

STATEMENT OF THE HONORABLE RAY GARRETT, JR., CHAIRMAN,
SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, ON THE
MATTER OF DISCLOSURE BY BANKS AND BANK HOLDING COMPANIES
IN CONNECTION WITH THE PUBLIC DISTRIBUTION OF THEIR
SECURITIES.

(July 16, 1975)

Mr. Chairman, members of the Committee:

I am pleased to appear here today before this Committee to testify on the matter of disclosures by bank holding companies in connection with the public distribution of their securities. With me are John C. Burton, the Commission's Chief Accountant, and Ralph C. Hocker, and Richard H. Rowe, Associate Directors, and Howard P. Hodges, Jr., Chief Accountant, of the Commission's Division of Corporation Finance.

Recently there have been discussions in the press and within the government concerning the issue of disclosures by banks and bank holding companies seeking to distribute securities to the investing public. Some of the press discussions have suggested the existence of real conflict, and perhaps even antagonism, between the Commission and certain of the bank regulatory agencies, in connection with our actions to improve the quality and quantity of certain disclosures required to be made by bank holding companies in connection with their sale of securities to the public.

Much of this discussion has been exaggerated. There were significant differences of views initially encountered, when our staff sought to effect what we believed to be more meaningful disclosures about, among other things, the loan portfolios of certain

banks. In order to allay concerns that were expressed both by the banking industry and bank regulatory agencies, however, a formal dialogue was commenced through the establishment of an Interagency Bank Disclosure Coordinating Group, comprised of representatives from the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and, of course, our Commission.

The cooperation and accommodation achieved by the members of this group have been meaningful, and the banking agencies have been of material assistance to us by providing information about bank practices, activities and operations. Today, I believe that the four agencies have achieved a general conceptual consensus about the need for the protection of investors; the banking agencies are prepared, generally, to support the Commission's specific efforts to apply to bank holding companies our general Congressional mandate -- to provide "full and fair disclosure of the character of the securities sold in interstate commerce."

A number of large bank holding companies have filed registration statements in recent months, have provided the information requested by the staff, have had their registration statements become effective and have had successful offerings. I am providing the Committee with a list of bank holding companies that have been in registration since the beginning of the year. We believe that the disclosures banks are providing is of significant importance to investors, and that the capital raising process is working, and working effectively.

Although we are confident that important strides have been made in allaying the concerns initially expressed by the banking agencies, it is important to understand the

Commission's role with respect to this problem, as well as the origins of the questions raised and the methods by which they are being resolved.

The Commission's mandate to obtain full and fair disclosure to investors in a public offering of securities is contained in the Securities Act of 1933. That Act requires most issuers of securities, in connection with the distribution of such securities, to file a registration statement with the Commission and to deliver a prospectus to investors containing accurate and current information concerning the issuer. In addition, the Securities Exchange Act of 1934 provides for periodic reporting by issuers whose securities are held by the public, to insure continuous disclosure of material facts about publicly-held companies.

As the Committee is aware, the Commission historically has not had extensive experience with disclosures by banks, because securities offered and sold by banks are exempt from registration with the Commission under Section 3 of the Securities Act. Banks whose equity securities are publicly-held are not exempt from periodic reporting and proxy solicitation under the Exchange Act, but administration of the Act in that regard is assigned to the bank regulatory agencies.

Securities offered and sold by bank holding companies, however, are not exempt from registration with the Commission under the Securities Act, and, if their equity securities are publicly-held, they are subject to the Commission's administration as to periodic reporting and proxy solicitation. The desire of banks to expand into non-traditional banking activities has led to increased use of the bank holding company as a vehicle to engage in these activities, with the consequence of subjecting the financial

reporting of those banks that are part of a bank holding company system to the disclosure requirements of the federal securities laws.

There are today more than 1,600 bank holding companies. Approximately one quarter of these are subject to the jurisdiction of this Commission because their shares are held by at least 500 shareholders or because they have sought and obtained public financing. In 1970, 82 securities offerings by bank holding companies, covering almost \$700 million, including about \$133 million offered for cash, were registered with the Commission. In 1974, there were 302 such offerings, covering more than \$5 billion, of which more than half were offered for cash.

When a registration statement is filed with the Commission, the staff of our Division of Corporation Finance reviews it, with the objective of determining, to the extent feasible, whether full and fair disclosure appears to have been made, and written or oral comments are furnished to the registrant. Depending on the nature of the comments it receives, the registrant usually amends its initial filing to respond to our staff's comments. While the registrant can, under the Securities Act, allow its initial registration statement to become effective 20 days after it has been filed with the Commission, unless the Commission acts prior to that time to stop the effectiveness of the registration statement, the practice is for the registrant to file a delaying amendment to permit the staff an adequate opportunity to review the disclosures made and to permit the registrant to respond effectively to our staff's comments.

