Susan Schmidt Bies: Innovation in financial markets and banking relationships

Speech by Ms Susan Schmidt Bies, Member of the Board of Governors of the US Federal Reserve System, at the Financial Executives International 2004 Summit, San Diego, California, 27 April 2004.

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I am very pleased to be here for the Financial Executives International 2004 Summit. As many of you know, before my appointment to the Board of Governors, I was quite active in this organization, particularly on the Committee on Corporate Reporting. I also served on the Financial Accounting Standards Board's Emerging Issues Task Force. Now, as a member of the Federal Reserve Board, and Chair of the Board's Committee on Supervisory and Regulatory Affairs, I find myself focusing on the growth and evolution of the financial system from a slightly different perspective than when I was a chief financial officer.

The continuing evolution of the banking and financial markets has created opportunities both for providers and for users of financial products, and this evolution has been beneficial to the economy. However, innovations in financial products also have given rise to some new challenges for market participants and their supervisors in the areas of corporate governance and compliance. The events of the past three years demonstrate again that fraudulent conduct and weak corporate governance at a few firms can dramatically change the cost of capital and impose additional regulatory burden on even well-managed organizations.

When similar events occurred in the 1980s, FEI, one of the five members of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, took the lead in defining best practices for internal controls. FEI should be proud that the COSO Internal Control Framework was the basis of much of the internal control mandates of the Sarbanes-Oxley Act and still is seen as the seminal work in its field. Fundamental elements of corporate governance and compliance naturally become more challenging as activities become more complex. The major breaks in the internal controls of corporations in the past few years, and the role of bankers in those events, has led bank regulators to change their view of bankers' relationships with their corporate clients. Today, I'd like to touch on some of these challenges and on how financial institutions and their corporate customers can adopt new ways of working together. I am going to talk about some new regulatory guidance on complex structured finance transactions and guidance on industry best practice regarding credit risk transfer instruments. I also want to speak about an issue that is confusing to many companies: anti-tying regulation as it relates to services provided by banking organizations.

But before I talk about these issues, I would like to step back and discuss some broader, longer-term issues that affect accounting and corporate governance. Looking beyond the isolated cases of outright fraud, I believe a fundamental problem is this: As organizations have grown in size and scope, innovative financing techniques have made it more difficult for outside investors to understand a particular firm's risk profile and the performance of its various lines of business. Traditional accounting standards have not kept pace with the risk-management tools employed by sophisticated corporations. Thus, more meaningful disclosure of firms' risk-management positions and strategies is crucial for improving corporate transparency for market participants.

Financial innovations and disclosure

Over the past few decades, firms have acquired effective new tools with which to manage financial risk. For example, securitization helps a firm manage the risk of a concentrated exposure by transferring some of that exposure outside the firm. By pooling assets and issuing marketable securities, firms obtain liquidity and reduce funding costs. Of course, moving assets off the balance sheet and into special purpose entities, with the attendant creation of servicing rights and high risk residual interests retained by firms, generates its own risks and reduces transparency unless the firm takes additional steps to enhance disclosure.

Several types of securitization have grown rapidly over the past decade. One of the fastest growing has been asset-backed commercial paper, which soared from only $16 billion outstanding at the end of 1989 to about $690 billion as of year-end 2003. Commercial mortgage securitizations have also proliferated noticeably since the early 1990s. The dollar amount of outstanding securities backed by commercial and multifamily mortgages has risen from $36 billion at the end of 1989 to just under

$450 billion as of this past September. In addition, commercial banks and finance companies have moved business loans off their books through the development of collateralized debt obligations. Securitized business loans amounted to $100 billion in the third quarter of 2003, up from a relatively miniscule $2 billion in 1989.

Firms also use derivatives to manage their risk exposures to price fluctuations in currency, commodity, energy, and interest rate markets. More recently, firms have used credit derivatives, a relatively new type of derivative that allows them to purchase protection against the risk of loss from the default of a given entity. By purchasing such protection, financial and nonfinancial firms alike can reduce their exposures to particular borrowers or counterparties. Credit derivatives also allow financial firms to achieve a more diversified credit portfolio by acquiring credit exposure to borrowers with which they do not have a lending relationship. For example, European insurance companies reportedly have used credit derivatives to acquire exposure to European corporations that, because they rely primarily on bank lending, have little publicly traded debt outstanding.

