite honestly, however, that did not tell very much.

In 1964, Congress amended the securities laws and required all publicly-held banks (defined as banks with 500 or more stockholders) to conform to periodic disclosure and security registration requirements of Federal bank supervisors. While banks were still not under the wing of the Securities and Exchange Commission, the periodic disclosure requirements, proxy solicitation requirements and disclosure of insider transactions prescribed by bank supervisors were similar to the requirements of the SEC for other publicly-owned companies.

It was about that same time -- i.e. the mid-1960's -- that many bankers who had formerly sought to avoid disclosure, voluntarily agreed to the disclosure requirements of the national security exchanges and the Securities and Exchange Commission. This came about through three developments: First, those publicly-owned banks that were covered by the 1964 amendments to the Securities Act were already required by regulation of bank supervisors to provide information similar to that required by the SEC. They thought they might as well seek a listing on an exchange and enjoy the supposed benefits and prestige of such a listing. Second, the industry was entering an era when bankers started to become much more concerned than previously with the performance of their stock in the markets. Many believed that a national listing would improve the market acceptance of their stock and the price-earnings multiples. And third, there developed a rapid acceleration of the bank holding company movement after the mid-1960s. Bank holding companies did not have any exemption from the Securities Act of 1933 such as banks enjoyed. As a result, our largest banking organizations, and many smaller ones, voluntarily submitted to the scrutiny of the SEC in connection with their financial reporting and the distribution of debt and equity securities.

Overseeing bank holding company security distributions was nothing new for the Securities and Exchange Commission. Banking organizations such as First Bank System, Inc. and Northwest Bancorporation had been under the jurisdiction of the SEC since its inception. However, the SEC's volume of banking holding company security work increased manyfold in the late 1960s and early 1970s. In the words of former SEC Chairman Ray Garrett, this additional work produced no particular problems for the Commission. It was aware of no serious problems confronting banks and as a result raised no embarrassing questions about their financial reporting and descriptions of their business in filings with the Securities Exchange Commission. In 1973, this began to change.

By the fall of 1974, two major banks had failed. Interest rates were very high. Money markets were nervous. Energy, inflation and unemployment were serious problems. And there began to develop serious concerns about liquidity, capital adequacy, risk in foreign currency transactions, and asset quality of our banking system. To such concerns the Securities and Exchange Commission appropriately responded in December 1974 with its accounting series release (ASR) number 166. That policy statement urged all registrants to communicate to investors any unusual or significant changes in the degree of business uncertainty for a reporting entity. More specifically, the statement urged disclosure of the nature and current status of bank loan portfolios. While ASR 166 was general in its terms, it was not a rule. That release, however, as well as all SEC registration forms are subject to the Commission rule number 408, which states:

"In addition to the information expressly required to be included in a registration statement, there should be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances in which they are made, not misleading."

As it should have, the Securities and Exchange Commission was getting serious about reporting requirements for banking organizations by year-end 1974.

Many banking organizations were planning to tap the capital markets early in 1975; few did. Chemical New York Corporation was one of the first to try. Chemical put out its preliminary or red-herring prospectus for its security offering in the usual manner. "Usual" in this context meant that the forms were complete with the standard phraseology that formerly had been acceptable to the SEC. Unfortunately, in this case, security salesmen began to solicit and line up buyers on the basis of the preliminary prospectus. After issuance of the preliminary prospectus, representatives of Chemical met with the staff of the Securities and Exchange Commission to work out acceptable disclosure under ASR 166 and Rule 408.

Shortly after the date of the offering, the issue was almost sold out. Then buyers started to read the final prospectus which included narrative and statistical disclosure of troublesome loans and loans to Real Estate Investment Trusts which had not been in the preliminary prospectus. Buyers balked, and Chemical had no choice but to withdraw the offering.

The Chemical episode brought the disclosure issue into the open. At first, the Chemical withdrawal was viewed with great concern on grounds that no bank holding company could meet the SEC's disclosure requirements, and the industry thus would be precluded from raising much-needed capital in the markets. To some, it looked like the makings of a real controversy, with the banking industry and bank supervisors on one side and the SEC, accountants and analysts on the other. And with Senator Proxmire's Committee on Banking, Housing and Urban Affairs serving as referee.

Actually this was not the case. All agreed that more meaningful disclosure would have to be provided by banking organizations. The controversy, as I mentioned earlier, centered on what was meaningful.

Two examples of the "what was meaningful" controversy related to asset quality: The first had to do with bank examiners' loan classifications, the second with the past-due or delinquency status of bank loans. In their bank examinations, examiners evaluate all loans above a specified size. Most of the loans reviewed are not classified, which means that in the examiner's judgment these loans are of acceptable quality. Others are classified by examiners. Some who advocate more disclosure have suggested that banks disclose the dollar volume of loans classifed by examiners. For good reason, bankers don't want to do this, and in this area the bank supervisors generally agree with the bankers.

