REPORT OF
THE BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM
ON THE PROPOSAL OF THE
SECURITIES AND EXCHANGE COMMISSION
TO AMEND ARTICLE 3 OF REGULATION S-X
(File No. 57-610)

In order to assist the Securities and Exchange Commission in identifying meaningful criteria for disclosure requirements applicable to concentrations of investments in the securities of a particular issuer, a survey was conducted of a sample of 101 banks selected to provide a cross-section of the universe affected by the proposed regulation. Criteria used in selecting the banks included size, geography, and the ratio of municipal and other securities to total assets.

Using the 5 per cent threshold contained in the Commission's proposal, 95 per cent of the banks surveyed would have had some disclosure requirements. Moreover, it should be noted that the number of issuers that would be required to be disclosed ranged from 1 to 29 per bank. Based on these data, the Board believes that nearly every bank in the United States would have concentrations in the obligations of a single issuer equal to or exceeding 5 per cent of its equity capital. Furthermore, many banks would have holdings of several issuers above the 5 per cent level. It is clear, therefore, that the 5 per cent threshold would create a substantial reporting burden for the banking system.

Moreover, the Board does not believe that benefits from such disclosure measured in terms of meaningful information for the use of

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the public, would be commensurate with the burden of the requirements.

Statutory provisions dealing with both investment securities and loans to a single borrower or obligor apply a 10 per cent criterion. Section 5136 U.S. Revised Statutes applies a 10 per cent limit on investments in securities other than municipal general obligations and obligations of the U.S. Government and Federal agencies. Section 5200 U.S. Revised Statutes applies a 10 per cent limit on unsecured loans by National banks to any one borrower. A higher per cent limitation is applied to secured loans and varies with the type of security. The 10 per cent level has, therefore, been long regarded as a benchmark in determining concentration levels in banks. Based on the lack of serious financial difficulties for all but a very few banks, the 10 per cent level appears to have been both realistic and practical. Moreover, a reporting requirement that applied a threshold of 5 per cent would create an anomalous situation whereby a bank would be required to disclose investment in securities of a single issuer, but would not be required to disclose loans to a single borrower even though such loans might be twice the amount of the disclosed investment. For all these reasons, the Board believes that a 5 per cent cut-off is too low.

A 10 per cent reporting threshold contains in only slightly reduced degree many of the problems attendant to the 5 per cent cut-off. Firstly, the 10 per cent criterion would be burdensome; it would capture about 77 per cent of the banks, and some banks would have

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several issuers to disclose. Secondly, experience indicates that such a concentration level has not proven unduly risky with respect to either loans or investments. Thirdly, the requirement would be somewhat contradictory inasmuch as concentrations in investment securities would be disclosed whereas loans of the same amount would not.

We believe there is considerable evidence to support a 20 per cent reporting threshold. Such a disclosure requirement would capture about 40 per cent of the banks, but would not cause an undue burden or cause confusion since most banks would have only a few issues to disclose. Secondly, the disclosure requirement would principally deal with municipal securities since banks hold relatively few nonpublic securities--less than 3 per cent of the total investment securities held by all insured commercial banks in the United States as of June 30, 1975, were represented by holdings of obligations other than those issued by the U.S. Government, U.S. agencies, and municipalities. In addition banking statutes is many of the States apply the 20 per cent threshold on loans to one borrower.

As we stated before, experience with municipal debt in the postwar years has reaffirmed the record for high quality with regard to the prospects for ultimate repayment that was demonstrated during the Great Depression of the 1930's. Although more than 400 State and local default situations had been reported between 1945 and early 1970, most of these appear to have been temporary or technical in nature and to have involved quite small governmental units.

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Even when a State or local governmental unit defaults for a time on its obligations, the economic tax base remains and the unit has to cure the default in one way or another before it can reenter the credit market. Thus, we believe that the chances of ultimate significant loss, especially by investors in general obligation bonds, those most likely to represent the principal disclosure item, are small. This experience, we believe, argues strongly for the larger 20 per cent threshold.

The definition of the term "issuer" as presently contained in the proposal is believed to be too broad resulting in improper aggregation of issues. Under present construction, a revenue bond issued by a State or political subdivision would be aggregated, for the purposes of determining a concentration, with the general obligation securities of that State or political subdivision. While this may be entirely proper in certain circumstances, such aggregation probably should not occur in situations where the revenue obligations are to be repaid from completely separate and independent sources, e.g., special purpose taxes, sewer fees, etc. We would urge, therefore, that consideration be given to redefining the term "issuer" so as to exclude, to the extent practicable, aggregation of securities that have totally independent sources of repayment.

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