Vítor Constâncio: Accounting, financial reporting and corporate governance for central banks

Opening remarks by Vítor Constâncio, Vice-President of the ECB, at the third conference on accounting, financial reporting and corporate governance for central banks, Frankfurt am Main, 4 June 2012.

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Good morning, Ladies and Gentlemen,

It is my great pleasure to welcome you, on behalf of the Executive Board of the ECB, to the third conference on accounting, financial reporting and corporate governance for central banks. We are indeed pleased that so many eminent speakers in these fields are present to lead the discussions.

Given the current circumstances, and particularly with regard to the financial crisis, the issues of financial strength and accounting practices of central banks have moved into the focus of public attention. High quality accounting and reporting frameworks are essential in policy objectives. Our aim for today and tomorrow is to compare notes on recent accounting developments from a central bank perspective and in that way to learn from each other's experiences. I am therefore delighted to see that – once more – there has been such a strong response to our invitation.

The conference is structured around a number of presentations on three interrelated parts, each of which is dealt with in a number of presentations from different perspectives.

The first part deals with the impact of international accounting developments on central banking, with particular focus on the interaction between accounting and financial stability. In my remarks I would like to focus on the tension between these two fields of expertise.

The turmoil on international financial markets over the last years has revealed a number of shortcomings in the area of accounting These shortcomings are to a large extent underpinned by the current accounting paradigm and the dominance of the shareholder value approach. The shareholder value approach typically adopts a short-term perspective and aims to determine the value of a particular reporting entity as if the owners were to sell the entity today in an arm's length transaction. The short-term perspective in turn builds upon the illusion of efficient markets, rational investors and complete information. I would like to highlight that the outcome of such an accounting paradigm is often misleading for investors and detrimental to financial stability.

From the perspective of financial stability considerations, let me briefly recall **two specific examples** where the current accounting paradigm may be detrimental: First, the extent to which the application of fair value accounting may provide adverse incentives regarding management and investment decisions. The crisis has largely confirmed the scepticism that fair value is not the most relevant measurement for all asset portfolios at every moment. That would not be the case if all financial markets would obey to the canons of perfect competition, would process information with full efficiency and would not be subject to overshooting, herd behaviour and price misalignments during significant periods of time. As this does not correspond to the real world, full fair value tends to create what has been dubbed as "artificial volatility" in a company's earnings, particularly in the case of financial institutions. When profits are artificially inflated, this may lead to higher dividends and bonuses based on the recognition of unrealised gains. The undesirable side effect of such payments would be an effective depletion of capital; a capital cushion that might be needed at a later stage when the markets correct. In some cases fair value accounting may provide information that is in my view outright wrong even for investors. Consider the recent example of a swiss bank. The bank's recently published first quarter results was only SFr 44m because the bank had to recognise losses in the range of SFr 1.5 bn from an improvement in its own creditworthiness that raised the value of its own debt securities. Presumably the opposite occurred in some previous year, meaning recognition of profits, when it may have suffered a decrease in its rating. It is doubtful that this, in my view, distorted information provides the right incentives for proper risk management and can indeed be considered to be "useful", which is a stated objective that accounting should meet in line with the IASB's Conceptual Framework.

From a financial stability perspective, the impact of "short-termism" and volatility of accounting information can be very detrimental as both may aggravate pro-cyclicality. This means more severe downturns and more acute building up of risks, resulting in a misallocation of resources that lead to an overall welfare loss for society. This is also consistent with the findings of a recent paper by the Federal Reserve Bank of Boston[1] which also concluded that implementing fair value accounting more broadly may not necessarily provide financial statement users with more transparent and useful reporting. Additionally, it stressed that financial stability may be negatively impacted by fair value accounting due to the interconnectedness of financial institutions, markets and the broader economy.

The ***second example*** where accounting seems to have an impact on market dynamics and cyclicality within the financial system is the provisioning or impairment methodology The main criticism of the "incurred loss" model that is currently in place was that it did not reflect the need for earlier recognition of loan losses. Under this model, the bank would usually start to provide for the related credit losses only once those losses actually materialised.

From a financial stability perspective, and I hope we can all agree, this is too late and is highly pro-cyclical. In my view one of the key lessons from the crisis is that consideration should also be given to the losses that are inherent to specific assets and are expected to arise over the lifetime of these assets.

These two examples point to another striking feature of the current financial reporting regime, namely that traditional performance measures mainly based on accounting figures relating to net income are inadequate in periods of high volatility.

Therefore let me now turn to potential remedies.

First of all, let me be clear on one thing: There is no way back to full historical cost accounting. In some cases, for example trading book items, fair value information may indeed be useful. There are however a set of possible measures which may help address the described shortcomings and to – at least partially – reconcile the needs of investors and prudential regulators.

First, adjustment measures should be put in place at regulatory level to prevent the depletion of regulatory capital via distributions during upturns. A concrete example would be the introduction of a non-distributable Economic Cycle Reserve along the lines of what was proposed by Adair Turner in the so-called "Turner Review" (March 2009).

Second, we should move from the current "incurred loss impairment model" to an "expected loss impairment model". In this context, the ECB welcomes the IASB proposal for a new impairment methodology that is based on the concept of "expected losses", which would contribute to mitigating pro-cyclicality. Given that the work in this field is on-going, the ECB urges the IASB to continue working together with the Basel Committee on Banking Supervision with a view to developing an operational solution to a more forward-looking provisioning approach.