The reason for not disclosing examiner loan classifications is that bankers and supervisors, understandably I think, fear that such disclosure would be misleading. Let me explain why. There are three categories of classified loans: Substandard, doubtful and loss. Loans classified <u>substandard</u> are defined as "Loans or portions thereof not classified doubtful or loss and which involve more than normal credit risk due to the financial condition or unfavorable record of the obligor, insufficiency of security, or other factors noted in the examiners' comments." A <u>loss</u> classification means what it says, while <u>doubtful</u> means that some loss is imminent but an exact amount cannot be determined at the time of examination.

The bulk of so-called classified loans fall in the "substandard" category. These loans should be viewed as weak and deteriorating credits, which, without corrective attention of bank loan personnel, may further deteriorate and become losses. The earlier in the life of a bank loan that an examiner recognizes a weakness or deterioration and classifies that credit "substandard", the more time bank loan personnel have to work on it to avoid a loss. Thus, all other things equal, if both examiner and bank loan personnel are doing their job, there should be an inverse relationship between volume of loans classified substandard and actual losses. It is the actual and potential losses that investors should be interested in, not how hard the examiner and bank loan personnel are working to avoid losses.

As the game has been played up til now, most good bank managers want examiners to be critical or conservative in their evaluation of loans since this gives the banker an early warning for correcting problems or potential problems. If bankers had to disclose the volume of loans classified substandard, this relationship would undoubtedly change. A better case can be made for disclosing in one form or another the dollar volume of loans classified doubtful and loss by examiners, since there should be a close relationship between these classifications and actual loan losses.

On the past-due loan disclosure controversy, some have suggested that banks should disclose the volume of all loans more than 60 days past due, or some other reasonable time period. This sounds simple enough, but it is no secret that bankers renew past-due loans and extend payments on others. And what initially may appear very simple and precise becomes complex and inexact. Some then suggest that banks should disclose all past-due plus renewed-and-reset loans. To this, one can argue that some loans are renewed with collateral or additional collateral which makes them better loans than before they were renewed. And many banks for good reason make loans for 90 or 180 days with full intention of renewing the loan at maturity. With these added complexities, the advocates of this type disclosure have then suggested that bankers should disclose the volume of loans _they_ consider past due or troublesome. And here it takes no great wisdom to see that the more alert and conservative bank will disclose what appears to be a lower-quality portfolio than the bank that does not recognize its problems.

While there are areas such as these where there is controversy about what is meaningful, there are many other areas where the several parties involved seem to be in agreement. In general, the additional and revised financial reporting requirements for banks and bank holding companies are going to recognize: 1) changes in accepted accounting practices, 2) changes which have taken place in banking, and 3) the changed philosophy toward more openness in disclosing information. These changes will be reflected in: 1) periodic reports of condition and income and dividend reports submitted by all banks, 2) annual and interim reports by banks and bank holding companies to stockholders, 3) proxy solicitations, and 4) security registrations. And there is considerable effort by the regulators to get more consistency in the financial reporting required.

Some of the changes and additional information that will become available will tell more about the liquidity position of the reporting entity. There will be more information on volatility of deposits and liabilities and maturity of investment securities. And more information will be available on the type and quality of a bank's lending activity, domestic, foreign, and future commitments.

The three Federal bank supervisors, the Financial Accounting Standards Board, and the Securities and Exchange Commission are evaluating the benefits, costs, and possible adverse effects of greater disclosure by banks and bank holding companies. The bank supervisors are proposing changes which would require greater disclosure, through regular condition and income reports, by large banks and bank holding companies (banking assets of $300 million or more) than by the smaller institutions. In summary, the areas of proposed additional disclosure requirements being considered are as follows:

A. Greater detail of Asset, Liability, and Capital composition.

B. Type of securities, maturities, and average rates of investment portfolio.

C. Greater detail of loans by type, maturity and geographic location and information regarding non-performing loans.

D. Size and maturity breakdown of deposits, long-term debt, and funds borrowed.

E. Net income as percentage of stockholder equity and average total assets.

F. Average interest rates on various types of assets and liabilities.

G. Foreign banking operations including maturity breakdown for various items.

H. Schedule of loan commitments by type of loan and borrower.

I. Analysis of loan loss experience and reserve for loan losses.

While the final chapters have not been written on the bank and bank holding company disclosure controversy, it is obvious that they will be disclosing more about their operations in the future than in the past. And this I think is good for all concerned, for knowledge that disclosure must be made is a form of management discipline. And while more disclosure will not guarantee effective management, it will supplement with market discipline, the discipline provided by the supervisors.