TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING ISSUES INVOLVING FINANCIAL INSTITUTIONS
AND ACCOUNTING PRINCIPLES

BEFORE THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

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U. S. Securities and Exchange Commission
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STATEMENT OF RICHARD C. BREEDEN
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Good morning Chairman Riegle and Members of the Committee.

I am pleased to be with you again this morning to discuss the accounting principles utilized by financial institutions. As recent history should vividly demonstrate, the accounting principles that federal regulators promulgate or permit financial institutions to utilize can have an enormous impact on the appearance of solvency of firms, as well as on the rate of their growth and the pattern of their risk-taking. If misused, accounting principles can conceal insolvency from creditors, investors and regulators. In some cases, as with the thrift regulators' dilution of accounting standards, discussed below, the accounting rules may facilitate fraud on investors. In other cases, accounting principles may be used to justify postponing treatment or resolution of even fatal problems in particular firms at the very time they may be expanding through the use of publicly-guaranteed funds.

Misuse of accounting standards played an extremely large, and in some ways pivotal, role in allowing the rapid and reckless growth of the thrift industry, as well as in concealing the depth of its problems. In response to the Committee's inquiry, this testimony will seek to trace the role that misuse of accounting principles played in the collapse of the thrift industry. At the outset it should be noted, however, that many other factors were involved in the creation of this problem over a period of decades. The availability of federal deposit insurance was obviously a prerequisite to the willingness of the public to add more than one-half trillion dollars in deposits with thrift institutions in less than a decade. Other factors included chronic underfunding of the Federal Savings and Loan Insurance Corporation ("FSLIC") through inadequate premium levels; fundamental conflicts of interest in the structure of the regulatory system; excessive influence by the regulated firms and their trade association over the Federal Home Loan Bank Board ("FHLBB"); statutory forbearance requirements and other causes. Since these issues are beyond the scope of the Committee's inquiry, they are not addressed by this testimony.

In the following testimony, I hope to answer the specific questions posed by the Committee and to address three broader themes. First, I would like to describe the role played by specific regulatory accounting principles ("RAP") and inappropriate or unique interpretations of generally accepted accounting principles ("GAAP") in the growth, and ultimate collapse, of the thrift industry overall. Second, I would like to review how the operation and impact of specific accounting standards and regulatory interpretations adopted by thrift regulators facilitated the distortion of capital levels and the dramatic expansion of loan and investment activities by thrifts. Finally, in discussing the issue of the "trading" portfolio versus the "investment" portfolio, I would like to review the broader issue of market-based accounting and its bearing on the proper role of financial accounting for financial institutions.

I. THE ROLE OF CAPITAL REQUIREMENTS AND BUSINESS EXPANSION IN THE THRIFT CRISIS: ACCOUNTING FACTORS

A. The Systemic Industry Problems

As the Committee appreciates, the assets of savings and loan institutions traditionally were concentrated in long-term, residential mortgage loans, typically at fixed rates of interest. These mortgage loans were largely funded by very short-term deposits. This fundamental maturity imbalance between long-term assets and short-term liabilities meant that the net worth and earnings of thrift institutions were inherently vulnerable to interest rate fluctuations.

At the same time, federal law capped the rate of interest that could be paid on bank and thrift deposits. This made thrifts vulnerable to periodic bouts of disintermediation when market rates exceeded permissible interest payment ceilings. While the rate ceilings created periodic problems in funding new mortgage originations, they also acted like a governor on an engine to prevent it from running too fast and overheating. Because rates were limited, it was very difficult for institutions to grow rapidly in size. Small problems, therefore, tended to remain small for extended periods of time. This gave even a slow regulatory system the time to discover and to correct problem situations.

In the 1970s, the nation experienced extended periods of inflation and interest rate volatility, and new consumer-oriented financial products, such as money market mutual funds, were developed that paid market rates of interest.

Depository institutions lost large volumes of their controlled-rate federally insured deposits, and they did not have the authority to offer comparable uninsured products. In response to these developments, regulators authorized thrift institutions in May, 1978 to offer six-month money market certificates in $100,000 denominations priced slightly above U.S. Treasury bills of the same duration. 1/ Then, in 1980, Congress enacted legislation that, among other things, created interest-bearing checking accounts for individuals and established a schedule for the deregulation of interest rates paid to depositors. 2/ The 1980 legislation also vastly expanded the scope of federal deposit insurance by increasing the amount of insurance per account from $40,000 to $100,000.

Following the expansion of the deposit insurance coverage and the removal of all rate limitations, depository institutions were suddenly able to raise virtually unlimited volumes of deposits. Depositors were largely indifferent to the financial health of the institutions to which they lent money because they were shielded by federal insurance. A brokered deposit business emerged to direct deposit money toward institutions paying the highest rates of interest, which were generally the institutions representing the greatest risk. Thus, a system of slow growth due to

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1/ See FHLBB, "New Certificate Accounts," 47 Fed. Reg. 21,438 (1978).

2/ Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.).

limited funds availability was replaced in a very brief time with one in which institutions could raise and lend out vast sums in a very brief period.

Few, if any, market restraints existed due to the presence of government deposit insurance. This left a regulatory system, designed in many respects for a system of small, mutual institutions incapable of rapid growth, as the sole discipline for a vastly expanded industry now equipped with the funding equivalent of jet engine afterburners capable of sudden and dramatic acceleration of growth.

Throughout the 1970s and 1980s, thrifts also experienced increased competition and lower spreads from their portfolio mortgage lending due to the growth of increasingly efficient secondary markets for mortgage-backed securities. Thus, thrifts were no longer the dominant source of liquidity for mortgages, and the origination function often could be performed by mortgage bankers and others at much lower cost.

While the average cost of funds for thrift institutions rose from seven percent in 1978 to just over 11 percent in 1982, the preponderance of long-term, fixed-rate mortgages in thrift portfolios prevented a corresponding increase in revenues. In both 1981 and 1982, the average cost of funds actually exceeded the average return on mortgages. On a true market value basis, the thrift industry as a whole was probably insolvent as early as the mid-1970s. Insolvencies became widespread during the period from 1978-1980. 3/

In 1982, Congress enacted legislation that accelerated the removal of interest rate controls by permitting new money market deposit instruments. This legislation also authorized federally-chartered thrifts to invest up to 40 percent of their assets in nonresidential real estate lending, and to invest as much as 30 percent of assets in consumer loans. 4/ These changes in federal law allowing greater diversification of portfolio assets by federally-chartered thrifts were modest compared to the actions of California, Texas and certain other states, which in the early 1980s essentially removed all portfolio or business activity limitations. 5/ Thus, statutory change at both the state and federal level altered the types of lending and the overall risk pattern of the thrift industry.

So long as it was done in a prudent manner, diversification of asset powers to allow thrifts to offer credit cards or to extend other types of non-mortgage loans was a means to reduce, rather than to increase, the risk structure of the thrifts.

3/ See E. Kane, The S&L Insurance Mess: How Did It Happen? 75 (1989). Kane estimates that in 1978, on a mark-to-market basis, the thrift industry had, in the aggregate, a negative net worth of between 6.87 percent ($35.1 billion) to 10.31 percent ($52.7 billion) of total industry assets. Kane also estimates that by 1980, the negative net worth had increased to between 12.78 percent ($78.6 billion) and 19.17 percent ($117.95 billion) of assets.

4/ Depository Institutions Act of 1982, Pub. L. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.).

5/ See, e.g., Cal. Fin. Code Section 7250 (West 1989); Tex. Banking Code Ann. Section 852a (Vernon 1989).

Indeed, one reason for the problems of the thrifts was their dependence on only one basic product. Over time, other firms became more efficient in various aspects of mortgage financing, and it was difficult for most thrifts to diversify. In addition, thrifts had been restrained from reducing their interest-rate vulnerability due to fixed rate mortgages. Indeed, with strong Congressional support, the regulatory policies of the FHLBB during the late 1970s did not authorize federally-chartered thrifts to offer adjustable rate mortgages. These types of mortgages were not authorized for federal thrifts until June 1981. 6/

By the early 1980s, Congressional action to reduce the dependency of thrifts on fixed rate mortgage lending was long overdue. However, entering new lines of finance or other types of business, without experience or market share, often results in heavy start-up losses. By this time, most thrifts were already insolvent, though their financial statements did not have to portray this insolvency. As a result, many thrifts had to fund losses incurred in entering new lines of business with deposits, rather than absorbing such losses out of stockholders equity or earnings. Restricting new thrift lending powers to those institutions with high levels of tangible capital (or conducting such activities in separately capitalized holding company affiliates unable to draw on the capital or funding of the thrift itself) would have prevented sensible product diversification from having an adverse impact on the deposit insurance fund.

6/ See FHLBB, "Adjustable Mortgage Loan Instruments," 46 Fed. Reg. 24,148 (1981).

B. Thrift Capital Levels

One potential source of discipline, appropriate capital requirements, would have served both to assure that thrift owners risked some of their own money in the loans they made, and to provide a cushion against loss. More important, a meaningful capital standard would have served as a check against uncontrolled growth, since the permissible level of investment is directly tied to capital requirements.

The thrift industry was permitted to engage in unchecked expansion, however, because, starting in the 1970s and continuing into the mid-1980s, the thrift regulators consistently acted in a manner that eroded the discipline of a capital standard during the period when it was most necessary. In November 1980, the FHLBB lowered the minimum net worth and reserve requirements that thrift institutions were required to satisfy from five percent to four percent. It further reduced capital requirements to three percent in January 1982. Thus, just as thrifts obtained vast new abilities to raise deposits, the regulatory agency acted to increase industry leverage from 20:1 to over 33:1. See the attached Chart 1.

