Roger W Ferguson, Jr: Certified public accountants - partners in financial stability

Remarks by Mr Roger W Ferguson, Jr, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the American Institute of Certified Public Accountants National Conference on Banks and Savings Institutions, Washington, 8 November 2001.

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I appreciate the opportunity to participate in the American Institute of Certified Public Accountants' (AICPA) National Conference on Banks and Savings Institutions. As Certified Public Accountants (CPAs) serving the banking industry you contribute to our financial system as bank managers, financial executives, analysts, internal and external auditors, and advisers. Your role in strengthening the internal control and transparency of banking organizations is a major one that we, as banking supervisors, are increasingly recognizing in our risk-focused examination policies, capital adequacy approaches, and disclosure initiatives.

The impact of terrorist attacks

Recently you, as CPAs with key roles in our financial system, have seen at first hand financial institutions and other companies--and indeed our country--work to overcome the challenges caused by the attacks of September 11. Besides causing unimaginable personal loss and grief, the attacks rippled across our country, disrupting sales, production, and air travel and damping the confidence of consumers and businesses. And the attacks severely, if temporarily, disrupted financial market operations and activity.

As testimony to the resilience of the American spirit, the immediate impact of the attacks has proved transient. Our society and, in particular, our financial system are rebounding from the initial influences of the attacks. In the financial sector, market participants showed great creativity, flexibility, and resolve in addressing the difficulties that arose on September 11. To help the process, the Federal Reserve moved quickly to ensure financial market liquidity through record lending at the discount window and an infusion of funds through open market operations. We encouraged financial institutions to provide their customers reasonable relief, such as waiving late payment fees, extending loan terms, restructuring debt obligations and easing credit terms in situations arising from the September 11 attacks. Also, the Federal Reserve and other federal banking agencies jointly issued a statement indicating our willingness to work with banks when increased extension of credit to customers may have caused a temporary decline in capital ratios.

As companies directly affected by the attacks struggled to resume their business, the accounting profession assumed an important role. This was recognized in part by the release by the Securities and Exchange Commission (SEC) on September 14 that relaxed the auditor independence rules to permit auditors to help their clients with internal reconciliations and certain accounting-records-related recovery efforts. With the SEC's action, many accountants and auditors quickly assisted clients in reconstructing records and information. As a result, many private firms and financial institutions were able to move to off-site locations and quickly restart operations. We applaud your efforts and those of the businesses you serve.

The longer-term prospects for the U.S. economy remain sound, just as they were before September 11. Our flexible markets, entrepreneurial spirit, well-educated work force, and major advances in information technology provide a sound foundation for the long-term growth of productivity, employment, and standards of living. In the medium term, consumer and business behaviors will significantly affect the way our economy progresses. Policymakers have reacted vigorously to changing macroeconomic conditions. As you know, the Federal Open Market Committee has reduced its target for the federal funds rate by 150 basis points since September 11.

Banking supervision and accounting and disclosure

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations with the objective of improving market discipline and fostering stable financial markets. Effective market discipline can complement bank supervision and regulation.

With sufficient accurate and relevant information, market participants can better evaluate counterparty risks and adjust the availability and pricing of funds to promote better allocation of financial resources.

The concept of market discipline is assuming greater importance among international banking supervisors as well. The most recent proposal to amend and augment the Basel Capital Accord, which was published in January and called Basel II, seeks to strengthen the market's ability to aid bank supervisors in regulating capital adequacy. It consists of three pillars, or tools: risk-based capital (pillar I), risk-based supervision (pillar II), and disclosure of risks and capital adequacy to enhance market discipline (pillar III). This approach to capital regulation, with its market-discipline component, signals that sound accounting and disclosure will continue to be important parts of our supervisory approach for many years to come. I understand that these efforts to enhance our capital rules will be addressed later today in a separate session, so I will not discuss them in depth. However, I would like to point out that our goal in the Basel process is to develop a risk-sensitive framework that provides appropriate incentives to banking organizations to maintain strong capital positions and sound risk-management systems. The history of the 1990s, which included episodes of global financial instability spreading from small countries through international capital markets and banks, underscores the need to maintain adequate capital in the internationally active banks. For the sake of maintaining financial global stability, I hope that everyone values that goal.

On an international level, Basel II would also improve disclosure by many banks in foreign countries as well as in the United States. The proposal recommends specific disclosures to convey better an institution's capital adequacy and risk profile. The incentives in Basel II should greatly diminish the opacity that cloaks many international financial institutions and help bring about a convergence in international norms on banking disclosure. I believe that counterparties will expect, indeed force, greater disclosure. Recent history certainly teaches us that understanding a counterparty's balance sheet and risk appetite is necessary for accurately pricing any transaction or even for deciding whether to engage in a transaction.

Increased supervisory emphasis on controls and risk management

The Federal Reserve also seeks to strengthen audit and control standards for banks. This goal is in large part due to our recognition several years ago that examining banks' business processes can provide a clearer assessment of their safety and soundness than focusing exclusively on transactions --that is, reviewing the means rather than the results. Examining such processes became more necessary after we recognized years ago that the widening use of derivatives enabled an institution to substantially change its risk profile within hours--possibly shortly after the conclusion of an examination. In addition, interim reporting is becoming more important in our monitoring of individual banks and the sector as a whole. The quality of management information and financial reporting is dramatically affected by internal control systems, including internal and external audit programs. Financial reporting and good internal controls are rising in importance with banking regulators because they directly affect our ability to promptly identify institutions in distress and work toward a satisfactory resolution.

