



January 11, 1996

Financial Accounting Standards Board
Director of Research and Technical Activities
File Reference No. 154-D
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: 88
File Reference: 1082-154
Date Received: 1/17/96

Dear Sir or Madam:

We have reviewed your Exposure Draft entitled "Consolidated Financial Statements: Policies and Procedures" and wanted to forward to you our comments.

The attachment gives our comments in detail; however, in brief we believe that the proposed standard should be modified to exclude entities which gain control of a bankrupt or liquidating entity through appointment as receiver or trustee.

The Federal Deposit Insurance Corporation (FDIC) is somewhat unique in that our company is a business entity which has regulatory powers. We are a business entity in that we are an insurance company which generates revenues through assessment of insurance premiums on banks and thrifts. With the exception of our statutory responsibility for the failed Federal Savings and Loan Insurance Corporation and a federal mandated affordable housing program, we are not taxpayer funded. We follow generally accepted accounting principles, and produce the full complement of financial statements. We have enclosed a copy of our 1994 annual report so you can get a better idea of our business.

Although we are a business entity, our regulatory facet puts us in the position of being responsible for failed banks and thrifts. Under the proposed accounting standard, we might be considered as having acquired control of these failed banks and thrifts on the date we are appointed receiver. As such, the proposed standard would then require us to mark-to-market the assets and liabilities of these entities and consolidate them with our corporate financial statements. We currently have several hundred of these entities in liquidation.

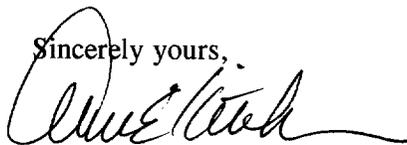
While FDIC may be unique, our circumstances would be similar to any person or entity which acquires control of another entity through a regulatory action or appointment as a receiver or bankruptcy trustee. We do not believe that consolidation of a liquidating entity with a going-concern is an intended result of the proposed standard. The attachment gives more detailed reasons as to why we believe such a requirement would not be in the best interests of financial statement readers.

The proposed standard does provide for an exception related to temporary control, but that exception is generally defined to be control which is expected to last less than one year. However, the average life of the receiverships we are responsible for is about six to seven years. We suspect that other cases of liquidating entities also involves time periods in excess of one year.

We ask that you consider modifying the proposed standard to exclude control acquired over liquidating entities. We have included suggested text in the attachment which could meet that objective.

Thank you for taking the time to read this letter and the attached and enclosed material. If you have any questions concerning these comments, please call me at (703) 516-5376.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Alvin E. Kitchen', with a large, stylized initial 'A'.

Alvin E. Kitchen
Deputy Director

Attachment

Enclosure

cc: William Longbrake, Deputy to the Chairman for Finance
and Chief Financial Officer, FDIC
Steven Seelig, Director, Division of Finance, FDIC

**Attachment: Comments Regarding the Exposure Draft on
"Consolidated Financial Statements: Policy and
Procedures"**

Background on the Federal Deposit Insurance Corporation (FDIC)

FDIC is variously characterized as a quasi-governmental agency or as a government sponsored enterprise (GSE). These characterizations stem from FDIC's unique nature as a business enterprise with regulatory powers.

The regulatory powers stem from FDIC's mission in maintaining public confidence in banking institutions by protecting depositors' accounts through deposit insurance, promoting sound banking practices, and reducing the disruptions caused by bank failures. These regulatory powers are found in the Federal Deposit Insurance Act¹. Three of the more relevant sections for purposes of these comments are §9 ("Powers of Corporation"), §11 ("Insurance Fund"), and §13 ("Miscellaneous Powers and Privileges of Corporation").²

§11(c) covers the appointment of FDIC as receiver or conservator, and §11(d) addresses FDIC's powers and duties as receiver or conservator. §13(c) describes FDIC's authority in its corporate capacity to purchase assets from a receivership or conservatorship and to provide assistance in the case of open deposit institutions (for the purpose of preventing a bank failure). We refer to FDIC acting in its *corporate* capacity to distinguish that action from instances when FDIC is acting in its capacity as a receiver or conservator.

