An Update on Emerging Issues in Banking

Financial Transparency and Regulatory Policy

May 30, 2002

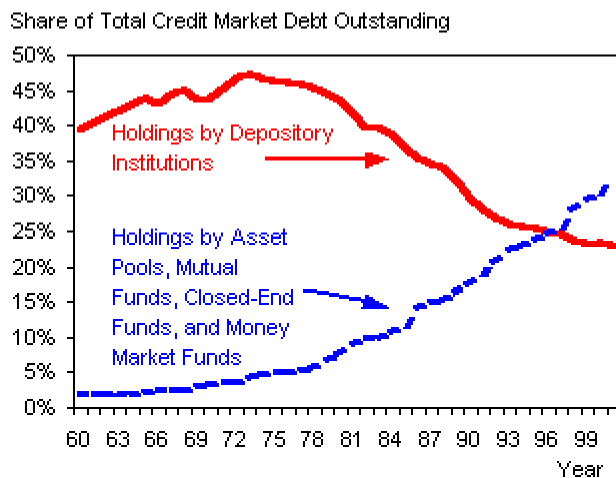
Summary

Financial transparency is of vital importance to market participants and regulators alike. The FDIC's mission to promote public confidence in the U.S. banking system gives it a shared responsibility for defining the rules of the road in the financial marketplace. To that end, the FDIC is hosting a June 4 symposium entitled Enhancing Financial Transparency where the nation's leading experts from the private and public sectors will address the issue from the perspective of financial analysis, accounting standards, and regulatory policy. The entire symposium will be webcast live on www.fdic.gov. This issue of *FYI* summarizes a few of the topics that symposium participants will address.

The importance of financial transparency and investor confidence in financial markets can hardly be overstated in the current environment. During the ten-year economic expansion that ended in early 2001, an increasing percentage of credit market assets were held by what could be termed "market-based" lenders while fewer were held by depository institutions (Chart 1).[1] While information technology has been widely cited as the driving force behind higher rates of growth in economic activity and productivity in the New Economy, market-based lending and investing has also brought powerful new efficiencies. With the growth of market-based funding sources, capital has become more widely available, risks have been more widely and more efficiently allocated among investors, and the interests of investors and issuers have been increasingly aligned.

Chart 1

Market-based lenders have surpassed depository institutions as holders of credit market debt



Source: Federal Reserve Board, *Flow of Funds* (Haver Analytics).

Credit market debt includes: corporate and foreign bonds, government and agency securities, residential and commercial mortgages, consumer credit, open market paper, other loans and advances, and bank loans not elsewhere classified.

Perhaps the most fundamental distinction between market-based financing and institution-based financing is how information is used. While traditional bank lending requires high quality *private* information about borrowers, market-based lending and investing requires high quality *public* information about issuers. This information-in the form of financial statements, audit opinions, credit ratings, and analyst reports-is continuously conveyed to investors through the media, the internet, and specialized information services. Chart 1 shows that as access to public financial information has increased over time, market-based lenders have increased their share of the financial marketplace at the expense of depository institutions.

In the wake of the collapse of Enron in December 2001, considerable controversy has emerged over the quality of reported financial information. Enron helped bring the term "special purpose entity" into the general business lexicon. While moving assets off the balance sheet is nothing new--especially for banks that securitize loans or companies that finance real estate using "synthetic leases"--the concerns raised by Enron have led analysts, investors and the accounting community to re-examine these affiliate relationships, the risks they pose for parent companies, and the valuation issues raised by financial transactions with affiliates.

Accounting practices employed in the reporting of corporate earnings have also come under scrutiny as corporate bankruptcies have soared and earnings have fallen.[2] One practice that has been questioned involves the reporting of *pro forma* earnings totals that have often been relayed to investors by the press but that may omit key expense items, thereby boosting the bottom line. By one estimate, companies that make up the NASDAQ 100 index reported *pro forma* profits of $19.1 billion for the first three quarters of last year, but later reported a loss of $82.3 billion for the same period in public filings that

conformed to generally accepted accounting principles (GAAP).[3] Controversy has arisen also over the treatment of stock options as a form of employee compensation that does not appear on the earnings statement, and the treatment of premiums paid for acquisitions that do not need to be reported as an expense unless the stock price of the surviving company suffers after the merger.

