Susan Schmidt Bies: Strengthening the financial system of the 21st century through sound accounting and disclosure

Remarks by Ms Susan Schmidt Bies, Member of the Board of Governors of the US Federal Reserve System, at the Symposium on Building the Financial System of the 21st Century: an agenda for Europe and the United States, Rüschlikon, Switzerland, 28 February 2002.

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I appreciate the opportunity to participate in a symposium that is exploring ways to improve the financial systems of Europe and the United States. The unfolding concerns in recent months about the quality of the accounting, auditing, and disclosure practices of major nonfinancial and financial companies give added importance to our discussions here. As banking supervisors, we have increasingly recognized the importance of sound accounting and disclosure in our risk-focused examination policies, capital adequacy approaches, and risk-management practices to address the growing complexity of banking organizations.

As organizations grow in size and scope, outside investors have more difficulty understanding a particular firm's unique combination of risks and business line earnings. Modern risk-management tools can describe risk in ways that traditional accounting standards for recognition and measurement cannot. Thus, disclosure of firms' risk-management positions and risk management strategies--not necessarily another accounting schedule--is becoming a key component of improving market transparency. Tonight, I would like to address the role of disclosure in describing the risk exposures of financial organizations.

Evolution of risk management

The last decades of the twentieth century were, without doubt, periods of dramatic change in financial engineering, financial innovation, and risk management practices. Traditionally, net interest income has been the primary source of income to bankers. Deposit interest rates in the United States were fixed by regulators until the 1970s and rarely changed, so that fixed-rate, term loans did not create significant income volatility. By the end of the 1970s, however, bankers in the United States were faced simultaneously with deregulation of interest rates on deposits and rising interest rates due to the prevailing high inflation. In 1980, price and credit controls that were enacted to curb inflation further increased market volatility. Bankers found themselves paying higher rates on outstanding six-month certificates of deposit than they received as interest on prime-rate loans when money market interest rates fell 800 basis points from March to June. As a result, at the beginning of the 1980s, asset/liability models were developed at banks to help manage the effects of the variability of interest income and expense. Banks began to match the repricing frequency of loans and investments against that of deposits and other funding sources. Scenarios were created to determine the sensitivity of net interest income to varying interest rates and loan and deposit growth patterns. Larger banks began to describe the volatility of their interest margins in the Management's Discussion and Analysis (MD&A) section of their annual and quarterly reports.

By the start of the 1990s, bankers had new tools to manage balance-sheet risk. Loans could be securitized so that term-loan volume that exceeded fixed-rate funding could be sold to investors who would bear the risk of rising interest rates. Securitization also meant that banks were better able to manage the periodic swings in liquidity when loan demand grew beyond the flow of new deposits. Of course, the movement of loans off the balance sheet into special purpose entities, as well as the creation of servicing rights and high-risk residual interests retained by banks, has resulted in a different set of risks.

Derivatives have become another tool for banks to manage risk exposures. A mismatch between the rate sensitivities of assets and those of liabilities creates the potential for unacceptably large swings in net interest income. Banks can now use interest rate-based derivatives--options, futures, forwards, and so on--to mitigate their exposures by changing the timing of interest-rate effects on net interest income. Interest-rate derivatives are also used to hedge fee income and expense streams, such as mortgage servicing rights.

Credit-risk management has evolved in a similar way. New tools supplement the credit judgments of individual lending officers making decisions within the criteria established by the credit policies of their organizations. Today, scoring models help them quickly decide on applications for consumer and small business loans because the small size and large number of these types of credits make them particularly amenable to statistical modeling. Since these models have not been in place throughout the course of a full credit cycle in the United States, they lack the validity that additional experience will bring.

Larger, more complicated credits still require individual credit analysis by loan officers, but tools have been developed to manage the resulting credit exposures. Loan syndications help the lead bank to diversify risk by limiting the size of individual credits in the loan portfolio. Credit derivatives and notes allow further mitigation of risk by transferring unwanted exposures to other market participants. Thus, credit officers today can mitigate and diversify risk with new tools that go beyond the traditional underwriting criteria that had been used in the past to establish the risk appetite of the bank.