In practice, the discipline that might have been provided by capital requirements was significantly eroded by two other regulations of the FHLBB. These were known as the "five-year averaging" and "20-year phase-in" provisions. Whatever their original rationale, 7/ these provisions led to disastrous results

7/ Both provisions were designed, at least in part, to permit a gradual building of reserves and net worth by mutual institutions financing residential mortgages in local markets.

when used by institutions that could attract deposits on a nationwide basis and engage in commercial lending and direct investments.

The "five-year averaging" provision was adopted by the FHLBB in December, 1972. 8/ This regulation permitted thrifts to base the calculation of their minimum net worth and reserve requirements on average liabilities and deposits over the five year period comprising the year of the calculation and the preceding four years, rather than on current liabilities and deposits. 9/ This method of computation drastically lowered capital requirements for those thrifts that had expanded most aggressively.

For example, assuming a three percent capital requirement, if a thrift increased its deposits by 100 percent annually for five years, its capital requirement ultimately would be lowered by 61 percent. Stated differently, if a thrift accepted $100 million in new deposits it would require $1.16 million in additional capital, rather than the $3 million that would have been required without averaging (and the approximately $5 - 6 million that would have been required for a bank to accept the same $100 million in deposits at that time). To further illustrate the effects of five-year averaging, if a thrift with liabilities of $100 million experienced 1000 percent growth in one year (which was not

8/ 37 Fed. Reg. 26,579 (1972). The original provision called for three-year averaging. 36 Fed. Reg. 21,667 (1971).

9/ The minimum net worth requirement was computed as a percentage of total liabilities, and the minimum statutory reserve requirement was computed as a percentage of insured deposits.

unknown in the industry), its capital requirement for accepting and relending $1 billion in funds would be would only $9 million, compared with at least $50 - $60 million for a bank. The aggregate industry-wide reduction (or dilution) of the capital required to support the growth of thrifts due to five-year averaging was very significant. See Chart 2 for an illustration of the effect on capital requirements of five-year averaging in a hypothetical case.

The "20-year phase-in" provision lowered capital requirements for newly-chartered thrift institutions that had not reached their twentieth anniversary of deposit insurance. New thrifts using this provision determined their capital requirements by multiplying three percent of their liabilities by the fraction of twenty years that the thrift had been covered by deposit insurance. Thus, a newly insured thrift needed to have only one twentieth of the normally-required reserves and net worth (5 percent or 3 percent depending on the time period). By permitting a debt-to-equity ratio as high as 666 to one, this provision essentially eliminated any meaningful capital restrictions on growth for the newest and most inexperienced thrifts trying to break into a volatile and changing industry. 10/ The effects of 20-year phase-in on the leverage of a hypothetical thrift with capital of $1 million is depicted in Chart 3.

10/ Prior to November 1983, when the FHLBB eliminated the use of the 20 year phase-in provision by new applicants for insurance, a new institution could leverage $2 million in initial capital stock or pledged savings to support $1.3 billion in liabilities after the first year. See FHLBB, "Reserve Requirements and Policies Relating to Insurance of Accounts of de Novo Institutions," 48 Fed. Reg. 54,320, 54,324 (1983).

The reduction of capital requirements, when combined with the use of overly permissive accounting practices (discussed in Part II below), permitted thrifts that were teetering on a shrinking or nonexistent capital base to engage in high-velocity expansion. Indeed, from year-end 1980 to year-end 1985, aggregate thrift assets grew from $621 billion to $977.5 billion. During the same period, although RAP permitted capital to be shown as increasing, aggregate industry tangible capital fell from more than $32 billion to only $3.2 billion. See Chart 4.

Thus, in only five years, taxpayer risks grew by more than $400 billion, or more than 72 percent, while tangible capital levels were falling precipitously. With virtually no capital at risk, the operators of such thrifts had nothing to lose and everything to gain by adopting a strategy of rapid growth and enormous risk-taking. In fact, it was precisely those thrifts in the most precarious position that had the greatest incentive to engage in speculative business activities.

Whether financial regulators should have permitted the continued operation of troubled thrift institutions is a separate question from whether those regulators should have fostered accounting principles that had the effect of creating an <u>appearance</u> that those thrift institutions complied with capital requirements. If a decision was made to forbear closing institutions due to an expectation that a change in the economy or other factors would permit their recovery, that decision should at least have been made openly. Instead, accounting principles were modified in a way that allowed insolvent institutions to appear to have positive net worth, thereby creating, in effect, a "stealth" balance sheet. Through accounting prestidigitation, net worth suddenly appeared out of a sea of insolvency.

In December, 1983, the Task Group on Regulation of Financial Services (Task Group), which was chaired by then-Vice President Bush and included the heads of all federal financial regulatory agencies, adopted and announced an initial recommendation that the FHLBB should be required to utilize the same capital standards as the Federal Deposit Corporation ("FDIC"), as well as the same accounting principles for determining such capital. Total thrift assets at the time of this recommendation were approximately $820 billion. These recommendations were included in the Task Group's final report, entitled Blueprint for Reform, which was issued in late 1984. 11/ Legislation to implement these recommendations was introduced in early 1987. Unfortunately, these recommendations were not enacted into law until the passage of FIRREA, signed into law on August 9, 1989. 12/ By the time this legislation was adopted, aggregate thrift assets were approximately $1.25 trillion, an increase of roughly $430 billion, or approximately 50 percent in the more than five years since the original recommendations of the Task Group to tighten thrift capital and accounting standards.

11/ See Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services 82 (1984).

12/ Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 and 15 U.S.C.).

II. HOW THE THRIFT ACCOUNTING TECHNIQUES FACILITATED EXPANSION WITHOUT REAL CAPITAL AND CONCEALED TRUE FINANCIAL CONDITION

A. RAP Techniques and GAAP Interpretations

The Committee's letter of request invites discussion of two separate issues: (1) the differences between GAAP and RAP, and (2) the extent to which problems associated with the thrift industry may have stemmed from a lack of adequate standards as opposed to a failure to enforce existing standards. These two issues are related aspects of the problems created by the use of accounting standards to create the appearance of solvency among thrift institutions that in economic fact were not solvent. 13/ Unlike the fabled "emperor's new clothes," however, the thrift accounting standards did conceal the underlying reality from most observers. Indeed, the appearance of earnings and solvency was used to justify not only expansion, but also dividends, enormous salaries, acquisitions, and many other expenditures that drained cash from failing firms.

"Regulatory accounting principles" are accounting standards established by regulatory agencies to monitor compliance with statutory and administrative requirements. In the case of federally insured depository institutions, RAP govern the financial reports that are submitted to the relevant federal oversight agency.

13/ While this testimony focuses on the impact of RAP accounting and the standards imposed by the regulators, it is also fair to ask whether these standards were appropriately applied by financial institutions and their outside auditors. As the numerous lawsuits against outside auditors suggest, there are substantial questions about whether auditors fulfilled their obligations.

The most legitimate justification for the use of RAP would be to require more conservative reporting of earnings or net worth by a regulated firm than GAAP might be interpreted to permit. However, the actions of the FHLBB relating to RAP over a significant period were designed to permit the firms overseen by the FHLBB to report an inflated net worth compared to that permitted by GAAP.

By contrast, generally accepted accounting principles are established by private sector standard setters such as the Financial Accounting Standards Board ("FASB") 14/ and the American Institute of Certified Public Accountants ("AICPA"). 15/ This development of standards by the professional accounting bodies takes place under oversight of the Commission. GAAP, including those principles that specifically address the financial services industries, provide the framework for the accounting measurements and disclosures that are required for the sale of securities and periodic financial reports by every type of public company.

Banks and thrifts that are not part of a holding company are the only firms exempted from the uniform application of the Securities Act of 1933 ("Securities

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14/ The FASB issues guidance in the form of Statements of Financial Accounting Standards ("FASs"), Interpretations, Technical Bulletins, Statements of Financial Accounting Concepts and minutes of The Emerging Issues Task Force.

15/ The AICPA issues guidance in the form of Notices to Practitioners, Industry Audit and Accounting Guides, Statements of Position, Accounting Interpretations, Issue Papers and Accounting Standards Executive Committee ("AcSEC") Practice Bulletins.

Act") and the Securities Exchange Act of 1934 ("Exchange Act"). 16/ As a result of Exchange Act Section 12(i), four separate federal banking and thrift regulators -- not the Commission -- have the authority and responsibility to administer and to enforce the disclosure and reporting provisions of the Exchange Act with respect to publicly-held banks and thrifts. 17/ The anomalous result is that while 11,000 public companies, including 1,100 publicly-owned bank and thrift holding companies, are subject to Commission review, some 650 publicly-owned banks and thrifts that are not part of holding companies are exempted from Commission oversight.

One result of this splintered authority was that the FHLBB, not the SEC, presided over hundreds of initial public offerings of thrift common stock to the public during the years in which it was allowing the use of distorted financial statements for thrifts. Thus, the opportunity for another agency to require public disclosure of these thrifts' true financial condition was lost.

Having adopted standards which permitted net worth to be overstated, the FHLBB could not represent any meaningful independent protection for investors. Indeed, the FHLBB actually had an enormous conflict in overseeing the Securities Act. Every dollar of equity raised by thrifts from investors benefitted the FSLIC

16/ Securities Act Sections 3(a)(2), (5), 15 U.S.C. 77c(a)(2), (5); Exchange Act, Section 12(i), 15 U.S.C. 78l(i).

17/ These are Exchange Act Sections 12 and 13 (the continuous reporting provisions), Section 14 (the proxy provisions) and Section 16 (governing reporting of insider transactions and short-selling trading).

(part of the FHLBB). Thus, the agency with discretion over how much bad news investors should know about directly benefitted from every dollar that was invested. This same conflict exists today with the FDIC.

