Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

Perspective on Market Value Accounting

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Perspective on Market Value Accounting

I. Signature Guarantees

I am pleased to have this opportunity to discuss with you matters that are of mutual concern to the Commission and the banking industry. When Sarah Miller graciously offered me the opportunity to participate today, she also provided a list of suggested topics that I might choose from, all of which are important and timely. I do wish to touch briefly upon a few of those topics.

First, just after the beginning of the year, the Commission adopted a new rule under the Exchange Act, which was designed to facilitate the acceptance of signature guarantees from eligible guarantor institutions. The rule requires transfer agents to establish written standards for the acceptance of signature guarantees and enables transfer agents to reject a request for transfer because the guarantor is not a member of, or participant in, a signature guarantee program.

At the same meeting, the Commission voted to propose another new rule under the Exchange Act, which would require a registered transfer agent to provide written notice to at least one registered securities depository when terminating or assuming transfer agent services on behalf of an issuer or when changing its name or address. The proposed rule is intended to respond to the problem of unannounced transfer agent changes that affect the prompt transfer of securities certificates.

Also, at this meeting, the Commission announced the adoption of amendments to its shareholder communications and related rules to implement provisions of the Shareholder Communication Improvement Act of 1990. These amendments, adopted substantially as proposed, require, among other things, banks that hold shares for beneficial owners of securities in nominee name to forward to the beneficial owners the proxy statements of investment companies registered under the Investment Company Act, as well as the information statements of both Investment Company Act registrants and companies with a class of securities registered under Section 12 of the Exchange Act.

With respect to the previously described signature guarantee rule, financial institutions involved in the transfer or sale of securities for their customers are now required to establish written standards and procedures regarding signature guarantees. However, banks do have six months from the February 24 effective date to comply with the new requirements. As part of these standards and procedures, the Commission will permit transfer agents to accept only guarantees submitted by banks and other institutions that are members of a signature-guarantee program. In effect, this requirement means that transfer requests submitted by banks and other institutions will be rejected by the transfer agents if the bank is not a participant in a signature-guarantee program. Banks that are not aware of this new requirement may be in for an embarrassing surprise when they discover that their signature guarantee is rejected by a transfer agent because the bank is not a participant in a signature-guarantee program.

II. Secondary Market Disclosure

I also would like to say a few words about secondary market disclosure. It should be obvious to everyone that all the participants in the municipal securities industry need to work together to ensure that the partnership that has developed between investors and the issuer continues into the secondary market.

Cost effective secondary market disclosure is an idea whose time has come. Many municipal issuers have recognized the value of secondary market disclosure and voluntarily provide information to the market. The willingness of an issuer to provide this information to the secondary market should produce value in terms of liquidity and accurate pricing, at the time of resale, that can be factored into the return demanded by investors.

Although I believe that a decision to provide secondary market information should be intuitive, a great deal of effort already has been devoted to creating awareness among issuers of the need for secondary market disclosure. The efforts of the American Bankers Associations' Corporate Trust Committee, the GFOA, the National Federation of Municipal Analysts, and the PSA, to name a few, will be the catalysts for continued improvement in secondary market disclosure.

I do not view the voluntary, organized presentation of information to the secondary market as a source of greater liability for issuers than they already encounter. If there are liability issues that need to be addressed, those issues should be placed in their proper perspective and should not become an impediment to improving voluntary disclosure efforts.

The Commission also has a role to play here. It is unfortunate that the Commission has not done more thus far to work with the industry as it attempts to implement a voluntary disclosure program. As many of you are aware, last June the Commission tabled a proposal by the MSRB to create a system that rapidly transmits pre-default notices from trustees to the market. This proposal would have been limited initially in its scope, yet it could be expanded in the future to allow for the submission and dissemination of other types of relevant secondary market information. In fact, issuer groups, including the National Council of State Housing Finance Agencies and the National Council of Health Facilities Financing Authorities, as well as other organizations such as the ABA's Corporate Trust Committee, have spearheaded efforts to develop uniform periodic reporting formats in anticipation of disseminating this information through the MSRB's facilities.

