

NEWS

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

(202) 755-4846



THE SEC'S EVOLVING ROLE IN BANK REGULATION

Address by

John R. Evans
Commissioner
Securities and Exchange Commission
Washington, D.C.

American Institute of
Certified Public Accountants
National Conference on Banking
Washington, D.C.
December 12, 1977

I appreciate the opportunity to participate with you in this National Conference on Banking and to discuss the evolving role of the Securities and Exchange Commission in bank regulation.

In many important respects, the banking system of the United States is unique among all developed nations. It is composed of thousands of independent banks, with private management; there is relative ease of entry either at the state or federal level; and there is vigorous local, regional, and national competition among banks to obtain deposits and extend credit. While these characteristics have generally been beneficial, they have, on occasion, resulted in bank frauds, unduly risky or illiquid bank loans, overexpansion of bank credit, monetary instability, bank failures and panics. Because the manner in which banks fulfill their function affects all economic activity, it is in the national interest to assure that banks are regulated in such a way as to promote competence, honesty, and stability without destroying the vigor and benefits that accrue from a private competitive banking system.

Regulation of banks appears to have developed through trial and error, with each banking crisis forming the basis for additional supervision and control until banks have become subject to a not wholly logical regulatory framework involving

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for speeches by any of its Commissioners. The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

state authorities as well as three federal bank regulatory organizations. Ever since the era when Robert Morris founded the nation's first bank, hoping that it would help to support the badly shaken credit of the new government, and Alexander Hamilton, as Secretary of the Treasury, was instrumental in creating a national bank with branches throughout the country, there have been continual efforts to alter the way banks operate and are regulated. Just during my tenure as minority staff director of the Senate Committee on Banking, Housing and Urban Affairs and as a Commissioner of the SEC, I have witnessed several such efforts, including various studies made under former Congressman Patman; the Hunt Commission; the FINE Study; and, most recently, the so-called Lance Hearings.

Whatever one thinks of the merits of "reform" movements, it is clear that basic changes in banking regulation are rather difficult to achieve. Although unnoticed by some, during the past few years there has been a quiet revolution in the field of banking regulation in which an agency that is not generally thought of as a bank regulator, the Securities and Exchange Commission, has become increasingly involved.

When the Securities Act of 1933 was enacted, requiring corporations offering securities to provide full and fair disclosure with respect to their securities and operations, banks were exempted from its registration provisions. A year later, when the Securities Exchange Act subjected listed

companies to periodic reporting, proxy regulation, and insider trading requirements, banks were effectively exempted because their securities were not listed on stock exchanges. When the continuous disclosure requirements of the Securities Exchange Act were amended in 1964 to include all public companies with assets over \$1 million and more than 500 shareholders, the three federal bank regulatory agencies were made responsible for administering those provisions with respect to publicly owned banks. Thus, traditionally, banks were free from all SEC regulation with the notable exception of our anti-fraud powers.

The erosion of this traditional pattern over the last few years is probably best typified by the Securities Acts Amendments of 1975, in which the SEC was granted significant direct and indirect authority over bank securities clearing agencies, transfer agents, municipal securities departments, and other related areas such as reporting of securities holdings and transactions, and lost and stolen securities. Moreover, the SEC was directed to study all the securities activities of banks. As a result of that study, the Commission concluded that it would not be necessary to subject banks to the full panoply of SEC broker dealer regulation from which they are now excluded, but that for the protection of investors, the federal banking agencies should be required, in consultation with the Commission, to

establish personnel training and competency standards, recordkeeping requirements, and examination procedures to regulate the conduct of banks effecting securities transactions for others, and to advise the Commission when there is reasonable cause to believe there may be a violation of federal securities laws by a bank under their jurisdiction. Legislation to that effect was recommended and has been introduced. I should add that the bank regulatory agencies have established an Interagency Task Force which is now working with our staff toward accomplishing some of our recommendations even in the absence of legislation.

The involvement of the SEC in the field of bank regulation can, however, be traced to two other sources. The primary cause has been the decision of banks to become affiliated with bank holding companies, which are subject to all of the registration and reporting provisions of the federal securities laws. As of the end of last year, there were 1,912 bank holding companies registered with the Federal Reserve Board. About 450 of these holding companies, controlling virtually every major bank in the United States and having over two-thirds of the total bank assets in the nation, are required to file periodic reports with the SEC pursuant to the Exchange Act.