The Commission has long advocated repeal of Exchange Act Section 12(i) and modification of Sections 3(a)(2) and 3(a)(5) of the Securities Act, to remove these discrepancies. In 1984, all the federal financial regulatory agencies concurred with this recommendation of the Task Group on Regulation of Financial Services chaired by then-Vice President Bush, as a means of providing better and more consistent protection to investors at lower cost. These reasons have, if anything, become more compelling in the intervening time. As the following discussion will show, the fragmentation of reporting and accounting oversight also contributed to the thrift industry problems.

During the early 1980s, thrift RAP were significantly more liberal than GAAP. For example, thrift regulated entities were permitted by RAP to employ accounting techniques whereby:

- thrifts could increase capital by the amount that certain assets had appreciated above recorded depreciated cost, without recognizing the decrease in value of other assets;
- loan origination fees could be immediately recorded as income on a basis more liberal than GAAP would have permitted; and
- losses on assets sold could be amortized over the remaining contractual life of the asset.

Thrift regulators also tolerated flawed interpretations of GAAP that enabled the regulated entities to comply with the lowered capital requirements. As a result, regulated thrifts:

- amortized expenses of acquiring troubled thrifts over 40 years while booking income on the discounted market value of assets over 10 years;
- created intangible assets and income from assisted combinations of troubled thrifts;
- accelerated income on certain real estate investments; and
- capitalized losses on speculative forward commitments.

Thus, it was the interpretations of GAAP combined with RAP that masked the erosion of capital in the industry. 18/ Literally thousands of thrift institutions were not only permitted to continue operations, but even allowed to grow enormously in size, even though they were economically insolvent.

As Chart 5 shows, the application of GAAP would have resulted in a significantly larger number of thrifts being classified as "insolvent," in each of the years following 1982.

B. Use of RAP to Avoid Risking Capital

1. Appraised Equity Capital

Appraised equity capital, authorized by the FHLBB in late 1982, was a technique that allowed a thrift to increase capital by the amount that certain of its

18/ A more detailed discussion of the manner in which these techniques and interpretations were manipulated by the regulated entities to avoid real capital risk is set forth below.

capital assets (e.g., property and equipment) had appreciated above their recorded depreciated cost. 19/ The rule permitted thrift institutions to recognize appreciation in the value of buildings even where those assets had not been sold, with a corresponding increase in net worth for RAP purposes.

As discussed in the last section of this testimony, a market-value approach to accounting rather than historical cost should be utilized wherever possible to provide a more accurate picture of an entity's net worth. However, the thrifts were implementing this approach highly selectively. Indeed, only adjustments that increased the value of certain assets were made, and there was not any obligation to recognize the far greater decrease in value of other assets.

The appraised equity capital rule became ineffective as of December 31, 1986. 20/ During its life, the rule resulted in an estimated increase to reported regulatory net worth of $2.2 billion -- approximately four percent -- as of that date. Thus, more than $65 billion in deposits were allowed to be accepted and loaned out backed solely by such write-ups. 21/

2. Loan Fees

Beginning in 1979, thrifts were allowed to recognize income from construction loan fees for RAP purposes on a basis that was more liberal than

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19/ FHLBB, "Amendments to Net Worth and Statutory Reserve Requirements," 47 Fed. Reg. 52,961 (1982).

20/ FHLBB, "Appraised Equity Capital," 50 Fed. Reg. 45,988 (1985).

21/ R. Brumbaugh, Thrifts Under Siege: Restoring Order to American Banking (1988) at 44. These calculations are based on data supplied by the FHLBB.

permitted by GAAP. Thrifts were allowed to recognize income from loan fees equal to 2.5 percent of the loan amount, plus $400, immediately upon origination of a loan. Thus, for a $20 million construction loan, RAP would allow a thrift to record $500,400 in loan fee income [($20 million x .025) + $400] on the day of closing. In contrast, GAAP allows immediate recognition of loan fee income only to the extent of costs incurred in originating loans, which in this example might reasonably have been $100,000. The remainder of the fees are taken into income ratably over the life of the loan if it remains current, or upon sale. The earnings for RAP purposes arising from loan fees were greatest for those thrifts with significant construction loan volume. This almost certainly induced many institutions to enter into additional construction loans (however risky) in order to generate immediate income. A thrift making $1 billion per year in new construction loans, for example, could report $25 million per year in income from loan origination fees, even though the loans might be extraordinarily speculative and ultimately might never be repaid.

3. Loan Loss Deferrals

As noted above, many thrifts maintained large portfolios of low-interest, long-term mortgage loans that, in the high-interest rate environment of the early 1980s, could be sold only at a substantial discount from their face amount. Both GAAP and RAP allowed such portfolios to be carried at cost, without reflecting the dramatic and very real loss in market value that had occurred. However, if any such mortgage loan was sold (such as to a secondary mortgage agency), GAAP required the full amount of the actual loss to be recognized. 22/

To encourage portfolio restructuring, the FHLBB issued regulations in 1981 that allowed thrifts to book the entire amount of a loss on sale as an asset for RAP purposes. Thrifts could then amortize the losses realized on the sale of such loans over the remaining contractual life of the assets sold. For example, a thrift that sold a $500 million face amount of mortgages and incurred a loss of $150 million could treat this accumulated and realized loss as an asset included in net worth. The thrift could, as a result of the accounting entry, maintain its current level of activity without injecting new capital, notwithstanding a $150 million reduction in the real value of the enterprise.

The deferral of losses on assets sold created a major divergence between GAAP and RAP measures of net worth. Deferred losses exceeded $6.3 billion, or 13 percent of reported regulatory net worth, as of December 31, 1985. At then-applicable capital levels, this $6.3 billion in losses was all the capital required to continue to support $207.9 billion in loans.

The option to defer losses on assets sold encouraged thrifts to incur more risk. Since thrifts could book 2.5 percent loan origination fees as income immediately, many thrifts reported substantial profits from relending the proceeds from the sale of old loans that created losses that would not be fully recognized for

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22/ As discussed in the last section of this testimony, the use of mark-to-market accounting would eliminate this incentive to hold assets that can be sold only at a discount from book value.

as long as 30 years. Thrifts also received tax benefits from the sale of old loans, since the sales resulted in realized losses for tax purposes.

C. Accounting Interpretations

1. Purchase and Goodwill Accounting

In the early 1980s, the FHLBB encouraged and facilitated the sale of financially troubled and insolvent thrifts to healthier institutions. As part of many such transactions, the staff of the FHLBB permitted accounting techniques with respect to the treatment of goodwill that made the acquisition of troubled thrifts more attractive.

The "buyer" in such transactions often put up little or no cash because the institution being acquired had little real value. Indeed, in many cases, the buyer assumed the assets and liabilities of an institution with a significant negative value. The assets of these troubled thrifts (mostly long-term mortgages) had, for the most part, depreciated in value as a result of changes in interest rates. In accordance with GAAP, they were recorded on the buyer's books at fair market value. The "discount," or difference between the original book value and the fair market value, was booked as income over the estimated life of the assets on an interest-method basis. The net liabilities (i.e., the fair value of total liabilities less the fair value of the assets acquired) were recorded as goodwill and expensed on a straight-line basis over an amortization period.

GAAP recognize that there is considerable judgment to be applied in determining the appropriate amortization period for goodwill, specifying only that the goodwill be amortized over the period benefited, not to exceed 40 years. Many thrifts were permitted by thrift regulators to use the maximum 40-year period, resulting in a yearly "expense" for goodwill of one-fortieth of the total amount. Because the typical life of the purchased assets averaged about 10 years, however, this meant that the "discount" was recorded as income over a shorter period. Thus, during the first 10 years after the acquisition, the income from amortizing the purchase discount would exceed the expense from goodwill, generating net income for the acquiring thrift. 23/

From 1974 to 1981, FHLBB guidance required thrifts to amortize goodwill over no more than 10 years. 24/ In August 1981, the FHLBB directed its staff to eliminate this restriction on acceptable goodwill amortization periods, with the result that some thrifts indiscriminately used the 40-year maximum amortization

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23/ The impact of this provision can be seen in the treatment of an acquisition of a troubled thrift whose assets had lost $1 billion in actual value from a face amount of $3 billion, due to an increase in interest rates. In this circumstance, a buyer that assumed the net assets would have recorded liabilities of $3 billion, loans of $2 billion and goodwill of $1 billion. Absent payment defaults, in subsequent years the loan balance would be gradually increased to correspond to the principal payments of $3 billion. These increases would result directly in additions to interest income of $1 billion. Assuming the loans have an average estimated maturity of ten years, and that the income is recognized on a straight-line basis, income will be increased by $100 million in the first year solely as a result of this amortization practice. Assuming the goodwill is amortized over 40 years, the goodwill expense will be $25 million in the first year, resulting in a net increase to net worth of $75 million (before tax) after one year and $750 million after 10 years. Further, since GAAP requires amortization of loan discount using the interest method, the enhancement of income in the earlier years is amplified.

24/ FHLBB Memorandum R-31a (March 8, 1974).

period allowed by GAAP. 25/ While this accounting treatment purportedly was based on GAAP, the SEC refused to allow thrift holding companies reporting to the Commission to amortize goodwill over a period longer than 25 years. Shorter periods were required when the transaction involved a troubled institution. 26/ The ability to extend the amortization of goodwill had the effect of increasing the apparent profitability of acquiring institutions, as well as increasing the overall capital of the thrift industry by eliminating the capital shortage of the insolvent thrifts.

25/ See FHLBB, "Treatment of Goodwill Acquired in Mergers," 46 Fed. Reg. 42,274 (1981). The FHLBB had earlier proposed to adopt a regulation codifying the guidance in Memorandum R-31a, stating that "[t]he use of different accounting periods in this instance may give rise to distortions in net worth levels and computations." 45 Fed. Reg. 72,661, 72,662 (1980).

