BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Governor Partee

From Stanley J. Sigel SJS

Subject: Summary Statement of Issues to be raised at the Wednesday meeting of principals

It is recommended that four problem areas be raised at the meeting with SEC:

(1) Nonperforming loans;
(2) Loan loss reserves by type of loan;
(3) Some aspects of disclosure of foreign operations;
(4) Weighted average yields on securities by type of security and by maturity.

In each of these cases, it is recommended that the Board members at the meeting be prepared to make specific suggestions for deletion or substitution of language in the August 1 version of the SEC Guide 61. Attached to this memorandum are summary presentations of the major issue or issues to be discussed in each of these areas and recommendations of appropriate specific language changes.

Before raising the major areas of specific problems, the Board members at the SEC meeting may wish to make passing reference to a number of general points in order, first, to indicate that there were a number of points being discussed at staff level, and also, to prevent SEC from getting any mistaken notions that anything not specifically discussed at the meeting will necessarily be reflected in Regulation F and/or in Large Bank Supplements to the Report of Condition.

The following general observations might be referred to in this way, making it clear that we do not expect the SEC to change its approach:

(a) We are concerned about the impact on the level of reporting burden. We welcome the changes made in this version of the Guide to excuse banks from the requirements of the 5-year retrospective reporting and the daily average basis where these cause undue and unwarranted burdens. Nevertheless, in general, considerations of reporting burden seem to be given too low a priority, particularly in light of President Ford's programs in this matter.

(b) We are concerned that the low priority given in the SEC general approach and procedures to the desirability of comparability between respondents for purposes of disclosure as well as for agency supervisory and policy use. This affects several areas, the procedures with respect to the definition and separate disclosure of foreign and domestic operations being the most pervasive but not the only example. We understand the rationale for the SEC approach but still feel that the net result will be deterioration in the quality of information available for all purposes and/or increase in reporting burden.

(c) These general concerns with burden, comparability, and need for information to serve not only disclosure but other purposes as well and the specific issues we will now raise will almost inevitably result in differences between SEC Guide 61 for bank holding companies and the way the banking agencies call for information both from banks and from holding companies.

Following are the statements on the four major areas listed at the beginning of the memorandum.

(1) NONPERFORMING LOANS

The SEC, in Item C of Section III of the August 1 version of Guide 61 requires the disclosure of the amount outstanding, original contracted interest for the reported period, and the amount of interest actually reflected in income during the period for all loans 60 days past due as to interest or principal, loans renegotiated because of a deterioration in the financial position of the borrower, and other loans that have attributes that, in the opinion of management raise serious doubts as to the ability of the borrower to comply with the present payment terms of the loan.

Discussion. The SEC requirements raise several problems with respect to which the Board may wish to offer changes in the specifications: (a) amounts outstanding; (b) past-due loans as a disclosure measure of nonperforming loans; (c) loans subject to "serious doubts" by management; (d) coverage of loans; (e) industry concentrations; and (f) treatment of income from fees.

(a) The aggregate amount of loans in each nonperforming loan category.

The Board has viewed the disclosure of total dollar amounts of nonperforming loans as one of the most objectionable aspects of the Guide 61. Such disclosure is subject to serious misinterpretation. It would not improve the ability of investors to predict future loan losses or bank earnings. 1/ Finally such disclosures may give an exaggerated and misleading impression of a bank holding company's present and future difficulties, with consequent adverse effects on the company, financial markets and the banking system with no clear offsetting public benefits. Disclosure of the income effect of nonperforming loans on bank holding company earnings should suffice to allow the investor to make informed judgments and decisions.

(b) Past-due loans vs. non-accruals.

The income-impact measure of loans past-due for some specific number of days has a number of deficiencies. It excludes loans below the cut-off which are in serious enough shape for management to have put on a non-accrual basis. It includes loans that the management judges to be perfectly sound or to be about to return to a normal payment basis. Because of differences in management policy with respect to non-accrual, the measure of income impact of past-due loans will be erratic, noncomparable as between banks, and difficult to interpret.

1/ A staff analysis of various studies on the predictive value of the amounts of nonperforming loans compared to that of information already publicly available is attached.