The business aspects of FDIC are highlighted by §9 which provides among other things that FDIC shall have the power to make contracts, to sue and be sued, and "to prescribe, by its Board of Directors, bylaws not inconsistent with law, regulating the manner in which its general business may be conducted, and the privileges granted to it my law may be exercised and enjoyed."

In furtherance of its corporate mission, FDIC maintains three insurance funds: the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the FSLIC Insurance Fund (FRF).³ The total assets of these three funds are approximately \$27 billion, \$3.7 billion, and \$1.4 billion, respectively, as of September 30, 1995. Both the BIF and SAIF are fully self-funding through insurance premiums levied on banks and thrifts. Neither the BIF nor the SAIF receives taxpayer monies (with the exception of an immaterial amount received for administering a statutorily required

¹ The FDI Act is codified under 12 U.S.C. 1811 *et seq.*

² These three sections are codified under 12 U.S.C. sections 1819, 1821, and 1823, respectively.

³ FSLIC stands for Federal Savings and Loan Insurance Corporation, the entity that insured savings and loans prior to its failure in 1989.

affordable housing program⁴). FRF does receive taxpayer appropriations.

As a business entity, FDIC follows generally accepted accounting principles and prepares the full complement of financial statements (balance sheet, income statement, and statement of cash flows as well as related footnote disclosures).

When a bank fails, FDIC carries out its statutory responsibility to assure that insured depositors are paid. In carrying out this responsibility, FDIC normally becomes subrogated to the depositors and as result becomes the largest creditor of a failed bank (the Bank Insurance Fund usually accounts for more than 95 percent of the dollar claims against a failed bank). There is thus a significant financial relationship between the insurance funds and the failed bank and thrift receiverships. This relationship is reported as "Receivables from Bank Resolutions" on the balance sheet in the case of the BIF. That line item has in the past accounted for more than half of the total assets of the BIF. We are pointing this out, because it may be atypical in bankruptcy cases for the fiduciary (FDIC in our case) to have such a significant financial interest in the entity being administered (failed bank and thrift receiverships in our case).

Applicability of the Proposed Standard to FDIC

As described above, FDIC is appointed as a receiver or conservator of a failed deposit institution. By law, FDIC

shall as conservator or receiver, and by operation of law, succeed to—all rights, titles, powers, and privileges of the insured depository institution, and of any stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution, and title to the books, records, and assets of any previous conservator or other legal custodian of such institution.⁵

In addition, FDIC

may, as conservator or receiver—take over the assets of and operate the insured depository institution with all the powers of the members or shareholders, the directors, and the officers of the institution and conduct all business of the institution; collect all obligations and money due the institution; perform all functions of the institution in the name of the institution which is consistent with the appointment as conservator or receiver; and preserve and conserve the assets and property of such institution.⁶

⁴ For example, FDIC received a government appropriation of \$7 million for the affordable housing program in fiscal year 1994. During the calendar year 1994, the BIF earned \$5.6 *billion* in insurance premium revenue.

⁵ FDI Act ¶11(d)(2)(A).

⁶ FDI Act ¶11(d)(2)(B).

In addition, FDIC may exercise some control over an institution in cases where FDIC provides financial assistance to an institution with the goal of preventing its failure. This control may flow from either regulatory powers or from contractual rights inherent in an assistance agreement.

Based on the foregoing, it is possible that FDIC would meet the definition of control given in the proposed standard. As such, FDIC may be required to consolidate the institutions that it has control over with the corporate-level insurance funds, and the controlled entities would then be accounted for at fair market value at the time control is deemed acquired.

The circumstances FDIC finds itself in was alluded to in the proposed standard in paragraph 80 which stated that

an entity with that ability [to elect or appoint a majority of the members of the corporation's governing board] may lose control, for example, in the event of bankruptcy....

