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STATEMENT OF JOHN S.R. SHAD,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

CONCERNING S&L ACCOUNTING AND FINANCIAL REPORTING

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Chairman Dingell,

Your letter of July 9th requested testimony concerning the Commission's responsibilities regarding savings and loan associations ("S&Ls") financial reporting; enforcement of the federal securities laws with respect to S&Ls and associated persons; differences between Regulatory Accounting Principles ("RAP") and Generally Accepted Accounting Principles ("GAAP"); and S&L accounting practices for transactions such as acquisition, development and construction ("ADC") loans. Your staff has also asked for information concerning filings made with the Commission relating to Beverly Hills Savings and Loan Association, which is set forth in an appendix hereto.

I. COMMISSION AUTHORITY OVER S&L FINANCIAL REPORTING

Under the Securities Exchange Act of 1934 ("Exchange Act"), publicly-owned companies are subject to the Commission's regulations regarding the appropriate disclosure of financial information in the following areas:

- registration of classes of securities,
- periodic reports,

° proxy solicitations and information statements, and

° tender offer documents.

Commission Regulation S-X and the Commission's Financial Reporting Releases ("FRRs") set forth the accounting principles that must be employed in preparing financial statements for inclusion in these Commission filings. In addition, Commission Staff Accounting Bulletins are issued to provide further guidance.

Commission disclosure authority in the above areas covers publicly-held holding companies that own banks and S&Ls. 1/ The Commission's authority does not, however, extend to federally-insured publicly-held banks and S&Ls. Instead, Congress has provided that the federal agencies that regulate depository institutions, including the Federal Home Loan Bank Board (the "bank regulators"), not the Commission, are to administer the financial disclosure system for individual banks and S&Ls that are publicly owned.

Section 12(i) of the Exchange Act, as amended in 1974, specifically vests in the bank regulators the "powers, functions, and duties vested in the Commission to administer and enforce" requirements in these areas, including the financial

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1/ As of June 11, 1985, 972 bank holding companies and 63 S&L institutions (including holding companies and a few non-federally insured S&Ls) were filing with the Commission.

reporting requirements. Thus, banks and S&Ls file their financial reports with their bank regulators. 2/ The bank regulators are responsible for reviewing those reports.

Correspondingly, the bank regulators, not the Commission, specify the accounting principles and other requirements that must be followed in preparing the disclosure documents of publicly-held depository institutions. Section 12(i) requires each bank regulator to issue regulations "substantially similar" to those issued by the Commission under certain provisions of the Exchange Act, unless the bank regulator specifically finds that such regulations would not be "necessary or appropriate in the public interest or for the protection of investors."

Unlike the other bank regulators, the FHLBB has automatically incorporated in its requirements all Commission financial reporting rules for the purpose of Exchange Act filings. 3/ The FHLBB's staff has informed us that they follow the Commission's staff interpretations of Regulation S-X and GAAP as well even though they are not obligated to do so. There is, of course, the possibility that interpretations and enforcement of

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2/ The staff has been informed by the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve Board that a total of approximately 900 institutions file financial reports with them pursuant to Section 12(i) of the Exchange Act.

3/ 12 C.F.R. 563d.1.

accounting requirements by the FHLBB will differ in some respects from what the Commission would have required.

Under the current statutory framework, there are certain limited situations in which single transactions will require that filings under the federal securities laws be made with both the bank regulators (by a federally-insured bank or S&L) and the Commission (by the other party to the transaction). 4/ These situations are limited to:

- Formation of a holding company structure by a Section 12(i) bank or S&L, and the conversion of a mutual S&L into a holding company structure; and
- The acquisition, subject to the approval of security holders, of a Section 12(i) bank or S&L, by a holding company through the issuance of securities.

II. ENFORCEMENT OF S&L SECURITIES VIOLATIONS

The Commission enforces the requirements of the federal securities laws with respect to the companies that file with it. Section 12(i) vests in the bank regulators the authority to "administer and enforce" certain Exchange Act provisions, and the bank regulators are thus charged with enforcement of those requirements for those filing with them. The Commission,

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4/ Sections 3(a)(2) and 3(a)(5) of the Securities Act of 1933 generally exempt from the registration provisions securities issued by a bank or S&L.

however, retains its authority to investigate and pursue enforcement actions involving alleged securities fraud by banks and S&Ls or their associated persons.