26/ This position was embodied in Staff Accounting Bulletin ("SAB") No. 42, an interpretative release issued in 1981. The FASB ultimately adopted the general concepts of this interpretive position as an industry-specific GAAP, FAS No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions, issued in February, 1983. FAS No. 72 requires that goodwill, to the extent that it results from the assumption of excess liabilities, be amortized on an interest method over the life of the interest bearing assets acquired. It also requires that regulatory assistance be netted against goodwill.

SAB No. 42A was issued in December 1985 to deal with issues relating to the formation of thrift holding companies that become Commission registrants. This SAB indicated that the use by such companies of the long goodwill amortization periods permitted in their filings with the FHLBB would not be acceptable in Commission filings. It further noted concerns with the use in Commission filings of purchase accounting (with 40-year goodwill) for mergers of failing institutions.

The change in accounting standards for goodwill created purely imaginary earnings and net worth for regulatory purposes. In 1982 alone, over $15 billion in goodwill was created in purchase transactions, thereby enabling thrifts to maintain approximately $500 billion in deposits and to make an equivalent volume of loans without a single dollar of tangible capital investment. In that year, goodwill as a percentage of total industry GAAP capital rose from six percent to approximately 82 percent. 27/

The dramatic effects of these accounting techniques on the capitalization and discounting of goodwill in the presentation of thrift capital can be seen in Chart 6.

The extended period for amortization of goodwill coupled with the 10-year booking of acquisition discount as earnings, as Chart 7 shows, also produced a distorted and misleading picture of income.

In some instances, specific types of transactions were structured to take advantage of these and similar measures. As the number of insolvent thrifts expanded rapidly in certain areas of the country, thrift regulators had difficulty soliciting financially sound buyers. In what were referred to as "Phoenix" transactions, the regulators would select several thrifts, which were usually all

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27/ W.K. Black, Ending Our Forbearers' Forbearance: FIRREA and Supervisory Goodwill, Stan. L. & Pol'y. Rev. (Spr. 1990) 100, 106 (citing R. Brumbaugh, supra, note 21 at 40-41, 50). The figures provided include all industry goodwill, and are not limited to goodwill affected by the techniques described above. However, it has been estimated that as much as 90 percent of aggregate thrift goodwill was related to such "supervisory acquisitions."

insolvent, and designate one of the insolvent thrifts as the purchaser of the others. By applying purchase accounting and goodwill concepts, the new, but still economically insolvent, thrift formed by the combination immediately generated reported profits. The shorter amortization period applied to the discount on purchased assets relative to that which applied to the corresponding goodwill resulted in a substantial artificial inflation of earnings. 28/

2. Acquisition, Development and Construction Lending Loans

During the 1980s, financial institutions, especially thrifts, engaged in types of transactions involving the funding of real estate development that were

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28/ As a result of the passage of FIRREA, existing capital standards were required to become not less stringent than those utilized for national banks. In addition, FIRREA mandates an additional capital test by requiring that, irrespective of the level of GAAP capital, a thrift must also have a minimum level of capital excluding computation of goodwill and other non-tangible items. This provision is vital to insuring that thrift operators must have their own funds at risk in their operations, and that all new deposits and loans must be backed by a minimum amount of tangible capital, not simply goodwill or other intangibles. The Office of Thrift Supervision ("OTS") recently has attempted to withdraw permission for thrifts to use long goodwill periods for RAP purposes. This transitional rule provided for the phase-out of the use of supervisory goodwill for purposes of calculating "core capital" by December 31, 1994. In a few cases, lower courts have allowed thrifts to continue to recognize supervisory goodwill because these institutions had received FHLBB staff "forbearance letters" authorizing the longer period of goodwill prior to the enactment of FIRREA. Even though such promises were often made by the staff, and were not voted on by the FHLBB itself, at least two lower courts have held that the letters are binding notwithstanding the provisions of FIRREA. See, e.g., Winstar Corp. v. U. S., No. 90-8C (Ct. Cl. July 27, 1990) (35-year goodwill amortization period upheld), and Franklin Federal Savings Bank v. OTS, CIV-2-90-166 (D. Tenn., July 16, 1990). The excesses permitted in this area, therefore, continue to affect the industry.

mischaracterized as lending activity. Acquisition, development, and construction ("ADC") loans typically were structured so as to give the financial institution the risks and rewards of investor participation rather than the lender's normal principal and market rate of interest payment arrangement.

GAAP require that accounting treatments reflect the substance of transactions rather than their form. By improperly characterizing these transactions as "loans," financial institutions were able to inflate their income. For example, on a $10 million mortgage at 12 percent that was legitimately structured as a loan, the lender would normally recognize interest income of at least $1.2 million per year. 29/ However, if the transaction were structured so that the lender (and not the borrower) had significant capital at risk, interest accrual would not be appropriate because the transaction would be accounted for as a joint venture transaction. 30/

To assist institutions and auditors in evaluating the substance of ADC transactions, the AICPA published a series of guidelines beginning in 1983. 31/

29/ As noted earlier, RAP treatment of loan fees resulted in substantial additional income in the period that the loan was made.

30/ Where the transaction is accounted for as a joint venture, the financial institution might be able to capitalize the interest payment, which would increase the carrying amount of the asset. The benefit to the financial institution of this accounting treatment, however, would be less than the benefit of including interest income.

31/ See, e.g., Notice to Practitioners, "Certain Real Estate Lending Activities of Financial Institutions" (November 1983); Notice to Practitioners, "ADC Loans" (November 1984). In February 1986, the AICPA issued new and expanded guidance (continued...)

In October 1984, the FHLBB proposed to adopt a statement of policy concerning the regulatory accounting for certain real estate activities. 32/ This policy, which was intended to be consistent with the AICPA's guidelines, was not adopted until April 1985, and was applicable only to transactions occurring after that date.33/

ADC loans proved to be a major problem area, as thrifts suffered large losses from high risk investments improperly accounted for as loans. Given the judgmental nature of the accounting requirements in this area, and the temptation to report investments as loans (thereby obtaining up-front fee income and accelerated recognition of interest), unequivocal guidance and strict enforcement by the FHLBB were necessary, but did not occur in many cases.

3. Repurchase Transactions

During the mid-1980s, some financial institutions engaged in certain speculative forward commitment transactions, known as "dollar-rolls," that were

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31/ (...continued) which encompassed the earlier notices. Notice to Practitioners, "ADC Arrangements" (November 1986). The guidance was generally consistent with how the Commission staff applied the accounting literature.

32/ 49 Fed. Reg. 43,557 (1984).

33/ FHLBB, "Statement of Policy, Accounting for Acquisition, Development and Construction Loans," 50 Fed. Reg. 18,233 (1985). The adopting release stated that "classification of ADC transactions is best left to the insured institution and its independent public accountant," and indicated that examiners would review the institution's documentation of its decisions and that supervisory agents would review any examiner's concern and discuss them with the institution. 50 Fed. Reg. at 18,235 (1985).

accounted for as borrowing/lending (financing) arrangements. The effect of accounting for these transactions as financing was to defer loss (or gain) recognition.

The most significant example of this practice was that engaged in by Financial Corporation of America ("FCA"), a public holding company. Reports filed with the Commission showed that, as of June 30, 1983, FCA had total assets and stockholders' equity of $10.7 billion and $219 million, respectively. During the third quarter of 1983, three significant factors affected FCA's size and operations: American Savings & Loan Association was acquired, which approximately doubled FCA's asset base; FCA initiated a program of purchases of securities financed by repurchase agreements; and FCA aggressively sought increased deposits, including brokered deposits. By September 1984, 13 months after the American S&L acquisition, FCA's assets had more than tripled to $32.4 billion and repurchase obligations, which had been non-existent in June 1983, had risen to $7 billion, or approximately 22 percent of total assets.

In mid-1984, the Commission's staff determined that FCA's investment and repurchase transactions were, in substance, forward commitments to purchase securities. Since GAAP preclude accounting for such transactions as leveraged investments and recognize that these are speculative transactions, mark-to-market accounting is required for these commitments. The application of mark-to-market resulted in restatement of FCA's financial statements, including recognition of a loss of $155 million on these transactions. Further, following the loss recognition, FCA experienced serious liquidity problems, including a single quarter withdrawal of deposits of $6.84 billion. Ultimately, FCA became insolvent, and resulted in a loss to the public of billions of dollars.

The foregoing is not, of course, a complete survey of all the differences between RAP and GAAP for both banks and thrifts. In some cases, the bank regulators (and post-FIRREA the OTS) have adopted principles that are more conservative than GAAP. However, in order to make sure that RAP might not be utilized in the future to weaken accounting principles and to conceal financial problems, we should consider other long-range improvements to accounting by financial institutions.

III. THE PROPER ROLE OF FINANCIAL REPORTING: MARKET BASED ACCOUNTING

The Committee's last question focuses on a matter that is also a major area of current Commission concern: the valuation of financial instruments held by financial institutions. Under current practice, GAAP for banks and thrifts are based principally on a historical cost framework. These institutions are permitted to carry assets on their books at amortized cost, even in instances where the current value of the assets has eroded substantially, and where a market-based standard would provide a far more accurate measure of the institution's financial health.

As we enter the decade of the 1990s, we should consider a fundamental shift in the goal we set for the accounting standards for financial institutions. Financial institutions are in the business of buying and selling financial instruments, all of which have a value measured in terms of current market conditions. Determining the current value of an institution's assets, not recording their original cost, should increasingly be the goal toward which we must work.