The loss of control by one entity in the event of bankruptcy suggests that another entity (the bankruptcy court, receiver, trustee, or similar entity) gains control. FDIC may be interpreted as being on the receiving end of such a transfer of control.

Exceptions to the Requirement to Consolidate

FDIC finds it hard to argue that it is outside the scope of the proposed standard because of the significant statutory restrictions on its powers (i.e., FDIC presumably would not argue that its power is so constrained or restricted by laws and regulations that it does not effectively have control). The proposed standard specifically anticipates that control will probably exist within limitations.⁷ In addition, the proposed standard indicates that having a fiduciary responsibility as FDIC does as receiver or conservator does not mean that an entity lacks control.⁸

The proposed standard exempts certain entities "that in accordance with generally accepted accounting principles carry substantially all of their assets and liabilities at fair value." FDIC generally does not use what is normally thought of as fair market value accounting, although we do make significant use of net realizable value in our valuation process. However, observers might not interpret FDIC's valuation as meeting the definition of fair value for purposes of this proposed standard.

The proposed standard also exempts entities in cases where control is considered temporary, generally defined as a period of one year or less. FDIC cannot meet that standard given that the receiverships we administer generally last for six to seven years.

⁷ For example, ¶12 states that the "powers of a controlling entity need not be restricted. Control rarely, if ever, exists without restrictions."

⁸ ¶81 states that "fiduciary responsibilities generally do not prevent a parent from using or directing the use of the individual assets of its subsidiaries in ways that enable the parent to obtain benefits inherent in those assets."

The proposed standard expands the one-year rule to include cases where "circumstances beyond management's control are likely to require more time [*than one year*] to complete the ultimate disposition."⁹ Nevertheless, the timing of the termination of a receivership might be considered within FDIC's control. For example, FDIC's authority includes the power to make a final settlement payment to all unsecured creditors shortly after declaration of an institution's insolvency.¹⁰ FDIC opts for the usual longer term receivership for various policy reasons including the need to avoid depressing local economies by rapidly "dumping" assets and our fiduciary responsibility to receive the highest possible prices for the assets through a normal liquidation rather than a "fire sale".

In sum, it appears that FDIC may come within the scope of the proposed standard and that FDIC would find it difficult to meet any available exception.

Negative Effects of Consolidation

Imposition of Fair Market Value Accounting

One of the first negative effects would be the requirement to account for the controlled entity assets at fair value. Currently we report such assets at net realizable value because valuation of failed bank assets is impractical. Generally such assets are impaired and there is no established market for impaired assets. At least to the present, FDIC has found the problem of producing a reliable valuation insurmountable.

Most recently (July 1995), we released a research paper which discusses the use of present value techniques as an overlay to our net realizable value process.¹¹ That paper found that use of present value would not be beneficial and would arguably be detrimental. Some of the reasons include: 1) there are no market values of assets comparable to failed bank assets with which to set an appropriate discount rate; 2) use of present value distorts the nature of FDIC's business by implying that FDIC is in business to produce a market rate of return on the liquidation of failed bank assets and to profit from bank failures; and 3) the mechanics of discounting produce interest income which FDIC is prohibited by law from earning until all creditor claims have been made whole. We have concluded that our use of net realizable value is either functionally equivalent to fair market value or is the closest practical alternative.

Commingling of Corporate and Receivership Assets and Liabilities

The next problem would be the apparent commingling of corporate assets with receivership assets. We account for receivership assets separately to ensure that liquidation proceeds are distributed in accordance with applicable

⁹ ED ¶16.

¹⁰ See 12 U.S.C. 1821(a)(4)(B).

¹¹ That research paper is available to the FASB upon request.

laws and regulations.¹² Consequently, we produce separate financial statements for each receivership for purposes of court filings and upon the request of any interested party such as a depositor, creditor, or shareholder.