The improvements in technology, the quick pace of financial innovation, and the evolving risk-management techniques almost ensure that businesses will increasingly use almost limitless configurations of products and services and sophisticated financial structures. Accordingly, outsiders will have ever more difficulty understanding the risk positions of many large, complex organizations. These developments represent significant challenges to standard setters and to firms. For market discipline to be effective, accounting standards must evolve to accurately capture these developments.

Company managers must also do their part, by ensuring that public disclosures clearly identify all significant risk exposures - whether on or off the balance sheet - and their effects on the firm's financial condition and performance, cash flow, and earnings potential. With regard to securitizations, derivatives, and other innovative risk-transfer instruments, accounting measurement of a company's balance sheet at a point in time is insufficient to convey the full effect of a company's financial risk profile.

Organizations should continue to improve their enterprise-wide risk-management and reporting functions. The FEI's leadership in the proposed COSO Enterprise Risk Management Framework demonstrates this organization's recognition of the importance of this new discipline. I would like to challenge companies to use their new risk-management discipline as a framework also to begin disclosing this information to the market, perhaps in summary form, paying due attention to the need for keeping proprietary business data confidential. Disclosures would not only provide more qualitative and quantitative information about the firm's current risk exposure to the market but also help the market assess the quality of the risk oversight and risk appetite of the organization.

My last comment on disclosures is that less than fully transparent disclosures are not limited to "complex" off-balance-sheet transactions. One glaring example is the treatment of expenses associated with defined-benefit pension plans. In recent years we have seen how the accounting rules for these plans can produce, quite frankly, some very misleading measures of corporate earnings and balance sheets. In effect, firms use expectations of the long-term return on assets in defined-benefit plans to calculate current-period pension costs (income). At the same time, they use a spot rate to discount the future liabilities. This accounting is reconciled with economic reality by gradual amortization of the discrepancies between the assumed and the actual returns experienced on pension assets. As many of you are aware, this smoothing feature can create very large distortions between economic reality and the pension-financing cost accruals embedded in the income statement.

A recent study by Federal Reserve staff indicates that "full disclosure" of the underlying details, by itself, does not appear to be a panacea.[1] The study adopts the premise that most of what investors need to know about the true pension-financing costs, not the mixed-attribute accounting costs, can be reflected in two numbers disclosed in the pension footnote. These two numbers are the fair market value of pension assets and the present value of outstanding pension liabilities. The study finds that these direct measures of pension assets and liabilities tend to be ignored by investors in favor of the potentially misleading accounting measures, and as a result, the average firm with a defined-benefit plan in 2001 may have been 5 percent to 10 percent overvalued relative to an otherwise similar firm without a defined-benefit plan.

[1] Julia Coronado and Steve Sharpe, "Did Pension Accounting Contribute to a Stock Market Bubble?" *Brookings Papers on Economic Activity*, July 2003.

In general, the test for useful disclosure should be the following questions: Are the firm and its accountants providing investors with what is needed to accurately evaluate the financial position of the firm and the risks that it faces? And is the information provided in a manner that facilitates accurate assessments by investors? Ultimately, improved transparency would benefit corporations by reducing uncertainty about the value of their securities, which would lower the cost of, and increase access to, market funding.

Complex structured finance transactions

Financial innovation also has given rise to an increase in the sophistication of complex structured finance transactions. While we can hope that we are seeing the end of the corporate governance scandals that have plagued companies world-wide, we must remain alert to the underlying causes of these scandals - inadequate corporate governance structures, compliance frameworks, and internal controls - and redouble our efforts to create a new compliance environment. This new compliance environment must address the growth in complex structured finance transactions.

What do we mean by complex structured finance transactions? Although each deal can vary, complex structured finance transactions generally have four common characteristics. First, they typically result in a final product that is often nonstandard and structured to meet the specific financial objectives of a customer. Second, they often involve professionals from multiple disciplines within the financial institution and may involve significant fees or high returns in relation to the market and credit risks associated with the transaction. Third, they may be associated with the creation or use of one or more special-purpose entities designed to address the economic, legal, tax, or accounting objectives of the customer or the use of a combination of cash and derivatives products. Fourth, and perhaps most important, they may expose the financial institution to elevated levels of market, credit, operations, legal, or reputational risks.

