Remarks
By
Donald E. Powell Chairman,
Federal Deposit Insurance Corporation
Before the
America's Community Bankers Annual Convention
Washington, D.C.

FOR IMMEDIATE RELEASE
PR-109-2004 (10-18-2004)
David Barr (202) 898-6992

Media Contact:
David Barr (202) 898-6992

My main subject this morning is accounting and governance—what the changes in these areas mean for you, and what they mean for the bank regulators. Also, on a related subject, what the changing dynamic should mean for the housing GSEs.

You all are acutely aware that the legacy of Enron and other high-profile bankruptcies are still with us. Part of the response to those scandals reflected a need to strengthen financial reporting and internal controls in this country.

There were some top managers in corporate America who misused their positions, manipulating the financial reporting system in their own favor and at the expense of investors. Their accountants, attorneys and, in some cases, bankers allowed this to happen.

All of those involved in these scandals did our country a disservice. As Professor Rajan of the University of Chicago puts it in his recent book, sometimes capitalists are the worst enemies of capitalism.

While Enron's legacy has been, in part, a needed housecleaning, it reflects another characteristic of our society—a desire to identify villains and a fondness for sweeping legislative reforms when public indignation reaches a critical mass. Such reforms can affect the lives of the innocent, as well as the guilty, in unanticipated and unintended ways. This is not good for America.

In Sarbanes-Oxley and in a number of accounting pronouncements over the last few years, we have seen an understandable correction to the excesses of earlier years.

Many of you are living with the effects of that correction. While most of you have no intention of defrauding investors or deceiving your regulators, many of you have expressed concerns as to whether the costs you are incurring are generating any real benefit.

Bank regulators tend to work case by case, taking corrective action against those who need it, and letting the rest go about their business. As such, it should not surprise you to know that regulators have been doing, and continue to do, all we can to ensure that reforms are applied in a commonsense manner, with full and appropriate deliberation to all costs and benefits.

We have worked very closely with FASB, the SEC, and the AICPA over the last few years on a number of issues of interest to you. The bank regulators maintain an ongoing dialogue with these organizations and those conversations have been productive. They have, I believe, resulted in an appropriate balance of legitimate objectives. The FASB, in particular, must consider the needs of investors and the general public, along with the business realities of all issuers of financial statements, not just banks. Bank regulators have interests in bank safety-and-soundness that transcend accounting issues.

I applaud the accounting standard-setters for the seriousness with which they have considered all points of view, and their willingness to take the time for full and appropriate deliberation on several issues of vital importance to bankers and bank regulators.

Last year's proposal on accounting for loan losses is one example. The bank regulators expressed concerns over the proposed guidance in our comment letter, as did many others. After carefully reviewing the comment letters, the AICPA decided to proceed only with guidance to improve disclosures, which was consistent with the regulators' recommendation.

Early this year, the FASB began to question whether the existence of a right of setoff should prevent a loan participation from being accounted for as a sale. This is a complex issue and I applaud FASB for drawing on the best technical expertise before making a decision. The FASB's recent tentative decisions on setoff will preserve sale accounting for loan participations, while at the same time identifying best practices for participation agreements.

At the end of September, the FASB delayed the effective date of guidance issued earlier this year on other-than-temporary impairment of investment securities. This step was necessary after banks and bank regulators learned that accounting firms planned to take a restrictive view of how this guidance should be applied to available-for-sale securities whose values had declined due to increases in interest rates.

We shared our concerns about this development in the context of how banks manage their available-for-sale portfolios. The FASB responded promptly, and we would encourage you to review and comment on the proposal they have issued before the comment deadline at the end of this month.

On a side note, there is an unresolved issue with the SEC that does not pertain to accounting, about which bank regulators have great concern. The recent “broker push-out” proposals by the SEC would, we believe, cause substantial dislocations to longestablished bank trust businesses without substantially improving the well-being of trust customers. These proposals represent cost without benefit. We strongly believe that the comments and concerns raised by bank regulators need to be addressed in whatever final rule the SEC adopts. These are examples of why you should continue to be knowledgeable of, and actively engaged in, the policy and rule-making process.

Another important issue is the subject of internal controls.

We believe that in many respects, the internal control requirements of Sarbanes-Oxley were modeled after the sound practices most banks follow that were already required under FDICIA. We in the bank and thrift industries had our own Enrons, our own scandals and our own housecleaning some time ago. Lessons were learned and corrective actions taken.

