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July 7, 2017

Commissioners
Securities and Exchange Commission
c/o Secretary
100 F Street,
NE, Washington, DC 20549-1090.

Comment on Industry Guide 3, Statistical Disclosure by Bank Holding Companies

File Number S7-02-17.

Dear Commissioners,

On behalf of more than 400,000 members and supporters of Public Citizen, we comment here on potential changes to the disclosures called for by Industry Guide 3, formally known as Statistical Disclosure by Bank Holding Companies.

The Securities and Exchange Commission (SEC, Commission) first published Guide 3 in 1976 and last updated it in 1986.[1] Since then, the banking industry has transformed dramatically. Interstate banking has led to massive concentration, compounded by the repeal of the Glass-Steagall restrictions on mergers with investment banks. In 1986, there were 14,210 banks insured by the Federal Deposit Insurance Corp. (FDIC). Largely because of mergers, there were only 5,112 by year-end 2016.[2] The assets of the *entire* banking industry insured by the FDIC in 1986 was $2.9 trillion.[3] Today, one bank, namely JP Morgan Chase, holds over this amount. Bank holding companies now not only engage in traditional loan-making operations, but also trade in derivatives, control merchant banks that own operating companies such as warehouses or copper mines, and invest in commodities. The derivatives exposure of the largest banks include notional values in the hundreds of trillions of dollars.

Translating this information to investors has proven difficult. Average investors may find it difficult to understand the true status of a large bank, and even some sophisticated investors have thrown up their

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[1] The architecture of bank disclosure involves more than Guide 3. Banks file Consolidated Reports on Condition and Income (Call Reports). Large banks file comprehensive capital analysis and review along with stress testing. Large banks also file resolution plans or "living wills," which are plans for the event of insolvency. These documents relate to bank safety but relate to investment decisions as they do describe facets of the financial institution. Item 305 addresses derivatives disclosures, which is not limited to banks.

[2] Number of Institutions, FDIC (website visited June 23, 2017) https://www5.fdic.gov/hsob/HSOBRpt.asp

[3] FDIC Assets 1934-2016, FEDERAL DEPOSIT INSURANCE CORP. (website visited May 31, 2017) https://www5.fdic.gov/hsob/HSOBRpt.asp

hands. For example, Pershing Square chief Bill Ackman bought a $1 billion stake in Citigroup in 2010 on the grounds that it'd written down its failed loans, and he later sold for a $400 million loss.[4]

The complexity of these institutions is further demonstrated by the fact that even senior managers of firms have sometimes proven unable to understand key developments at their own banks. JP Morgan CEO Jamie Dimon infamously required months to realize that a London trading desk loss was not a "tempest in a teapot," as he originally thought, but an "egregious" mistake that led investors to devalue JP Morgan stock by 30 percent.[5] Bank of America failed to identify a $4 billion accounting error for years. In the summer of 2008, banks reported rosy results. Yet by the fall, 12 of the 13 largest proved to be insolvent.[6]

In the years leading to the financial crisis, banks reported glowing results. Then, abruptly, in a matter of months, banks reported disastrous problems, leading to a taxpayer bailout that ultimately cost trillions of dollars. These problems didn't develop in a matter of months. Instead, they were hidden from investors and the public, and apparently even from regulators.

In short, bank disclosures remain obviously inadequate. The SEC's request for comment on Guide 3 is therefore welcome. Public Citizen believes that the Commission's goal should be robust disclosure where investors are fairly and completely informed about bank operations.

The stakes are high, and trust in banking is low. In the 1970s, Gallup polls show that three out of five Americans said they trusted big banks "a great deal" or "quite a lot." Since the financial crisis of 2008, confidence has collapsed. In June 2012, less than 25 percent said they trusted big banks. Luis Aguilar, then a commissioner at the Securities and Exchange Commission, cited data showing that "79 percent of investors have no trust in the financial system." [7]

The Commission, under the former chair, launched a sweeping disclosure review. Unfortunately, that chair premised the review initially as a push to reduce disclosure. We believe there is no substantiated wish on the part of investors for less disclosure. In the banking industry especially, such a premise is misplaced, as calls for reduced disclosures do not withstand the clear shortfalls in bank reporting.