As we are all too aware, in the most extreme cases, complex structured finance transactions appear to have been used in fraudulent schemes to misrepresent the financial condition of public companies or evade taxes. As a result, the corporations that engaged in these improper transactions and the financial institutions that structured and advised on these transactions have been subject to civil and administrative enforcement actions. The existence of these schemes has also sparked an investigation by the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs, as well as numerous lawsuits by private investors.

Although these events have raised serious concerns, it is important to recognize that structured finance transactions and other market innovations, when used and designed appropriately, play an important role in financing corporate America. Structured finance transactions, as well as financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, and specialized financial conduits that manage pools of purchased assets, have served the legitimate business purposes of bank customers and are an essential part of U.S. and international capital markets.

However, financial institutions may assume substantial risks when they engage in these transactions without a full understanding of their economic substance and business purpose. These risks often are difficult to quantify but the result can be severe damage to the reputations of the companies engaging in the transactions and their financial advisers, and in turn, impaired public confidence in those institutions. These potential risks and the resulting damage are particularly severe when markets react through adverse changes in pricing for similarly structured transactions that are designed appropriately.

Assessments of the appropriateness of a transaction for a client traditionally have required financial firms and advisers to determine if the transaction is consistent with the market sophistication, financial condition, and investment policies of the customer. Given recent events, it is appropriate to raise the bar on appropriateness assessments by taking into account the business purpose and economic substance of the transaction. For those of you who are CFOs or other senior officials of corporations seeking to engage in complex structured finance transactions, you should expect to receive more questions from your bankers on why you wish to engage in certain transactions, how you will account for them for financial reporting and tax purposes, and how you will explain them to your shareholders and other stakeholders. You can expect this heightened level of inquiry because, when banking organizations provide advice on, arrange, or actively participate in complex structured finance

transactions, they may assume legal and reputational risks if the end-user enters into the transaction for improper purposes.

The Federal Reserve has been working with the other federal banking agencies and the Securities and Exchange Commission to develop interagency guidance on complex structured finance transactions. We believe it is important for all participants in complex structured transactions to understand the agencies' concerns and supervisory direction. Our goal is to highlight the "lessons learned" from recent events as well as what we believe to be sound practices in this area on the basis of supervisory reviews and experience.

As in other operational areas, strong internal controls and risk management procedures can help institutions effectively manage the risks associated with complex structured finance transactions. Here are some of the steps that financial institutions should take to establish such controls and procedures:

- Ensure that the institution's board of directors establishes the institution's overall appetite for risk (especially reputational and legal) and effectively communicates the board's risk tolerances throughout the organization.
- Implement firm-wide policies and procedures that provide for the consistent identification, evaluation, documentation, and management of all risks associated with complex structured transactions - in particular, the credit, reputational, and legal risks.
- Implement firm-wide policies and procedures that ensure that the financial institution obtains a thorough understanding of the business purposes and economic substance of transactions identified as involving heightened legal or reputational risk and that these transactions are approved by appropriate senior management.
- Clearly define the framework for approval of a complex structured finance transaction or a new complex structured finance product.
- Implement monitoring, risk reporting, and compliance processes for creating, analyzing, offering, and marketing complex structured finance products.

Of course, these internal controls need to be supported and enforced by a strong "tone at the top" and a firm-wide culture of compliance.

As a result of recent public and supervisory attention to complex structured finance transactions, we expect that banks will be asking more questions, requesting additional documentation, and scrutinizing financial statements more carefully to guard against reputational and legal risk. For example, for transactions identified as involving heightened risks, we expect that the bank's staff would obtain and document, before approval of the transaction, complete and accurate information about the customer's proposed accounting treatment of the transaction, financial disclosures relating to the transaction, and the customer's objectives for entering into the transaction. This enhanced due diligence may appear to impose some documentation burdens on the corporate customers of banking organizations, but this information should be substantially similar to the information that corporate customers are providing to their own senior management and boards of directors as part of their own internal review and approval process for complex structured finance transactions.

Our supervisory reviews indicate that many financial institutions have already taken steps to enhance their internal controls and due-diligence processes in order to filter out transactions with unacceptable levels of reputational and legal risk. As a result, some financial institutions have turned down deals with unfavorable risk characteristics that they may have accepted in the past. While we applaud these developments, we hope that the guidance we are developing will help further improve the awareness, among both banking organizations and their corporate customers, of sound practices in this area.

