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**ACCOUNTING FOR
THE REALITIES
OF BANK PORTFOLIO
MANAGEMENT**

ACCOUNTING FOR THE REALITIES OF BANK PORTFOLIO MANAGEMENT

by Eugene L. Larkin, Jr.

Mr. Larkin is a partner of Haskins & Sells in the New York office. He was chairman of the committee of the American Institute of CPAs that prepared *Audits of Banks*, published in 1968. The article that follows is based on talks Mr. Larkin has presented in recent months at seminars on "How to Improve Portfolio Performance".

February, 1970

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That the stated purpose of accounting is to report financial consequences of an enterprise's transactions is well recognized. Not so fully appreciated, however, is that the manner in which the financial consequences of a proposed transaction will be reported frequently influences the decision on whether or not, or when, the transaction will actually be consummated. That such situations exist is unfortunate. Ideally, a management decision should have as its objective the overall good of the enterprise and not the effect on the financial statements.

In the normal situation, of course, the better a transaction is economically, the more favorable will be its effect on reported financial results. But with banks' securities transactions, this is very often not true. Frequently, portfolio actions that are economically less favorable produce better reported earnings than do actions that are economically more favorable. The reason is that present bank accounting practices do not fully portray the realities of portfolio management. I say this in full realization of the significant improvements that have occurred in bank accounting practices over the last several years, including the 1969 revisions in the reporting requirements of the Federal bank regulatory authorities.

There is, in my opinion, a method of reporting banks' investment transactions that does in fact reflect the realities. It has been followed by a handful of banks for several years. It has been recognized as an acceptable alternative to present methods by the Committee on Bank Accounting and Auditing of the American Institute of Certified Public Accountants. The Committee's views are expressed in its publication *Audits of Banks* issued in March 1968.

This method to which I refer provides for inclusion in operating earnings of all elements of banks' investment earnings and their inclusion in the fiscal periods to which they are applicable.

In order to provide background to describe this method, I shall recite a few facts concerning banks' investment earnings.

Elements of Investment Earnings

Banks' total investment earnings consist of three elements, namely, the stated interest, the purchase premium or discount, and the gain or loss on sale or redemption. These three elements are closely and directly related; in combination they constitute the investment yield that is reflective of prevailing market interest rates. One of these elements, the stated interest, is fixed; the other two vary in response to market changes; their function is to adjust the stated interest rate to the prevailing market interest rate. Premium or discount effects this adjustment to the market rate at date of purchase for the period to maturity. Gain or loss constitutes a further adjustment to reflect the effect from date of sale to maturity of the change in the prevailing interest rates between the date of purchase and the date of sale.

The stated interest is received in fixed amounts at fixed intervals during the period the security is held. Premium or discount and gain or loss, on the other hand, each occurs as of a single moment, one at the date of purchase, the other at the date of sale. Premium or discount is the difference between the *par value* of a security and an amount representing approximately the present value of the future payments of interest and principal to be received to maturity, discounted at the appropriate prevailing interest rate *at date of purchase*. Gain or loss is the difference between the *book value* of a security and an amount representing approximately the present value of the future payments of interest and principal to be received to maturity, discounted at the appropriate prevailing interest rate *at date*

of sale. Common factors in determination of both elements, therefore, are (a) length of period to maturity and (b) difference between prevailing market interest rate and either stated rate (in the case of premium or discount) or yield rate at date of purchase (in the case of gain or loss).

Problem of Recognizing All Elements of Investment Earnings

The foregoing states the realities of banks' investment earnings. The problem is to find a method of accounting that both conforms with generally accepted accounting principles and also results in the fairest possible presentation of investment earnings. Under generally accepted accounting principles, there is a presumption that all transactions applicable to the holding of an asset relate to the period it is held. Applying this concept to the securities of a bank would require recognition of securities gains and losses at the time of realization. For the reasons I intend to present, I believe that the peculiar character of banks' investment portfolios justifies an exception from this general presumption. I should mention at this point, of course, that the present regulations of the Federal bank regulatory authorities require immediate recognition of securities gains and losses.

Similar Problem in Other Industries

The need to report investment earnings in a meaningful manner is not peculiar to the banking industry. It exists in every industry where security investments are significant, and each such industry has developed a form of financial reporting of securities transactions considered appropriate to its particular circumstances.