Now some of you are being asked to do more. Standards for internal controls required of public companies are clearly more stringent than earlier standards. Many non-public companies over $500 million in assets that are subject to the FDICIA requirements are unclear as to whether the new standards apply to them or whether their auditors will, de facto, require those standards.

The FDIC will issue a letter to all insured banks and thrifts clarifying that for purposes of year-end 2004 financial reporting, the current internal control attestation standards in AT 501 are fully satisfactory and meet the FDIC's requirements for non-public insured depository institutions.

However, in the spirit of full disclosure, there is discussion of changes to these standards as many of you know. Those discussions are occurring in the accounting profession and among the bank regulatory agencies. While this bears watching, I want to be clear – the existing standards remain in effect and apply to your year-end financials.

From a cost-benefit perspective, there is some sense in which the internal control arrangements that make economic sense for a publicly traded or large company might not make economic sense for smaller, or closely held, firms. Depending on what the larger firms are required to do, it is at least plausible that safety-and-soundness objectives could be met at lower cost using a simpler set of standards for smaller institutions.

The FDIC decided in 1993 that $500 million was the appropriate size for imposing the FDICIA audit and reporting requirements on institutions. By law, the FDIC can raise this threshold. Is $500 million still appropriate today? We have not reached any decisions in this regard, and there are many considerations to be weighed, including the views of our fellow regulators. But, I can assure you that, in the near future, this issue will be seriously considered.

I would like to conclude by discussing another timely accounting and governance issue - the housing GSEs.

Together, Fannie, Freddie, and the FHLBs have grown to approximately $2.5 trillion in assets. Needless to say, they are an important funding source for home mortgages and related lending. They are charged with an important mission to support low- to moderate-cost housing and to provide flexible sources of funding to banks (which I believe they have done quite successfully over the years).

The relationship between the three GSEs and banks and thrifts, especially community institutions, is extensive and vital.

FDIC-insured depository institutions hold over $1 trillion in mortgage-backed securities, primarily those issued by Fannie and Freddie. On the liability side, banks and thrifts have borrowed approximately $533 billion in FHLB advances as of mid-year 2004.

These advances are important to our insured institutions because of the relative ease with which they can be used to raise large amounts of cash in a short period of time, without the overhead costs of obtaining deposit funding, and because of the ability they provide to match maturities on the asset and liability sides of the balance sheet.

We have had some concerns with institutions that entered into leverage programs funded by advances or got involved with structured advances without understanding or managing the risks involved. But for the most part, institutions are using advances responsibly as part of their overall funding strategies.

In short, our view based on the conclusions examiners are reaching and the results of offsite analyses is that insured institutions are not exposed to excessive risk as a result of their interaction with the GSEs under currently foreseeable scenarios.

Because of the changes in their business environment, their substantial size, and the widespread perception of being part of the federal safety net, there is a consensus among many people that the GSE regulator must have greater powers and more tools than is now the case.

What should those additional powers and tools be? Perhaps insight could be gained by looking at how banks and thrifts are regulated. After all, banks borrow with federal support and lend to important sectors of our economy. Bank regulators, like GSE regulators, must strike a balance between promoting safety-and-soundness and allowing regulated entities to lend and innovate.

The important principles of bank regulation include:

- independence of the political process;
- authority to determine its own budget; and

- strong supervision and enforcement powers, including the ability to set capital requirements and appoint a receiver if need be.

Over the years, these principles have allowed bank regulators to effectively contain the spread of problems. I cannot imagine why similar principles would not be equally effective in regulating GSEs.

Before I conclude, I would offer one cautionary note that goes back to my remarks on Enron, villains and sweeping reforms. We as bank regulators must also resist the tendency to be complacent in good times and overreact in bad times. We are human. Either we don't know what the risks are, or we suspect what the risks might be, but either don't articulate our case, or are unwilling to take unpopular action.

But when hindsight makes the risks evident, we are – all too often - the first to criticize and take harsh action. You and I both know from experience that this dynamic can lead to greater swings in the marketplace.

So let me conclude by imploring you to continue to be engaged in the process by which these issues are resolved, and assuring you that we, at the FDIC, will continue to work with you to get them right.

Thank you.

Last Updated 10/18/2004