A secondary, but important, cause for the increasing influence of the SEC over bank disclosure was an amendment of Section 12(i) of the Exchange Act in 1974 by Congress to

require the banking agencies to "issue substantially similar regulations" with respect to periodic reporting, proxy regulation, and insider trading as those adopted by the SEC unless those agencies specifically find that such regulations are not necessary or appropriate in the public interest or for the protection of investors, and publish such findings in the Federal Register together with detailed reasons therefor.

These two events have subjected all major banks in the United States to the federal securities laws, and the regulatory jurisdiction of an agency which strongly advocates the philosophy of full and fair disclosure to fulfill its responsibility of protecting investors and acting in the public interest.

The first major step taken by the Commission affecting bank disclosure was the promulgation last year of Guides 61 and 3, entitled "Statistical Disclosure by Bank Holding Companies." These guidelines call for disclosure relating to the distribution of assets, liabilities and stockholders' equity; investment portfolio; loan portfolio; summary of loan loss experience; deposits; return on equity assets; interest rates and interest differential; foreign operations; and commitments and lines of credit.

When the guides were first proposed in October, 1975, many bankers and the bank regulatory agencies suggested that the increased disclosure by banks would be burdensome and

might result in withdrawal of deposits, trigger the failure of particular banks, and destroy public confidence in the entire banking industry. The guides have now been in effect for over a year, and, to the best of my knowledge, there has not been any noticeable adverse effect on the operations of bank holding companies or on their ability to obtain capital.

I know that there are many well respected individuals who question the benefits of the Guide 61 disclosures, and others who still claim such disclosures are misleading. In this regard, I want to call your attention to a report from the research department of a large retail brokerage firm which stated that Guide 61 is "probably the most important change in bank disclosure ever" and the portion of the guide requiring a breakout of non-performing loans is "one of the most valuable."

Just as significant, at least from my perspective, is a letter from an executive vice president of a large bank holding company in Texas. The bank officer stated:

During the past month [our] Loan Administration staff . . . completed the process of allocating the Reserve for Possible Credit Losses at December 31, 1976 to several loan categories. To their surprise, and mine, they found that the process was both accomplishable and meaningful. The allocation was constructed on the basis of a loan-by-loan analysis of risk of loss. It, therefore, provides a complete description of the risks inherent in . . . [our] loan portfolio.

An important feature of the allocation procedure is the determination of the unallocated portion of the reserve. Since approximately 50% of . . . [our] reserve is unallocated, this procedure provides statistical definition of the conventional statement that "the reserve is adequate in the opinion of management." It is clear that this breakdown of the reserve into allocated and unallocated portions will soon replace the current crude statistical yardstick of the ratio of the reserve to total loans.

One can expect that after a few years the banking industry will become more comfortable with the notion of an allocated and an unallocated reserve.

* * *

In summary, I believe that the analysis of bank financial statements has been enhanced importantly by the required allocation of the Reserve for Possible Credit Losses.

I understand, however, that there continues to be considerable controversy regarding the breakout of loan loss reserve by type of loan. In fact, some of you here today have, for various reasons, opposed this type of disclosure. Those who are so opposed should know that the Commission's staff reviewing the disclosure would have no objection to the omission of the suggested information from a filing--provided there is a discussion of the contents of the loan portfolio similar to that furnished by Citicorp and Manufacturers Hanover Company in their most current registration statements and in their annual reports on Form 10-K.

We have also received suggestions for other changes such as increasing the past due criterion on non-performing loans from 60 to 90 days, which I am sure the Commission would

find acceptable if there is agreement on a standard number of days to be used by all registrants in their reports. When Guides 61 and 3 were issued last year, the Commission indicated it would monitor its experience with the guides and would re-examine this area in July of 1978. If you have suggestions that you believe would improve the guides, please let us know in time to meet that commitment which we intend to keep.

This past year, the SEC embarked upon a re-examination of possibly an even more fundamental issue affecting bank disclosure. In the past, the SEC has relied on the various forms required by Regulation F of the Board of Governors of the Federal Reserve System with respect to the form and content of banks' financial statements and related schedules. In April the SEC, for the first time, proposed the establishment of comprehensive requirements in Article 9 of Regulation S-X as to the form and content of consolidated and unconsolidated financial statements of bank holding companies and banks in an attempt to present such information to investors in a more meaningful and understandable manner.