In those industries in which holdings of equity securities are substantial, no entirely satisfactory method has been developed to allocate on an

equitable basis total investment earnings, including securities gains and losses, to the applicable fiscal periods. These industries, for the most part, either recognize gains or losses at the time of sale or, alternatively, recognize changes in market values currently. Neither of these methods is theoretically ideal. Recognition of gains and losses only at the time of realization disregards true change in the value of the securities during the period they are held. The alternative practice of currently recognizing changes in market values also produces distortions among fiscal periods, since it permits temporary market fluctuations to influence the amount of gains and losses recognized in each period. This latter method is, of course, essential where values must be calculated currently, as by open-end investment companies. Companies in industries using either of these methods generally report in their income statements their gains and losses (whether computed as realized or on the basis of market values) separately from dividends and interest, thereby distinguishing investment results that may be applicable to more than one fiscal period from those identifiable with the current fiscal period. A very few types of large investors (notably some pension funds) attempt to recognize currently the portion of unrealized portfolio appreciation represented by growth and inflation but not the portion represented by temporary market fluctuations. This is accomplished by including in income, in addition to dividends, a fixed percentage (say 3%) of book value of the equity portfolio and increasing the book value correspondingly.

This percentage is based on past experience and is adjusted only when new assumptions are made regarding long-term growth and inflation.

Banks' Present Reporting Practices for Securities Transactions

As a result of the regulations governing financial reporting that stemmed from the Securities Acts Amendments of 1964 and the 1969 revisions of these regulations, banks' practices for reporting securities transactions are much superior to those of prior years. Securities gains and losses, previously carried directly to undivided profits (or to a reserve) or, more recently, classified as non-operating items in the income statement following net operating earnings, are now included in "net income" and are presented (net of their related income tax effect) directly following "income before securities gains and losses." The practice of amortizing bond discounts, as well as premiums, is now quite generally followed. (The deep discounts at which bonds have been selling in recent years may have been more responsible for this trend than any encouragement from the regulatory authorities since such amortization results in including these deep purchase discounts in operating income over the period to maturity or earlier call date.)

Nevertheless, the new format has not corrected all aspects of the situation where unsound investment decisions can produce better reported results than can sound decisions. For example, net income for the current year can still be improved through the immediate realization of securities gains that perhaps, for sound economic reasons, should preferably not be realized until the following year. Also, selling securities in a market with higher yields than those prevailing when the securities were purchased and immediately reinvesting the proceeds in similar securities will produce an immediate loss, offset by increased operating earnings in the current and subsequent years.

Many bankers believe that, even under the new format, a bank's performance will be measured, not by its net income, but by its income before securities gains and losses. If they are correct, then the swapping of securities losses for increased operating earnings would improve apparent operating results.

A Solution to the Problem for Banks

As I have already indicated, a method of recording and reporting total investment earnings in the fiscal periods *to which they apply* presently exists for banks. That such a method is available to banks and not to most other large investing institutions, is the result of the nature of banks' investment portfolios. Banks' securities investments consist, with minor exceptions, of low-risk, fixed-income, fixed-maturity obligations. These portfolio characteristics provide bases for the periodic measurement of investment earnings not possible with a portfolio containing equity securities or fixed-maturity obligations with more than a minimum degree of risk. A bank can usually assume that the face amount of a security will be paid by the obligor and will be paid at maturity (or earlier call date).

The method I am endorsing has the following essential features:

1. Inclusion of the stated interest in income in the periods in which earned. (This represents no change from present practice almost universally followed.)
2. Amortization of both purchase discount and purchase premium over the periods from dates of purchase to maturity dates (or earlier call dates). The periodic amortization would be applied as an adjustment to the carrying value of the securities and would be included in interest on investments. For the sake of simplicity, the amortization can be computed on a straight-line basis, although the theoretically ideal method would be to apply a constant rate to the carrying value of the investment to adjust it to par at maturity.
3. Deferral of securities gains and losses and amortization over the periods from dates of sale to maturity dates (or earlier call dates) of the securities sold. The sum of the deferred balances (whether debit or credit) would be treated as part of investment securities and the amortization would be included in interest on investments. Again, for simplicity, I would suggest straight-line amortization.