Further, while we recognize that banks report information that may be valuable to investors at agencies other than the Commission, this should not serve as an excuse to dismantle the integrity of the Guide 3 disclosures. For example, a number of items required in Guide 3 are provided in related forms under other regulatory regimes. The SEC suggests they might be eliminated in Guide 3 as an unnecessary cost to industry. We believe that "related" documents do not replace the Guide 3 requirements, as investors are unlikely to seek out multiple sources for their information. Moreover, the related documents are not redundant. The need for the Commission to aggregate this disclosure information is clear. Our comment

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[4] Frank Partnoy and Jesse Eisinger*, What's Inside America's Banks,* THE ATLANTIC (January/February 2013) https://www.theatlantic.com/magazine/archive/2013/01/whats-inside-americas-banks/309196/

[5] Bartlett Naylor*, TOO Big*, PUBLIC CITIZEN (June 2016) https://www.citizen.org/sites/default/files/toobig.pdf

[6] See interview with Federal Reserve Chair Ben Bernanke, *Financial Crisis Inquiry Commission*, FCIC (Nov. 7, 2009) http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/FCIC%20Interview%20with%20Ben%20Bernanke,%20Federal%20Reserve.pdf

[7] Frank Partnoy and Jesse Eisinger*, What's Inside America's Banks,* THE ATLANTIC (January/February 2013) https://www.theatlantic.com/magazine/archive/2013/01/whats-inside-americas-banks/309196/

now focusses on relatively new activities of banks, namely derivatives, trading, and merchant banking. We conclude with a discussion of accounting for the loan portfolio.

Derivatives and trading

Among large banks, the most conspicuous change in operations involves derivatives. At the end of the third quarter of 2016, 1,438 insured U.S. commercial banks and savings associations reported derivatives activities.[8] A small group of large financial institutions dominates derivatives activity. During the third quarter of 2016, four large commercial banks represented 89.7 percent of the total banking industry notional amounts and 84.4 percent of industry net credit exposure.[9] At large banks (with more than $250 billion in assets), trading revenues, which include derivatives trading, accounted for more than 24 percent of net operating revenues. For those with less than $1 billion in assets, it accounted for about 1 percent.[10]

Given the derivatives activity of large banks, Public Citizen believes Guide 3 should require banks with more than $250 billion in assets to expand their reporting.

For derivatives and other assets that are traded, the SEC presently requires (under Item 305 of Regulation S-K) an analysis of risk. Firms are offered three alternatives:

- A tabular presentation of fair value information and contract terms relevant to determining future cash flows, categorized by expected maturity dates.
- A sensitivity analysis expressing potential loss in future earnings, fair values or cash flows from selected hypothetical changes in market rates and prices.
- Value at risk (VaR) disclosures expressing potential loss in future earnings, fair values or cash flows from market movements over a selected period of time with a selected likelihood of occurrence.

This is intended to disclose risks arising from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. However, banks may choose which methods, model characteristics, assumptions and parameters they use in complying with the item, and registrants may use more than one disclosure alternative across each market risk exposure category. Consequently, investors may be unable to compare one registrant to another. Further, none of these may be the analysis the firm actually uses to manage risk. To manage their risks, banks may develop their own internal model. We propose that the SEC require disclosure of all these formats under refinements to Guide 3.

In addition, the SEC should require uniform reporting within these categories. JP Morgan and Citigroup both report on their sales of credit protection. Citigroup reports its positions by industry, product and

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[8] Quarterly Report on Bank Derivatives Activities, Third Quarter 2016, OFFICE OF THE COMPTROLLER OF THE CURRENCY, available at http s://www.occ.go v/top ics/capital-markets/financial-markets/derivatives/derivatives-quarterly-rep ort.html

[9] Quarterly Report on Bank Derivatives Activities, Third Quarter 2016, OFFICE OF THE COMPTROLLER OF THE CURRENCY, available at http s://www.occ.go v/top ics/capital-markets/financial-markets/derivatives/derivatives-quarterly-rep ort.html