In recent years, the Commission, often after consulting with the FHLBB, has taken a variety of enforcement actions against thrift institutions that file with it, in cases arising from failures to disclose material adverse information and other disclosure problems. For example, the Commission recently brought an administrative proceeding against Broadview Financial Corporation, an S&L holding company, alleging that Broadview had improperly recognized $4 million in revenues from the "sale" of a contract to acquire property. 5/ As a result of the Commission's review and comment process, Broadview restated its 1982 earnings from the transaction. As a result of a subsequent administrative proceeding on the same matter, Broadview is required for three years to have an interim review of its quarterly financial statements performed by its auditors and to have its audit committee review the accounting for certain major real estate transactions.

In 1983, the Commission brought an administrative proceeding against two state-chartered and insured S&Ls, Southeastern Savings & Loan Company and Scottish Savings and Loan Association, Inc. 6/ The Commission alleged that the respondents

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5/ Securities Exchange Act Release No. 21949 (April 17, 1985).

6/ Securities Exchange Act Release No. 20266 (Oct. 6, 1983).

had improperly deferred net losses in connection with the sale of securities and ordered them to amend their filings by restating their financial statements to reflect the losses incurred and by disclosing all material facts relating to these transactions.

In 1982, the Commission issued a Report of Investigation pursuant to Section 21(a) of the Exchange Act concerning Fidelity Financial Corporation and Fidelity Savings and Loan Association. 7/ This proceeding involved the offer and sale of retail repurchase agreements. The Commission concluded in its report that Fidelity and the Association appeared to have violated the antifraud provisions of the federal securities laws in connection with those transactions, by, among other things, omitting material information or making misleading statements concerning the financial condition of the two companies and the securities underlying the retail repurchase agreements.

In addition to enforcement actions such as those discussed above, the Commission has disciplined accountants for improper professional conduct relating to S&L audits. 8/ The

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7/ Securities Exchange Act Release No. 18927 (July 30, 1982).

8/ Rule 2(e) of the Commission's Rules of Practice, 17 C.F.R. 201.2(e), authorizes the Commission to discipline professionals (including accountants) practicing before the Commission, if they are not qualified to practice; lack character or integrity; engage in unethical or improper professional conduct; willfully violate, or willfully aid and abet violations of, the federal securities laws; or have been enjoined from violating those laws.

Commission instituted disciplinary proceedings to determine whether three certified public accountants engaged in improper professional conduct in connection with the issuance of an unqualified audit opinion and an unqualified review report on the financial statements of Southeastern Savings & Loan Company and Scottish Savings and Loan Association, Inc. 9/ The Commission censured the accountants and required certain undertakings. Two of the accountants agreed that, for a period of three years, they would not become involved directly or indirectly in any audit engagement of any entity or company, if its financial statements could reasonably be expected to be filed with the Commission. The third accountant represented that, with respect to his current position, he was not, and did not intend to become, a director of audit and accounting, in charge of an inter-office inspection program, and involved in consulting on engagements involving public entities.

III. ROLE OF REGULATORY ACCOUNTING PRINCIPLES

The Subcommittee has inquired concerning the differences between RAP and GAAP. Regulation S-X provides that financial statements filed with the Commission will be presumed misleading unless prepared in accordance with GAAP. Financial statements prepared in accordance with GAAP are the cornerstone of

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9/ Securities Exchange Act Release No. 21095 (June 25, 1984).

financial disclosures to investors under the Commission's disclosure system.

In the case of reports filed with the bank regulators -- either pursuant to Section 12(i) or for other regulatory purposes -- those agencies' accounting requirements may differ from GAAP for specific transactions or filings. Such regulatory accounting principles or requirements, which are referred to as RAP, do not apply in the vast majority of instances. In those cases where RAP requirements differ from GAAP for Exchange Act filings, the bank regulator is required by Section 12(i) to find that conforming with the Commission's requirement is not "necessary or appropriate in the public interest or for the protection of investors".