My view is that the financial sector benefits when bankers, regulators, and auditors all focus on the quality of internal control systems. Banks benefit directly from having more efficient and effective operations and indirectly from improved audit efficiency and reduced regulatory burden. Auditors benefit from learning more about their client's business and better understanding the supervisor's perspective. As banking supervisors, we benefit from tapping the auditor's expertise in assessing systems of internal control. Auditor expertise is not sufficient, however. Auditor independence is also critical to the relationship between supervisors and the profession. Without it, the process breaks down; suspicions rise over auditor motives and the supervisor's ability to rely on auditor findings and recommendations is diminished.

The revisions of Basel II also address internal controls through a proposed capital charge for operational risk. Developments such as the widespread adoption of technology, large-scale mergers, e-commerce, and the increased prevalence of outsourcing, can increase operational risk. While the regulatory reforms are being developed--and in the interim before a formal revision to the Basel Accord--supervisors will continue evaluating management's ability to control operational risk.

This aspect of the effort to amend the Accord has been criticized by some in the industry either as unnecessary or as creating a formulaic approach that is only a crude approx-imation of a proper capital charge. I suggest the events of September 11 indicate that operational risk is an issue that cannot be ignored. I invite both internal and external auditors to monitor Basel II and offer their counsel on how best to reflect operational risk in capital.

Both managers and supervisors focused on the operational aspects of banking in the years leading up to year 2000, a date that was uneventful in large part because of the preparations that were made. Now we know that the possible loss of physical facilities and key personnel, which were generally not considered as part of Y2K planning, must be factored into financial firms' disaster-recovery scenarios. Similarly, providing reliable backup to key infrastructure--electricity, telephone, water--is likely to play a larger role in financial institutions' planning. As we go forward, the operational preparedness of regulated institutions will figure more prominently in our supervisory program.

The role of the external auditor in the banking sector

The Federal Reserve and other supervisory agencies have long recognized the key role that the accounting and auditing profession plays in assessing internal controls. Guidance issued by the Federal Reserve and other regulatory agencies reflects the important role that both internal and external auditing play in enhancing internal systems and monitoring risk. As required by statute, banking organizations with assets of more than $500 million must have annual independent audits. The banking agencies encourage all small institutions to follow suit. In a similar vein, the Basel Committee has produced extensive guidance on the roles of both the external audit and internal audit and the ways these can be factored into the supervisory process.

As I said, market discipline is becoming a key element of supervisory thinking, and market discipline depends on prompt, accurate financial information. External auditors help significantly in ensuring that financial statements are reliable and useful to the marketplace. Periodic financial statements of banking organizations are also used by the Federal Reserve in our risk-focused supervision programs. These reports contribute to pre-examination planning, facilitate off-site monitoring programs, and ultimately help in determining the institution's financial condition. A strong external audit program assists us in moving away from detailed, burdensome, and what some consider invasive examinations.

Supervised institutions might well decide to use the expertise of the external auditor for more than routine financial reports. External auditors could also review the quality of internal controls and systems and assess the internal audit function's scope and adequacy. We are all well aware that a strong system of internal control is the foundation for the safe and sound operation of the financial organization. Furthermore, a financial institution's board of directors is responsible for setting the control environment, and senior managers are responsible for laying down the internal control process. Recognizing that responsibility, I would not be surprised if boards of directors and senior managers are asking their external auditors to review the internal audit function and recommend improvements in light of the changed business environment post-September 11. External auditors should be prepared to answer such questions from directors as the following:

- Is the internal audit function appropriate for the size of our institution and the nature and scope of our business, and are we receiving unbiased assessments?
- Is our internal audit function competent given the current environment?
- Are the resources available to our internal audit function adequate given the nature, complexity, and risk of our institutions' activities?
- Are weaknesses being fully identified and reported promptly to us?

External auditors can also help federal regulators by encouraging financial institutions to frequently reassess and refine their risk-management practices. A risk-management system should continually monitor financial risks in a changing business climate, such as the outlook for credit risk, market risk, liquidity risk, and operational risk.

Of course, the potential benefits of external audits can be realized only when audits are performed according to high professional standards. This is not a time when the accounting profession can be complacent. Each firm should review its own internal practices to ensure that audits are of the best quality, consistent with sound practices and high standards of ethics and independence. The peer -review process should be viewed as an opportunity to improve quality rather than a somewhat routine compliance obligation. I certainly encourage the auditing profession to police itself and to strive continually to improve audit quality. By doing so you avoid suspicions regarding the competence and judgment of independent auditors. Also keep foremost in mind that your ultimate client is not management but the shareholder. You need not only to watch for misleading financial statements but also for companies that apply the technical rules underlying accounting standards in ways that cover losses or otherwise obscure the condition and performance of an institution. Attention to these matters will help ensure that audits deliver their promised benefits, that transparency is enhanced, and that market participants and supervisors are better able to regulate the risk-taking of financial institutions in ways that promote financial stability.

Conclusion

In the face of a rapidly evolving external environment, I see wisdom in staying the course, encouraging improved risk-management processes and better disclosure. I also see, however, that the time is right for banks and other financial institutions, infrastructure providers, and utilities to work independently and, possibly, collaboratively, to yield a tougher, more resilient financial system. I am sure that regulators will support those efforts, and I encourage the accounting and auditing community to provide your professional support as well.

The accounting and auditing community has traditionally played an important role improving risk-management and disclosure practices. Whether manager, analyst, auditor, or adviser, CPAs truly are partners in the quest for greater financial stability. I appreciate the opportunity to share these thoughts with you today, and thank you for the important role you play.