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STATEMENT ON

REPORTING BY FINANCIAL INSTITUTIONS

PRESENTED TO The

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE COMMITTEE ON ENERGY AND COMMERCE,
~~HOUSE OF REPRESENTATIVES~~
House

BY

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CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

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Mr. Chairman, I am pleased to have this opportunity to discuss bank accounting and reporting and the FDIC's responsibilities under the Securities Exchange Act of 1934. In approaching this subject, I will first describe the two bank financial reporting systems that the FDIC administers: Call Reports and Securities Exchange Act disclosures. Next, I will briefly explain the use of regulatory accounting principles (RAP) that mark limited departures from generally accepted accounting principles (GAAP). I will also examine the application of Financial Accounting Standards Board Statement No. 15 (FASB 15) to troubled debt restructurings. Finally, I will comment on the use of net worth certificates.

Call Reports

Section 7(a) of the Federal Deposit Insurance Act (12 U.S.C. 1817(a)) requires all FDIC-insured banks to file Reports of Condition and Income ("Call Reports") each quarter with their primary federal financial institution supervisory authority. Insured state nonmember banks submit these reports to the FDIC. National and state member banks submit their reports to the Office of the Comptroller of the Currency and the Federal Reserve Board, respectively. The three banking agencies, under the auspices of the Federal Financial Institutions Examination Council, have developed uniform interagency Call Report forms. These forms contain a balance sheet, an income statement, and numerous supporting schedules. The supplemental schedules cover various balance sheet accounts, loan charge-offs and recoveries, past due and nonaccrual loans, interest rate sensitivity, and certain commitments and contingencies.

The information collected in the Call Reports assists the three federal banking agencies in discharging their responsibility to maintain a safe and sound banking system. We use these reports most extensively to detect at an early stage those banks whose financial condition is deteriorating. We attempt thereby to reduce the bank failure rate and to limit the exposure of our Insurance Fund. We also employ the Call Reports as a source of individual bank and aggregate data for other regulatory, research, and informational purposes. I might add that we have made these reports publicly available (except for select sensitive financial data such as the amount of loans past due 30 through 89 days) since 1972. We strongly welcome market discipline as a supplement to supervisory discipline and we believe investors and depositors are entitled to accurate information about the institutions with which they are associated.

Securities Exchange Act Disclosures

A second separate financial reporting system affects insured state nonmember banks with publicly-held securities rather than all insured banks. In 1964, amendments to the Securities Exchange Act of 1934 ("1934 Act") extended its coverage to banks having: (1) over $1 million in total assets; and (2) a class of equity securities held by more than 500 stockholders or a class of securities listed on an exchange. Section 12(i) of the 1934 Act (15 U.S.C. 78l) assigns the related enforcement authority over banks to the three federal banking agencies. It also requires each of the agencies to issue regulations "substantially similar" to those issued by the Securities and Exchange Commission (SEC) pursuant to the 1934 Act, unless the agency specifically finds that an SEC regulation is not "necessary or appropriate in the public

interest or for the protection of investors." The FDIC has issued regulations comparable to those of the SEC setting forth the registration, disclosure, and periodic reporting requirements for bank issuers of publicly-held securities. These disclosures are designed primarily for the use of investors in bank stock, but are also relevant to other members of the public. The Bush Task Force Report recommended that this regulatory function be assigned to the SEC. We believe that this transfer of responsibilities would be appropriate.

While each of the approximately 8,800 insured state nonmember banks files a quarterly Call Report with us, only 234 of these banks are also registered with the FDIC under the 1934 Act. These banks must file both the periodic reports mandated by our securities disclosure regulations (12 C.F.R. Part 335) and the Call Reports. For most insured state nonmember banks, therefore, the only comprehensive publicly available financial information is derived from Call Reports.

GAAP and RAP

The Call Report is basically a fixed-format set of financial statements whose preparation is founded in the body of generally accepted accounting principles. The three banking agencies have, however, established in the Call Report instructions a few regulatory accounting principles that represent departures from GAAP. For example, GAAP provides that, if certain conditions are met, a transfer of loans with recourse from one party to another is treated as a sale of the loans by the first party. However, for regulatory reporting purposes, all transfers of loans with recourse must be treated as financing transactions (borrowings) and not as sales. All or the bulk of the

risk is retained by the transferring bank in recourse arrangements and our supervisory responsibilities focus on the assessment of risk. Accordingly, we believe that banks should continue to reflect loans that have been transferred with recourse as assets in their Call Reports even though, under GAAP, such loans would be removed from the bank's balance sheet.

Let me emphasize that our intent is not to establish reporting rules that would cause a bank to appear healthier than it really is. That would be counterproductive. Our Call Reports require departures from GAAP only for those transactions where RAP better enables us to assess banking risks. A review of the so-called RAP-GAAP differences for banks clearly shows that RAP does not improve the reported financial condition of banks.[1/] Indeed, RAP tends to produce lower bank earnings and capital and higher total liabilities than GAAP. The effect on total assets depends on the specific regulatory accounting principle. Moreover, each person who receives copies of bank Call Reports from the FDIC is informed that agency instructions require some departures from GAAP.