At the June meeting, several Commissioners, particularly the Chairman, expressed concern about the initially limited scope of the MSRB's proposal, and the requirement that information be submitted only in electronic form. The MSRB, I believe, has responded in a satisfactory manner to these concerns. While I would eventually like to see a more comprehensive approach, there are a number of difficult issues that would need to be resolved before it will be prudent to undertake a more significant effort. In my view, it is important for everyone to continue moving forward. I hope that the Commission will act soon to permit the MSRB to begin implementation of its pilot program.

III. Market Value Accounting

Now, having provided you with an update on some issues with which the Commission is involved that may have a direct impact on your operations, I wish to spend the remainder of my time here today focusing on a topic that every bank employee with which I am acquainted has inquired as to my views --- and that is market value accounting.

Since I am a member of the Commission, it should come as no surprise to anyone that I am a market value proponent. However, although my message is somewhat the same, my approach is, I hope, different than others -- it is certainly my intention to be softer and of the kinder, gentler variety than what you may be accustomed.

The market value debate has a long history. In 1938, U.S. banking regulators agreed to adopt historical cost as the primary measurement attribute. Curiously enough, that agreement was reached largely out of concern with the effect that reporting market values would have on the behavior of depositors and investors, and on public confidence in our nation's banks. Since securities were said to be held for the long-term and because interest rates were stable and regulated, historical cost accounting worked fairly well and restored public confidence in the banking system after the economic crises of the 20s and the 30s.

However, the world has changed dramatically since the adoption of the historical cost method in 1938. As a result of the deregulation of interest rates in the 1980s, the economic environment has become increasingly volatile. Practically overnight, financial institutions were forced to confront and find ways to control their exposure to changing interest rates. Indeed, the so-called "first" thrift crisis of the early 1980s resulted almost exclusively from adverse interest-rate movements following deregulation. Richard Pratt, former Chairman of the Federal Home Loan Bank Board, testified before Congress that the thrift industry had a negative net worth of almost $180 billion in 1981 at the same time that it was publicly reporting a positive net worth of more than $30 billion. That difference was due almost entirely to interest rate movements.

Today's economic environment has substantially weakened whatever original strength there may have been in the 50-year old presumption that investment securities will be held to maturity. And the use of historical cost for investment securities continues to perpetuate that myth. The fact is that while historical cost may have worked reasonably well in the past, it no longer accurately reflects the activities of today's financial institutions. So while historical cost was originally adopted to prevent reporting of what was considered to be artificial distortion, its current use distorts and obscures the very real economic volatility that exists today. Historical cost accounting no longer results in a realistic measure of financial institutions' capital, too often operating earnings are manipulated by the selective recognition of gains while losses go unrecognized. It is clear that the marketplace is entitled to have better and more timely information on which to base investment decisions. This notion is underscored by the fact that over the last five years, the losses experienced by bank investors was in excess of $10 billion.

The statutory mandate of the Commission is to protect investors. Probably the best method in which to protect investors is to provide them with enough information so that they can make informed decisions and choices. One way to accomplish that method would be to provide investors information that is cost effective, neutral, comparable, and relevant. As a general proposition, historical cost accounting does not accomplish those objectives and, specifically, does not accomplish those objectives with respect to investment securities.

Congress has conferred on the Commission statutory responsibility for defining the content of accounting principles for companies filing with the Commission or making public offerings of securities. Since its inception, the Commission has looked to the private sector to establish and improve accounting principles. When the FASB replaced the APB as the primary private sector standards-setting body in 1973, the Commission indicated in Accounting Series Release No. 150 that the Commission:

> . . . intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and

standards through the FASB with the expectation that the body's conclusions will promote the interests of investors.

The Commission oversees all aspects of the FASB's activities and decisions. The Commission periodically meets with the FASB. The Commission's staff also closely follows each FASB project. For example, the Commission's staff generally participates on FASB task forces, meets with and discusses the status of each project with the FASB staff on a frequent basis, reviews comment letters submitted to the FASB, attends many FASB meetings and public hearings, and provides ongoing input into the standard-setting process.

I believe quite strongly that the historical relationship between the FASB and the Commission should be maintained. Thus the establishment of accounting standards, including decisions concerning the scope, the implementation and the timing of any implementation of market value accounting, properly belong in the first instance with the FASB.

As everyone here is well aware, the FASB has been grappling with the issue of market value accounting for some time. Since 1986, the FASB has had on its agenda a project to develop broad standards for financial accounting and reporting issues regarding financial instruments, including the valuation of securities investments. On November 14, 1990, the FASB unanimously agreed to accelerate consideration of a portion of that existing financial instruments project.