The complex organization

Mergers and the expanded powers given to financial institutions by both law and regulation have increased the size and variety of operations within leading financial organizations. Significant developments in financial theory and technology have enabled innovations in financial instruments that facilitate the separation and reallocation of risks to parties more willing and able to bear them. The pace of financial innovation has quickened considerably. The twenty-first century will see financial firms offer, and businesses use, almost limitless possible configurations of products and services and sophisticated financial structures. A byproduct of these developments will be that it will become ever more difficult for outsiders to understand the positions of financial organizations and snapshot financial reporting as of a moment of time will be less meaningful.

Indeed, as financial and technological innovation continues, financial institutions and businesses generally will necessarily engage in more complex activities. In response, the risk management practices of businesses and banks should adjust. Transparency requires that as these practices advance, so must the approaches used by firms to disclose their financial condition and performance as well as their risk profile and risk-management activities.

Nonetheless, the intended or unintended risk of opaqueness that comes with complexity raises serious issues, particularly as entities become larger and more complicated and hence increasingly difficult to supervise. The Federal Reserve and other banking supervisors around the world have recognized the importance of market discipline in encouraging sound risk management practices and in promoting the stability of financial markets. Effective market discipline can complement bank supervision and regulation. But its prerequisite is having the information necessary to understand the risks in the entity the market is observing.

With sufficient, timely, 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. Lenders and investors have an obvious interest in meaningfully assessing a firm's risk-management performance, underlying trends, cash flow, and income-producing potential. In this regard, transparency is essential to providing market participants with the information they need to effect market discipline.

Sound, well-managed companies can benefit if enhanced disclosure enables them to obtain funds at risk premiums that more accurately reflect their lower risk profiles. On the other hand, well-managed firms could be penalized as a result of inadequate disclosures if market participants are unable to assess their fundamental financial strength and sound risk-management practices.

Achieving sound accounting and disclosure practices for complex firms

While most market participants favor sound accounting standards and meaningful disclosure, it has become clear in recent months that some companies have not been completely transparent in their application of accounting and disclosure standards to specific transactions. In these situations, accounting practices and techniques have neither reflected nor been consistent with how the business has been run, that is, its overall business strategy. As a result, the market was not able to appropriately discipline the risk-taking activities of these firms on a timely basis because it lacked the information from either financial statements or other disclosures to do so. As information became available, as it virtually always will at some point, the market reflected its concerns about underlying business practices and accounting through the declining values of equity and debt instruments and in the rates charged by counterparties to obtain funds. These premiums were placed not only on offending firms but also on those whose statements might have also lacked some clarity. The message is clear that the marketplace will respond quickly when companies are found to lack sound accounting and disclosure practices.

At this point, we do not have all of the facts about many of the situations involving alleged accounting and auditing problems, but consensus is growing that changes should be made to some underlying accounting standards and to their application by companies and their auditors. Many different groups are undertaking initiatives to correct the problems that have recently been identified. For example, the U.S. Financial Accounting Standards Board and the International Accounting Standards Board are considering how to improve the accounting for financial instruments and standards for consolidated financial statements so as to achieve greater transparency of companies' exposures to special purpose vehicles and other unconsolidated entities.

The U.S. Securities and Exchange Commission has issued recommendations that focus on disclosures regarding liquidity and capital resources, including off-balance-sheet arrangements; certain trading activities that include non-exchange-traded derivatives accounted for at fair value; and the effects of transactions with related parties and certain other parties. The accounting profession has announced initiatives to curb external auditors of publicly traded companies from also providing internal audit and consulting services to their clients. Possible regulatory measures are being explored and many other fundamental reforms are under development by private-sector organizations.

Improvements in accounting and auditing standards are needed to address the potential problems that have been identified. In particular, it would be very helpful if fundamental principles and standards could be revised to emphasize that the financial statements should clearly and faithfully represent the economic substance of business transactions. We need to insist on higher professional standards and not permit financial officers and auditors to benefit from "gaming" the rules-based accounting standards that are increasing in complexity, particularly in the United States. Standards should ensure that companies give appropriate consideration to the substantive risks and rewards of ownership of the underlying assets in identifying whether risk exposures should be reflected in consolidated financial statements.

