Better Late Than Never: SEC Proposes Guide 3 Update

September 23, 2019

In a long-awaited milestone, the SEC has **proposed** an update of Guide 3, the industry guide for banking organizations. The proposal eliminates a number of the current requirements under Guide 3 and streamlines many of those that remain. The three "new" credit quality ratios in the proposal are, in practice, already included in most registrants' disclosures, and thus are not significant new requirements.

The last time that Guide 3 was changed was 1986. In the many intervening years, the Financial Accounting Standards Board (**FASB**) and the International Accounting Standards Board (**IASB**) have issued accounting standards that have created an overlap between the disclosures required by Guide 3 and U.S. generally accepted accounting principles (**U.S. GAAP**) and the International Financial Reporting Standards (**IFRS**). The SEC's market risk disclosure rule, passed in 1997, also introduced interest rate and market risk disclosures that did not exist in Guide 3. In addition, disclosures required by the U.S. banking agencies' rules implementing the Basel Pillar 3 disclosures for standardized approach banking organizations with total consolidated assets of $50 billion or more and advanced approaches banking organizations also overlap with many of the Guide 3 disclosures, as discussed in more detail at the end of the this memo.

The SEC published a request for public comment in March 2017 on a wide range of potential changes to Guide 3, including how Guide 3 could be updated to avoid overlapping disclosure requirements. The current proposal reflects the feedback that the SEC received in response to that request. Comments on the current proposal are due 60 days after publication in the Federal Register.

As a reminder, the disclosures required by Guide 3 and the proposal are not required to be presented in the notes to the financial statements, and therefore are not required to be audited or submitted in XBRL format.

Existing Requirements vs. Proposed Changes

The table on the following pages compares the disclosures under Guide 3 with the requirements proposed to be included in its replacement, new subpart 1400 of Regulation S-K, and provides additional commentary on the changes.

Existing Requirement	Proposed Change	Commentary
	Scope and Reporting Periods	
General Applicability By its terms, Guide 3 applies to bank holding companies (**BHCs**). In practice, other registrants with material lending and deposit activities also comply with Guide 3, including (1) banks, (2) savings and loan holding companies (**SLHCs**), (3) savings and loan associations and (4) certain other financial services registrants.	Proposed Item 1401 would expressly apply these disclosure requirements to only (1) BHCs, (2) banks, (3) SLHCs and (4) savings and loan associations.	The proposed scope would be consistent with current practice, and only exclude a handful of registrants that currently comply with Guide 3 disclosures. The SEC has not proposed to expand the scope to cover insurance companies, online marketplace lenders or other fintech companies.
Reporting Periods Five years of loan portfolio and summary of loan loss experience data and three years of all other information. Two years for all information if the registrant has <$200M of assets or <$10M of net worth. Any additional interim period information must be disclosed if necessary to keep the information from being misleading or if a material change in the information or the trend evidenced thereby has occurred.	Reporting periods would be tied to the annual reporting periods of the relevant financial statement requirements, which are generally: • Two years for balance sheets; and • Three years for income statements, or two years for emerging growth companies in IPOs.[1] Five years of credit ratios would be required in initial registration statements and initial Regulation A offering statements. Any additional interim period information must be disclosed if a material change in the information or the trend evidenced thereby has occurred.	The proposal should streamline filings by tying required statistical disclosures to the financial statement period. There is an exception for the three new credit ratios, described below, which require five years of disclosure.
Daily Averages Unless otherwise indicated, reported averages are daily averages. Weekly or month-end averages may be used if data on daily averages would involve undue burden or expense, provided that such averages are representative of the registrant's operations.	*Codified with no substantive changes*	

[1] Smaller reporting companies may also present only two years of income statements.

Existing Requirement	Proposed Change	Commentary
Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rates and Interest Differential		
Average Balance Sheets Average balance sheets, showing interest income and expense and average rates and yield on all major categories of assets and liabilities. Major categories of assets and liabilities should include: • Loans, taxable investment securities, non-taxable investment securities, interest bearing deposits other banks; • Federal funds sold and securities purchased with agreements to resell and other short-term investments; • Savings deposits, other time deposits, short-term debt, long-term debt; and • Any other significant assets or liabilities. Must be separated by domestic and foreign categories for registrants required to make separate disclosures of foreign activities under Item 9-05 of Regulation S-X.	Proposed Item 1402 would codify these existing average asset and liability disclosures, but would include the following new, disaggregated categories: • Federal funds sold; • Securities purchased with agreements to resell; • Federal funds purchased; • Securities sold with agreements to repurchase; and • commercial paper.	Proposed Item 1402 is largely consistent with Item 1.A. of Guide 3 but requires more granular disclosure of average federal funds bought and sold, securities repurchase and resale agreements and commercial paper.
Volume and Rate Analysis Changes in net interest income, showing volume and rate analysis. Must be separated by domestic and foreign categories for registrants required to make separate disclosures of foreign activities under item 9-05 Regulation S-X.	*Codified with no substantive changes*	While generally unchanged, the reduced reporting period for income statement items (two years) and the additional mandatory average balance sheet items would result in slight changes to the presentation of volume and rate analysis.
Margin and Average Spread Average interest-earning assets, net interest income, gross margin, net interest margin and average spread.	*Codified with no substantive changes*	

