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Statement of the Shadow Financial Regulatory Committee

on

**"Fair Value" Reporting for Insured
Depository Institutions Required Under FDICIA**

May 24, 1993

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 provides for structured early intervention and resolution of insured depository institutions when their capital declines below specified ratios of their total assets. If effectively implemented, early intervention will result in the FDIC (and, hence, solvent institutions and taxpayers) having to take almost no losses as a result of bank and thrift failures. Implementation, in turn, depends importantly on how capital is measured. For this purpose, capital should be measured and reported in accordance with economic rather than historical-cost accounting values.

FDICIA requires that the federal bank and thrift regulatory agencies develop a method of reporting the estimated "fair value" of the assets and liabilities of insured depository institutions in a supplementary statement. The Committee believes that these estimates are equivalent to estimates of market values, and are feasible and practical.

Furthermore, estimates of economic capital should include valuation of both the liability as well as the asset side of the balance sheet. Hence, we take issue with the Federal Financial Institutions Examination Council's (FFIEC) proposal to limit fair

value reporting to financial assets (as is required by Financial Accounting Standards Board Statement No. 107). This limitation misstates a financial institution's capital. Neglecting liabilities is particularly perverse when the institution has taken the risk-reducing step of hedging the exposure of asset values to interest-rate changes.

In response to the FFIEC request for comment on disclosure of estimated fair values, the Committee offers the following additional suggestions:

Reporting Institutions and Dates

Section 112 of FDICIA applies to institutions with \$150 million or more in total assets. The Committee suggests that the regulatory agencies develop a supervisory mechanism to determine fair values of assets and liabilities for smaller institutions. Smaller institutions also can be weak and may fail unless their economic capital is sufficient to absorb losses from their operations. A delay in or exemption from determining fair values would continue the risk that some institutions would be permitted to continue operations despite dangerously low economic capital.

Reporting Periods

Fair value estimates should be disclosed with the quarterly call statements. The reporting institutions should be able to provide the required numbers without great expense, and the regulatory agencies should want to learn about changes in the institution's economic (fair value) capital expeditiously.

Methods of Estimating Fair Values

Reporting fair values is not as difficult nor as radical a change as its opponents allege.

° Many assets, particularly securities, are regularly traded or their prices can be obtained from brokers' quotations. These assets should be valued at their current market price for the quantities that the institution holds as of the report date.

° Similarly, liabilities that are traded, such as subordinated debentures and marketable CDs, can be valued at their current market prices.

° Financial assets (such as loans) and liabilities (such as nontraded CDs and savings deposits) not having their own market prices can be valued at market by utilizing the current prices of comparable instruments or by determining market rates of return to discount projected cash flows. Discounting includes calculating the effect of changes in interest rates on fixed interest obligations and estimating the probability that troubled assets (e.g., loans) will not be repaid as promised.

° The market values of off-balance sheet assets and liabilities can be similarly estimated and recorded.

° Intangible assets can be valued in a manner similar to that used for tangible assets. For example, mortgage servicing and credit card servicing rights often are bought and sold, and hence can be assigned market values. The intangible asset that measures the value of core deposits can be estimated using well-developed statistical models and current prices.

Format of Reports

The "fair" or economic values of assets and liabilities, and their difference, capital, should be reported as supplementary information to the institutions' quarterly balance sheets (call statements). If loans and other assets are valued at their economic values, the "reserve for loan losses" can be eliminated. (Under GAAP, this reserve is shown as a deduction against loans and under bank regulatory accounting it is partially added back as an addition to capital.)

The primary purpose of fair value accounting is to provide the supervisory authorities and the public with more meaningful measures of capital. For this reason, it is sufficient that this information be presented in a supplementary statement; the effect of changes in market values need not be reflected directly in the institutions' statements of income and expense.