The bedrock for current general-purpose financial reporting for almost all industries is the "historical" cost model. 34/ In most cases, historical cost produces reliable information because it is based on verifiable recorded amounts for transactions. However, as many observers have noted, the cost system has been subject to abuses and can lose its relevance in a changing economic environment, such as that experienced by the thrift and banking industries in the 1980s. As observed by Edward J. Kane, using historical cost undervalues an institution's best portfolio decisions and overvalues its worst ones. Worse, by not modifying carrying values to reflect subsequent market developments, irrefutable and often readily observed evidence is neglected. 35/

The nation's experience with the crisis in the savings and loan industry, as well as many of the largest bank failures, demonstrates the inherent and

34/ Under the historical cost model, most assets are recorded at their acquisition price, which is presumed to be more objective. Departing from the historical cost rule (i.e., using the lower of cost or market, or "LOCOM") is generally done only when the future utility (or revenue-producing ability) of an asset is less than its cost. Such differences should be recorded in the period in which they occur. (See, e.g., Financial Accounting Standards Board Statement of Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," (December 1984), paragraphs 67-69; Accounting Principles Board, "Accounting Research Bulletin No. 43," Chapter 4, paragraphs 8 and 9.)

35/ E. Kane, supra note 3, at 31.

substantial dangers of a reporting system for financial institutions that is premised on historical cost accounting principles. Market-based information can permit regulators and investors alike to make a much more meaningful assessment of the real economic value and risk exposures of a financial institution. Knowing current market value also allows regulators to take appropriate actions before a situation deteriorates irretrievably.

When a financial institution becomes insolvent, the loss to the insurance fund, and ultimately to the taxpayers, is measurable based solely on the market values of its assets and liabilities -- historical costs are irrelevant. The risk exposure to the insurance system should therefore be calculated on the same basis that its ultimate obligation will be calculated. Although market values perhaps cannot be measured with the same degree of precision as historical costs, it has been appropriately noted that the best possible estimate of a relevant concept is better than a precise measure of an irrelevant one. 36/

While some have argued that mark-to-market accounting would produce unacceptable volatility in operating results, and other problems, market-based accounting has long been required of broker-dealers and investment companies. Thus, firms like Salomon Brothers, Merrill Lynch and others with huge securities positions routinely use daily mark-to-market accounting without such problems. So too, mutual funds with hundreds of billions in securities report must utilize mark-to-market accounting. It is therefore questionable whether this method of

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36/ The Brookings Institution, "Blueprint for Restructuring America's Financial Institutions" (1989).

reporting by banks and thrifts would produce any significant problems -- especially as to their holdings of securities irrespective of "trading" or "investment" intent.

The Commission recognizes that transforming the accounting standards of banks and thrifts from a cost to a market-based standard is a complex undertaking, and we realize that studies are currently under way concerning these issues. 37/ The objective of these efforts should be to achieve financial reporting that uses appropriate market-based measures of valuation at the earliest possible date.

A. Trading Versus Investment

The Committee's question focuses on one aspect of the cost-based/market-based accounting issue: the accounting treatment that should be accorded to debt securities held by a financial institution. Presently, banks and thrifts report debt securities classified as trading assets at market prices. Securities classified as investments are carried at cost (less provisions for credit losses), or at the lower of

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37/ Several studies are currently under way concerning these issues. The FASB has a significant project addressing the accounting for financial instruments, which encompasses the issue of market-based measures. The FASB currently is focusing on disclosure of value information. In addition, the International Accounting Standards Committee and the Canadian Institute of Chartered Accountants have a similar joint project which is in the early stages. Both projects involve consideration of value-based accounting and disclosure. As part of the study of the Federal deposit insurance system required by section 1001 of FIRREA, the Department of the Treasury, in consultation with the federal banking agencies and others, is to evaluate several topics, including the feasibility of market value accounting. See FIRREA, Section 1001(b)(4).

cost or market if the institution does not have either the intent or the ability to hold the securities. 38/

Under current GAAP, recording investment securities at cost generally requires that an institution have the ability and intent to hold the securities to maturity. 39/ The rationale for this treatment is that, if the security is held to maturity, it will be redeemed at its face amount. Therefore, temporary fluctuations in market value due to interest rates changes are considered irrelevant since they do not affect ultimate realization. 40/ This justification is irrelevant, however, to the value of the investment, and to the true value of rate of return in an institution's portfolio. Even if the principal of a debt security is ultimately paid 29 years in the future, this does not eliminate the relevance of a

38/ In most other major countries, trading accounts are generally carried at market; however, Germany and Japan generally use LOCOM. For non-trading debt investments, the accounting is generally at cost or LOCOM -- Japan and Germany use LOCOM, Canada uses principally cost, while certain other countries (e.g., the United Kingdom and France) distinguish among cost, LOCOM, or market based on the purpose of the investment.

39/ Under existing accounting rules, when the institution does not have the ability to hold the instruments to maturity, market losses must be recognized. Thus, the passage of FIRREA, which required thrifts to dispose of junk bonds and other risky investments, forced the recognition of significant market losses that had occurred as a result of a declining value of these speculative investments. If the thrift regulators had used market-based measures to assess the capital requirements of thrifts during the last decade, it would have been clear that some of these institutions did not have the ability to hold these investments to maturity.

40/ AICPA Industry Audit Guide, "Audits of Banks," 30 (2d ed. 1984).

significant decline in the return on the true value of that security during the intervening years.

This accounting rule was developed in a vastly different economic environment than the one in which institutions must function today. Today financial institutions actively manage their interest earning asset and interest bearing liability portfolios to maximize net income and to manage interest rate risk. This "asset/liability" management often requires frequent buying and selling of investment securities to restructure asset and liability maturities. The continued use of the historical cost model in this environment is inappropriate because of the diminished relevance of the resulting financial information.

Further, the continued use of historical cost accounting for investment securities has enabled institutions to "manage" the timing of gains and losses. Some thrifts did trade out of their so-called investment portfolios, but only when doing so allowed recognition of a gain. "Gains trading", i.e., selling profitable positions and holding losing positions, also referred to as "cherry picking," had the effect of inflating the thrift's apparent short-term profitability while inevitably leading to declines in future yields.

In the late 1980s, just before the passage of FIRREA, the FHLBB finally sought to curtail gains trading through the adoption of regulatory accounting guidance. 41/ However, the guidance was controversial and complex, and OTS

41/ 12 C.F.R. 563c.102 (effectiveness delayed until April 1, 1990 by 55 Fed. Reg. 126 (1990)).

subsequently deferred implementation of this guidance to permit the AICPA to clarify the principles and to develop guidance for banks as well as thrifts.

In the interim, the Commission's staff has acted to enhance the information provided in filings with the Commission. Financial institutions filing with the Commission must consider the need to furnish the amount of gross unrealized gain and loss in the investment portfolio, and are required to provide a description of the accounting policies followed in reporting its investment portfolio, and an analysis of any material effect on future earnings from unrealized portfolio losses and portfolio sales. In appropriate circumstances, failure to disclose such items will result in enforcement action by the Commission. The staff will continue its current practice of carefully considering the adequacy of disclosures made by financial institutions. The Commission's staff has also encouraged the AICPA to provide accounting and disclosure guidance applicable to both banks and thrifts in order to avoid conflicting accounting requirements among financial institutions. 42/

In May 1990, the AICPA published for comment proposed rules intended to provide practical guidelines for evaluating the intent and ability of an entity to hold securities to maturity. 43/ Under the proposal, trading securities would

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42/ See Letter of December 20, 1989 from Mr. Edmund Coulson, the Commission's Chief Accountant, to Mr. Jack Kreischer, Chairman of the Accounting Standards Executive Committee of the AICPA.

43/ AICPA Exposure Draft of Proposed Statement of Position, "Reporting by Financial Institutions of Debt Securities Held as Assets" (May 25, 1990). The proposal would apply to (continued...)

continue to be marked to market. Other debt securities in the investment portfolio would be carried at cost if the institution has the current ability to hold to maturity and the intent to hold for the foreseeable future (which is arbitrarily defined as one year). However, if it reasonably is expected that the institution would sell debt securities in response to probable events in the foreseeable future, including interest rate changes, the securities would be classified as held for sale and carried at the lower of cost or market. A substantial number of comments have been received on the proposal, and most have criticized it as unworkable.44/ Indeed, many of the commentators suggest that the proposal would not result in consistent reporting and would not deal with abuses such as gains trading.

The Commission will carefully oversee the AICPA's deliberations on this issue to ensure a sound and effective proposal. The constraints on the AICPA committee to remain within the framework of existing formal accounting literature may lead only to an interim resolution of this issue. However, because it is inherently difficult to distinguish portfolio categories based on intent and ability, particularly considering the dynamic market environment in which investment

43/ (...continued) banks, thrifts, financial companies, insurance companies and credit unions.

44/ Of course, major securities firms are already required to mark their often enormous portfolios to market on a daily basis.

decisions are made, serious consideration must be given to reporting all investment securities at market value.

B. Additional Market-Based Measures

Steps currently being taken to clarify the accounting treatment for investment portfolios should be part of a broader move in the direction of mark-to-market accounting. The benefits of market-based accounting warrant consideration of a broader shift in this direction. The presumption that market-based information is the most relevant financial data attribute should be recognized. It may be appropriate to utilize historical cost only where specifically justified by the circumstances in the future.

The Commission recognizes that the move to a full-scale application of market-based accounting requires careful and deliberate planning. The Commission is aware that strong views are held and valid concerns exist concerning a shift to market value accounting. In particular, great care must be taken to ensure that the costs of implementation and ongoing compliance do not exceed the expected benefits. With respect to reliability of market value information, additional work will be necessary to develop reasonable and cost-effective valuation techniques for those assets and liabilities that do not have a liquid market. 45/ We need to explore ways to reduce subjectivity of estimates to an acceptable level. The Commission does not underestimate the significance or

45/ Valuations are used by well managed institutions in making business decisions and are applied routinely in business combinations.

importance of these and other issues. However, we believe that their resolution must be aggressively pursued.