Of course, the burden of making full disclosure of all material facts rests solely on the registrant and cannot be shifted to our staff. But, our staff nevertheless undertakes to satisfy itself, to the extent feasible under the circumstances, that the disclosures in a

registration statement are complete, so that investors can make meaningful investment choices.

Registration under the Securities Act is effected by filing a registration statement which complies with the appropriate form adopted by the Commission. These forms prescribe certain items of information that must be supplied. When applicable, and staff review is concerned with determining compliance with the requirements of that form. The forms, however, are not necessarily exhaustive of the disclosure burden. All registration forms are subject to the Commission's Rule 408, which states:

“In addition to the information expressly required to be included in a registration statement, there should be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances in which they are made, not misleading.”

Rule 408 recognizes that the changing nature of our economy and of the elements in it are such that full and adequate disclosure cannot be assured merely by responding to items in a form. The registrant and the staff must address areas that are of current significance or concern; the flexibility and informality of the review process I have just described is intended to achieve this. Comments that were appropriate last year may no longer be, due to changing economic or other conditions; comments that no one considered last year may be critical now, for the same reasons.

In any given case, appropriate disclosures are those that will be helpful to the ordinary investor in determining whether to invest in the security being offered. Much bank regulation and financial reporting required of bank regulatory authorities has been devoted to maintaining the solvency of banks and protecting their depositors. However, someone being asked to purchase an unsecured debt security of the parent of a bank, or

an equity security of the parent, is not limited in his concerns to whether the bank will remain solvent, important as that is.

When the parent -- the bank holding company -- must look to dividends from the bank as the primary, if not the sole, source of funds to pay interest and principal on the notes or debentures, or dividends on shares, being offered, the investor is naturally interested in the future earnings potential of the bank. Recognizing this, we have encouraged bank holding company registrants to provide full disclosure of factors which have a significant effect upon historical earnings or which may have a significant effect upon future earnings. Changes in the nature of the banking business have influenced the type of disclosure that is most meaningful.

As banks have diversified, both geographically and in terms of the nature of their other business activities, it has become increasingly difficult for investors to identify the sources of income of a bank holding company. Since various sources of income can have a wide range of risk characteristics, it has become difficult for the investor to assess future earnings potential of bank holding companies. In addition, this assessment of future earnings may be as much a function of an analysis of present and anticipated future economic conditions as of an analysis of the results of prior years.

In other words, evaluations about future earnings which are based solely on extrapolations from prior experience are not sufficient, especially during periods of rapid change in the business environment. Certainly, we have seen these rapid changes in recent months.

Generally speaking, it was in late 1973 that problems involving banks, and thus bank holding companies, began to emerge as a result of the unsettled economy. In

addition, the troubles of both the Franklin National and U.S. National banks had a strong impact. In the fall of 1974, some major public accounting firms that audit banks and bank holding companies advised us that they were experiencing more than the usual difficulties in evaluating loan loss reserves in light of current economic conditions. They indicated that additional, more detailed, disclosure was needed.

At that time, we were considering a statement dealing with current uncertainties in various areas of financial reporting and a discussion of bank loan portfolios seemed to be appropriate. This policy statement, which was issued as Accounting Series Release (ASR) No. 166 on December 23, 1974, urges all registrants to communicate to investors any unusual circumstances or significant changes in the degree of business uncertainty existing in a reporting entity. This release was exposed, prior to its release, to the federal bank regulatory agencies for their comments, and some revisions were made in it as a result of their comments.

Chemical New York Corporation was one of the first bank holding companies to file a registration statement that the staff reviewed for the disclosures urged by ASR 166. The staff met with representatives of Chemical on several occasions in an attempt to develop a satisfactory response that included quantitative data that would be meaningful to investors, including data concerning the quality of its loan portfolio.

Our staff requested that Chemical amend the prospectus to disclose the amount of nonincome producing loans as of the end of each of the last three years. Chemical described nonincome producing loans as those on which interest payments have been past due for sixty days, as well as certain others which had been placed in that category by its

own loan officers. This was considered by the staff to be one appropriate response, among others, to the disclosures called for by ASR 166.

In addition, disclosure was also effected for the aggregate amount of loans outstanding to real estate investment trusts (REIT's), the amount of commitments to make additional loans to REIT's, and the dollar amount of REIT loans which were included in the nonincome producing loan category. The revised prospectus of Chemical included narrative and statistical disclosure of troublesome loans and loans to REIT's that had not been in the initial prospectus. On the basis of this experience, our staff began asking all bank holding companies that proposed to offer securities to the public to develop meaningful disclosure with regard to the quality of their loan portfolios.