[10] FDIC quarterly report, FDIC (website viewed June 2, 2017) https://www.fdic.gov/bank/analytical/quarterly/2016_vol10_4/fdic_v10n4_3q16_quarterly.pdf

credit rating of underlying reference entity. JPMorgan reports them by maturity and credit rating of underlying entity. This makes some comparisons possible, but not all. The SEC should require uniform reporting so that this information can realistically be used by investors seeking to make choices. We recommend the rubric suggested by Prof. Viral Acharya of the New York University Stern School of Business.[11] Specifically, banks should classify exposures based on product types (such as single name credit default swaps (CDS), index CDS, interest rate swaps, currency swaps, commodities, equities, etc.), by major currency categories, maturity (buckets) of contracts, type of counterparty (bank, broker-dealer, corporation, government-sponsored enterprise, mono-line, insurance firm, etc.), and credit rating of counterparties. Separately, the bank should itemize the size of exposures, including gross value, fair-value, and netting. Finally, banks should report on concentration, such as its largest 10 counterparties, and the names of counterparties accounting for 75 percent of its exposure. Reporting these figures should involve little extra cost as the investment banks already maintain such information for their internal risk management purposes. Some banks already voluntarily report some of this information.

Risk Weighting

Evolving capital standards may lead banks to adjust the risk of their operations. Risk weighting standards are critical to prudential regulators and they also contain important information for investors, as they indicate if the bank is engaging in relatively more or less risky products. Guide 3 should include a table showing the capital requirements for each asset class as well as for major portfolios within those classes. For market risk and operational risk, Guide 3 should also require a table showing the capital requirements for each method used for calculating them. Disclosures should be accompanied by additional information about significant models the bank uses. These additions are endorsed by the Financial Stability Board.[12]

Commodities Ownership and Merchant Banking

The Commission notes new activities permitted for banks such as commodity ownership. Banks have also expanded their merchant banking activities and ownership of commercial enterprises. A Public Citizen analysis of bank ownership in these areas found poor and incomplete disclosure. [13]

From news reports, the public can determine that Goldman Sachs has owned an aluminum warehouse; Morgan Stanley has owned oil reserves; JP Morgan has owned electricity operations, etc., but these holdings are not reported in the firms' SEC filings other than in general terms. For example, Morgan Stanley reported "We engage in the production, storage, transportation, marketing and trading of several commodities, including metals (base and precious), agricultural products, crude oil, oil products, natural gas, electric power, emission credits, coal, freight, liquefied natural gas and related products and indices."[14] Many of these assets are contained in subsidiaries; the largest six banks have more than

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[11] Viral Acharya, *A Transparency Standard for Derivatives,* (2010) http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/Acharya_Proposal_Disclosure_Standard_v3.pdf

[12] Enhancing the Risk Disclosure of Banks, ENHANCED DISCLOSURE TASK FORCE, (October 2012) http://www.fsb.org/wp-content/uploads/r_121029a.pdf?page_moved=1

[13] Bartlett Naylor, *Big Banks, Big Appetites,* PUBLIC CITIZEN (April 4, 2014), https://www.citizen.org/sites/default/files/banking-commodities-consequences-repport.pdf

[14] Morgan Stanley annual report (2012) available at: http://www.sec.gov/Archives/edgar/data/895421/000119312513077191/d484822d10k.htm#rom484822

14,000 such subsidiaries between them, however they are not listed in a single document, and it is challenging to impossible to determine them in the aggregate. Public Citizen recommends that banks list all their merchant banking and commercial assets by name, acquisition value, and market value.

Loan Portfolio

In traditional bank activity, namely disclosures on loan-making, we believe Guide 3 can also be enhanced. The true value of a bank's loan portfolio is central to investor understanding of a bank's worth. Some loans may be repaid, while others may be written down, or abandoned as uncollectible. Since the financial crisis, investors have tacitly believed that the reported loan values of the largest banks may be overstated. The evidence comes from the relation between the bank's book value, and its market value. Book value is the measure of assets less liabilities. Loans are a major part of a bank's assets. Market value is what it would cost to purchase all the company's stock. Generally, the market value should be equal to or greater than the book value, as a promising firm grows revenue and profits. Since the financial crisis revealed that banks had made disastrous loans, the book value of many major banks was less than the market value.