Credit risk transfer and conflicts of interest

Financial market innovation and the development of increasingly complex structures for credit risk transfer also may give rise to legal or reputational risk. In recent years, we have seen considerable advances in the management and transfer of credit risk, including credit default swaps and collateralized debt obligations. These practices and the development of new and more liquid markets have come about because of better risk measurement techniques. They have the potential, I believe, to substantially improve the efficiency of world financial markets through the diversification benefits

that credit risk transfer mechanisms can provide. However, the fundamental elements of risk management must be kept firmly in mind if these innovations are to succeed.

By their design, credit risk transfer instruments segment risk for distribution to the parties most willing to accept them. A key point, however, is that market participants must be able to recognize and understand the risks underlying the instruments they trade and be able to successfully absorb and diffuse any subsequent loss. Another consideration is whether one party to the transaction is entering into the trade with an unfair advantage by virtue of its role as a lender to the same or a related entity.

Financial firms that have large corporate loan portfolios increasingly have accessed the credit derivatives market to help them manage their risk while continuing to extend credit to corporate customers. While this development has created market efficiencies and investment opportunities, these positive factors have been somewhat overshadowed by concerns that some credit market participants who receive material nonpublic information in the ordinary course of their normal business activities may need to better control access to that information. Specifically, access to material nonpublic information needs to be walled off from personnel who conduct securities and derivatives trading.

The potential for conflicts of interest between loan origination and credit derivatives trading activities has been recognized by the industry as well as regulators, and that is a commendable development. In October 2003, the Joint Market Practices Forum, a collaborative effort of the Bond Market Association, the International Association of Credit Portfolio Managers, the International Swaps and Derivatives Association, and the Loan Syndications and Trading Association, issued a *Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants*. The statement articulates principles and recommendations regarding the handling and use of material nonpublic information by credit market participants that maintain loan portfolios or engage in other activities that generate credit exposures and, in that connection, enter into transactions in securities or security-based swaps, including certain credit derivatives.

The statement of principles fulfills a number of objectives. The most critical, in my view, is the promotion of fair and competitive markets in which the inappropriate use of material nonpublic information is not tolerated. At the same time, the statement allows lenders to effectively manage credit portfolio activities to facilitate borrower access to more-liquid and more-efficient sources of credit. This effort recognizes that the liquidity and efficiency of our financial markets are related directly to the integrity of, and public confidence in, those markets.

The joint statement describes two models of credit portfolio management: the “private side” model and the “public side” model. In reality, most banking organizations appear to have adopted a hybrid model that lies at some point along a continuum between pure private and pure public.

In general, in a private-side model, credit derivatives traders may have access to material nonpublic information, but traders must pre-clear each transaction they execute. In a public-side model, traders are walled off from private-side information and personnel to prevent their access to material nonpublic information. Accordingly, the circumstances in which a transaction is restricted because of the trader's possession of material nonpublic information is limited.

The forum's statement of principles also provides several meaningful recommendations, some of which already have been adopted by the major participants in the credit derivatives markets. Among other things, the recommendations call for market participants to have in place policies and procedures for handling material nonpublic information, internal controls, an independent compliance function, recordkeeping requirements, and training programs. Additional specific recommendations are advanced for credit portfolio management activities conducted from the private side and from the public side.

At a recent Bond Market Association conference, attendees noted that the principles contained in the statement generally are workable. However, questions of interpretation do arise under the statement and can be expected to continue to arise as the market develops additional innovations in credit portfolio management.

Questions of interpretation may arise in determining whether and to what extent information is public or private, especially for organizations operating in global markets. Does material nonpublic information on one name in an index fund taint the entire index? Are the bank's internal ratings or changes in internal ratings private information? Issues of “signaling” private information also arise when public-side traders become aware of transactions entered into on the private side. That is, to

what extent can traders infer material nonpublic information through action (or inaction) in private-side business lines?

Last, but certainly not least, information may be confidential or proprietary even if it does not rise to the level of material nonpublic information. The misuse of confidential or proprietary information that is not material nonpublic information may not give rise to securities law violations, but it may give rise to common law claims.

The statement and recommendations of the Joint Market Practices Forum brings to light important potential conflicts of interest in credit derivatives trading and helps to identify issues that may arise in connection with credit portfolio management. The statement and recommendations provide guidance on credit portfolio management for financial institutions that may be new to the derivatives markets and provide a catalyst to further improvements in the risk management environment. Credit risk transfer is still a relatively young market, and attention to issues such as these should help participants develop confidence in both the new instruments and markets that will lead to more liquid and reliable transactions.