It should be noted, however, that due to the peculiar sequence of events, when the Chemical offer was withdrawn it was popularly attributed to the additional disclosures we required. That is not a reasonable conclusion, in light of all the circumstances surrounding that particular offering, and in light of the fact that, subsequently, other bank holding companies have met our disclosure requirements and have had successful offerings when market conditions are otherwise favorable.

In order to obtain a better understanding of the operations and activities of banks, representatives of the Commission met with representatives of three bank regulatory agencies and, at the suggestion of the Commission, an Interagency Bank Disclosure Coordinating Group was formed with representatives from each of the bank regulatory agencies. The purpose of the Group is to increase communication among the agencies and, more specifically, to develop meaningful disclosure guidelines for loan portfolios and related items, with a goal of attaining coordinated disclosure among the agencies. In

these efforts, the banking agencies have made available to the Commission the considerable knowledge and understanding which the agency representatives have accumulated during years of direct contact with the banking industry.

Since its first meeting, on May 21, 1975, the Interagency Group has met three times. A subordinate group comprising certain representatives of the task force and staff personnel, has also met several times during the past six weeks. The bank agency representatives have provided valuable assistance as the Commission's staff has proceeded with drafts of our Guideline for Statistical Disclosures by Bank Holding Companies. While this process has been going on, bank holding companies have been filing registration statements covering large offerings of debt and, in one instance, equity, securities. The processing of these registration statements has proceeded, and proceeded effectively.

The Commission's staff has been seeking disclosures which we believe would be considered important by investors. The focus of many of the disclosures suggested is to provide information to help differentiate among banks as to sources of income and exposure to risks.

Thus, for example, registrants have been asked to provide a breakdown of loan portfolios by types of loans. With this information, we believe that investors will be in a better position to evaluate the potential effects of future economic events. The same concept -- providing information for risk assessment -- underlies our suggestions for disclosures of the sources of funds and their sensitivity to interest rate fluctuations. Among other things, this information helps investors evaluate the ability of banks to move into, or out of, situations with favorable or unfavorable risk/return characteristics.

As I have indicated, we are in the process of preparing guidelines, in cooperation with the banking agencies, to assist bank holding companies in making statistical disclosures relating to their loan portfolios and related items, particularly with respect to their distributions of assets, investment portfolios, loan portfolios, deposits, long-term debt and funds borrowed, interest rates and differentials, commitments, loan loss experience, and international operations. We hope to have these guidelines available shortly.

In his letter of invitation, Chairman Proxmire identifies seven specific topics as to which there has been debate about the appropriate extent of disclosure by banking institutions. It may be useful to provide a brief discussion of our practices with respect to each of these matters.

(1) Non-Accrual Loans

Terms, such as “non-accrual” to describe certain types of bank loans, do not, by themselves, enable investors to make meaningful comparisons between bank holding companies. Many banks use different terms, such as “non-income producing” loans, to express the same concept. Whatever the term used, however, all bank managements decide what types of loans will be placed in a special category, based on their determination of when there is more than a normal risk, so that monitoring by bank loan officials is necessary.

It is the practice of many banks to discontinue accruing interest income and to record interest income only when payments are received on certain loans. The criteria for placing loans on a non-accrual basis are not uniform among banks and in many cases are subjective. Loans on which an interest payment is 30 days delinquent are placed on a

non-accrual status by some banks, whereas others may wait as long as 180 days. In some cases, loans are placed in a special category status even when not delinquent, because of the concern of the bank that problems may arise before ultimate collection.

Whenever registrants state the amount of their non-accrual loans, they are also expected to outline the criteria they use for placing loans in that status. The guidelines on which our staff is working will attempt to define a class of loans which involve more than normal credit risks, so that all bank holding company registrants can be required to furnish meaningful information to investors on a fairly uniform basis. This is a very difficult area, and has been the subject of much discussion among the bank regulatory agencies and the Commission. Our major objective has been to obtain meaningful disclosure about the quality of loan portfolios and the potential effects on future income. Different approaches have been necessary for different registrants because of the lack of uniformity in description of the troublesome loans.

(2) Loan Loss Reserves

We require disclosure provisions for loan loss reserves. When the provision for the valuation part of the reserve exceeds the amount required by the banking agencies' formulas for reserve provisions, we require disclosure of the reasons for the additional provision. ASR 166 recognized that, when there were unusual risk characteristics of the loan portfolio, mere disclosure of the loan loss provision might not be sufficient.