As for those nonmember banks subject to the public disclosure provisions of the 1934 Act, our regulations prescribe that "Financial statements filed with the FDIC ... shall be prepared in accordance with generally accepted

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[1/] The one exception to this statement is net worth certificates. The Garn-St Germain Act of 1982 deemed these certificates to be net worth and authorized their purchase (from "qualified institutions") by the FDIC. To date, the only FDIC-insured institutions that have "qualified" have been savings banks. No commercial banks have issued net worth certificates to the FDIC.

accounting principles and practices applicable to banks" as modified by the FDIC "in specific areas" (12 C.F.R. 335.601). Our instructions for preparing 1934 Act statements incorporate by reference the Call Report instructions. A registered bank that reports a transaction on a RAP basis could conceivably receive a qualified (or adverse) auditor's opinion because of this departure from GAAP if the departure had a material effect on the financial statements. Nevertheless, my staff has informed me that it has rarely seen such an opinion from an auditor and is not aware of any recent examples. Moreover, certain registered banks have bridged the difference between GAAP and RAP for a transaction while satisfying both their regulators and their auditors. They have accomplished this by preparing their 1934 Act financial statements in accordance with GAAP while including a footnote explaining the RAP treatment for the transaction and the effect on the statements had RAP been followed.

FASB 15

Let me now turn to an accounting principle that has attracted considerable attention in recent weeks. The FDIC, in concert with the Office of the Comptroller of the Currency and the Federal Reserve Board, has implemented joint regulatory policies toward agricultural and oil and gas lenders. We explained these policies in March 11 testimony before the Senate Banking Committee. In a statement to that Committee, we jointly took the position that all banks should account for the loans they restructure in accordance with GAAP as set forth in Financial Accounting Standards Board Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (FASB 15).

In testimony before the Subcommittee on April 24, Chairman Shad of the Securities and Exchange Commission provided a clear, concise description of the provisions of FASB 15 from a creditor's standpoint, its conceptual basis, and its relationship to loan loss recognition for GAAP purposes. Our view of the accounting for loan losses and restructured loans under GAAP is fully consistent with Chairman Shad's comments. FASB 15 represents sound historical cost accounting principles as stated by Chairman Shad.[2/] I fully support his synopsis of FASB 15.

The Call Report instructions advise banks to prepare their reports in accordance with GAAP, except in those few instances where the instructions depart from the provisions of authoritative accounting pronouncements. The regulatory instructions have never set forth reporting rules that deviate from FASB 15. Thus, it has been acceptable for banks to report troubled debt restructurings in conformity with this accounting standard since its issuance in 1977. Hence, in accounting for and reporting debt restructurings, large banks routinely follow the provisions of FASB 15.[3/] However, many smaller banks (which as a group represent nearly 90 percent of the state nonmember

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[2/] Under the historical cost framework, GAAP does not generally provide for the recognition of unrealized gains and losses on holdings of financial instruments when interest rates change. For example, the carrying value of debt securities is generally based on historical cost, even though market values may fluctuate significantly over time. These market values would, however, be disclosed in the financial statements or their footnotes.

[3/] According to the December 31, 1985, Call Reports, the five largest U.S. commercial banks held $297 million in restructured debt. Total loans and leases at these banks aggregated $285 billion.

banks under our supervision) have not been sufficiently aware of the accounting procedures applicable to debt restructurings. Small banks may be unfamiliar with these procedures and may be uncertain about the accounting treatment that would apply if they were to modify the terms of troubled loans. Accordingly, these banks may have been reluctant to restructure loans when working with troubled borrowers for fear of adverse supervisory reactions. This is unfortunate. An understanding of FASB 15 is especially important to the many agricultural lenders who are working with borrowers experiencing liquidity problems due to the severe economic problems in the farm sector.

Let me reiterate once more -- our action toward restructured loans is not a change in accounting rules for banks. As I stated in my March 11 testimony before the Senate Banking Committee, "Banks should be allowed to account for modifications of loan terms as reduced income ... when such treatment is in accordance with" FASB 15. In determining whether a restructuring does in fact comply with FASB 15, a bank creditor must also assess the collectibility of a loan with modified terms. If a credit loss is probable and the amount is reasonably estimable, the loss must be recognized immediately. Very simply, a bad loan does not qualify as a FASB 15 restructured loan. The restructuring of loans is not a technique designed to conceal credit losses or delay their recognition.

Capital Forbearance, Net Worth Certificates, and Loss Deferral

We have not indicated approval for loan loss deferral programs which violate GAAP accounting and do not anticipate that we will do so.

While the FDIC opposed the 1982 legislation authorizing the use of net worth certificates, fortunately Congress enacted the law. The FDIC has since purchased $720 million of such certificates from 27 mutual savings banks, of which some $692 million issued by 19 institutions remains outstanding. However, the certificates were purchased with accompanying conditions that included stringent requirements for management improvements. These requirements plus a predictable drop in interest rates have proved highly successful in restoring the majority of troubled savings banks to a healthy status. The use of these certificates has saved the FDIC fund billions of dollars.

Given a reasonable prospect of a reversal in adverse economic conditions, the use of such devices as net worth certificates can avoid market disruptions and high costs to the insurance fund. However, the better way to approach this economic problem is capital forbearance, as we have provided for agricultural and energy banks in our joint statement with the other regulators. The forbearance program addresses the problem of reduced capital levels directly rather than through the use of "paper capital" certificates although the net effect is the same. Therefore, we believe that an extension of the net worth certificate program, or enactment of a loan loss deferral program, is unnecessary.

The FDIC has always advocated a policy of adhering to reporting and accounting procedures that accurately reflect the condition of commercial banks and savings banks and will continue to do so.

Mr. Chairman, that concludes my prepared remarks. I would be pleased to respond to your questions.

Thank you very much.