These problems lead to a preference for taking as the measure all loans put on a non-accrual basis. Each of these will have a definite and measurable income impact. However, because of the differences in bank non-accrual policy (some of which are determined by regulation), it is also necessary to require banks to describe in adequate detail their non-accrual policies and to disclose as a separate item the amounts of previous accruals that have had to be reversed when loans that have been past-due for some time are finally put on a non-accrual basis.

(c) "Other" loans subject to serious doubts by management.

This seems to cast too wide a net and is too subjective for meaningful comparisons. If the doubts are serious enough to put the loans on a non-accrual basis, they will be picked up; if they are not, it would be difficult to interpret the significance of having them in a nonperforming loan measure. Reported differences among banks may not reflect differences in portfolio quality or risk but rather (1) management discretion in applying the "serious doubts" criterion; (2) differences in posture toward singling out loans as problem credits that are not past due; or (3) differences in internal information and monitoring systems. The SEC's proposed subjective standard would tend to penalize banks operating under a conservative management posutre. The judgmental nature of this category also makes it extremely difficult to objectively verify or audit the reported data. The problems of misinterpretation inherent in this category far outweigh any benefits. It should be deleted from the nonperforming loans disclosure requirements.

(d) Coverage of loans.

The wording of the Guide seems to give the respondent the choice of whether or not to include home mortgage and consumer loans in the measures of nonperforming loans. To prevent confusion and noncomparability the wording should be changed to definitely exclude these categories of loans. SEC does require that if consumer loans exceed 10 percent of total loans, nonperforming consumer loans be disclosed as a separate item. Because of the different treatment of past-due loans with respect to charging them off, it does not seem helpful to treat them among nonperforming loans. The disclosure of loan write-offs will provide the relevant information to the public.

(e) Industry concentrations.

While the latest version of the SEC industry concentration instruction is less objectionable than the earlier one, the vagueness and lack of comparability will still limit its usefulness and it would be preferable to delete it altogether.

(f) Income from fees.

Appropriate fee income should be added to interest income in the income-impact measures. This would reflect the change already made in other parts of the Guide.

The Board positions stated above are all reflected in the attached proposed rewording of Item C of Section III of the Guide.

Proposed Rewording of Item C of Section III

Latest SEC version 1/	Proposed Rewording 2/
C. Nonperforming loans As of the end of each reported period, state the following for loans	C. Nonperforming loans As of the end of each reported period, state the following for loans
(a) which are contractually past due 60 days or more as to interest or principal payments;	
(b) the terms of which have been renegotiated to provide a reduction or deferral of interest or principal because of a deterioration in the financial position of the borrower (exclusive of loans in (a)); and	(a) the terms of which have been renegotiated to provide a reduction or deferral of interest or principal because of payment difficulties of the borrower; and
(c) which although not presently includable in (a) or (b), have attributes that, in the opinion of management, raise serious doubts as to the ability of the borrower to comply with the present payment terms of the loans.	(b) which have been placed on a cash or nonaccrual basis (exclusive of loans in (a)).
1. The aggregate amount of loans in each category described above;	
2. The gross amount of interest income which would have been recorded on all such loans during the period if all such loans had been current (in accordance with their original terms) and outstanding throughout the period or since their origination, whichever is shorter; and	1. The gross amount of interest income which would have been recorded on all such loans during the period if all such loans had been current (in accordance with their original terms) and outstanding throughout the period or since their origination, whichever is shorter; and
3. The amount of interest on all such loans which was reflected in income during the period	2. The amount of interest and appropriate fees on all such loans which was reflected in income during the period. Do not adjust for any reversals of interest accrued in a prior period.

1/ Passages in the SEC version omitted or reworded in the Proposed Rewording are underlined.

2/ Passages in the proposed wording that are additions to or rewordings of the SEC version are underlined.

(con't.)Latest SEC version [1]

Instructions (1) Loans in category 1(b) and 6 under Paragraph A need not be considered for disclosure pursuant to Paragraph C.

However, if such loans in category 6 exceed 10 percent of total loans, the information called for in Paragraph C for those loans considered nonperforming pursuant to clause (a), should be separately provided.