As noted above, the FHLBB requires S&Ls to use GAAP in filings made with that agency under the Exchange Act. However, for certain other financial reports filed with the FHLBB under its own rules and regulations to enable the Board to ensure the safety and soundness of S&Ls, RAP is permitted in three instances -- for mutual S&Ls; for privately-held stock S&Ls; and for all S&Ls in quarterly regulatory reports. To illustrate the differences between RAP and GAAP, in accordance with the Garn-St Germain Depository Institutions Act of 1982, "net worth certificates" issued by the Federal Savings and Loan Insurance Corporation are deemed assets and a component of net worth for RAP purposes; for GAAP purposes, such certificates are not recognized as assets and, therefore, are not a component of net worth.

IV. CURRENT S&L ACCOUNTING ISSUES

The financial services industry has evolved rapidly in recent years. Many restrictions have been removed on the types of investments and loans banks and S&Ls can make, and on the interest rates they can pay depositors.

Many financial institutions are seeking higher-yielding loans and investments that may also afford greater liquidity than mortgages. These include securitized loans, various guarantees and assets sold with recourse or subject to repurchase provisions.

In addition, banks and S&Ls are expanding into brokerage, insurance, real estate and other lines of business. This may require additional financial and other disclosures, and accounting tailored to such activities.

For example, real estate ADC lenders may assume varying degrees of risks of real estate owners or joint venturers. If they advance substantially all the funds necessary for project completion, participate in residual profits, or have no recourse to assets other than the project itself, the "loan" in substance may be an equity investment.

Whether an ADC arrangement should be accounted for as a loan or an equity investment affects the timing of income recognition on the transaction. In accordance with GAAP, if it is an equity investment, recognition of interest and fee income must be deferred until the project is completed and sold. If the arrangement is in substance a loan, interest

should be recognized as it accrues, subject to recoverability. Loan fees should be recognized in accordance with accounting guidance on loan fees. 10/ Generally, any fees in excess of the cost of making the loan should be taken into income over the life of the loan as additional interest.

In November 1983, the Accounting Standards Executive Committee of the AICPA issued a Notice to Practitioners which provided advisory guidance on accounting treatment of ADC loans. The AICPA believed additional guidance was necessary due to the increased entry by financial institutions, particularly S&Ls, into ADC arrangements for which loan accounting may not be appropriate. In November 1984, a second Notice to Practitioners was issued, clarifying the effect of personal guarantees by borrowers or third parties and the effect of agreements outlining the terms of the profit expected to be retained by the lender (including "equity kickers"). The AICPA is currently considering issuance of an additional Notice of Practioners to further refine the guidance in this area. The Commission, the AICPA, the FASB and the FHLBB are continuing to monitor developments in this area.

In the case of depository institutions that file with the Commission, the review and comment process seeks to identify

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10/ The FASB has a project underway to conform accounting for loan fees, which currently vary by historical industry categories.

ADC arrangements, and to ensure proper accounting for such transactions. The Broadview Financial Corporation situation cited above illustrates this process.

The Commission and accounting bodies, frequently in consultation with the FHLBB, monitor and respond to other accounting developments of significance to depository institutions. For example, in 1984, the Commission required three S&L holding company registrants to restate their financial statements because they had improperly accounted for "dollar-roll" transactions in mortgage-backed securities as repurchase agreements. As a result, Financial Corporation of America restated its operating results for the first six months of 1984 to report a net loss of $79 million, compared to previously reported net income of $75 million. Homestead Financial Corporation restated its financial statements by reducing its previously reported net income by $5.4 million for 1983 (a 26% decrease) and by $3.4 million for the nine months ended September 30, 1984 (a 32% decrease). The restatement by Guarantee Financial Corporation reduced its reported net income for 1983 by $300,000 and increased it by a similar sum in 1984.

In June 1985, the Commission issued a proposed rule relating to repurchase transaction disclosures. It also requested comments on a comprehensive basis with respect to the adequacy of accounting and financial reporting for assets and transactions such as repurchase agreements, interest rate swaps, securitized assets and sales of assets

subject to "put" arrangements.

