



Shadow Financial Regulatory Committee

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Statement No. 47

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Statement of the Shadow Financial Regulatory Committee on Congressionally-Mandated Accounting for Junk Bond Sales

The U.S. taxpayer is faced with a cost of more than \$150 billion to pay off depositors in insolvent savings and loan associations. One reason many of these institutions were not closed by the authorities before they lost billions of dollars in excessively risky loans and other investments is that their economic insolvency was covered up by traditional and regulatory accounting systems. These practices allowed "zombie" savings and loan associations to show assets at cost, even when the assets were, in actuality, worth far less.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) continues to authorize misleading reporting practices. In particular, although S&Ls are directed to dispose of their "junk" bond holdings no later than July 1, 1994, according to the Conference Report they can report these

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assets at cost, even when the economic value of the bonds is known to be lower. The Shadow Financial Regulatory Committee supports the Financial Accounting Standards Board (FASB) in opposing this Congressional interference with prudent regulatory practice. (The FASB position is stated in the attached letter.) It is contrary to generally accepted accounting principles (GAAP) because, under GAAP, securities that will not be held to maturity must be stated at the lower of cost or market. Consequently, allowing S&Ls to report at cost (if higher than market) "junk" bonds that will not mature before they must be sold is contrary to the Competitive Equality Banking Act of 1987, which requires that regulatory accounting conform to GAAP.

The Committee would require insured depository institutions to report all assets at their current market values, at least when these values are readily determinable, as is the case for marketable securities. It does not matter whether the securities will be traded or held -- their relevant value is given by the market. Unless such market values are regularly reported, both the supervisory authorities and the public are likely to be misled once more, and insolvent and undercapitalized institutions might again be allowed to play the "heads we win, tails the insurance fund loses" game that has been so costly to taxpayers.

Financial Accounting Standards Board

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TIMOTHY S. LUCAS
Director
Research and Technical Activities

August 9, 1989

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate
SD-534 Dirksen Senate Office Building
Washington, DC 20510

RE: Financial Institutions Reform, Recovery, and Enforcement Act of 1989

Dear Mr. Chairman:

The staff of the Financial Accounting Standards Board (FASB) wishes to express its disappointment in the conference committee's expression of intent accompanying the "Financial Institutions Reform, Recovery, and Enforcement Act of 1989." The report states, "The conferees do not intend that securities subject to divestment under subsection (d) be treated, for regulatory accounting purposes, as securities 'held for sale.'" We understand the desire on the part of Congress to achieve the objectives of restoring strength and order to the industry. However, we question whether this can best be achieved through permissive regulatory accounting practices that may send an ambiguous signal to financial statement users about the relative strength of the financial institutions that are affected by this legislation. Further, we believe that practice will be in conflict with another law, as explained below.

Roles of Regulatory and General-Purpose Financial Reporting

The FASB's objective is to establish and improve standards for general-purpose financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information. Business enterprises, including insured institutions, that present financial statements that purport to be in accordance with generally accepted accounting principles (GAAP) must comply with the requirements of FASB pronouncements.

The separation of regulatory and general-purpose reporting requirements has been a result of the differing needs and objectives of regulators and other users of financial information. The objective of general-purpose financial statements is to provide useful, representationally faithful information to a wide group of investors, creditors, and other users. The FASB has consistently maintained that general-purpose financial statements should be neutral and unbiased.

Mr. Donald W. Riegler, Jr.
August 9, 1989
Page Two



In the past, the FASB or its staff has reviewed and commented on a number of proposals by regulatory authorities to prescribe regulatory accounting practices to provide a means for insured institutions to meet minimum capital adequacy requirements. The FASB has acknowledged that Congress and regulators have the authority, through law and the development of regulations, to modify or to provide temporary or extended relief from regulations and thus to tolerate financial conditions of insured institutions that might not be acceptable in times of less economic stress. However, the FASB has consistently objected to proposals to include representations that are not in accordance with GAAP in financial statements issued or otherwise available to the public because those financial statements would be confusing and misleading.

Competitive Equality Banking Act of 1987

We believe that Congress expressed these same concerns in the "Competitive Equality Banking Act of 1987" (CEBA) that requires that regulatory accounting should conform to GAAP. One stated purpose of the CEBA is to require "the Bank Board and FSLIC to formulate regulations for the eventual application of GAAP to all thrift institutions." In response to the CEBA, the FHLBB has expended considerable effort to conform regulatory accounting requirements to GAAP. One result of this effort is a Statement of Policy, "Investment Portfolio Policy and Accounting Guidelines," which the FHLBB issued after corresponding with us to confirm their understanding of GAAP as it relates to accounting for investments. This Statement of Policy is specifically intended to conform regulatory accounting to GAAP in requiring that assets held for sale should be reported at the lower of cost or market value.

If the law now requires disposal of certain categories of investments by a certain date, then for those investments maturing after that date there can be no intent and ability to hold those investments to maturity. The appropriate accounting in accordance with GAAP is to report those investments at the lower of cost or market.

Sincerely,

A handwritten signature in dark ink that reads "Timothy S. Lucas". The signature is written in a cursive, flowing style.

Timothy S. Lucas

TSL/3948M

cc: Mr. M. Danny Wall