Premiums and Discounts

Little further explanation would seem necessary for the recommended treatment of premiums and discounts. They represent adjustments of the stated interest to produce a yield on the cost of the securities over the period to maturity equal to the prevailing market interest rate at date of purchase for securities of comparable quality and maturity. Accordingly, it would appear illogical to account for them in any way other than amortizing them as a modification of income and as an adjustment

of carrying value to the amount to be realized at maturity. As stated earlier, most banks amortize premiums, and there is a growing trend among banks to amortize discounts.

I might mention a practice followed by some banks that, from a financial reporting point of view, partially vitiates the desirable consequences of discount amortization. It is a practice that could also be a deterrent to wise investment in securities selling below par, particularly in a period when interest rates are expected to rise, with a concomitant decline in market values. The practice these banks follow is to reverse at the time of sale the discount amortization credited to interest on investments to the extent that the proceeds of sale are less than the carrying value (including amortization) of the securities sold. The rationale used to support this practice is that the amortization was not "earned" and therefore should be excluded from investment income. This rationale is inconsistent with the concept (and reality) that premiums and discounts are merely modifications of the stated interest.

A simple example demonstrates this inconsistency. Let us assume the simultaneous purchase of two securities of identical quality and identical maturity date, but with different interest rates, resulting in one security selling at a premium and the other at a discount. In such circumstances, the purchase prices should be such that their rates of yield at date of purchase will be almost identical, regardless of their respective stated interest rates. If the two securities are then sold at the same time, it is also reasonable to expect that, with amortization of premiums and discounts, their earnings during the holding period and their gains or losses on the sales will be substantially identical. Such would not be the reported result, however, if the securities are sold at a loss and all or a portion of

discount amortization on the discount security is reversed from income at date of sale; the reversal would eliminate or reduce the loss with a corresponding understatement of operating earnings. This practice accordingly is unsupported by logic.

On the subject of premiums and discounts, there are two other matters to consider.

First, discount amortization does not constitute taxable income. For tax purposes, such amortization is disregarded and gain or loss is computed on the basis of original cost. As discounts are amortized for accounting purposes, therefore, provisions for deferred income taxes are required.

Second, amortization of bond discounts is inappropriate in those instances in which the discounts reflect uncertainties regarding the ultimate realization at maturity of the face amount of the obligations. Discounts of this nature are rare among banks, however. Banks do not knowingly purchase high-risk obligations, and should an investment subsequent to purchase become of questionable value, it should be written down to estimated realizable value, regardless of whether it was purchased at a premium or discount.

Securities Gains and Losses

We now come to the most important—and most controversial—feature of the recommended method: including securities gains and losses in interest on investments over the period from the date of sale to the maturity date (or earlier call date) of the securities sold. I believe that this method of accounting for securities gains and losses produces the

fairest and most realistic presentation of investment results and has the further important advantage of encouraging the best possible management of the investment portfolio. Expressed in another way, it reflects the realities of the sales and subsequent re-investment transactions and is free of those features common to other methods that may act as deterrents to economically sound management of the portfolio. Under present methods, for example, a sale and reinvestment in a period of rising interest rates would produce a loss reportable in the income statement of the current year, with the offsetting benefits reflected in future reported results, despite the fact that the transactions might have no practical substance.

Securities Gains and Losses—Modifications of Yields

The basic theory in deferring and amortizing securities gains and losses is that such gains and losses represent modifications of interest earnings during the period from the date of sale to the maturity date of the securities sold. The theory recognizes that a gain or loss is offset by a corresponding decrease or increase in interest income during this subsequent period.

A simple illustration may help to clarify the foregoing statement.* Assume that a security in the investment portfolio maturing in two years had been purchased at a time when the prevailing market interest rate was 7%. Stated interest on the security, modified for premium or discount amortization, would therefore be producing a rate of return of 7% on the investment. Continued holding of this security to maturity would result in continuation of the 7% rate of return. Sale of the security two years before maturity in an 8% market, however, would result in a loss of approximately 2 points, that is, the 1% difference between the 7% purchase yield rate and the 8% market rate, multiplied by the two years to maturity. The reinvestment of the proceeds in a security of comparable quality in the 8% market would produce income of 8% (as contrasted with the previous 7%) in each of the two years to the maturity of the security sold, thus offsetting the 2 point loss. It is apparent, therefore, in this illustration, that the same economic result, except possibly for tax consequences, would be obtained whether the original security were held to maturity or whether it were sold and the proceeds reinvested. It appears only logical, therefore, that the method of accounting should reflect this economic reality. The deferral and amortization method does; conventional methods do only when the security is held to maturity or is sold for an amount exactly equal to book value.