(2) A renewal on current market terms of a loan at maturity will not be considered a renegotiation for purposes of clause (b) of Paragraph C.

(3) A loan remains in the category described in clause (b) until such time as the terms are substantially equivalent to the terms on which loans with comparable risks are being made.

(4) If a substantial portion of the loans stated pursuant to subparagraph 1 are concentrated in one or a few industries, separate disclosure of the information required by Paragraph C should be provided.

1/ Passages in the SEC version omitted or reworded in the Proposed Rewording are underlined.

(con't.) Proposed Rewording [2]

3. The amount of reversals of in interest accrued on all such loans in prior periods.

Instructions (1) Include all loans for disclosure under Paragraph C, except loans in categories 1(b) and 6 in Paragraph A.

(2) A renewal on current market terms of a loan at maturity will not be considered a renegotiation for purposes of clause (a) of Paragraph C.

(3) A loan remains in the category described in clause (a) until such time as the terms are substantially equivalent to the terms on which loans with comparable risks are being made.

(4) Explain in specific terms the policies and procedures of the registrant with respect to the classification of loans on a Cash or nonaccrual basis, as covered in clause (b) of Paragraph C.

2/ Passages in the proposed wording that are additions to or rewordings of the SEC version are underlined.

(2) LOAN LOSS RESERVES BY TYPE OF LOAN

The SEC, in item H of Section IX of Guide 61, calls for a breakdown of the loan loss reserve to show the dollar amount of this reserve applicable to each of eight categories of loans, including as a separate category any unallocated portion of the reserve. 1/

Discussion. All three banking agencies have strongly objected to this requirement on the grounds that the information required lacks meaning in light of the way banks determine the loan loss reserve, would serve no useful disclosure purpose, and would be difficult to interpret in any case.

The determination of the appropriate aggregate amount of the reserve account is a highly subjective and judgmental management matter. Banks do not generally calculate the loan loss provision separately for each of the loan categories used in the disclosure requirements although they may, of course, explicitly take into account particular loan situations. 2/ Since the loan loss reserve reflects a pooling of risks and the total amount of the reserve account is available to absorb losses in any type of loan, it is not necessary for management to predict the specific places where the risks will eventuate. Management's ability to determine an adequate aggregate amount of reserve balance is the relevant index of performance.

There would thus seem to be little disclosure value to be derived from requiring a detailed breakdown of the aggregate amount of the reserve account. Should such disclosure be required and banks presented amounts that reflected the management process of determination, the "unallocated" would dominate the presentation giving little of disclosure benefit. More likely, in an effort not to be unresponsive, banks would present breakdowns concocted ex post solely to meet the

1/ The loan categories include seven "for loans attributable to domestic operations only" -- (1) real estate loans, (2) loans to financial institutions, (3) loans for purchasing or carrying securities, (4) loans to farmers, (5) commercial and industrial loans, (6) loans to individuals, and (7) all other loans attributable to domestic operations -- plus an eighth category for "loans attributable to foreign operations." Each bank determines for itself the definitions of "loans attributable to domestic operations" and "loans attributable to foreign operations" on the basis of what "it believes is representative of its foreign activities and the risks pertaining thereto."

2/ The SEC staff, observing that some banks do look explicitly at certain large loans in determining the appropriate reserve and that these large loans can be classified into the required categories seems to conclude from this that all banks determine the total reserve loan category by loan category. This would follow only if the banks went through the bulk of their loan individually in the process.

the letter of compliance. Again there would be little of disclosure value and under such circumstances, the risk of misinterpretation inherent in the evaluation of this area of management judgment would be significantly increased.

Moreover, even if the original calculations were comprehensively done in detail by loan or by category, the meaningfulness of the results for disclosure purposes would be questionable. Among other things, the allocation of reserves to specific loan categories would require detailed prediction of the business cycle with respect to various segments of borrowers' business activity. Such determination would be conjectural at best, and the details of the predictions are not likely to be very good. Over time, the pattern of charge-offs will differ considerably from the pattern of reserve determination. Whether this difference is reflected in the breakdown of the amounts of reserve (so that, for example, negative reserves show up for some loan categories and very large reserves for others) or the pattern of reserves is adjusted each time to incorporate the hindsight given by the actual loan losses and charge-offs, the user of the disclosed breakdowns will be hard put to get any additional insight into management competence, management views of its risk situation, the actual risk situation, or earnings prospects.