The FDIC's mission to promote public confidence in the U.S. banking system gives it a shared responsibility for defining the rules of the road in the financial marketplace. The quality of reported financial information has a bearing on both the regulators' ability to assess risk from off-site and the extent to which market discipline can complement regulatory oversight.

From a regulatory perspective, two priorities emerge. The first is to avoid a rush to judgement that undermines the confidence of the public in its markets and institutions. Regulators should carefully note what is working in the system and why, while actively exploring the areas where reporting practices can be improved. Because of the wide array of private-sector and government-sector participants that combine to form our financial "rules of the road," regulators need to carefully listen to a number of perspectives before defining the problems and proposing solutions to fix them.

To promote these objectives, the FDIC is sponsoring a June 4 symposium entitled "Enhancing Financial Transparency." This is not a conference on bank accounting practices, but a wide ranging discussion of what is working in the U.S. financial reporting infrastructure and what needs fixing. Three panel discussions, featuring the nation's top experts from the private and public sectors, will address financial analysis, accounting standards, and policy proposals, respectively. In the interests of accessibility, the FDIC will carry the event live as a webcast starting at 7:45 am on Tuesday June 4.

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[1] Here the term "market-based lenders" refers to non-traditional institutions whose assets are either traded in markets or can be readily marked-to-market using public information. These institutions typically issue liabilities in the form of publicly-traded securities or mutual shares. They include money market funds, mutual funds, closed-end funds, government-sponsored enterprises, and various types of asset pools.

[2] See Alan Deaton, "Large and Small Companies Exhibit Diverging Bankruptcy Trends," FDIC *FYI*, January 31, 2002. http://www.fdic.gov/bank/analytical/fyi/2002/fyi013102.html

[3] "Finance And Economics: Out, by $100 billion; Pro-forma Accounting," *The Economist*, February 23, 2002, p. 77.

Chart 1

Market-based lenders have surpassed depository institutions as holders of credit market debt

Year	Depository Institutions	Market-Based Lenders
1960	39.5%	1.9%
1961	40.6%	2.0%
1962	41.6%	2.0%
1963	42.3%	2.1%
1964	43.1%	2.1%
1965	44.0%	2.3%
1966	43.3%	2.7%
1967	44.6%	2.5%
1968	45.1%	2.6%
1969	43.8%	3.1%
1970	44.1%	3.5%
1971	45.4%	3.6%
1972	47.0%	3.7%
1973	47.5%	4.2%
1974	47.0%	4.9%
1975	46.4%	5.0%
1976	46.4%	5.1%
1977	46.1%	5.3%
1978	45.4%	5.8%
1979	44.5%	6.9%
1980	43.6%	7.6%
1981	41.8%	9.1%
1982	39.7%	10.0%
1983	39.8%	9.9%
1984	39.0%	10.7%
1985	36.9%	11.7%
1986	35.6%	14.2%
1987	34.8%	15.1%
1988	34.0%	15.3%
1989	32.1%	16.3%
1990	29.9%	17.6%
1991	28.1%	19.1%
1992	26.9%	20.7%
1993	26.1%	22.3%
1994	25.7%	22.9%

1995	25.5%	23.9%
1996	24.9%	24.6%
1997	24.7%	25.5%
1998	23.9%	28.1%
1999	23.4%	29.5%
2000	23.5%	30.5%
2001	22.9%	32.7%

Source: Federal Reserve Board, Flow of Funds (Haver Analytics).

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Market-based lenders include: asset pools, mutual funds, closed-end funds, and money market funds.