IV. CONCLUSION

The thrift crisis confirms that effective regulation of financial institutions requires adherence to sound accounting principles. It is essential, for the purposes of both general financial reporting and regulatory reporting, that financial institutions adhere to accounting standards that result in an accurate portrayal of the institution's financial position and results of operation.

The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose. This may also become the camouflage for improper and unsafe practices. Because of these dangers, all publicly-held companies, including financial institutions, should be required to adhere to a uniform set of accounting principles. The principles should be established through a standard-setting and review process, overseen by a single agency, that is immune to tampering by a failed industry or its regulators. The value of uniform standards will be enhanced if, wherever possible, they are based on market-based measures of valuation.

We must learn from our experience in the thrift crises as we develop today's disclosure standards. Although accounting techniques were used to enhance the perception that thrift institutions were operating on a safe and sound basis, they did not -- and could not -- make any thrift institution more safe or sound in fact. Changes in accounting standards do not change the underlying business reality. They may, however, alter the way that we perceive and measure that reality. It is therefore especially important that appropriate uniform standards be adopted in order to ensure that the heightened capital adequacy standards established by FIRREA will be effective, and that we seek to become aware of insolvency or financial crisis at the earliest possible time, not when it is already too late.

Total Assets of FSLIC Insured Institutions

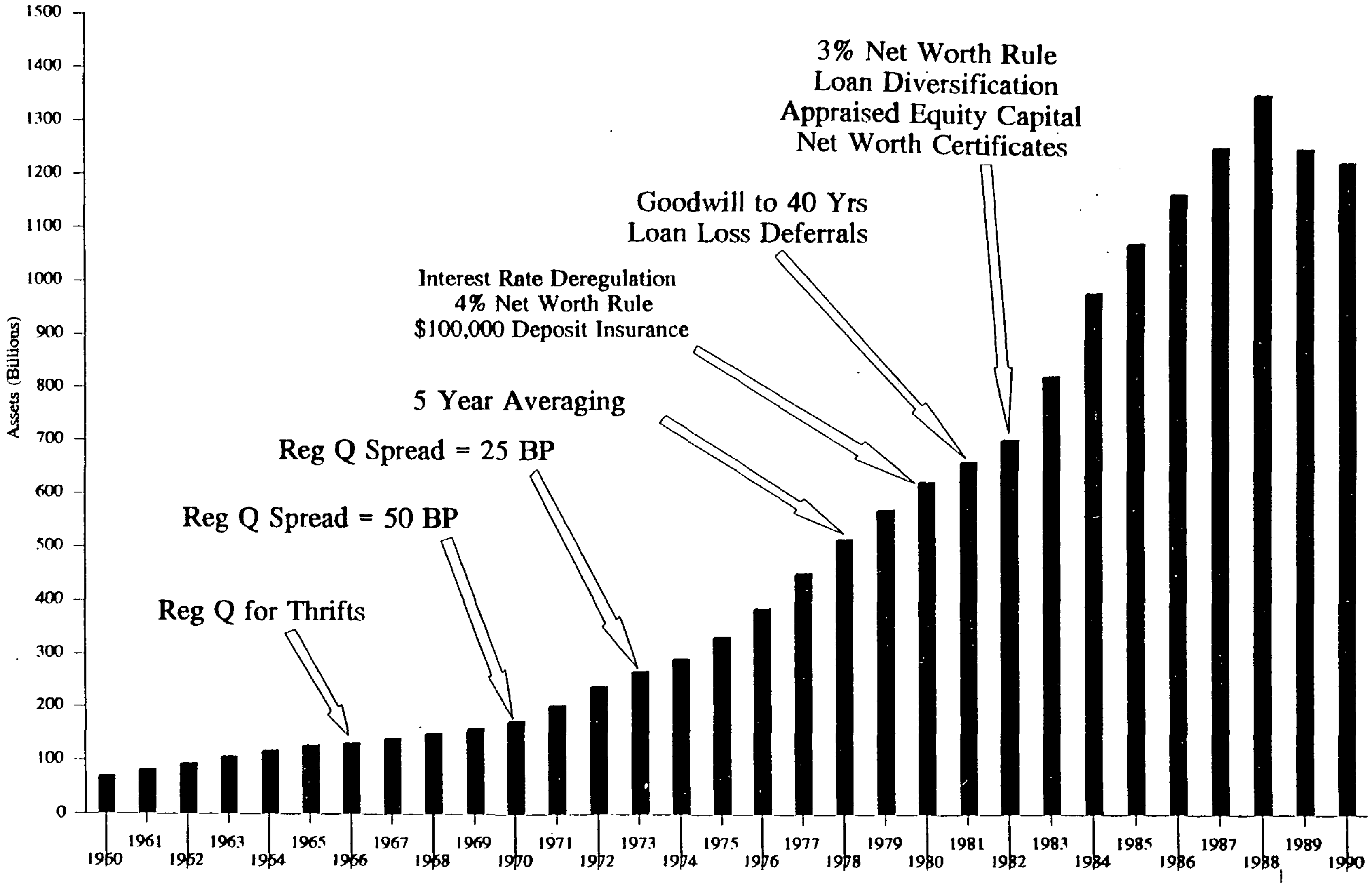
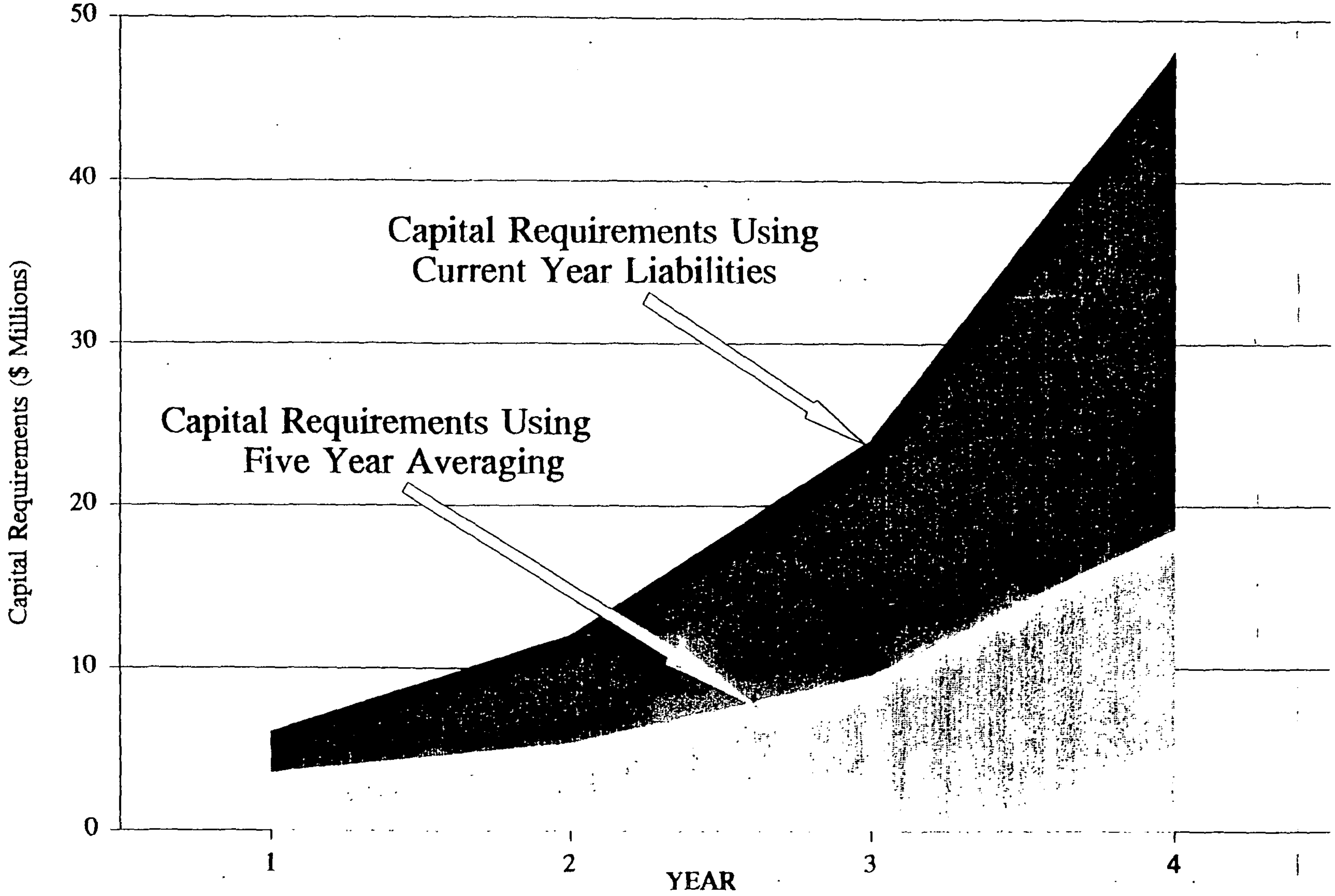


CHART NO. 1

CHART NO. 2



Assumes a hypothetical thrift with liabilities of $94 million in year -3, $96 million in year -2, $98 million in year -1, $100 million in year 0, $200 million in year 1, $400 million in year 2, $800 million in year 3 and $1.6 billion in year 4. Hence, this thrift has relatively static growth in years -3 to 0, and 100% growth in years 1 to 4.