Specific Recommendation

Delete item H of Section IX, which requires the allocation of loan loss reserves by loan categories. Strengthen, if necessary, item G of Section IX, which already requires respondents to describe the factors that influence management's judgment in determining the additions to loan loss reserves to be charged to operating expenses.

If that is not acceptable to the SEC, another -- but less desirable -- suggestion would be to reword item H to read "To the extent that the amount outstanding of loan loss reserves is directly and specifically identified in its determination with particular loans or with particular categories of loans, show the amounts thus specifically associated with each of the eight major categories specified in Section III(a). All amounts of the loan loss reserves not specifically identified in this way in the determination of the reserve should be shown as unallocated." The information resulting from such an instruction would still not be of value for disclosure but at least it would have less chance of producing doctored figures and of misleading the user of the disclosure.

(3) SOME ASPECTS OF FOREIGN DISCLOSURE

The major issue to be raised in this area concerns the reporting of information on individual countries. The SEC, in item B of Section VII, requires that "if 5 percent or more of consolidated total average assets are related to one foreign country, such country shall be identified and the amount shall be indicated." Item C has the comparable requirement with respect to gross revenues and income before taxes.

Discussion. The SEC view is that an investor should know if a bank holding company's business is so concentrated in a particular country that adverse developments there could significantly affect the company's performance. There are some questions as to whether the particular SEC requirements would provide information relevant for this purpose and whether the reporting of country data would be potentially more harmful to the respondent and its shareholders than the value of the information to prospective investors.

The Board had strenuously objected to providing the Church Committee with country information on individual banks mainly on the grounds that in some cases such information, particularly for deposits, might reveal individual customer data. However, the SEC's requirements do not give rise to such concerns to the same extent. For one thing, there is a high cut-off. To be reported, a bank holding company's foreign operations would have to be 10 percent of the company's total operations, measured in terms of assets, gross revenue, or income. For the relatively few banks thus involved in any separate foreign disclosure, individual country reporting would be required only if business associated with a given country where 5 percent or more of the total for the bank. This is a very high cut-off and very few individual countries would be reported and in almost all cases there would be major industrial countries where the problem of data identifying individual customers would not arise. Moreover, there is no SEC requirement for individual country reporting of liabilities regardless of concentration, so there will be no concern about disclosure of individual depositors.

In addition to the concern about individual customer disclosure, there is also the problem that identifying significant business with a particular country could subject a bank to pressures from third countries. However, the customer country would usually be a relatively small one in these cases and the likelihood of any country other than a major Western European nation or Japan being identified is very small.

Given these circumstances, what is needed is not a blanket objection to the level of individual country reporting required by the Guide but some assurance that in the event that some sensitive disclosure should arise the respondent could be exempt from such disclosure. The form of exemption that the SEC Guide does provide for such cases is inadequate. The SEC permits omission of country data only in cases where the disclosure would "involve violation of the banking confidentiality requirements of any country."

Moreover, SEC staff has indicated that this is intended to be interpreted very narrowly. Thus the SEC formula would not provide for exemptions in cases where country disclosure could breach the "traditional" confidentiality between a bank and its customers. Also, the SEC would not provide for exemption in cases where a bank could be subject to adverse political pressures as a result of the reporting requirements. Nor would the SEC's current position seem to permit banks to omit information where release was not strictly prohibited by secrecy laws but where the legal code permitted banks to be used for breach of customer confidentiality. It might also be pointed out that in practice a determination of the applicability of secrecy laws could be a highly complex matter.

Recommendation

The Board should recommend alternative language that would broaden the situations in which a bank coult omit requested data, even though the chance is small that circumstances would arise where such exemption would be needed.