The adequacy of the loan loss reserve seems to us, however, to be largely a matter of judgment. Generally speaking, loan officers and the management of a bank are in the best position to make that judgment, although their judgment is subject to review by their independent accountants and also by bank examiners.

(3) Concentrations of Credit

While no general policy on credit concentrations has yet evolved, our staff has required specific disclosures with respect to loans and commitments for loans to REITs because of their unique nature. Our staff will, however, also continue to raise questions as to concentrations of loans in other commercial sectors and, where appropriate, disclosure will be requested. While objective rules or guidelines in this area may be difficult to draw, the flexibility of our informal review process is particularly valuable.

(4) Loans to Insiders

Generally the Commission's proxy rules require disclosures in proxy statements filed with the Commission and sent to shareholders of material indebtedness to the subject company or its subsidiaries by any of its officers and directors and each associate of any such person. However, where the lender is a bank, such disclosure may consist of a statement, if such is the case, that the loans to such persons

- (i) were made in the ordinary course of business;
- (ii) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons; and
- (iii) did not involve more than the normal risk of collectibility or present other unfavorable features.

This requirement is not dissimilar to that generally relieving industrial issuers from disclosing indebtedness to it by its officers and directors or their associates, if such indebtedness arises out of purchases made subject to the usual trade terms and other transactions in the ordinary course of business.

Our staff is considering revisions to our proxy rules and registration forms relating to the disclosure of transactions with officers, directors and associates.

Disclosures have been made in the past by bank holding companies regarding loans which were not made on substantially the same terms as those prevailing at the time for comparable transactions with unaffiliated persons, as well as disclosures regarding loans to such officers and directors and their associates which involved a higher than normal risk of collectibility.

The Commission recently found certain filings of a bank holding company deficient, among other reasons, because they failed to disclose loans by the company's principal bank subsidiary to companies in which certain officers and directors of the subsidiary had a substantial interest. Certain of these loans were made at preferential rates of interest for the purpose of purchasing and carrying controlling blocks of stock of other banks which were later acquired by the bank holding company at a profit to the officers and directors. The Commission took enforcement action against this registrant, caused it to make corrective disclosures and ordered the issuer to amend its filings with the Commission.

(5) Securities Holdings

The Commission's rules under Regulation S-X, the Commission's Regulation as to the Form and Content of Financial Statements, require that a prospectus disclose both the carrying amount and the market value of investment securities. Accordingly, we have not experienced difficulties in obtaining disclosure in this area.

While our rules do not explicitly require disclosures of contingencies for unusual market or other risks associated with securities holdings, we have, in specific cases,

required the disclosure of special factors which can be identified as adversely affecting the liquidity of investment portfolios.

(6) Asset Structure

We have generally required disclosures in prospectuses of the structure of the deposit and borrowing base utilized to support a particular banking institution's asset structure and earnings effects. Registrants are required to set forth a capitalization table that details the stockholders' equity and the long-term debt securities. In addition, tables are furnished showing the composition of deposits over a period of several years and of the interest rates paid on the various types of purchased funds employed by the registrant. Analyses are also furnished in a tabular form, showing changes in loan and investment assets of the bank.

The data furnished by registrants have not been as uniform as we would like, and our staff is attempting to develop guidelines for the extent of the statistical disclosure that should be reported for loans and deposits. We expect the guidelines to draw upon the reporting requirements of the bank regulatory agencies, in order to curtail costs to, and burdens on, registrants in complying.

(7) Leasing Transactions and Letter of Credit Commitments

We have required disclosures of leasing transactions and standby letters of credit commitments. Many of the bank holding companies furnish separate financial statements for nonblank subsidiaries. These financial statements list the principal classes of assets of the subsidiaries and set forth leasing receivables whenever they are a principal class of assets. Also, where leasing activities are significant, the tax effect of leasing activities

may be one of the items required to be set forth separately in a schedule explaining the items comprising the provision for deferred income taxes.

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The question of appropriate loan portfolio disclosures by banking institutions under the federal securities laws is of recent vintage and still of somewhat uncertain resolution. We recognize the fact that banks are not like other issuers in all respects, but, by the same token, the banks must recognize that persons who invest their funds in securities issued by them or their holding companies are entitled to the same kinds of protections offered to investors in industrial companies. Over the last five months, important progress has been made in reconciling the different perspectives of the Commission and the banking authorities. We are optimistic that, within the next few weeks, we will publish guidelines which will assure continued full disclosure by bank holding companies without jeopardizing traditional bank regulatory precepts.