Anti-tying restrictions on banks

Finally, I want to discuss the nature of anti-tying regulations for financial institutions, an issue that can be very confusing to nonbankers. As innovations create new financial instruments, services, and markets, and as firms expand the scope of the types of financial services they offer, the business-decision process is similar to that which many of you apply in your own business. Financial institutions are trying to build customer loyalty by offering a broader menu of financial services to corporate customers. The concern addressed by anti-tying restrictions is that banks may force customers to take unwanted products to obtain needed services.

The Federal Reserve Board and the other federal banking agencies have long required that banking organizations establish and maintain policies and procedures to ensure compliance with the anti-tying restrictions, and the agencies monitor these policies and procedures through the supervisory process. In addition, more-targeted examinations may be conducted to review marketing programs, training materials, internal risk management reports, internal audits, and any internal investigations.

In 2002 and 2003, the federal banking agencies received a number of inquiries concerning the scope, effectiveness, and impact of the anti-tying restrictions on banks. Some of these inquiries suggested that commercial banks were unfairly competing for investment banking business by tying the provision of bank credit to investment banking business. In this connection, a March 2003 survey by the Association of Financial Professionals indicated that 24 percent of the 218 large corporate respondents to the survey had been told explicitly by a commercial bank that the company had been denied credit or had been extended credit on less favorable terms because the company did not award the bank underwriting business. In response, the commercial banks stated that they were not involved in impermissible tying but rather engaged in the pursuit of relationship banking that is completely legal, efficient from an economic perspective and, indeed, encouraged by the Gramm-Leach-Bliley Act as a means to provide customers with “one-stop financial shopping.”

Some of the confusion surrounding the tying debate may stem from a misunderstanding of the law. Not all tying arrangements are illegal ties. The statute expressly permits certain forms of tying and authorizes the Board to grant additional exemptions by regulation or order. The anti-tying law and the Board's regulations expressly permit a bank to condition the availability or price of a product or service on a requirement that the customer also obtain a *traditional bank product* from the bank or an affiliate of the bank. A traditional bank product generally is a loan, discount, deposit, or trust service. On the other hand, conditioning the availability or price of a loan on a requirement that the customer engage the bank for an underwriting, or obtain some other product or service that is not a traditional bank product, clearly is prohibited.

Incidentally, the anti-tying statute applied to banks is tougher than the general corporate antitrust laws. Unlike the general anti-tying laws, the statute applicable to banks does not require a showing of market power to support a violation. It can be difficult to determine whether a violation of the anti-tying statute has occurred, as it generally involves a careful analysis of specific facts and circumstances that are not memorialized and can involve divining the intent of the parties to a transaction.

In light of these complexities, the Board published and sought public comment on an interpretation of the anti-tying statute and related supervisory guidance. The proposed interpretation was published to

help banking organizations and corporate customers clarify permissible practices under this complex statute in today's financial services environment. Importantly, the interpretation proposes guidelines that could be followed when a bank seeks to engage in traditional “relationship banking,” that is, serving customers based on the profitability of the overall customer relationship, including the establishment of some regulatory “safe harbors.” The guidance would communicate our expectations as to the types of policies, procedures, internal controls, and training programs that should help banks comply with the anti-tying restrictions. It would also emphasize the importance of the compliance and internal audit functions in ensuring compliance with the law and regulations.

Among the comments received on the anti-tying guidance was a November 7, 2003, letter from the Department of Justice and published on its own website. The Justice Department has recommended that the Board interpret the anti-tying statute in a manner consistent with, and no broader than, the interpretation of federal antitrust laws. If this limitation is precluded, the Justice Department urged the Board to exercise its statutory authority to expand the scope of exemptions so as to limit the scope of the statute to ties involving small businesses and individual consumers. The letter expressed concern that the anti-tying statute may prohibit some pro-competitive practices, in particular, multiproduct discounting.

The Board's staff continues to review and analyze the comments that have been received, and we expect to issue final guidance later in the year.

Conclusion

FEI's focus on providing corporate financial officers with information to keep them aware of evolutions in best business practices and process has contributed to the financial strength of businesses today. The organization also provides an effective source of dialogue on emerging issues in finance and governance. I encourage you, as senior officers of your firms, to keep this discussion alive within your firms. When businesses have a strong focus on corporate ethics, a robust internal control culture, and transparent disclosure, financial markets can provide capital efficiently.