As a result of the April proposals, the Commission received letters from 168 interested organizations and individuals. Many of the commentators favored the SEC's overall approach, but almost everyone criticized certain of the particular proposals. Much controversy, for example, was

created by the Commission's proposal requiring banks to report a single earnings per share figure, taking into account gains and losses from sales of investment securities, rather than the two separate earnings per share figures reported by most banks since 1969. Some of the other aspects of our April proposals, which were soundly criticized by certain of the commentators, include: the proposed classified balance sheets to report earning assets separately; the failure to permit tax equivalent amounts of interest in income statements; the proposed reporting of foreign activities; the proposed reporting of insider loans; the proposed categories by which loans were to be reported on balance sheets and interest income on the income statements; and the proposed requirement that trading account securities were always to be stated at market value.

Based on its review of the many thoughtful letters of comment, the Commission's staff submitted its recommendations to the Commission. Last Thursday, at a meeting which was open to public observation pursuant to the Government in the Sunshine Act, the Commission voted to publish for comment extensively revised proposals relating to financial statements of bank holding companies and banks. It is my understanding that copies of our revised proposals have been, or will be, made available at this Conference. Tomorrow, Howard Hodges and Charlie Oglebay of the Chief Accountant's Office in our Division of

Corporation Finance will appear on a panel before this Conference and will, no doubt, discuss in detail the technical aspects of the revised proposals.

As always, the Commission has attempted to balance the burdens on registrants with the benefits to investors in formulating its viewpoint. I believe the Commission has been very responsive to the comments which were received. More particularly, the Commission's revised proposals: do not require the originally proposed classification of balance sheet accounts; contain a simplified categorization of loans and interest income; and include tests of materiality which focus primarily on stockholders' equity and gross revenues. The revised proposals will also permit continued reporting of two earnings per share figures.

Two aspects of Article 9 which may merit special mention involve foreign operations and the form of income statements. With respect to foreign activities, a significant change from other SEC releases is that all foreign information will be covered by the report of the certifying accountants since such information will be included in a note to the financial statements. A revised definition of foreign operations has been proposed for banks and bank holding companies which, subject to an exclusion for certain guaranteed loans, would cover operations located and conducted entirely outside the United States, and would also cover loans made from the United

States to a debtor located outside the United States. It is our hope that this definition, if adopted, will be expanded to cover foreign operations of these companies in all areas where such information is required by the Commission, including segment reporting. We are also requiring that income of foreign operations be shown before the allocation of income taxes. If so desired, the registrant may also furnish a net income figure.

The second important change in Article 9 has to do with the presentation of the income statement. The income statement has been revised and terminology changed from the April proposals. However, the basic format has not been changed. It still contemplates the presentation of income in basic categories of interest income, interest expense, other income, and other expense. This approach has already been adopted by major bank holding companies in many parts of the country, and we feel it will not present an unwarranted burden on those large or smaller bank holding companies which as yet have not adopted this format. The Commission believes that the investor, when looking at the revised income statement, will immediately get a much clearer presentation of the results of operation of the major elements in the bank's business, namely the borrowing and loaning of funds. We do not anticipate that banks will have any serious problems in complying with the changes requested in the new Article 9 since most changes are merely reclassifications of accounts or, as in the case

of foreign disclosure, the furnishing of information which has already been required by a rule setting body for the accounting profession.

I urge you to consider carefully the Commission's revised proposals and to submit your letters of comment. Our current thinking is that Article 9 will not be effective for periods ending before June 30, 1978. Once Article 9 has been adopted, and assuming our monitoring of Guides 61 and 3 shows no unnecessary adverse impact, the Commission will make conforming changes and other minor adjustments to Guides 61 and 3.

You may be relieved to know that after Article 9 and the Guides are in place, the SEC has no present plans for additional, special reporting requirements on the banking industry. However, the real impact of the quiet revolution in banking regulation, to which I alluded earlier, is that now most banks are either directly or indirectly in the mainstream of the SEC's continuously evolving disclosure policies.

An example of action by the Commission, which may affect the disclosure made by bank holding companies and may eventually affect banks, is our interpretive release in August emphasizing our view that the current reporting provisions require disclosure, within the aggregate remuneration reported, of all forms of management remuneration including salaries, fees, bonuses, and certain personal benefits sometimes

referred to as "perquisites." The Commission stated:

Among the benefits received by management which the Commission believes should be reported as remuneration are payments made by registrants for the following purposes: (1) Home repairs and improvements; (2) housing and other living expenses (including domestic service) provided at principal and/or vacation residences of management personnel; (3) the personal use of company property such as automobiles, planes, yachts, apartments, hunting lodges or company vacation houses; (4) personal travel expenses; (5) personal entertainment and related expenses; and (6) legal, accounting and other professional fees for matters unrelated to the business of the registrant. Other personal benefits which may be forms of remuneration are the following: the ability of management to obtain benefits from third parties, such as favorable bank loans and benefits from suppliers, because the corporation compensates, directly or indirectly, the bank or supplier for providing the loan or service to management; and the use of the corporate staff for personal purposes.