In addition, various private sector bodies are addressing accounting and disclosure issues concerning repurchase transactions. For example, the Accounting Standards Executive Committee of the AICPA currently is considering a proposed Statement of Position for S&Ls to increase disclosure concerning repurchase transactions and mortgage-backed securities. A Statement of Position issued in 1984 provided guidance to S&Ls on accounting for repurchase transactions. An AICPA Special Task Force studied the adequacy of existing guidance for auditing repurchase transactions, and issued a report providing comprehensive guidance for auditors in June 1985. In addition, the Governmental Accounting Standards Board has proposed accounting and disclosure guidance for the municipalities involved in these transactions.

The FASB, under Commission oversight, has dealt with a number of issues involving financial institutions. For example, in March 1985, the FASB issued guidance on collateralized mortgage obligations and accounting for the receipt by S&Ls of Federal Home Loan Mortgage Corporation participating preferred stock. An exposure draft on accounting for loan fees is expected this quarter, and the FASB is considering adding a project to its agenda on financial assets and transactions.

V. REGULATORY RECOMMENDATIONS

As described above, under the current system, the bank regulators have authority over securities law disclosure and financial reporting requirements for banks and S&Ls. Each of the four bank regulators maintains a separate securities division to perform the responsibilities handled by the Commission for all other publicly-owned companies. To eliminate the inefficiencies and anomalies inherent in this system, the Bush Task Group on Regulation of Financial Services has recommended consolidation within the Commission of the securities reporting requirements of all publicly-owned banks and thrifts. Specifically:

- All banks and thrifts publicly issuing securities (but not deposit instruments) to the investing public should be subject to the registration requirements of the Securities Act; and
- Administration and enforcement of disclosure requirements under the Exchange Act should be transferred exclusively to the Commission, by repealing Section 12(i) of that Act.

If these recommendations were adopted, about 900 publicly-held banks and S&Ls would become subject to the Commission's reporting and enforcement authority under the Exchange Act.

The Task Group recommendations would result in more uniform regulation and financial disclosure to investors and securities analysts, at lower cost. They also would facilitate the comparative analysis of investment opportunities.

While the FHLBB has incorporated Commission disclosure rules by reference in its Exchange Act rules, the other bank regulators have adopted their own Exchange Act rules. The proposals would eliminate these inconsistencies, as well as delays by the various agencies in conforming their regulations governing depository institution filings with those adopted by the Commission. The proposals would also reduce duplication of five agencies' staffs for the establishment, interpretation, processing and enforcement of securities disclosure requirements.

APPENDIX A

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BEVERLY HILLS SAVINGS AND LOAN ASSOCIATION

RELATED FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION

FORM	DATE FILED	NATURE OF FILING	STATUS OF FILING
1. Registration Statement under the Securities Act of 1933 covering mortgage pass-through certificates (filed with the Commission since the securities proposed to be offered were not obligations of, or guaranteed by, Beverly Hills Savings and Loan Association and thus not securities issued by a depository institution within the meaning of Section 3(a)(5) of that Act).			
S-11	3-24-82	Registration statement under Securities Act of 1933 for proposed offering of Second Mortgage Pass Through Certificates evidencing an undivided interest in a pool of second mortgage loans formed and serviced by BHSL.	Filing withdrawn on 3-22-83. No securities were sold.

2. Schedule 13D */ [Schedule filed by beneficial owners of equity securities registered under Section 12 of Securities Exchange Act of 1934.]

4-13-82	Filed by Alexis Eliopulos
4-13-82	Filed by Gary W. Neilsen
5-03-82	Filed by Bruce and Evlynn Kates
12-22-83	Filed by Werner K. Rey

3. Schedule 13G */ [Schedule filed by certain institutions and other beneficial owners of equity securities registered under Section 12 of the Securities Exchange Act of 1934.]

2-09-81	Filed by Zenith National Insurance Corp.

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*/ These schedules were erroneously filed with the Commission. Because they related to the beneficial ownership of securities of a federally-insured S&L, pursuant to Section 12(i) of the Securities Exchange Act of 1934, they should have been filed only with the FHLBB.