Leverage Ratios Supported By 20-Year Phase-in

(Ratio of Capital to Liabilities, Based on $1 Million of Capital)

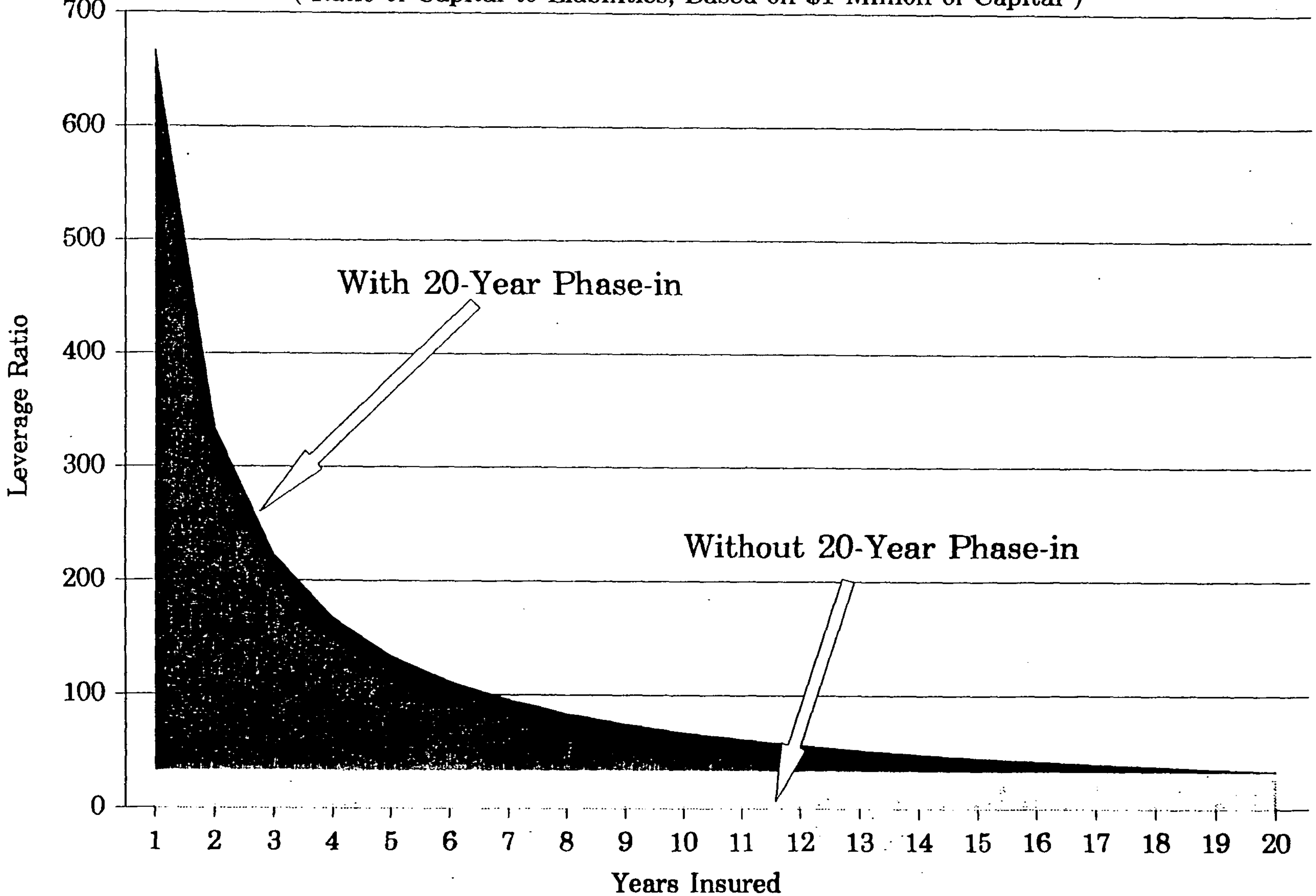


CHART NO. 3

CHART NO. 4

Total Assets and TAP Capital
of FSLIC-Insured Institutions, 1980-1989

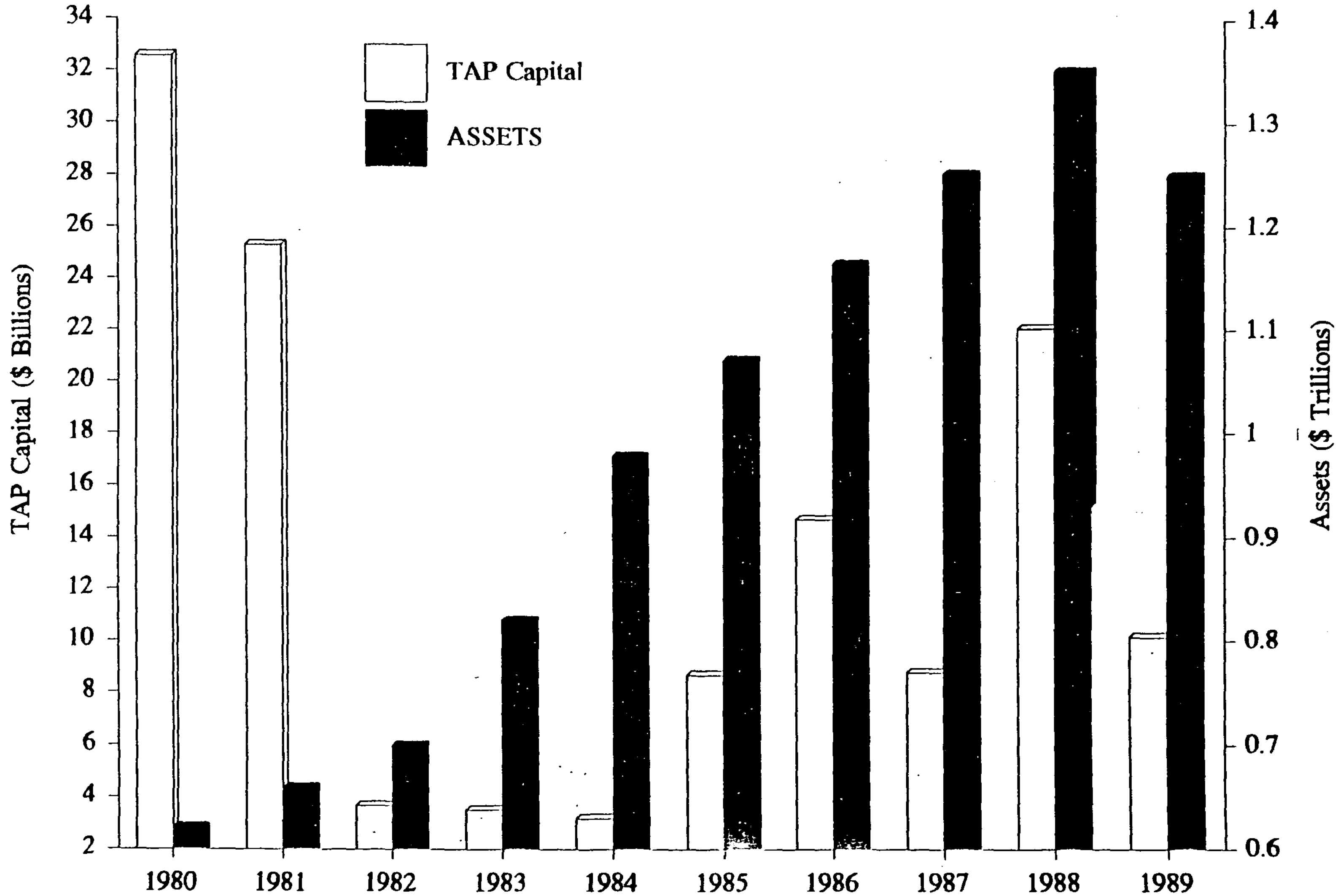
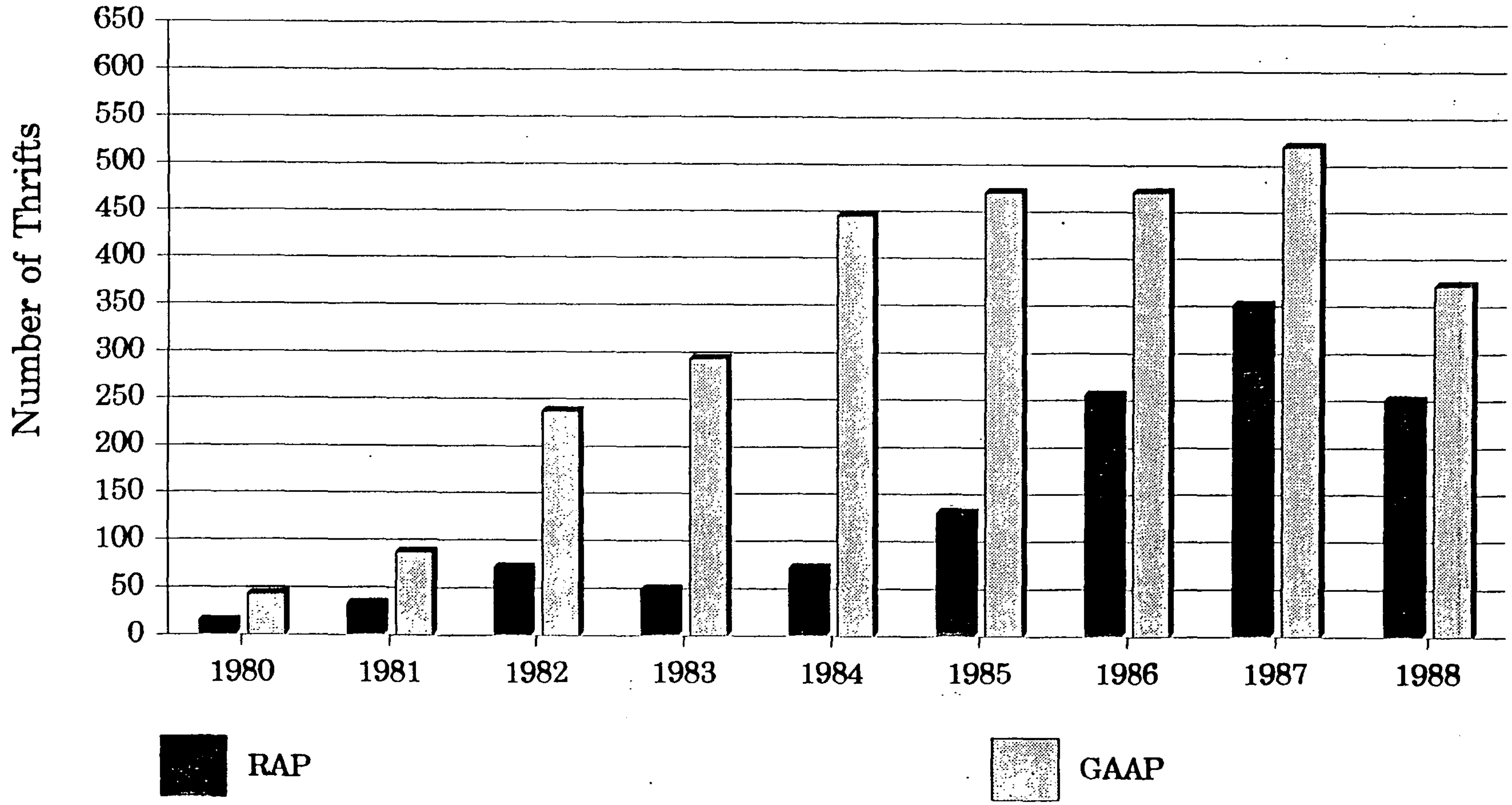