The logic of deferring and amortizing securities gains and losses can also be appreciated by recognizing that the sale of a security and the immediate reinvestment of its proceeds are consummated in the same or similar securities markets, that is, in markets with the same or similar prevailing interest rates. The illogic of recognizing gain or loss in such circumstances is clear; the funds invested have merely been transferred from one investment to another.

* In this and other illustrations that follow, I shall, for the sake of simplicity, not discount future amounts to present values.

A security loss can be viewed as the penalty required to reinvest in a market with higher yields than those earned on the investment being sold; a security gain can similarly be viewed as the compensation for reinvesting in a lower yield market. In either case, the penalty or compensation is clearly applicable to the period from the date of sale to the maturity of the security being sold.

Applicability of Certain Arguments

Some proponents of the deferral and amortization method take their position on the theory that once funds have been committed to an investment in a fixed-income, fixed-maturity obligation the effective economic rate of return on such funds for the entire period to maturity of the obligation initially purchased is the prevailing yield rate at the date of the initial purchase, regardless of the number of times the investments are sold and the proceeds reinvested and regardless of changes in prevailing market interest rates during that period. Their position presumes that changes in prevailing market interest rates are the only factors affecting the price of a fixed-income, fixed-maturity obligation. This presumption is not wholly accurate. The market yield rate is undoubtedly the principal factor affecting the prices of the types of investments that banks purchase, but there are also two other important factors, namely, the degree of risk and the length of the period to maturity. Consequently, the effective economic rate of return *can* be changed during the period to the maturity of the security initially purchased by switching into securities of greater or less risk or of longer or shorter maturities. This flexibility does not, however, invalidate the logic of the argument for deferral and amortization; this method still eliminates from investment earnings the increases and decreases attributable to changes in prevailing market interest rates, while permitting investment earnings to reflect the real changes, in the appropriate fiscal periods, attributable to changes in the quality or maturities of the investments.

Application of Principle to Other Reinvestments

The discussion to this point has assumed sales proceeds are immediately reinvested in other securities. Such reinvestment does not always occur. Securities are sometimes sold to provide funds to meet loan demand or depositor withdrawals. Many proponents of the deferral and amortization method would limit its use to transactions involving immediate reinvestment of the proceeds in other securities. Absent such reinvestment, they believe that gains and losses should be immediately recognized. I do not share this view. Except in very unusual circumstances, deferral and amortization appears appropriate for banks in connection with all securities sales.

The underlying theory of the deferral and amortization method is the same whether sales proceeds are reinvested in securities or in loans (or in other income-producing assets). In each case, both the sale and the reinvestment are made in a market with the same prevailing interest rates. The fact that the market interest rates for loans may be higher than those for securities does not affect the concept because rates of interest on loans and on securities tend to move upward and downward together.

I also believe that the deferral and amortization method, except in unusual circumstances, is appropriate when the sales proceeds are used to meet depositor withdrawals. This conclusion is based on

the reasonable presumption that most depositor withdrawals (including seasonal withdrawals) are temporary and that as the withdrawals are restored (or are replaced with borrowed funds) they will be invested in income-producing assets. If withdrawals are not temporary, as for example, during periods of economic recession, one can rationalize that in substance the withdrawals are being met from loan funds (on which there is neither gain nor loss on realization). Supporting the theory that non-temporary withdrawals are met from loan funds is the fact that loan balances tend to decline more than deposit balances during such periods and that, therefore, proceeds of securities sales, which give rise to gains and losses, are effectively being reinvested in securities. Historically, amounts invested by banks in securities have increased during recession periods.