In addition, FDIC strictly observes the separate maintenance of the corporate level insurance funds as mandated by law.¹³ To consolidate the corporate level insurance funds with the individual receiverships would be to effectively nullify the rules and laws which require separate accounting. Consolidated reporting would also transform FDIC's creditor position with receiverships (the only material interest we have in receiverships since FDIC is prohibited by law from owning voting stock¹⁴) to one of in-substance equity interest. Again, the effect would be to void the intent of the statutes.

The net result of consolidation would thus be that FDIC would incur a significant cost in preparing consolidated statements which would go unused since our financial statement readers seek and the law requires disaggregated reporting. Corporate financial statement readers (e.g., banks and the U.S. Government) do not want receivership results mixed in and receivership financial statement readers (e.g., depositors, creditors, and shareholders) do not want corporate results mixed in. In sum, there would not be any benefits associated with the costs of consolidated reporting.

Incompatible Accounting Policies

Lastly, receiverships are also accounted for significantly differently than the corporate level insurance funds. This difference stems from the going-concern assumption in effect at the corporate level, whereas the receiverships are liquidating entities. At the corporate level, FDIC applies GAAP; at the receivership level, FDIC applies liquidation accounting which is a modified-cash basis of accounting. In general, this modified-cash basis of accounting recognizes transactions on the cash basis with accruals for expected losses. We cannot conform one policy to another without causing distortions at either the corporate or receivership level. To apply both policies would be contradictory; either an entity is a going-concern or it is not.

¹² For example, 12 U.S.C. 1821(d)(15) states that "The [FDIC] as conservator or receiver shall, consistent with the accounting and reporting practices and procedures established by the [FDIC], maintain a full accounting of each conservatorship and receivership or other disposition of institutions in default [*i.e., institutions which have failed*]."

¹³ For example, 12 U.S.C. 1821(a)(4) states that "The Bank Insurance Fund established under paragraph (5) and the Savings Association Insurance Fund established under paragraph (6) shall each be—(A) maintained and administered by the [FDIC]; (B) maintained separately and not commingled; and (C) used by the [FDIC] to carry out its insurance purposes in the manner provided in this subsection."

¹⁴ 12 U.S.C. 1823(c)(4)(B) states that "The [FDIC] may not use its authority under this subsection to purchase the voting or common stock of an insured depository institution."

Conclusions

When the definition of control was drafted, we think that the reference to fiduciary responsibility was directed at the fiduciary responsibility of corporate officers and directors engaged in regular business enterprises rather than at the fiduciary responsibility of bankruptcy trustees or similar persons.

We believe that bankruptcy situations in general and FDIC's circumstances in particular can be likened to the problems found in consolidations involving pension plans. The Board made an explicit exception for pension plans, stating that

although there is a long-standing presumption that consolidated financial statements are usually necessary, the objectives of financial reporting by pension plans, their operating environment, and accepted practices are sufficiently different from those of business enterprises and not-for-profit organizations. Furthermore, unless all the assets and liabilities of a subsidiary were measured at their fair values, to include them on a fully consolidated basis would not be compatible with the objective of reporting the amount of the plan's net assets available to pay benefits [¶95].

In a like manner, the objectives of financial reporting by FDIC and receiverships, our operating environment, and our accepted practices are significantly different than other business enterprises.

For example, one of the key objectives of bankruptcy accounting is disaggregated accounting; i.e., the bankrupt entity should be maintained separately from all other entities. One of the key elements of receivership reporting is the amount of net assets available to pay creditors; this is similar to the pension plan objective of reporting the amount of the plan's net assets available to pay benefits.

In addition, FDIC's financials are closely watched by both the banking industry and the government, the former because of their vested interest in the premium rates and the latter for several reasons including 1) the level of the fund balance is used as a measure of the soundness of the insurance fund¹⁵; 2) the fund balance is counted as a reduction of the national deficit and corporate cash flows are accounted for as government cash flows¹⁶; and 3) the corporate financials are used to gauge whether and to what extent the insurance funds may need to borrow from the government.¹⁷ Consolidation would have the effect of obscuring the disaggregated information that the banking industry and the government currently use and rely on.