As a solution, PIMCO, which is the world's leading bond investor, advises more granular disclosure on loan assets, including information on the credit quality, collateral backing, vintage year, regional distribution and industry sector.[15] Public Citizen supports this recommendation.

Loan Loss Provision

Guide 3 grew from the 1974 recession when banks experienced considerable loan losses, and the Commission agreed on the need for greater transparency.[16]

Loan loss reserves appear in two places: the balance sheet, in the form of loan loss reserves, which is a subtraction from outstanding loans; and on the income statement, as an addition or subtraction from the loan loss reserve.

Critically, loan loss reserves are left to management judgement. Empirical studies have shown that banks commonly exploit their latitude in judging loss reserves so as to manage earnings. This means they may increase loss reserves in good quarters while reducing them in bad quarters to give the impression of steadily improving operations.[17]

There is also a tension between prudential regulators and investors. Bank prudential regulators may support additional loan loss provisions (even when this might actually be part of earning management.)

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[15] Christian Stracke, *Shine More Light*, PIMCO (November 2012) https://www.pimco.com/en-us/insights/viewpoints/viewpoints/shine-more-light-enhancing-disclosures-can-help-bank-investors-and-security-prices/

[16] Disclosure, FEDERAL RESERVE BANK OF ATLANTA, (November 1983) https://fraser.stlouisfed.org/files/docs/publications/frbatlreview/pages/66648_1980-1984.pdf

[17] Eliana Balla, *Loan Loss Reserve Accounting and Bank Behavior*, THE FEDERAL RESERVE BANK OF RICHMOND, (March 2012) https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_brief/2012/pdf/eb_12-03.pdf

The SEC has penalized some firms for falsifying loan loss provisions. For example, the commission found that Trinity Capital Corporation and its wholly-owned subsidiary, Los Alamos National Bank, materially misstated its provision for loan losses and its allowance for loan and lease losses in filings from 2010 to 2012. As a result, for example, it reported 2011 income of $4.9 million instead of a $25.6 million loss. As a penalty, the SEC charged the firm $1.5 million.[18]

We are unaware of a clear accounting solution to the reportedly commonplace problem of earnings management through inaccurate loan loss provisions is commonplace. Consequently, we urge the SEC to intensify its investigations and enforcement in this arena. At Radian Group, a major mortgage insurer, whistleblower Michael Lutz believed the firm's loan loss reserves were inadequate and informed his superiors and subsequently the SEC. His superiors rejected his assessment and outsourced his job. At Public Citizen we support robust protection and support of whistleblowers, as they are often the best source of information. Rightfully, "Lutz wonders why the S.E.C. has not pursued the whistle-blower complaint he filed against Radian, which outlined its retaliation against him," according to a *New York Times* account. "'A big reason why people don't report these things is what happened to me in this instance," Lutz said. "That's a big deterrent to people. Every time issues like mine are not enforced, it reinforces the notion that these pieces of [whistleblower] legislation are paper tigers and nothing is going to come of it anyway.'"[19]

We urge the SEC to strengthen its publicity of whistleblower options for line bank employees and to respond aggressively so that those highlighting questions that should be explored by the agency do not become victims.

We thank the Commission for its attention to this important area. For questions, please contact Bartlett Naylor at [redacted], or [redacted].

Sincerely,

Public Citizen

[18] SEC Charges Trinity Capital, SECURITIES AND EXCHANGE COMMISSION (Sept. 28, 2015) https://www.sec.gov/news/pressrelease/2015-215.html

[19] Gretchen Morgenson, *A Whistle was Blown, but Who was Listening*, NEW YORK TIMES (April 28, 2017) https://www.nytimes.com/2017/04/28/business/30gretchen-morgenson-whistleblowers-radian.html