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Issue Paper

Subject: SEC/Bank Dispute Concerning Required Disclosure in Bank Holding Company Registration Statements

Issue: Should bank holding companies, in connection with the registration of securities for public sale, be required to disclose internal information relating to the loan portfolios of their constituent banks?

Discussion: Since March the SEC has been refusing to allow bank holding companies to market their securities unless they disclose certain information concerning loan portfolios. Specifically, the SEC is requiring disclosure in the following areas:

1. Non-Accrual Loans (listing of amounts of loans on which, for internal accounting purposes, income is booked on a cash basis rather than automatically accrued pursuant to the terms of the loan instrument).

2. Internal Loan Classifications (listing of amounts of loans which are regularly "watched" by bank management).

3. Loan Concentration by Industry as a Percentage of Capital (e.g., loans to all auto companies equal 22% of capital; loans to all oil companies equal 18% of capital, etc.).

The SEC contends that such information is "material" (within the meaning of the Securities Act of 1933) because:

1. Investors are generally worried about the condition of banks and are entitled to information revealing alleged weaknesses;

2. Investors are entitled to have the "raw" financial data to enable them to make predictions as to the current and future earnings prospects of banks; and

3. Investors are entitled to similar data concerning all bank holding companies to enable them to make comparative evaluations for investment purposes.

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Opposing Position. The SEC is being opposed by both the bank regulatory agencies and the bank holding companies (with Citicorp -- parent of First National City Bank -- taking the lead). One objection advanced by the Comptroller is procedural: the SEC position represents a radical departure from previous practice and therefore should be subject to public scrutiny via the normal administrative rulemaking process.

With respect to substance, Citicorp has taken the lead, but the bank regulatory agencies have expressed informal concurrence with Citicorp's arguments. In a comprehensive memorandum filed with the SEC May 6, Citicorp contends that the required disclosures would be extremely misleading, creating unwarranted public doubts about the viability of the Company in question, the banking system and the industries to which banks lend money.

With respect to non-accrual loans and internal classifications, Citicorp shows that there is no meaningful correlation between such status and ultimate collectibility and only slight correlation between such status and profitability, even for the current year. Moreover, to the extent disclosure of such internal classification would reflect adversely on market price, it penalizes the well-run, conservatively managed institution which handles its loan portfolio with extra caution.

They challenge the industry concentration request on relevancy grounds: like most big banks, Citicorp has loans exceeding 10% of its capital to over 30 industry sectors and the data is therefore meaningless. Finally, they note that there is virtually no legal precedent for requiring information on the grounds that disclosure is necessary to dispel adverse rumors or to provide a basis for comparison.

Impact on Bank Capital Raising. Since the SEC began taking this position (about mid-March), no major bank has come to the market. A large Chemical Bank issue was aborted after the required information was disclosed. Last week, after lengthy negotiations, Manufacturers Hanover issued a prospectus containing the required disclosure and prepared to come to market. On the eve of the offering, the issue was withdrawn. "Market conditions" were blamed, but other comparably rated issuers came to market the same week. Only

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a few small companies and Southeast Banking (the largest Florida holding company) have complied and been permitted to sell securities.

Moreover, recently the SEC rejected the 10-K filing (annual report required of all public companies) of a Virginia bank holding company on the ground that it lacked non-accrual loan data. If this policy is pursued, it could close the secondary market for any holding company which does not comply, since securities generally cannot be traded unless a current 10-K is on file.

Status: Negotiations have proceeded on three fronts: SEC/Citicorp; SEC/Bank Agencies/Treasury at Senior levels; SEC/Bank Agencies at staff level. Since the SEC rejected Citicorp's arguments and directed it to supply SEC staff with the requested information, there has been no further SEC/Citicorp contact. At the staff level, an SEC/Bank Agency task force has been taking up a variety of issues relating to regulation of bank securities, and the question is being considered in this context.

At the Senior level, Treasury has made two proposals to Chairman Garrett and to the bank agencies:

1. That in lieu of such disclosures, the relevant bank agency provide a certification as to the soundness of a bank's loan portfolio. Both the bank agencies (which are concerned about liability in the event a favorable certification proves incorrect) and the SEC are considering this proposal.

2. To break the SEC/Citicorp impasse, that Citicorp provide the requested factual information to the Comptroller, which in turn would provide it to the SEC staff. This would meet the SEC's argument that it cannot decide on Citicorp's arguments without the underlying factual material as to actual loan experience. This procedure would allow Citicorp to save face, since it has previously expressed that fear that if it provided such information directly to the SEC, it might ultimately become part of the public record. Citicorp and the Comptroller have agreed, the SEC is still considering it.

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Evaluation. The Comptroller's procedural concerns are soundly based: the SEC clearly has departed from past practices and, in addition, is treating bank holding companies differently than other issuers. What the SEC is in effect asking for is management's internal predictions as to the future profitability of its investments. An analogy would be a requirement that Gillette disclose its internal calculations as to the expected pay out cycle of a new deodorant which is not selling well. Disclosures of that nature have never been required.

In the final analysis, the SEC staff's problem appears to be conceptual: they do not seem to understand that for a bank, money is an earning asset analogous to a new plant or a machine. Accordingly, they view a $250 Million loan in technical default (i.e., debt service not current) not as a "capital" investment which must be evaluated according to overall return prospects, but as a direct threat to the bottom line. To treat such loans in that way -- i.e., requiring specific disclosure to the investor which at least implies some material risk of immediate loss -- is misleading and can undermine confidence in the major banks and thus the banking system.

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