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[1] *"Evaluating the Impact of Fair Value Accounting on Financial Institutions: Implications for Accounting Standards Setting and Bank Supervision"*, Federal Reserve Bank of Boston, December 2011.

Third, to better reflect actual risks in the performance measures for banks, my proposal would be to introduce more sustainable risk-adjusted performance indicators. A concrete example might be the use of a broader performance measurement framework as proposed in the September 2010 EU Banking Structures Report. Such broader performance measures would incorporate more forward-looking information, encompass more aspects of the performance than just profitability and therefore could be less prone to manipulation from the markets relative to a pure market-oriented indicator such as Return on Equity. Moreover, it provides investors with relevant risk-based information that is useful and relevant for investors. In this context, a BIS paper already proposed in 2005 the usefulness of complementing the current accounting reporting framework with risk information.[2]

Ladies and Gentlemen, not just for the aforementioned reasons do central banks have an interest in IFRSs. There is an additional reason. In particular, an increasing number of central banks around the globe either comply fully with IFRSs or apply an adjusted version of IFRSs. Issues like (a) volatility in the profit and loss account from the use of fair value accounting, (b) poor interaction of accounting rules with profit distribution rules and the resulting impact on the financial strength of central banks, as well as (c) the extensive disclosure requirements that might not be in line with policy objectives become relevant in this context.

I would like to emphasise that the ECB has been a strong supporter of the objectives and work of the IASB since its inception and I personally believe that the IASB has significantly progressed in a relatively short period. The IASB has recognised the widening stakeholder interest in the development of accounting standards, and I appreciate that it has actively engaged with central banks, supervisors and financial stability experts in developing what should eventually be a single set of globally accepted, high quality accounting standards.

Finally on this point I am delighted that Mr Hans Hoogervorst, Chair of the IASB, has agreed to join us today to share with us his vision on the future of IFRSs, and I am delighted that Mrs Flores, Chair of the European Financial Reporting Advisory Group is also here with us to present Europe's view regarding IFRS developments on financial instruments.

The second part of this conference deals with the sensitive issue of the financial strength of central banks.

This issue has become more relevant over the last years as, due to non-standard operations, balance sheet risks, and in particular credit risk, have increased for a number of central banks. A lot has been written by central bank experts in the past decade on central bank independence and the link with the central bank's financial strength, sometimes with conflicting views. A number of studies have argued that financial weakness could impair the central bank's pursuit of price stability. Other studies have suggested that central banks can successfully operate with negative equity.

The ECB takes this matter very seriously, especially when reviewing any legislative proposals in the EU which affect individual central banks. The ECB, as a relatively new institution, has been viewed as having a strong degree of independence based on the relevant EU legislation backing our establishment. In particular, the principle of central bank independence is an essential element of the ESCB Statute.

For the ESCB, the ECB has indicated in its 2010 Convergence Report that the overall independence of an NCB would be jeopardised if it could not autonomously avail itself of sufficient financial resources to fulfil its mandate. In the same report, recapitalisation needs, accounting rules, and profit distribution schemes are linked to the financial independence of the NCBs.

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[2] C. Borio and K. Tsatsaronis, *"Accounting, Prudential Regulation and Financial Stability: Elements of a Synthesis"* (September 2005).

The third part of this conference is devoted to financial reporting in central banks.

It is evident that in the context of the financial crisis the operations and balance sheets of central banks are in the public spotlight. The effective communication of the nature and the outcome of these operations is of profound importance. This is true mainly for two reasons.

The first reason is that the central bank is accountable to society for the use of resources entrusted to it. However, the financial performance of a central bank is not necessarily a good indicator of an effective pursuit of policy goals. Excess or little accounting returns as well as balance sheet risks can be associated with the central bank policy operations. However, the real benefit or loss for the society does not, in my opinion, come from these returns. It comes from the effective or ineffective implementation of policy objectives. And this very fact should be properly highlighted and communicated.

The second reason why communication is important is linked to the effectiveness of the policy operations. An operation is less likely to be successful if it is not combined with an appropriate communication that allows the stakeholders to understand the nature, the objective and the outcome of these operations. Financial reporting serves as an important communication channel here.

The ECB and the ESCB national central banks developed an own set of accounting rules for specific central bank operations back in the mid 1990's at a time when national accounting rules took precedence. The Eurosystem rules have not stayed static since then. New operations, analytical work and a continuous drive to improve these rules have led to the enhancement of the relevant legal instruments for a number of times. Looking back it seems that the harmonisation achieved then by Eurosystem central banks set a good example for wider harmonisation efforts which are being pursued nowadays.

Ladies and Gentlemen, the accounting profession has never been so challenging and important. In a changing, demanding and complex world your role is critical in maintaining the credibility of central banks. And, as you are aware, credibility is necessary in convincing market participants, governments and the society as a whole that the central bank's operations can achieve their objectives. Without this credibility, a central bank's potential to influence events will be substantially impaired.

In concluding I wish you two days of very fruitful discussions and hope that you find your visit to the ECB worthwhile.

Thank you for your attention.