In December of last year, the FASB issued Statement of Financial Accounting Standards No. 107 ("Statement") entitled "Disclosures about Market Value of Financial Instruments". This Statement requires all entities to disclose the fair value of financial instruments in the footnotes to the financial statements. This requirement applies to financial instruments that are either assets or liabilities, both on and off the balance sheet. The Statement is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets, for whom the effective date is for fiscal years ending after December 15, 1995.

The Statement defines fair value as the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If it is not practicable to estimate the fair value of some financial instruments, descriptive information about those instruments is required to be disclosed.

While this Statement has been criticized in some quarters as being too costly to implement, I wish to point out that one of the precepts of the FASB's mission is to promulgate standards only when the expected benefits of the resulting information exceeds the perceived costs. It is my understanding that the FASB strives diligently to determine that a proposed standard will fill a significant need and that the costs entailed in satisfying that need, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information.

I believe that Statement 107 adopts a broad, general guidance approach with an eye toward helping financial statement issuers minimize the costs of providing the required information. The Statement also takes a significant step toward market value accounting by providing information about the fair value of financial instruments which should help investors and others see more of a true picture of an entity's financial activities.

It was anticipated that the FASB would issue a proposed accounting standard during the first quarter of this year that would have required entities to disclose the changes in the fair value of financial instruments on the face of the balance sheet and in the income statement. The FASB has apparently backed off of this proposal. It is my understanding that the FASB is now in the process of studying two issues before proceeding further --- first, whether some portion of liabilities should be fair valued along with investment securities, and, second, whether changes in fair value should be reflected only in the balance sheet or in the income statement as well.

An objection had been lodged with the FASB's anticipated proposed standard that the application of fair value accounting to investment portfolios only, without applying the concept to the entire balance sheet, would distort earnings and capital. Such an objection appears, more or, less, to be a valid concern. I am hopeful that through its further study, the FASB will develop a proposed standard which will minimize these "distortion" concerns. With respect to the second issue, I believe that a case can be made that unrealized gains and losses should be booked through equity where they would not affect profits. There does not appear to me to be any compelling need to reflect these value fluctuations in the income statement, especially since the gains or losses are unrealized.

While a number of other objections have been raised to the application of market value accounting to the banking industry, there is one more which I wish to focus on specifically. Many individuals have asserted their concern that imposition of market value accounting would weaken the demand of financial institutions for long-term debt securities, including Treasury bonds, mortgage securities and municipal bonds. I am uncertain as to how to respond to that concern as a general matter since I am unable to predict the economic behavior that would result from a change to a market value or fair value accounting standard. However, I will note that it is my understanding that commercial bank ownership of municipal bonds decreased by an estimated $136 billion during the years 1986 to 1990, an amount equal to 59 percent of their holdings at year-end 1985.

The reason for the drop in commercial bank ownership of municipal bonds was not related to any change in accounting standard, but rather to the Tax Reform Act of 1986. The Tax Reform Act apparently sapped any appetite which may have once existed for municipal bonds on the part of commercial banks. It is obvious that if our tax laws were modified to eliminate certain provisions of the Tax Reform Act, the demand of banks for municipal bonds, whether or not long-term, would increase dramatically, regardless of the imposition of market value accounting. I am pleased to see that the banking industry is now pressing Congress to change some of this adverse impact of the Tax Reform Act because I believe it would be beneficial, for a number of reasons, for banks to own municipal bonds.

In any event, I am of the opinion that, at least in concept, market value accounting as a general proposition is superior to that of historical cost accounting. By issuing Statement 107, the FASB has taken a significant step toward implementing market value or fair value accounting, and I am of the view that it is important for this momentum to be maintained. I hope that the FASB continues to work diligently toward issuing in the near future a proposed accounting standard marking investment securities and related liabilities to market. Obviously, at this stage, only a proposed standard is being considered, which of course would be subject to a public hearing and a public comment process. However, if implemented, such a standard would potentially provide investors more timely information on which to base investment decisions which could not help but contribute to the efficiency of our capital formation process. I also believe that such a standard, by enhancing investor confidence, would prove to be beneficial to the banking industry.