Recommended Change in Language for Item VII (3) p. 29 -- "If disclosure of the information specified below would involve violation of the banking confidentiality requirements of any country, divulge individual customer information, or seriously impair the ability of a bank to conduct business in a country, registrants may omit the requested information provided a statement is made in the filing indicating the general nature of the data omitted. The staff may at its discretion ask for the justification for omitting particular information." 1/

Alternatively, if the Board is not willing to accept any country disclosure, it could argue that the effect on any given bank of adverse developments in a country is so nebulous and dependent on particular circumstances that the disclosure required by the SEC would be virtually worthless to the investor in predicting country risk and should therefore be eliminated. As a replacement, the Board could recommend that the SEC require respondents to submit a narrative on country risk and foreign developments that could adversely affect the bank.

1/ The essential change in the wording is the addition of the underlined words. This language has already been communicated to SEC staff in the hopes it could be accepted at staff level. We were informed that the narrow wording was deliberate and strongly held and that the suggested wording was not acceptable.

Net income by country. Even if the Board is willing to accept the SEC country disclosure requirements in terms of assets and gross revenues, it might want to object to the reporting of net income by country since this information would be virtually meaningless and probably misleading.

Reporting net income by country would require so many arbitrary accounting and allocation assumptions as to make the figures of nebulous value. Comparison of banks will be impossible and assumptions about performance based on the data are as likely to be wrong as right. The SEC staff recognizes that the information will involve arbitrary assumptions but believes that constant arbitrariness over time will reveal meaningful data on a bank's sources of income. But is is not clear what useful impressions the investor would have from information on net income by country that he would not have in any case from the disclosure of information on assets and revenues.

Aside from the question of meaning and usefulness, net income data by country could also be one of the most politically sensitive figures for which disclosure is required. It would subject banks to charges of exploitation. It might also cause problems with foreign tax authorities, since SEC figures would probably vary from those reported for tax purposes.

Recommendation

The Board should strongly urge the SEC to delete disclosure of net income by country from item C of Section VII (page 31). It should also be pointed out that such information is probably also not very valuable on a broad geographic basis and that this requirement too should be dropped from item C. 1/

1/ Similar considerations also argue for eliminating income as one of the materiality measures (in Instruction (2) of Part VII) that determine whether or not a respondent must disclose anything on foreign operations. It is too erratic and arbitrary.

(4) WEIGHTED AVERAGE YIELD BY TYPE OF SECURITY BY MATURITY RANGE

The SEC, in item B of Section II of Guide 61, in addition to setting forth a maturity distribution of the investment portfolio, also requires disclosure of the "weighted average yield" for each range of maturities for each type of security specified. 1/

Discussion. Although useful for performance analysis, the disclosure of yield by maturity groupings would appear to be duplicative in the context of total reporting requirements. Comparison of market values by range of maturities, already available, provides a more direct standard for measuring portfolio performance. Any added benefit from reporting yield by maturity category is not likely to offset the added burden on respondents in calculating such data.

To a great extent, disclosure of yield by maturity would appear to be an analytic "proxy" for market value. Market values by identical maturity categories are presently required by SEC pursuant to Rule 9-05(b)(3) of SEC Regulation S-X and by comparable regulations of the banking agencies. Aggregate yield by major investment security classification, without differentiation by maturity, is required in another part of Guide 61 (Part VI - Interest Rates and Interest Differential).

Further, it would appear that yield comparisons could be misleading. If one bank has a much larger concentration of holdings of a given security type in the upper classifications (AAA & AA) for a given maturity range than does another bank, even a substantially lower comparative yield under such circumstances would not be indicative of poorer portfolio performance on the part of the first bank. On the other hand, market value disclosure in the above situation would be a more complete and direct index of performance because it would take into account the qualitative factor of holdings which the yield disclosure does not do. In addition, yield can be readily derived from the market values given, should analysis preference be directed toward such data.

Last October, the agencies had proposed a similar presentation as part of the Large Bank Supplements. Comments received questioned the need for such disclosure and indicated problems with certain definitions and calculation procedures, however, and the report was subsequently eliminated by the agencies in the package of Large Bank Supplements finally issued.

Recommendation

Delete the last sentence of Item B of Section II, which calls for the weighted average yield disclosure

1/ The maturity distribution by type of security is already reported in Schedule B of the Call Report.