This release was issued in response to numerous inquiries, some of which may have been generated by the publicity given to recent SEC enforcement cases revealing the failure of certain corporations to disclose the value of various personal benefits received by members of management.

One of the personal benefits mentioned in our August release, with which the Commission has had recurring experience and with which you should be particularly interested, is the utilization of compensating balances by public companies in connection with obtaining favorable loans for insiders. In 1973, we adopted amendments to our accounting regulations to

require additional disclosure by corporations about compensating balances which distort the interest rates stated for the corporation's outstanding debt. In the release which proposed these amendments, the Commission noted that:

Compensating balances maintained for the benefit of affiliates, officers, directors or principal stockholders may be of particular significance to investors. Separate disclosure of such items may be required under other Commission rules and regulations even if they are not individually of a magnitude such that they would meet the materiality guidelines set forth above.

During investigations of corporations suspected of securities violations, our staff has found various examples of insiders benefiting from compensating balances and the Commission has authorized enforcement actions in at least seven cases.

Bank holding companies themselves also may be required to disclose the granting of favorable loans to management of customers because of the materiality of this information to a subsidiary bank. For example, in 1975 we instituted proceedings against a registered bank holding company in Tennessee, for failure to disclose in its filings with the Commission certain matters, including information about correspondent banking loans. Its principal subsidiary followed a general policy of making credit available to controlling stockholders of, or senior officers and directors of, the banks which maintained deposits with it and for which it performed clearing and various other services and from

which it obtained loan participations and other business. Since correspondent banking was an important source of business, the bank apparently engaged in this policy for the purpose of facilitating or promoting the correspondent relationships. In some instances, the bank was alleged to have made loans to individuals of limited means, evidenced by a demand or short-term personal note and secured by the pledge of the stock of a correspondent bank, for the purpose of acquiring a substantial block of the stock of the correspondent bank. Often these notes were not called or were extended for many years. Absent the correspondent relationship, these persons apparently would not have qualified for such loans or would not have received the favorable interest rates or terms. The Commission charged that the subsidiary bank's policy of granting these loans should have been described in the company's filings with the Commission. As a mitigating factor, the holding company stated its opinion that the bank's practice of making loans to persons in control of or senior officers and directors of banks, secured by pledges of correspondent bank stock and for the purpose of obtaining or maintaining a correspondent relationship with such banks, is a practice engaged in by other banks both in their competitive area and elsewhere. We accepted the offer of settlement made by the holding company and ordered the company to amend certain reports and to comply with its undertakings to, among other

things, amend and redistribute its pending registration statement.

To obtain more data regarding whether the practice of giving so-called "sweetheart loans" is a common one and in order to determine whether bank holding companies should disclose additional information about loans to executives of corporate borrowers, including other banks, the Commission's staff has requested bank holding companies with pending registration statements filed under the Securities Act for information about such loans. The staff has also asked bank holding companies whether they or their subsidiaries have extended any loans to the parent's officers and directors on terms that were more favorable than could have been obtained by unrelated persons in order to determine whether such indebtedness should be specifically described. In light of the responses to our staff's inquiries to bank holding companies, we have discontinued the routine use of these comments. I suspect, however, that the area of management remuneration and business practices will be considered further by the SEC as well as the banking agencies and should be of concern to you.

There will continue to be changes in the operations and regulation of banks. While no one can predict the exact course these changes will take, there is no doubt in my mind that they will include more meaningful disclosure of banking

operations. In my opinion, appropriate disclosure will act as an impartial regulator, provide important information to investors and depositors, and increase confidence in banking.

As financial executives, and internal auditors and as outside independent accountants, you are called upon to play a critical role in assuring compliance with the federal securities laws and upholding the integrity of our country's banking system. How you fulfill that role is also undergoing a fundamental re-examination on Capitol Hill, at the SEC, and by various industry groups. I encourage you, on behalf of investors, depositors and the general public, to meet the continuing challenges with which you will be faced.