Existing Requirement	Proposed Change	Commentary
	Investment Portfolio	
Investment Portfolio – Value For each of the last three years, disclose the book value of investments in most securities.	*Eliminated*	This requirement would be eliminated because it now overlaps with U.S. GAAP and IFRS disclosure requirements.
Investment Portfolio – Yields For each of the last three years, show the book value of securities that are due in one year or less, after one year to five years, after five years to ten years and state the weighted average yield for each range of maturities.	Proposed Item 1403 would <u>not</u> require disclosure of the book value of securities for each range of maturities. Proposed Item 1403 would codify the requirement to disclose weighted average yield for each range of maturities, but would apply <u>only</u> to debt securities that are not held at fair value through earnings.	
Issuer Concentration If the aggregate book value of securities from a single issuer exceeds 10% of the registrant's stockholders' equity at the end of the most recent reported period, disclose the name of such issuer and the aggregate book and market value of the securities.	*Eliminated*	This requirement would be eliminated because it now overlaps with U.S. GAAP and IFRS disclosure requirements.
	Loan Portfolio	
Loans by Type Disclose loans by types of customer. The specified categories for domestic loans are: (1) commercial, financial and agricultural, (2) real estate – construction, (3) real estate – mortgage, (4) installment loans to individuals, and (5) lease financing, and for foreign loans are: (6) governments and official institutions, (7) banks and other financial institutions, (8) commercial and industrial, and (9) other.	*Eliminated*	This requirement would be eliminated because it now overlaps with U.S. GAAP and IFRS disclosure requirements.

Existing Requirement	Proposed Change	Commentary
Loans by Maturity and Interest Rate Sensitivity Disclose loans due (1) in one year or less, (2) between one and five years, (3) between five and ten years, and (4) after ten years. Include a separate presentation of all loans due after one year with fixed interest rates versus those with floating or adjustable interest rates.	Proposed Item 1404 would codify currently required maturity and interest rate sensitivity disclosure, but would expand disclosure to each category of loans required to be disclosed under U.S. GAAP or IFRS financial statements. To the extent non-contractual rollovers or extensions are included for purposes of measuring the allowance for credit losses under U.S. GAAP or IFRS, such non-contractual rollovers or extensions should be considered for purposes of the maturities classification and the policy should be briefly disclosed.	Although not mentioned in the proposal, interest rate sensitivity has, since 1997, been covered by the SEC's market risk disclosure rule.
Loan Portfolio Risk Elements Disclose: non-accruing loans by type; potential problem loans, the aggregate amount of cross-border outstandings to borrowers in each foreign country where they exceed 1% of total assets, and any concentration of loans exceeding 10% of total loans not otherwise disclosed.	*Eliminated*	While there are certain differences between disclosure required under Guide 3 and U.S. GAAP, the loan portfolio risk elements disclosure would be eliminated because reasonably similar disclosures are required by SEC rules, U.S. GAAP or IFRS.
Interest Bearing Assets Disclose the nature and amounts of any other interest-bearing assets that would be disclosed if those assets were loans.	*Eliminated*	Interest bearing asset disclosure would be eliminated because IFRS requires similar disclosure and U.S. GAAP requires disclosure of nonaccrual and past due financing receivables.
	Allowance for Credit Losses	
Loan Losses Provide an analysis of loan losses, by type, including changes in the allowance for loan losses, recoveries, net charge offs and provisions, as well as an analysis of the allocation of the allowance.	*Loan loss exposure eliminated* Proposed Item 1405 would require the disclosure of **credit ratios** for each reporting period, along with each component of the ratio's calculation. The disclosure would be based on loan categories required to be disclosed under U.S. GAAP or IFRS.	This requirement would be eliminated because it now overlaps with U.S. GAAP and IFRS disclosure requirements.