CHART NO. 5

Number of Insolvent Thrifts Based On RAP and GAAP Capital Requirements



Goodwill as a Percent of GAAP Capital for FSLIC Insured Institutions

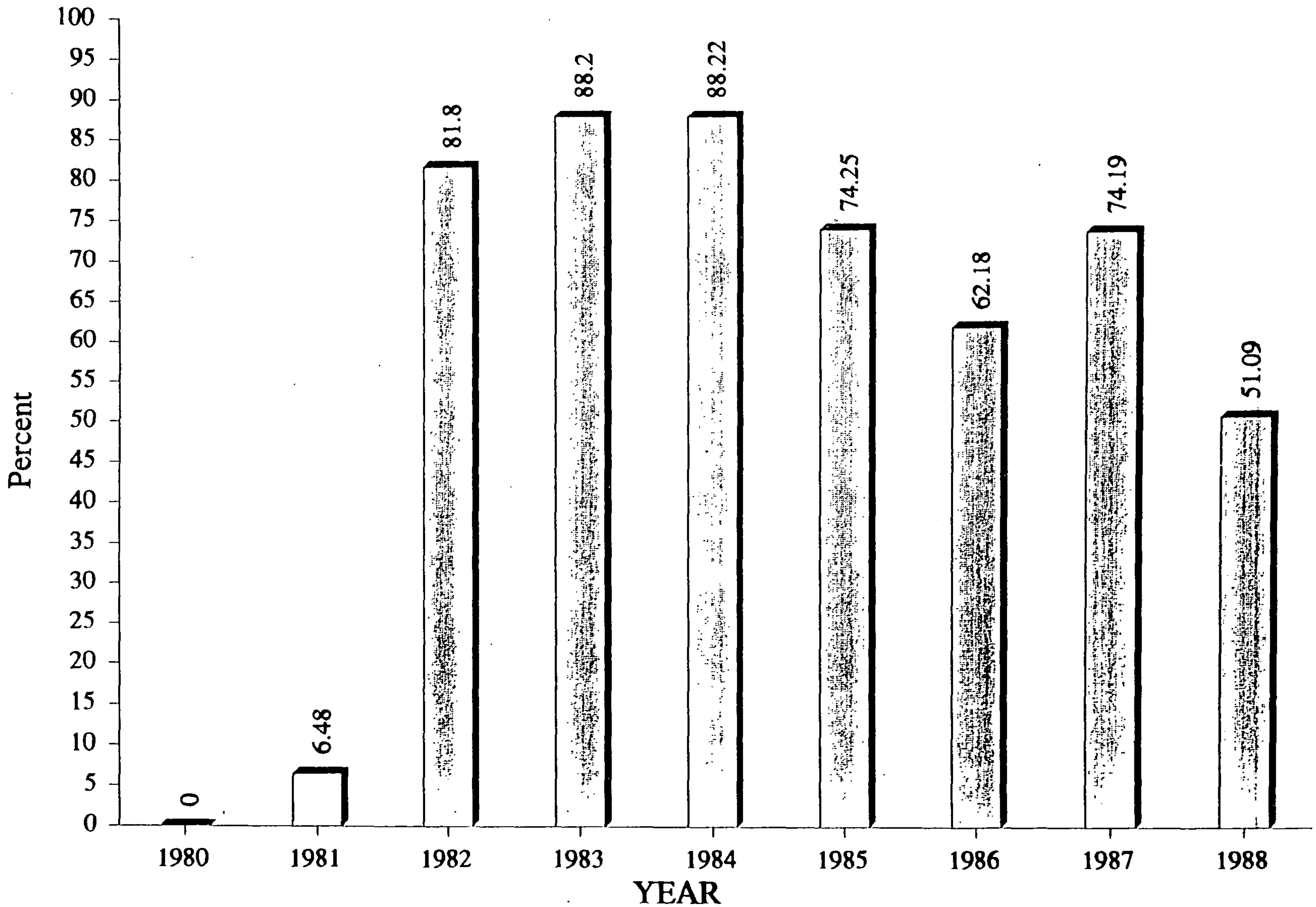
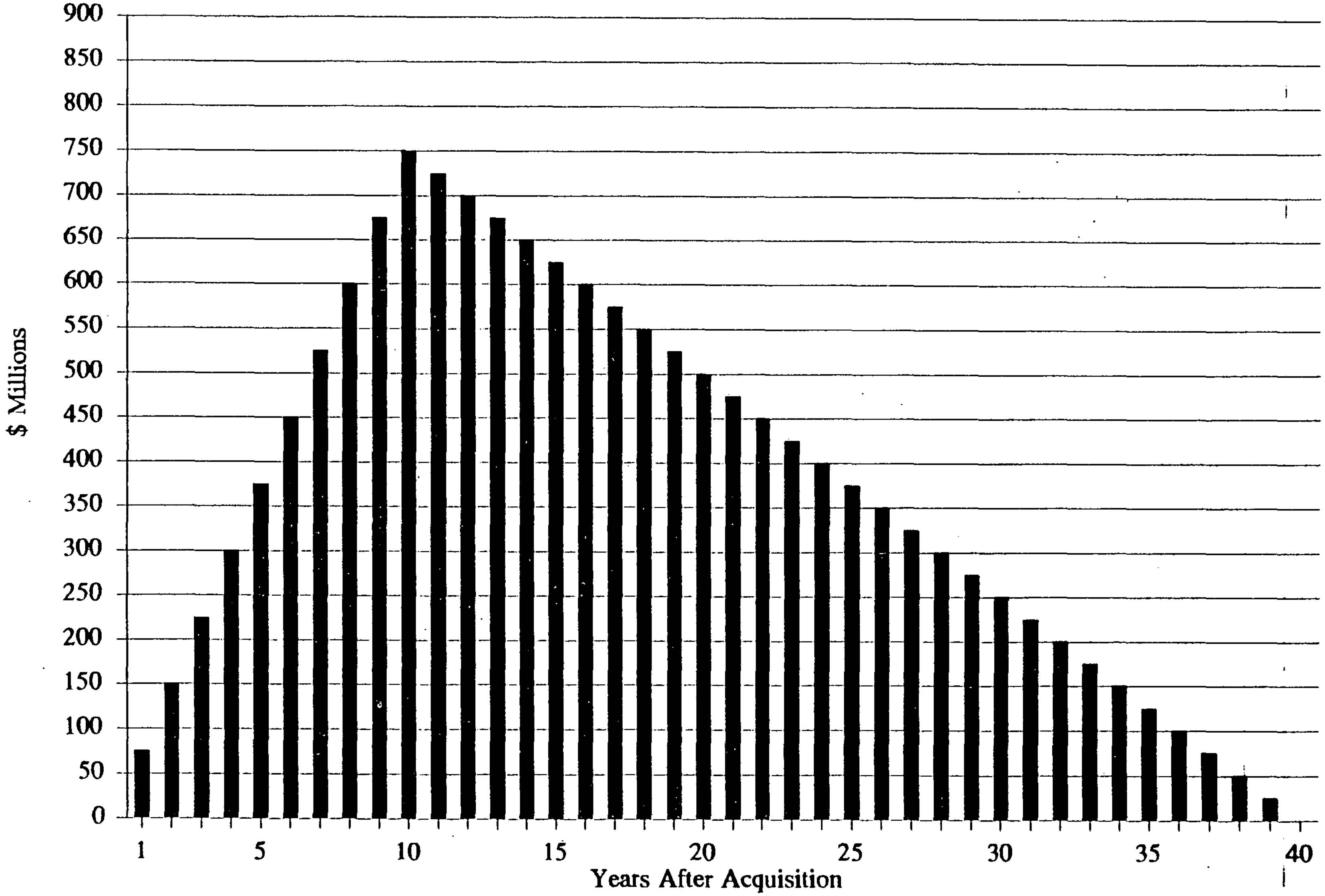


CHART NO. 6

Cumulative "Earnings" Created by Acquisition Per $1 Million of Goodwill and Discount



Assumes $1 Million in goodwill and discount, with 40-Year write-off of goodwill (2 1/2% per annum) and 10-Year booking of discount (10% per annum).

CHART NO. 7