There is admittedly some imperfection in the logic for deferral and amortization when sales proceeds are used to meet depositor withdrawal. The method presumes that the prevailing market interest rates at the time the withdrawals are restored and reinvested will approximate those prevailing when the securities were sold. This normally is a reasonable presumption. There will be instances, however, in which this presumption proves to be erroneous, as, for example, when a security yielding 7% is sold at a loss in an 8% market and the delayed reinvestment is made in a market that has returned from the 8% level to a 7% level. Although some distortions in reported operating earnings could occur in such circumstances, they would in total and over the long term be far less severe than those resulting from the immediate recognition of securities gains and losses and the resultant understatement or overstatement of current and future investment earnings.

Practicability of Total Deferral

The application of the deferral and amortization method to all securities gains and losses (as contrasted with only those where the proceeds are immediately reinvested in securities) has two other principal advantages. It is easy to apply and it does not offer an option of choosing which gains and losses to recognize immediately and which to defer.

A principal argument that has been advanced in opposition to the deferral and amortization method is the difficulty of applying it. Although this difficulty appears to have been exaggerated, there is some validity to the argument under a method providing for the deferral of some gains and losses and the immediate recognition of others. Under such a method, each deferred balance must be identified with the security purchased with the proceeds of sale in order to write off its unamortized balance at such time as the reinvestment security is sold in a transaction not qualifying for deferral treatment. Under the proposal for deferral of all gains and losses, however, this identification is unnecessary. A deferred balance need be classified only by date of maturity of the security sold, and for convenience the classification could be by year of maturity, rather than by specific date, thus permitting groupings of deferred balances.

Minimizing Undesirable Management Options

Some who oppose the deferral and amortization method have contended that it provides bank managements with an undesirable flexibility in reporting financial results. They point out, for example, that if securities are being sold both to meet depositor withdrawals and to reinvest in other securities, a bank management could identify the profit sales with the reinvestment activity and the loss sales with the deposit outflow, thus deferring

and amortizing the profits to benefit operating earnings and recognizing the losses in the so-called "below-the-line" section of the income statement. The deferral and amortization of all securities gains and losses eliminates this flexibility and also effectively eliminates the possibility of transferring the results of securities transactions (both earnings and gains and losses) from one fiscal period to another through the timing of securities disposals.

Incidentally, considerable flexibility is available under the method of accounting for gains and losses presently followed by most banks. Implementation of a decision to sell, for example, can be accelerated or delayed in order to realize the gain or loss in one, rather than another, fiscal period. In addition, since the unrealized appreciation or depreciation usually varies considerably among securities held in the portfolio, it is possible to control to some extent the amounts of gains or losses to be realized through securities sales.

Deferred Balances in the Balance Sheet

Another argument frequently advanced against the deferral and amortization method is that it results in inclusion in the balance sheet of amounts applicable to assets no longer held. It is pointed out that a loss, for example, is carried as an asset, although it has no value. This viewpoint fails to recognize that deferred balances, although arising from sales and measured by the period to the maturity date of the securities sold, do not apply to the securities sold but to the assets acquired (or, in the case of temporary withdrawal of funds, the assets to be acquired) with the sales proceeds. In addition, the aggregate asset values are no different than they would have been had the sales never occurred. For example, a \$1,000 bond purchased at par would continue to be carried at par, even though its current market price were \$980. On the other hand, if it were sold, the \$980 sales proceeds could be used to purchase \$1,000 face amount of an identical security. The newly purchased security would be carried at its cost, \$980, and the deferred balance would be \$20, for the same \$1,000 total book value as existed before the sale and repurchase of the identical security.

Tax Accounting for Deferred Balances

Securities gains and losses are recognized for income tax purposes in the year in which they are realized. Under the deferral and amortization method, therefore, the income tax effects of securities gains and losses must be deferred and amortized over the same periods as the related gains and losses.

Conclusion

For the reasons stated above, I am convinced that the amortization of premiums and discounts and the deferral and amortization of gains and losses result in the fairest presentation of operating earnings, in that such accounting is consistent with the realities of portfolio management. Under this method, banks are encouraged to manage their portfolios in the manner they consider most advantageous economically. They need never be concerned that a desirable investment action might have an adverse effect on the financial statements. On the contrary, the better the action is from an economic standpoint, the more favorable will be the reported results.

Bank managements, bank regulatory authorities, and all others interested in the financial reporting of banks will, hopefully, in time endorse this method of reporting securities earnings.