Existing Requirement	Proposed Change	Commentary
Credit Ratios Disclose the ratio of net charge-offs to average loans outstanding on a consolidated basis.	Proposed Item 1405 would require the disclosure of the following credit ratios, along with each of the components used in their calculation: (1) allowance for credit losses to total loans; (2) nonaccrual loans to total loans; (3) allowance for credit losses to nonaccrual loans; and (4) net charge-offs to average loans. The first three ratios would be disclosed on a consolidated basis, while the fourth (ratio of net charge-offs to average loans) would be disclosed by loan category presented in the financial statements. A discussion of the factors that drove material changes in the ratios, or related components, would be required.	Although not required under the existing requirements, many bank and savings and loan registrants already include the proposed new required credit ratio disclosures in their SEC filings as the components are required under regulatory reports. Particularly relevant to new registrants considering an IPO, registrants would be able to omit the information that is unknown and not reasonably available. The required discussion of factors driving changes in reported ratios would overlap with the analysis included in MD&A, which could be shortened by referring back to the proposed Item 1405 disclosures.
	Deposits	
Interest-Earning Deposits Disclose the average amounts of and the average rates paid for specified deposit categories that exceed 10% of average total deposits, the amount outstanding of certain time deposits of $100,000 or more and the aggregate amount of deposits by foreign depositors in U.S. offices, if material.	Proposed Item 1406 would generally codify current disclosure requirements. Changes would include requiring disclosure of: (1) the amount of U.S. time deposits that exceed the FDIC insurance limit and time deposits that are otherwise uninsured, segregated by maturity (instead of the amount of certain time deposits of $100,000 or more); and (2) separate presentation of the total amount of uninsured deposits. Foreign banking organizations would look to the definition of uninsured deposits in their home country.	
	Return on Equity and Assets	
Return on Equity and Assets Disclose the return on assets, return on equity, dividend payout ratio, and equity to assets ratio.	*Eliminated*	Return on equity and assets and related ratios would no longer be required since key performance indicators, such as ROE and ROA, are required in the Management's Discussion and Analysis section.

Existing Requirement	Proposed Change	Commentary
	Short-Term Borrowings	
Short-Term Borrowings Disclose the average short-term amounts outstanding and weighted average interest at end of period, maximum outstanding during period, and average outstanding and weighted average interest rates during the period.	The proposed rules would require disclosure of the average balance and related average rate paid for each major category of interest-bearing liability currently required to be disclosed, and disaggregation of major categories of interest-bearing liabilities.	
	Foreign Registrants	
Foreign Registrants Applies to foreign registrants, who may request that the SEC staff permit omission of information that is unavailable or cannot be compiled without undue burden or expense.	The proposed requirements would apply to all covered registrants, but generally take account of differences between IFRS and U.S. GAAP with respect to categories and classes of financial instruments with respect to which disclosure is required. For example, foreign private issuers that apply IFRS would be exempt from certain disclosures with respect to nonaccrual loans and troubled debt restructurings because those classifications of assets are not presented in IFRS. IFRS filers would also be exempt from disclosure of the allowance for loan losses by category of loan because that information is already required by IFRS in footnote disclosure.	The proposal would not codify Guide 3's undue burden or expense limitation for foreign registrants, but all registrants, including foreign registrants, are generally relieved from providing information that is "unknown or not reasonably available to the registrant" under Securities Act Rule 409. There should be no change in practice under the proposed rules because Securities Act Rule 409 permits omission of information that could not be obtained without unreasonable effort or expense.

Additional Commentary

Although not discussed in the proposal, many of the Guide 3 disclosures overlap with disclosures required by the U.S. banking agencies' rules implementing the Basel Pillar 3 for standardized approach banking organizations with total consolidated assets of $50 billion or more and advanced approaches banking organizations (as well as the corresponding Pillar 3 disclosure requirements applicable to non-U.S. banking organizations), which include, among others, quantitative disclosures about total and average credit exposures, including geographic and industry or counterparty type distribution, impaired loans and allowance for loan losses; quantitative disclosures about exposures (including netted credit exposures) on OTC derivatives, repos and eligible margin loans; quantitative disclosures of credit risk mitigants such as guarantees and credit derivatives; quantitative disclosures about exposures securitized by the bank; quantitative disclosures about equity investments; and quantitative disclosures about interest rate risk relating to non-trading activities.[2]

Finally, the SEC took the opportunity to remind registrants that its guidance on MD&A disclosure requires registrants to identify and discuss key performance indicators when they are used to manage the business and would be material to investors. As such, the SEC expects registrants to continue to make disclosures otherwise eliminated from the specific prescriptions of the proposed new rule when such disclosures are necessary to an understanding of the bank or savings and loan registrant's financial condition and results of operations.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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[2] *See, e.g.,* 12 C.F.R. §§ 217.63 (standardized approach), 217.173 (advanced approaches).