In addition to applying sound accounting treatments, company managers must ensure that public disclosures clearly identify all significant risk exposures--whether on or off the balance sheet--and their impact on the firm's financial condition and performance, cash flow and earnings potential, and, for regulated institutions, capital adequacy. Equally important are disclosures about how risks are being managed and the underlying basis for values and other estimates included in financial reports. A sound risk-management system should continually monitor risks in a changing business climate --including credit, market, liquidity, and operational risks. Disclosures consistent with the information used internally by risk managers could be very beneficial to market participants. Information on the sensitivity to changes in underlying assumptions could also be very meaningful to financial statement users. Companies should ensure that they not only meet the letter of the standards that exist but also that their financial reports and other disclosures focus on what is really essential to help investors and other market participants understand their businesses.

I particularly want to emphasize that disclosure need not be in a standard accounting framework nor exactly the same for all--otherwise we would be certain to create statistical artifacts and implications of safe harbors. Rather, what we should all be insisting on is that each entity disclose what that entity believes its stakeholders need to evaluate the entity's risk profile. Companies should be less concerned about the vehicle of disclosure and more concerned with the substance of what is made available to the public.

Enterprise risk management and disclosure

Leading companies have been taking advantage of the new innovations in risk management. New functions for chief risk officers are being created so that they can provide comprehensive oversight of the various risk exposures of the enterprise. The chief risk officer is an executive officer charged with independently monitoring risk identification, measurement, mitigation, and controls. A primary responsibility of the chief risk officer is oversight of risk reporting within the company.

Unlike typical accounting reports, information generated by risk management tends to be oriented less to a point in time and more to a description of the risks. For example, accounting information might report that the book value or disclosed fair value of a loan portfolio is $300 million and has dropped

$10 million from the last report. However, the risk report would show much more extensive information, such as the term and interest rate of the assets, their credit quality, and the range of values the portfolio would take under alternative future scenarios. The user of the report could tell if changes in value were due to declining credit quality, rising interest rates, or sales or payoffs of loans. By tracking the amount of loans in each internal credit grade and the amount of allowances or "provisions" set aside in each "bucket" for inherent losses, the user of the report could determine whether the credit risk of the portfolio was increasing or decreasing.

Other reports that risk officers are developing provide information on the extent to which the total return in a particular line of business compensates for its comprehensive risk. On an enterprise basis, a reader would be able to tell if the growing lines of business have risk exposures that tend to be offsetting and that thereby make the earnings of the corporation as a whole less volatile.

Financial institutions should continue improving their risk management and reporting functions. When they are comfortable with the reliability and consistency of the information in these reports, they should begin disclosing this information to the market, perhaps in summary form. Not only would this disclosure provide more qualitative and quantitative information to the market, but the resulting discussion about risk management practices would help the market assess the quality of the risk oversight and risk appetite of the organization.

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. 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 2001 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 aspects of our supervisory approach for many years to come. 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 includes 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 global financial stability, I hope that everyone values that goal.

Basel II would also improve risk disclosure by many banks worldwide. The proposal recommends specific disclosures to better convey 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 of international norms on banking disclosure. I believe that counterparties will expect, indeed force, greater disclosure. Recent history certainly teaches us that understanding what drives a counterparty's financial performance and its risk appetite is necessary for accurately pricing any transaction or even for deciding whether to engage in a transaction.

Conclusion

Sound accounting, auditing, and disclosure concepts, consistently applied, have long been at the heart of efficient markets. Accounting and auditing standards setters should continue their efforts to make more meaningful information available in financial statements and other reports. At the same time, the more complex nature of organizations--and constantly changing services, customers, and business conditions--imply that market participants need additional types of information to make appropriate investment decisions. Leading firms have been developing comprehensive risk management processes for internal decisionmaking that can provide the framework for more meaningful risk disclosures. Regulators and market participants should encourage financial firms to develop these new approaches and, in these early stages, give them the flexibility to choose the most appropriate format for risk disclosure. Taken together, these measures should improve the transparency of complex firms; in doing so, they will enhance the quality of information available for effective market discipline and banking supervision in ways that strengthen the financial system of the twenty-first century.