¹⁵ The insurance funds are required by law to be maintained at 1.25% of insured deposits.

¹⁶ This is true even though the insurance funds are legally trust funds which can be used for no other purpose than insurance of bank deposits.

¹⁷ The FDIC has the authority to borrow directly from the U.S. Treasury and indirectly from the U.S. Treasury from the Federal Financing Bank which is an arm of the Treasury.

It is in part for the reasons above that laws currently exist requiring the separate maintenance of both receiverships and the insurance funds. Thus our situation is in direct contrast to the usual circumstances calling for consolidated reporting. Whereas shareholders, creditors, members, donors, and other present and potential resource providers have sought consolidated reporting for other entities, the users of failed bank receivership and FDIC-corporate financial statements seek disaggregated reporting.

Recommendations

FDIC likely presents an extreme case involving liquidating entities; there are probably few, if any, other entities responsible for the liquidation of literally hundreds of failed corporations over a period of several years. Nevertheless, we believe that others which acquire control over a liquidating entity may encounter concerns similar to ours.

We recommend that the Board exclude from the scope of the proposed standard those entities which acquire control as a result of being appointed receiver, conservator, or similar function for purposes of resolving a failed corporation. We think this meets with the original intent of the proposed standard which sought to exclude cases involving temporary control. Although our control is not temporary in the usual sense (since we maintain control until the receivership is terminated), the entity being controlled is itself temporary. The troubling issue of management intent does not arise since the temporary nature of a receivership is a given; it is not a matter of whether, but when a receivership will be terminated. This exclusion would also be in keeping with the character of the exclusion for entities for which disaggregated reporting is critical (i.e., pension plans and the like).

We also ask the Board if they would affirm that FDIC does *not* have control in the case of open entities (we are not seeking an explicit modification of the proposed standard in this circumstance due to its unique nature). Up to now we have discussed only liquidating entities; however, as pointed out in the Background section, FDIC has the authority to provide assistance to open institutions for the purpose of preventing a bank failure. While we do not think that our contracts with an open bank constitutes control within the meaning of the proposed standard, the issue may come into conflict with a current tax regulation.

This regulation creates and defines the term "Agency Control" and mandates certain tax treatment for transactions meeting that definition.¹⁸ We need an affirmation that the meaning of control for purposes of the tax code is irrelevant for purposes of applying the proposed financial accounting standard. We do not see this as a significant hurdle since differences between tax accounting and financial accounting are well-recognized, but this is a case where the meaning of a single word ("control") should ostensibly be the same.

¹⁸ The word Agency is a reference to FDIC. See Regulation 1.597 entitled "Federal Financial Assistance."

Suggested Text

To address the concerns described above, paragraph 16 of the proposed standard could be modified as follows (italicized text represents the modifications):

A subsidiary shall not be consolidated if control is temporary at the date it becomes a subsidiary. Control of a new subsidiary shall be considered temporary if at the date of acquisition the parent is obligated to relinquish control within one year or management has decided to dispose of that newly acquired subsidiary and has a plan for and a reasonable expectation of disposition within one year. An exception to that one-year rule is that control also shall be considered temporary if at the date of acquisition circumstances beyond management's control are likely to require more time to complete the ultimate disposition; for example, a proposed sale of a newly acquired subsidiary to a prospective buyer may require further review and approval by a regulatory authority. *In addition, control shall be considered temporary if the parent acquires control through the parent's status as a receiver, conservator, bankruptcy trustee, or similar fiduciary and the newly acquired subsidiary is a receivership, conservatorship, bankrupt corporation, or similar entity.*

We have used the phrases "similar fiduciary" and "similar entity" to be broad enough to include cases where FDIC provides assistance to open institutions in order to prevent a failure. Although open bank assistance does not involve a receivership, it comes into being under similar circumstances (an exercise of FDIC's statutory powers) and involves a relationship which is fully intended to be temporary.